



State Tax Sourcing of Partnership Income & the Blended Apportionment Method

Multistate Tax Commission
DRAFT – JUNE 18, 2025

Sections with substantive changes from the May 19 version are highlighted in yellow.

If a heading is highlighted—there are changes throughout the section.

FOR DISCUSSION PURPOSES ONLY

This white paper is prepared by the Multistate Tax Commission (MTC) with input from a work group of state participants and the public. It is part of the MTC's uniformity project on state taxation of partnerships, is published as of the date shown, and is subject to revision.

This draft white paper is not intended to provide tax, accounting, or legal advice to taxpayers and cannot be cited for that purpose.

This draft is intended for discussion purposes only.

Those with questions on the white paper may contact Helen Hecht, at hhecht@mtc.gov.

TABLE OF CONTENTS

CONTENTS

Table of Contents	2
Introduction to the White Paper	6
Preparation	6
Reasons	6
Scope	6
Approach	6
Executive Summary	7
Findings	7
Generally (See Subsections I.A.-I.C.):	7
The Federal Pass-Through System (See Subection I.D.):	8
State Sourcing Rules – Generally (See Subsection I.E. and Section III):	10
The Attribution Principle (See Subsection I.F.)	11
General Take-Aways	12
Recommendations	13
Section I. Important Context for Understanding the Issues	14
I.A. Examples of Issues and Common Questions	14
State Rules for Sourcing Multistate Income – Generally	14
Treatment of Related Entities - Generally	14
Examples of Issues Created by the Pass-Through System	15
Summary of Some Common Questions	17
I. B. Overview of Important Law	17
CATEGORY 1: State Laws Governing Formation	18
CATEGORY 2: Federal Tax Law - Generally	20
CATEGORY 3: State Tax Sourcing Rules - Generally	20
Interactions Between These Three Categories of Law	20
I. C. Common Terms Used in the White Paper	21
Terms Used Consistently with Subchapter K and Federal Tax	21
Terms Used Consistently with State Governing Laws (ULC References)	24
State Tax Sourcing Terms as Used in this White Paper	24
I.D. Conformity to the Federal Pass-Through Tax System	25
Effects of State Conformity to Federal Tax Law - Assumptions	25
Elements of the Pass-Through System and Their State Tax Implications	26
Transactions Between Partners & Partnership or Other Related Entities	29
Conformity May Not Fully Incorporate Federal Anti-Abuse Provisions	32
I.E. General State Sourcing Rules for Income of Businesses	36
State Sourcing Rules – Generally	36

Application of Throw-Back or Throw-Out Rules & P.L. 86-272	40
Application of State Sourcing Methods – Taxable Corporations.....	41
Application of State Sourcing Methods – Proprietorships.....	42
Application of State Sourcing Methods – Simple Partnerships.....	42
I.F. Importance of the Attribution or “Conduit” Principle.....	45
Why the Attribution or “Conduit” Principle is Critical.....	45
How Attribution Works in Practice.....	45
Federal Recognition of the Attribution Principle.....	46
Attribution of an Item’s Domestic or Foreign Source	46
Attribution Principle in the State Tax Context	46
Significance of the Attribution Principle to Sourcing of Income	49
I.G. Summary – Issues & Important Context - Lessons	52
Lessons for Applying State Sourcing Rules to Partnership Income.....	52

Section II: Sourcing Partnership Income – Proposals for Addressing The Complex Issues.....53

II. A. General Framework for Sourcing Partnership Income.....	55
II.B. Use of Blended Apportionment	56
Effect of Blended Apportionment – Simple Example	56
Current State Use of Blended Apportionment.....	57
How does blended apportionment work generally?	57
When should blended apportionment be used?.....	63
II.C. Sourcing Special or Mandatory Allocations.....	66
II.D. Other Related -Entity Transactions	69
Add-Back Statutes	69
Transfer-Pricing Authority.....	69
II.E. Anti-Abuse Rules	70
IRC § 7701(o) - general economic substance rule.....	70
IRS Reg. § 1.701-2 – general partnership anti-abuse rule.....	70
IRC § 704(b) – substantial economic effect requirements.....	70
IRC § 6222 – consistency requirement.....	70

III. Summary of Multistate Research on State Tax Sourcing for Complex Partnership Structures.....72

III. A. Summary of Complex Partnership Structure Sourcing Issues Addressed by States.....	72
III. B. State Rules for Complex Partnership Sourcing.....	74
Alabama.....	74
Alaska.....	74
Arizona.....	74
Arkansas.....	76
California.....	76

Colorado	81
Connecticut	83
Delaware	86
District of Columbia.....	87
Florida	89
Georgia	91
Hawaii.....	91
Idaho	92
Illinois	93
Indiana	99
Iowa.....	102
Kansas.....	103
Kentucky.....	104
Louisiana	106
Maine.....	107
Maryland	109
Massachusetts.....	110
Michigan	121
Minnesota	122
Mississippi.....	124
Missouri.....	125
Montana.....	127
Nebraska	129
New Hampshire.....	131
New Jersey.....	132
New Mexico.....	133
New York.....	134
North Carolina	138
North Dakota	140
Ohio.....	142
Oklahoma	144
Oregon.....	145
Pennsylvania	147
Rhode Island.....	150
South Carolina.....	152
Tennessee	154
Texas	156
Utah	159
Vermont.....	160
Virginia.....	164

West Virginia.....167
Wisconsin.....170
**III. C. Examples of Cases and Commentary on Unitary Issues in the State Tax Sourcing of Partnership
Income.....177**

INTRODUCTION TO THE WHITE PAPER

NOTE: Materials related to the MTC State Taxation of Partnerships project can be found on the MTC website, here: [MTC Partnership Project Webpage](#).

Preparation

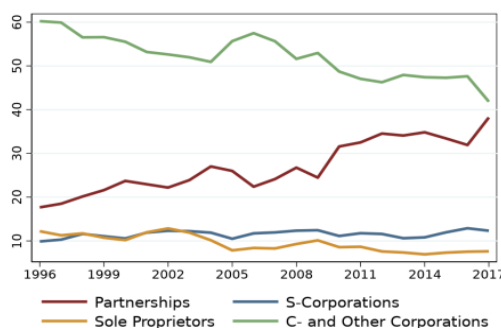
This white paper was drafted by the Multistate Tax Commission with the direction and advice of the work group established by the MTC Uniformity Committee to study state taxation of partnerships.

Reasons

The Uniformity Committee chose to focus on the taxation of partnerships and on the issues of sourcing partnership income for a number of reasons, including:

- The share of total business net income earned by partnerships has grown. (See the graphic to the right.¹)
- Today, there are many more large, complex partnership structures than in prior years.²
- States conform to the federal pass-through tax system which adds a layer of complexity to state tax reporting and computation.

(b) Share of Business Net Income Reported



Most states have not fully addressed how their income “sourcing” rules—that is, the rules for determining a state’s share of multistate income—should apply to partnerships taxed under the pass-through system, especially where there are complex partnership structures. Lack of clear rules means some income may not be taxed by any state. And differences between the states’ rules may subject partnership income to multiple taxation.

Scope

This white paper addresses how complex partnership structures, special allocations, and related-party transactions that affect the ability of states to tax partnership income and, in particular, how partnership income is sourced. It addresses the long-standing state sourcing rules, developed in the context of taxable corporations, and their possible application to the distributive share income of multistate partnerships, which is taxed to partners under the pass-through system.³ It focuses most on issues that have not been fully addressed by the states including the application of sourcing rules where there are corporate or tiered partners, related partnerships, and special or mandatory allocations of income, and related-entity (intercompany) transactions.

Approach

In order to help readers understand the issues and recommendations, this white paper provides general summaries of important partnership laws and concepts as well as references to other resources readers may want to consider. In developing findings and recommendations, it draws on existing state rules and approaches to sourcing partnership income.

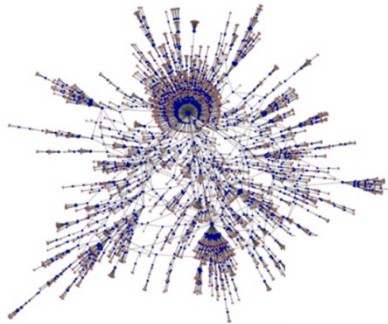
¹ Michael Love, “Where in the World Does Partnership Income Go? Evidence of a Growing Use of Tax Havens,” December 14, 2021, <https://www.law.berkeley.edu/wp-content/uploads/2022/03/2022-Michael-Love.pdf>.

² Tax Enforcement: IRS Audit Processes Can Be Strengthened to Address a Growing Number of Large, Complex Partnerships, U.S. Gov. Accountability Office, GAO-23-106020, Jul 27, 2023, <https://www.gao.gov/products/gao-23-106020>.

³ There are separate white papers addressing the state taxation of investment partnership income and the sourcing of certain guaranteed payments. (See those white papers on the project page above.)

EXECUTIVE SUMMARY

This section reflects a portion of the findings based on this draft of the white paper. It will be expanded and revised over time based on revisions or additions and on work group review and discussion.



This executive summary is designed to orient readers of this white paper as well as to summarize the findings and recommendations.

The issues addressed in this white paper are, necessarily, complex—in large part because the pass-through system created by Subchapter K, to which the states generally conform, allows the flexibility for taxpayers to create extremely large and complex partnerships while, at the same time, that pass-through system also depends, entirely, on the ability of each partnership to properly report the information their partners need to comply with tax requirements.

Findings

The white paper's most important finding is this:

The rules for sourcing multistate partnership income taxed on a pass-through basis need further development, particularly where there are corporate or tiered partners, complex structures, related-entity transactions, and special allocations of partnership items.

The findings below lay out important background and some of the specific gaps in the state sourcing rules (with references to sections of the white paper where these issues are discussed in more detail). But note that it may also be necessary for readers to consult other sources and authorities on some of the issues that are summarized in this white paper.

General Context (See Subsections I.A.-I.C.):

To understand the state sourcing issues that partnerships raise, certain context is critical.

- 1. Sourcing of partnership income may be affected by three important bodies of law:**
 - General state law governing partnership formation and operation,
 - Subchapter K and the federal pass-through tax system to which states conform, and
 - Existing state sourcing rules for business and related income.

- 2. Basic terminology is critical and imprecise or inconsistent use can create problems.**

Even common partnership terms can vary in their exact use or meaning under the three separate bodies of law above. Moreover, state tax rules may use somewhat different terms when referring to the same general concepts. When terms are used inconsistently, or when their particular use is not explicitly defined, it can create ambiguity and unintentional results.

- 3. The aggregate theory of partnerships is not a reliable guide for most questions.**

Scholars often refer to the aggregate theory of partnerships—contrasting it with the entity theory to which corporations generally adhere. The problem is that all partnerships, even traditional partnerships, are a blend of these two, sometimes contradictory, legal theories, and all partnerships have evolved to be more like entities over time. Moreover, different types of partnership entities vary in their aggregate versus entity characteristics. Nor is the aggregate theory necessary for imposing tax on a pass-through basis, as the U.S. Supreme Court recently noted in *Moore v. United States*. Instead, it is the tax rules themselves—and the attribution principle incorporated into those rules—that will determine how the pass-through system works.

4. Large, complex partnerships raise unique issues that state rules must address.

Traditional partnerships were generally small, simple businesses in which partners participated and shared income according to their relative investment. Most still are. But in recent years, there has been a rapid growth in the number of huge, complex partnership structures with thousands of entities and partners, related-entity transactions, and special agreements as to the allocation of partnership income, expense, gain, and loss. And it is these large complex partnerships that give rise to the most multistate income. State tax rules should, therefore, recognize and address the unique issues these partnerships may raise.

5. Care should be taken in categorizing partners—whose roles and relationships can vary.

The general state laws governing the formation of entities treat partnerships and partners very differently than corporations and their shareholders. For example, in corporate structures, ownership equals control—or at least the authority to control. But that is not true for partnerships. Part of the flexibility that partnerships offer is allowing their partners' to vary their different roles and relationships as well as to change those roles and relationships over time. So one characteristic of a partner does not necessarily dictate other characteristics.

For example, a partner with no capital interest can control the partnership's activities. And a partner with a 99% capital interest may be entirely passive and have limited liability. Nor does a partner's capital investment or role necessarily determine how much of the partnership's income that partner will be allocated. State tax sourcing rules should, therefore, not rely on these kinds of erroneous assumptions.

6. The partners' agreement is critical to understanding a particular entity.

Again, whereas corporate entities have greater uniformity in the ways in which they are structured and operated, partnership structures and the relationships and roles of partners can vary substantially and under state governing laws, partnerships are allowed substantial flexibility in determining the operations, decision-making, and roles of partners (including tiered partners and related-entity transactions). For these reasons, each partnership is, in large part, a product of its partnership or operating agreement.

The Federal Pass-Through System (See Subection I.D.):

Comparing the basic elements of the federal pass-through tax system created by Subchapter K to the existing state tax sourcing rules for partnerships reveals some apparent assumptions that are mistaken or inconsistent. The following are the basic elements of the pass-through system for states to keep in mind when creating sourcing rules:

7. There are no limits on the number and types of partners a partnership may have.

Partnerships may have an unlimited number of all types of partners, including partnership (tiered) partners, and this, in turn, can be used to create circular structures in which lower-tier partnerships own interests in upper-tier partnerships.

8. Contributions and distributions are generally non-recognition events.

Contributions and distributions to a partnership generally do not give rise to income or loss (with some exceptions). Instead, partners pay tax on their distributive share of the partnership's taxable income and loss in the year recognized or incurred, based on the activities of the partnership attributed to the partners.

9. A partner's distributive share is taxable regardless of any distributions actually received.

Partners pay tax on their distributive share of partnership income or loss when earned or incurred by the partnership, whether or not they receive any actual distributions (and they often don't). Partners may be allocated distributive shares of partnership income for a number of years before they receive any actual distributions from the partnership.

10. The character of items of partnership income is determined by the partnership's own activities and transactions.

While the attributes of a partners may affect the tax result, the character of items of partnership income is not determined by the partner's own attributes or the partner's role or relationship to the partnership—but on the partnership's own activities and transactions. Under the federal attribution principle in IRC § 702, the character of partnership items will be determined at the partnership level and attributed to the partners—including indirect, minority, passive partners.

11. The share of partnership income allocated to a partner can vary by item and need not match the partner's capital interest.

Allocations of partnership distributive share to the partners do not have to be in the same proportion as a partner's capital ownership and partners may receive different shares of different partnership items. But these so-called "special allocations" must have substantial economic effect—a standard that is, in part, related to the federal tax effect of the special allocations. (Some states have adopted a form of this substantial economic effect rule making clear that the same standards applicable for federal tax purposes also apply for state tax purposes.)

12. Mandatory allocations may implicate state tax sourcing.

Subchapter K may require partnerships to make certain mandatory allocations to partners in particular circumstances—generally where there is a built-in gain or loss which is deferred until the property is transferred to a third party. This treatment, which recognizes that the built-in gain/loss was accrued in a prior period, may also implicate state sourcing.

13. Partners and partnerships may engage in different types of transactions that implicate state sourcing.

Guaranteed payments or payments made under IRC § 707(a) raise apportionment questions. How should such payments be treated when computing the sales (receipts) factor of the partnership or corporate and tiered partners—especially where blended apportionment is used? Also, do states need the type of authority provided under IRC § 482 to ensure that related-party transactions involving partnerships are not used solely to affect state tax sourcing?

14. The federal pass-through system depends on anti-abuse rules that may not apply where the issue is state-tax related.

Federal anti-abuse rules are critical to the pass-through system working as intended, but some of these rules specifically reference the effect on federal tax. So where the federal tax and state tax treatment of income are only indirectly related—as with sourcing of multistate income—it is less clear whether states may rely on these rules.

15. The federal pass-through system relies on the consistency requirement under federal administrative rules, which may not apply to state tax issues.

The federal tax administrative rules require partners to report partnership income consistent with the way in which it was reported by the partnership and provide mandatory reporting of differences along with an expedited process for adjusting a partner's tax return when it takes an inconsistent position. It is not clear that states may rely on this consistency rule to require partners to report the state tax characteristics of partnership income consistent with the partnership's own reporting.

16. State rules may need to consider the inherent complexity of the pass-through system.

The inherent complexity of the pass-through system as well as the growing complexity of partnership structures may require states to adopt specific limits, presumptions, safe harbors, or other similar rules to make sourcing of multistate income more administrable

State Sourcing Rules – Generally (See Subsection I.E. and Section III):

Income from businesses conducted by corporations and individuals is generally sourced using the same state sourcing rules. (While states tax 100% of the income of residents, they give a credit for tax paid to other states with limits based on the sourcing rules and rates used by the resident state.) When it comes to sourcing the income of partnerships, critical elements of these state sourcing rules include the following:

17. Use of consistent sourcing rules for different forms of entities can contribute to equity and simplicity .

Use of the same general sourcing rules for different types of entities has the advantage of imposing tax on a more equitable basis and can also contribute to greater simplicity. That said, it is important to recognize and address the differences between income taxed on a pass-through basis versus income taxed at the entity level, and the unique issues pass-through taxation may raise. Otherwise, the form of entity may significantly change the sourcing result.

18. Because state sourcing rules have been developed in the context of taxable corporations, they often lack rules for addressing partnership income.

Both the state sourcing rules and the limits on state authority to tax multistate income have developed over time, through legislation, rule-making, or litigation, largely in the context of taxable corporations. As a result, there are gaps in state rules for sourcing income on a pass-through basis as well as a lack of guidance on how the general limits on state authority will apply in particular circumstances involving pass-through taxation.

19. One difficulty in developing comprehensive partnership sourcing rules is that states generally address such issues only in the context of taxable corporations or individuals.

States generally have nothing like IRC Subchapter K which addresses the treatment of partnership income under the pass-through system. Rather, any specific rules addressing the sourcing of partnership income are generally found in sections addressing the taxation of corporations or individuals. This may have contributed to the difficulty in developing more detailed rules for sourcing partnership income.

20. The constitutional limit imposed by the unitary business principle is relevant to sourcing of partnership income primarily in determining if partnership items are nonbusiness (non-apportionable) and must be sourced using rules of assignment.

The unitary business principle has been created by the U.S. Supreme Court to limit the authority of states to tax a portion of the multi-state income of non-resident, non-domiciliary businesses using formulary apportionment (as opposed to rules of assignment). This principle is generally applied in two related contexts. The first is determining when states can require combined filing of related corporate entities. The second is determining when items of income can be included in the net apportionable base to which a single apportionment factor is applied—that is, whether the items are business (apportionable) or nonbusiness (non-apportionable) income.

Since, under the pass-through system, partnerships do not file or compute their tax on a combined basis, the main relevance of the unitary business principle is the determination of what items of partnership income must be excluded from net apportionable income to be apportioned by a particular formula. When applying the unitary business principle to this question—two points are critical:

a. Apportionment can apply to less than the entire income of a unitary business.

States are not generally required to include the entire net income from a unitary business in the net income to be apportioned using a single formula. So, for example, states may require corporate combined filing of just the domestic entities engaged in the same unitary business—excluding foreign entities. While the unitary business principle may still be used as a test for whether this approach is fair—it would be incumbent to show that the tax result is significantly different.

b. A single entity or group may be engaged in multiple unitary businesses.

Most states recognize that a single entity or group may be engaged in business activities that are not related to each other but are part of different unitary businesses conducted by that entity or group. In that case, the net income of each business can be apportioned using a separate formula with the related factors for that particular business.

21. Another limit on state taxation—found in P.L. 86-272—has implications for both taxing partnership income generally as well as state sales (receipts) factor throw-back and throw-out rules.

The question of how the limitation on taxing “persons” under P.L. 86-272 applies to partnerships taxed on a pass-through basis is a difficult one on which there is little clear authority. This issue also affects the application of state throw-back and throw-out rules. The leading case on this question would attribute the activities of the partnership in the state to that partners—so that if either the activities of the partner or the partnership exceed the protection, the partner would be subject to tax, including on the partner’s share of partnership income.

The Attribution Principle (See Subsection I.F.)

The attribution principle is critical to the proper functioning of the federal pass-through tax system and was recognized by the U.S. Supreme Court in its recent decision in *Moore v. United States*. The application of federal sourcing rules has long depended on the characterization of items of income which, in the context of partnerships, is done at the partnership level and then attributed to the partners. Some states have recognized the application of the attribution principle for state taxation of partnership income in particular contexts. But the interaction between the unitary business principle and the application of the attribution principle is not clear.

22. Whether the attribution principle applies to state tax characteristic of partnership items is uncertain.

To the extent a state conforms to Subchapter K, there appears to be little doubt that federal characteristics of income are subject to the attribution principle—even to the extent that the federal character may determine state tax treatment. And, as at the federal level, this is true whether the partner is a direct or indirect partner and regardless of the partner’s role, relationship, or separate taxpayer attributes.

But there may be questions of an item’s character that matter only for state purposes. In these cases, it may not always be clear to what extent such character will be determined at the partnership level and attributed to the partners.

23. Treating important state characteristics of partnership income as properly determined at the partner level is not only inconsistent with the attribution principle, it would also allow taxpayers to easily shift the source of income.

One of the most important characteristics of income for state tax sourcing purposes is whether it is nonbusiness (non-apportionable) or business (apportionable) income. A state may apply the rules for this determination, first, to individual partnership items in relation to the partnership’s business, and then attribute this character to the partner. Alternatively, a state may apply the rules for this determination solely to the distributive share and its relationship to the partner. The second approach will effectively wipe out the character of the partnership items that would otherwise determine their sourcing.

Assume a partnership has all of its activities, property, payroll, and sales in a state. Also assume the partnership has one individual and one corporate partner. The state would presumably source the distributive share of the individual partner to the state, applying the attribution principle. But it could reach a different result for the corporate partner’s distributive share if the partner and the partnership are not unitary entities. Under some states’ rules, this might result in the distributive share being treated as nonbusiness income to the partner and sourced to the partner’s domicile. (See FJ Management discussed in more detail in subsection I.F.)

General Take-Aways

24.

Recommendations

SECTION I. IMPORTANT CONTEXT FOR UNDERSTANDING THE ISSUES

This Section I provides background information necessary to understand the state sourcing issues discussed. It is necessary in this section to summarize many of the rules discussed in very general terms—avoiding details that are less relevant to the issues to be addressed. So readers who are interested in the concepts or rules in this Section should consult additional authorities if they wish to understand their application in particular facts and circumstances.

Section I - Important Context for Understanding the Issues includes the following subsections:

- I.A. Examples of Issues and Common Questions
- I.B. Overview of Important Law
- I.C. Common Terms Used in the White Paper
- I.D. Conformity to the Federal Pass-Through Tax System
- I.E. General State Sourcing Rules for Income of Businesses
- I.F. Importance of the Attribution or the “Conduit” Principle
- I.G. Summary – Issues & Important Context - Lessons

I.A. Examples of Issues and Common Questions

To help users of this white paper understand the state sourcing issues to be addressed in Section II, this Section I gives some important context. First, this subsection I.A. looks at some simple examples of how the pass-through system creates unique state sourcing issues and summarizes the common sourcing questions that states are facing.

State Rules for Sourcing Multistate Income – Generally

States generally apply the same approaches to sourcing the multistate income of a business, regardless of the form of the business (e.g., corporation, proprietorship, partnership, etc.). (See further discussion in subsection I.E. below).

➤ **Nonbusiness Items – Rules of Assignment**

States apply rules to identify items of income and related expense that are considered “non-business” (or “non-apportionable”) and source those items using rules of assignment based on their character.

➤ **Net Business Income – Formulary Apportionment**

States source the net “business” (or “apportionable”) income of a business by applying a ratio based on the business’s total “factors” assigned to the state, including sales or receipts, property, and/or payroll.

Treatment of Related Entities - Generally

The constitutional basis for formulary apportionment is the unitary business principle.⁴ Net income from a unitary business or source may be apportioned by a state using a common apportionment formula for that net amount—without the need to source items of income and expense individually.

A single unitary business may be conducted by multiple related entities. And it may also be the case that a single entity conducts multiple unitary businesses. Today, when most states determine their share of multistate income from a unitary business conducted by related corporations, they apply formulary apportionment to the combined net business income from that unitary business or source, and not on a

⁴ See Hellerstein, Hellerstein & Appleby: State Taxation, ¶8.07-8.10 (WG&L).

separate entity-by-entity basis. This helps avoid the effects that related-entity structures or transactions might have on the ultimate source of the business's income.⁵

Examples of Issues Created by the Pass-Through System

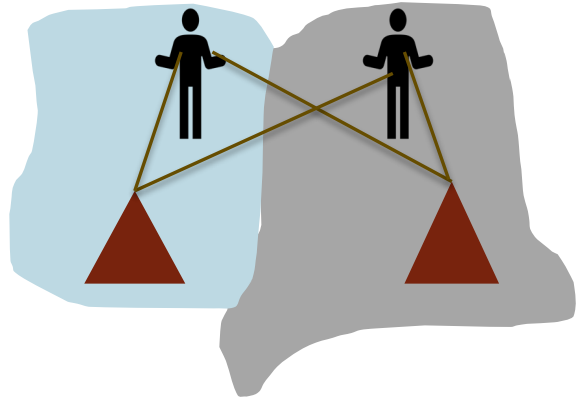
Applying state sourcing rules to partnership income taxed on a pass-through basis can raise some unique issues and create unexpected or unclear results. Below are three very simple examples meant to illustrate just a few of the many ways in which these issues may come up. (But their use should not be taken to imply that any of the results are “wrong”).

While the fact scenarios here are simple—the types of issues highlighted here have effects that range far beyond these simple scenarios, and there are many other similar issues that are not illustrated here.

Example 1:

This example shows the unexpected result for individual partners with income and loss from different partnerships in different states.

- Smith, a resident of State A, and Jones, a resident of State B, are separately engaged in similar businesses.
- Smith and Jones combine their businesses—in which they will have equal ownership and shares of income. But for state regulatory reasons, they create two separate partnerships:
 - P1 operating entirely in State A
 - P2 operating in entirely State B.
- States A and B apply the following sourcing rules:
 - Residents - source 100% of their income to the state and receive a credit for taxes paid.
 - Nonresidents - partnership business income (loss) is apportioned at the entity level and this source is attributed to direct and indirect partners' shares.
- Apportioned at the partnership level:
 - P1 has \$100,000 of net income apportioned entirely to State A
 - P2 has \$100,000 of net loss apportioned entirely to State B.
- Sourcing result for partners:
 - Federal tax and resident states returns -
 - Smith and Jones will both report their shares of both P1 income and P2 loss, offsetting those amounts for \$0 net partnership income.
 - Nonresident states returns -
 - Smith, as a nonresident, will report \$50,000 of loss to State B.
 - Jones, as a nonresident, will report \$50,000 of income in State A.



⁵ See Hellerstein supra fn. 4, ¶8.03.

Example 2:

This example shows how apportionment applied at the entity level and apportionment applied using a “blended” approach can have very different results:

- Corporation X is the managing member in LLC – receiving a 50% distributive share.
- X and the LLC have income and State A apportionment factors as follows:

X net income -	\$2 million
X receipts factor -	\$10 million / \$10 million

LLC net income -	\$12 million
LLC receipts factor -	\$0 million / \$20 million

- Two possible results – entity level versus blended apportionment:
 - Assume State A apportions LLC income at the entity level, attributing that source to X.

X’s income sourced to State A will be \$2 million
(none of which is from the LLC).

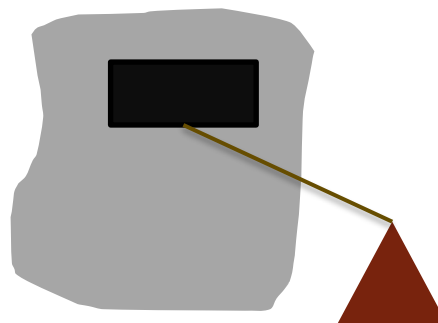
- Alternatively, assume State A apportions income using “blended” apportionment so that X will include its share of the LLC’s sales in its own receipts factor and then use this “blended” factor to source X’s total income, including its share of LLC income.

X’s income sourced to State A will be:

X’s total income = \$2 M + 50% of \$12 M = \$8 M

Blended factor = $\frac{\$10 \text{ M in State A}}{\$10 \text{ M} + 50\% \text{ of } \$20 \text{ M} = \$20 \text{ M}}$
= 50%

Net income sourced to State A = \$8 M x 50% = \$4 million



Example 3:

This example shows how results may differ depending on whether certain sourcing rules are applied at the partnership or partner level.

- Assume the same facts as Example 2 and that State A uses blended apportionment.
- LLC’s income is entirely a gain from the sale of property outside State A.
- State A’s rules would generally treat this type of gain as nonbusiness (non-apportionable) income under the circumstances.
- Two possible results:
 - None of the gain is taxable - State A’s rule for nonbusiness income is applied at the entity (LLC) level, the gain is sourced outside State A, and this source is attributed to X’s share.
 - A portion of the gain is taxable - State A’s rule for nonbusiness income is applied at the partner level and X’s share of gain is characterized as business (apportionable) income to X so that part is apportioned to State A using the blended formula.

Summary of Some Common Questions

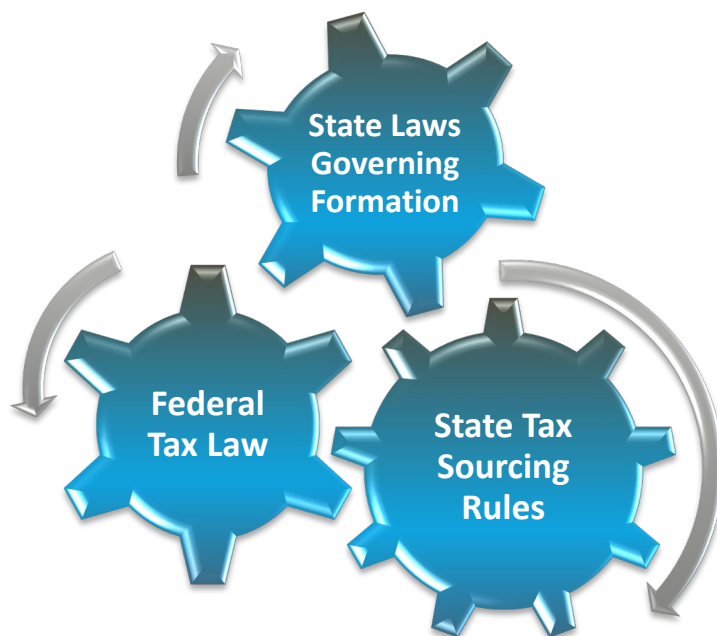
States today face common questions about sourcing of partnership income taxed under the pass-through system:

- When sourcing partnership income, do sourcing rules apply at the partnership or the partner level and if both, in what order?
 - Does this vary based on type of partner (e.g., individual, corporation, tiered partner, etc.)?
 - Does this vary based on partner's role (active, passive, direct, indirect, etc.)?
- If blended apportionment is used—how is it done?
 - What share of partnership factors should be included in a blended apportionment factor?
 - How should partner-partnership or related-entity transactions be treated in computing the apportionable income or apportionment factors?
- If blended apportionment is used—are there any limitations on when it is used?
 - Should the use be limited based on the unitary business principle?
 - Should the use be limited based on the type of partner?
- Do special or mandatory allocations of partnership income call for different sourcing rules?
- Are there any anti-abuse rules needed to avoid unintended sourcing results?

To better understand the reasons why partnerships and the pass-through tax system raise difficult sourcing issues, the following subsections discuss the important context in which partnership income is taxed, including: laws governing partnerships generally, common terms necessary for discussing the issues, what it means for states to conform to the federal pass-through system, the importance of the attribution principle, and a further analysis of the states' general sourcing rules.

I. B. Overview of Important Law

State taxation of partnership income is directly affected by three categories of laws. The first—state laws governing formation—will be discussed in this subsection I.B. The other two—federal tax law and state tax sourcing rules—are summarized briefly below and discussed in greater detail in this white paper.



CATEGORY 1: State Laws Governing Formation

Partnerships, like corporations, are the creatures of state statutory law. These statutes govern formation of partnerships and prescribe, in some detail, the legal rights and duties of partners and partnerships in relationship to each other and with third parties. State laws also allow for the creation of different forms of partnerships. Most importantly, when compared with corporations, partnerships have much greater flexibility in terms of their structure and operations as well as in the roles of partners.

Uniform Governing Laws

Most state governing statutes are largely consistent with the Uniform Law Commission (ULC) model acts. This white paper may reference these acts when discussing partnerships – see links here:

[ULC Partnership Act](#) (which includes general and limited liability partnerships)

[ULC Limited Partnership Act](#)

[ULC Limited Liability Company Act](#)

Partnership Laws are Influenced by Two Theories – Aggregate and Entity

Two legal theories of partnerships have influenced the development of state governing laws. These theories sometimes also come up in the context of state sourcing debates. The aggregate theory views partnerships as simply joint endeavors undertaken by separate persons—whether owning property collectively or taking certain collective actions. In contrast, the entity theory views partnerships as separate persons under the law (similar to corporations).

Introductory comments to the current ULC Partnership Act (as amended in 2013) address how these theories have influenced the governing rules as the following excerpts show:

“The National Conference of Commissioners on Uniform State Laws first considered a uniform law of partnership in 1902. Although early drafts had proceeded along the mercantile or "entity" theory of partnerships, later drafts were based on the common-law "aggregate" theory. The resulting Uniform Partnership Act ("UPA"), which embodied certain aspects of each theory, was finally approved by the Conference in 1914. . . .

In January of 1986, an American Bar Association subcommittee issued a detailed report that recommended extensive revisions to the UPA. . . . The ABA Report recommended that the entity theory "should be incorporated into any revision of the UPA whenever possible." . . . The Revised Uniform Partnership Act (1992) was adopted unanimously by a vote of the States on August 6, 1992. The following year, in response to suggestions from various groups . . . the Drafting Committee recommended numerous revisions . . .

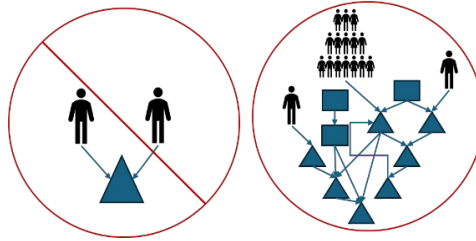
The [current] Act enhances the entity treatment of partnerships to achieve simplicity for state law purposes, particularly in matters concerning title to partnership property. RUPA does not, however, relentlessly apply the entity approach. The aggregate approach is retained for some purposes, such as partners' joint and several liability.”

This ULC Partnership Act is designed to govern the most traditional partnerships. But as these comments reflect, even these traditional partnerships have been influenced by the entity theory over time. The ULC Limited Liability Company Act and ULC Limited Partnership Act incorporate even more of the entity theory into their provisions, including providing limited liability for partners despite their role in the entity’s business.

STATE TAX IMPLICATION: Traditionally, state tax rules may have treated partnerships primarily as aggregates of persons and not as separate entities. For example, state rules may effectively assume that partners share ownership in partnership assets in a way that is similar to joint ownership. These assumptions about partnerships may no longer be sound. But see also the discussion of the attribution or “conduit” principle in subsection I.E. below.

Governing Laws Impose Few Limits on Partnership Size or Structural Complexity

Because state governing laws provide much greater structural and operational flexibility for partnerships than corporations, partnerships are often used for unique or complex business arrangements or where those arrangements may change over time. Nor do federal tax rules apply the kind of ownership limits on partnerships that they apply to S corporations. So partnerships can have thousands of partners and complex multi-tiered structures. Partners and partnerships can also engage in transactions with each other and with related partnerships. And federal tax data has long shown a rapid growth in large, complex partnerships.⁶



STATE TAX IMPLICATION: Given the flexibility in partnership structures allowed by general state governing laws and the growing complexity of partnerships that has been observed in recent years, state tax and sourcing rules should not assume that all partnerships are small, simple, uniform entities. Moreover, it is these large complex partnerships that give rise to the most multistate income.

Partner Roles and Control Vary and are Not Dictated by Ownership Share

Partners can agree to share income and control however they choose with very few limitations. A partner's role in or control of the partnership is not necessarily tied to that partner's ownership share or whether the partner has limited liability. And unlike corporate shareholders, partners' roles can vary widely—from a purely passive investor to an active participant or manager. For example, all members of an LLC have limited liability but any member may, nevertheless, participate in the company's activities or may engage in managing the company, alone or with others, regardless of ownership share. And it is not uncommon for partnerships of all sorts to be controlled by a partner that has only a minority ownership share as measured by capital.

STATE TAX IMPLICATION: Some state tax rules appear to assume that a partner's ownership share or limited liability will determine their role—that is, their control of or active participation in partnership activities. These mistaken assumptions can lead to misapplication of general state sourcing rules and the underlying principles on which they are based.

Only Limited Information is Required to be Filed with the State

State laws governing partnership entities typically do not require significant amounts of information to be filed when the entity is formed or to be reported over time. While LLCs may have to file a formal articles of organization and other partnerships may have a similar requirement, those documents typically do not contain extensive information on owners, assets, or activities⁷.

STATE TAX IMPLICATION: State tax reporting requirements are often the only requirements for most partnerships to report information on their owners or activities.

⁶ See "Large Partnerships: Characteristics of Population and IRS Audits," U.S. Governmental Accountancy Office, GAO-14-379R, Apr. 17, 2014, available here: <https://www.gao.gov/products/gao-14-379r>; and Love, Michael, "Who Benefits from Partnership Flexibility?" Columbia Law, Oct. 2024, available here: https://papers.ssrn.com/sol3/papers.cfm?abstract_id=5014267.

⁷ In 2021, Congress enacted the Corporate Transparency Act that was to take effect in 2024 and would require some unincorporated entities to report their beneficial owners. That law has been held up by litigation and concerns over enforcement.

CATEGORY 2: Federal Tax Law - Generally

In general, states are said to “conform” to the federal Internal Revenue Code (IRC) when taxing income. And most states also conform to IRC Subchapter K which creates a pass-through system for taxing partnership income. The substantive tax laws and the specific partnership rules interact in a number of ways—especially when it comes to how partnership income is tracked, reported, and treated for tax purposes. See for example IRC §§ 702 and 703.

The implications of conforming to the federal partnership tax system will be discussed further in subsection I.D below. Here, it is enough to note what a leading text says about this system:

“Subchapter K has a well-earned reputation as one of the most complex areas of the tax law, while a flow-through regime sounds simple enough in concept, implementing that regime is another matter.”⁸

STATE TAX IMPLICATION: Understanding the basics of the federal pass-through system is essential to understanding how state sourcing rules may apply to partnership income.

CATEGORY 3: State Tax Sourcing Rules - Generally

While states generally conform to the federal rules for determining domestic versus foreign income, they have their own approaches for determining their share of multistate domestic business income. State tax sourcing rules have been developed in the context of taxes imposed on individuals and corporations. So any rules specifically addressing partnership income are often found embedded in those sections of state tax law. This approach is generally consistent with the federal pass-through tax system, which seeks to apply the same substantive tax rules to partnership income that apply to other businesses, while imposing tax on the owners rather than the entity. But sometimes the application of state rules in the pass-through context is unclear.

Important aspects of these state sourcing rules are discussed in subsection I.F. below. Here it is important to note that many states face some challenges in updating their sourcing rules for partnership income that stem from the history of how sourcing rules were developed over time and ensuring that any rules specific to partnerships are consistent and based in sound principles.

STATE TAX IMPLICATION: Application of state sourcing rules to partnership income has often been overlooked in the focus on individuals and corporations and applying those rules in the pass-through context raises issues not addressed, or are addressed in ways that may not be consistent.

Interactions Between These Three Categories of Law

While the general laws discussed in this subsection are separate and distinct, there are many ways in which they interact or influence each other. For example, the relationship between a partner and the partnership may be determined, in the first instance, by state governing laws. This relationship may

⁸ The Logic of Subchapter K: A Conceptual Guide to the Taxation of Partnerships, Laura E. Cunningham and Noël B. Cunningham, West Academic Pub., 6th ed., p. 1.

affect how federal tax rules would apply to the computation of that partner’s income. And this, in turn, may affect how state sourcing rules would then apply to that income.

One important aspect of this dynamic is the use of terminology. The following subsection I.C., lists important terms and concepts that are derived from these three sources and how they will be used in this white paper.

I. C. Common Terms Used in the White Paper

Terminology is critical for any possible discussion of this subject. And, as Section I.B. above notes, there are three separate bodies of law that can affect definitions and usage of important terms—general state governing laws, the federal IRC, and state tax laws. As a result, some important terms and concepts may be defined and used somewhat differently in each context. Nor is it uncommon for the terms to be used inconsistently, even in the same context.

This subsection I.C. lists the most important terms and how they will be used in this white paper. In general, when choosing how to use a term, these definitions will defer first to the IRC Subchapter K or general federal tax usage and then to general state governing law.

As for state tax sourcing methods or concepts—the terms used to refer to them may also vary among the states. Therefore, this subsection also contains a summary of how certain state tax terms will be used.

Terms Used Consistently with Subchapter K and Federal Tax

Partnership	Entities taxed as partnerships under federal law (e.g., general partnerships, limited partnerships, LLCs, etc.). See IRC §§ 761(a) and 7701 and related regulations.
Partner	Persons taxed as partners under federal law. See IRC §§ 761(b) and 7701 and related regulations, including direct and indirect partners. (See below.)
Partnership agreement	As the term is used for tax purposes (consistent with state law) to describe the agreement of the partners generally, or on particular partnership matters. See IRC §761(c).
Partnership ownership interest or partnership interest	A general description of a partner’s ownership in a partnership or to the value of the partner’s partnership capital. See IRC §§ 704(e) and 864(c)(8) (among others). (Contrast this with the term “partner’s interest in the partnership” below.)
Contribution	Items including cash and property transferred by a partner to a partnership in exchange for a partnership interest. See IRC § 721.
Distribution	Items including cash and property transferred by a partnership to partners that represent a return of the partner’s capital or partnership interest. See IRC § 731.
Partnership item	In general, any tax-significant result generated from a transaction or event (including income, expense, gain, loss, etc.) that is recognized and treated under the general substantive tax rules. See IRC §§ 702 & 704 (and IRS Form 1065, Schedule K-1). Note that this white paper uses the term “item” broadly.
Character	Tax treatment of partnership items as determined by the nature of the item under general substantive tax rules. See IRC §§ 702(b) and 703(a).

Attribute (noun)	An aspect of a particular taxpayer that may affect the ultimate tax result (e.g., individual or corporation, filing separately or jointly, marginal tax rate, etc.)
Partnership income (loss)	A general reference to income (loss) determined and reported by the partnership. See Treas. Reg. 1.6031-(a)1 and IRS Form 1065.
Distributive share	The percentage or amount of a partnership's income (loss) or the percentage or amount of partnership items allocated to a partner in a given tax period. See IRC § 704.

Allocate or allocation	Because Subchapter K uses the term allocate to refer to the dividing up and attributing of partnership distributive share income (loss) or items to the partners, see IRC § 704(b) and related regulations, this white paper will use that term similarly—and not to refer to state sourcing of certain items.
Attribute (verb) or attribution	Assignment to the partners of important tax characteristics of partnership items, including sourcing, that are determined at the partnership level. See §§ 702(b), 875, 897(c)(4)(B), and 958(a)(2).
Partner’s interest in the partnership	The basis for allocating partnership income (loss) or a partnership item absent any agreement by the partners or where that agreement lacks substantial economic effect. See IRC § 704(b) and related regulations.
Inside basis	The tax basis in partnership assets or property which may also be attributed to particular partners. See IRC § 723.
Outside basis	The tax basis in a partner’s partnership interest. See IRC § 722.
Partner capital account	Generally refers to the partnership’s capital attributed to a particular partner. See Treas. Reg. § 1.704-1(b)(2)(iv).
Built-in gain (loss)	The amount of the fair market value of an item as compared to that item’s tax basis at a particular point in time—often the point at which the item is contributed to or distributed from a partnership. See IRC § 704(c).
Guaranteed payment	Amounts of cash or assets transferred from a partnership to a partner not dependent upon the partnership’s income. (Contrast this with distributive share above.) See IRC § 707(c).
Upper-tier partnership or tiered partner	A partnership that holds an interest in another partnership. See IRC § 706(d)(3) (among others).
Lower-tier partnership	A partnership in which another partnership holds an interest. See IRC § 706(d)(3) (among others).
Direct partner	A partner that owns an interest in a partnership.
Indirect partner	A partner or owner of a partnership or passthrough entity that, itself, owns an interest in another partnership.
Trade or business	The particular character of items, including those recognized by partnerships, that may determine their treatment for tax purposes. See IRC § 162 and related regulations (among others).
Active or passive	A characterization of a relationship between a taxpayer and an item or its source that, under the federal substantive tax provisions, may determine the treatment of items, especially losses. See IRC § 469 and related regulations.

Terms Used Consistently with State Governing Laws (ULC References)

Types of Partnerships	
General partnership	See the ULC Partnership Act.
Limited liability partnership (LLP)	See the ULC Partnership Act, Art. 9.
Limited partnership (LP)	See the ULC Limited Partnership Act.
Limited liability company (LLC)	See the ULC Limited Liability Company Act.
Types of Partners	
General partner	See ULC Partnership Act (including any partner in a general partnership) and the ULC Limited Partnership Act, Art. 4.
Limited partner	See ULC Limited Partnership Act, Art. 3.
Member	See ULC Limited Liability Company Act, Art. 1, Sec. 102(11) and Arts. 3 and 4.

State Tax Sourcing Terms as Used in this White Paper

Jurisdiction	The general authority of a state to impose requirements on a person.
Nexus	The general standard for state authority to impose tax on a person.
Doing business	Used in state tax imposition statutes to refer to a person's activities directed at the state that will subject that person to tax.
Source (noun and verb)	Refers generally to the state or states to which items of income or a share of net income from multistate activities will be attributed or to the attribution of those items under different approaches.
Apportion and apportionment	A method used to source multistate income that applies a single formula or ratio based on certain instate activities of the taxpayer to determine the percentage of that taxpayer's net income (and of all the items making up that income) that will be taxed in that state
Apportionment factors	The types of activities counted as part of the apportionment formula used to apportion income, including, primarily, the percentage of sales or receipts in the state, but sometimes also the percentage of property and payroll in the state.
Receipts factor	The apportionment factor that represents the ratio of sales or receipts in a state.
Assign	Determining the items or the amounts of those items located in a state for tax purposes—which may be applied to items making up the apportionment factors or to items of non-apportionable income.
Specifically assign and rules of assignment	A sourcing method and the specific rules which source particular items of income or expense to a state.
Apportionable business income	Income or items that may be constitutionally included in net taxable income sourced using an apportionment formula—sometimes referred to as “business income.”
Non-apportionable nonbusiness income	Income or items that may not be constitutionally included in net income sourced using an apportionment formula—sometimes referred to as “non-business income.”

Note: Other terms or concepts may be defined throughout this white paper as necessary.

I.D. Conformity to the Federal Pass-Through Tax System

Conforming to the federal pass-through tax system has a number of important implications for states—especially for the state tax sourcing rules which, it is fair to say, were not developed with partnerships in mind. This section focuses on the most critical of these implications. It starts with three important assumptions as to the general effects of federal conformity. It then provides a list of the key elements of Subchapter K’s pass-through system that have the greatest state tax sourcing implications. Finally, it looks at how transfers or transactions among related partners/partnerships are treated and how they may affect state sourcing.

Effects of State Conformity to Federal Tax Law - Assumptions

States generally conform to the IRC when taxing income. This “conformity” may be accomplished in many different ways. For example, state statutes may:

- Calculate state tax starting with a federal amount (e.g., taxable or adjusted gross income);
- Incorporate IRC provisions by reference, whether generally (with exceptions) or specifically; or
- Enact the actual language of particular IRC provisions—with or without modifications.

States may also conform to the IRC at a particular point in time (“static conformity”) or to the current version as amended (“rolling conformity”).⁹

In addition to conforming in various ways, states can, but often do not, explicitly provide for how any federal law “embedded” in their state tax law will be interpreted and applied when computing state taxes. For example, states may provide for whether federal regulations are controlling, how much state application may deviate from certain federal treatment, or how potential conflicts will be resolved, etc.

Also, since 2024 when the U.S. Supreme Court overturned the so-called *Chevron* deference approach to applying federal regulations,¹⁰ there have been questions about the extent to which federal courts will follow federal tax regulations. While state courts are not bound by this ruling, nevertheless, they may follow a federal court’s treatment of federal tax laws—even when it conflicts with federal regulations.

For simplicity sake, this white paper adopts the following general assumptions as to the effects of state conformity to Subchapter K.

Assumption No. 1 - Federal rules control the meaning of common tax terms.

As noted in subsection I.C. above, Subchapter K may define or use terms in a certain way and this white paper will defer first to the federal tax definition or usage. But this assumption also has a bigger implication for states. To the extent states conform to the federal tax law but wish to use common terms in a different way, they may need to specifically define them or indicate that they are being used in a particular way to help avoid confusion or unintended effects.

Assumption No. 2 - Federal regulations control statutory interpretation.

Even more than other sections of the tax law, Subchapter K lacks detail and is written in very general, sometimes vague terms.¹¹ As a result, consistent interpretation and application of the statutory provisions is highly dependent upon federal regulations and other IRS guidance. Therefore, this white paper assumes the federal regulations are generally controlling for state tax purposes as well.

Note that anti-abuse provisions raise additional questions for state conformity that are addressed in a later subsection.

⁹ See Hellerstein supra fn. 4, ¶7.02.

¹⁰ *Loper Bright Enterprises v. Raimondo*, 603 U.S. 369, 144 S. Ct. 2244, 219 L. Ed. 2d 832 (2024).

¹¹ Cunningham & Cunningham, supra fn.7, p. 1.

Elements of the Pass-Through System and Their State Tax Implications

IMPORTANT NOTE: As discussed in subsection I.B. above, state governing laws allow partnerships much more structural and operational flexibility than corporations. While the federal pass-through tax system imposes few strict limits on this flexibility, it has evolved to include numerous requirements aimed at ensuring it is not abused.¹² Specific application of these requirements, even in the federal tax context, is sometimes unclear.¹³ This white paper does not attempt address these requirements in detail. Rather, it focuses generally on aspects of the pass-through system that have direct implications for state sourcing of partnership income.

1. Partnerships are not subject to Subchapter S-type ownership limitations.

Unlike the limitations imposed on Subchapter S corporations,¹⁴ Subchapter K imposes no limits on the size or structure of partnerships that may be taxed on a pass-through basis. Partnerships may have partners that are individuals, corporations, taxable trusts, charitable or governmental organizations, foreign persons, and other pass-through entities including other partnerships, trusts, and S corporations. Nor is there any limit on the number of partners or on the number of tiers in a partnership structure. This means shares of partnership income and items may pass through multiple entities before reaching the ultimate taxpaying partners.

STATE TAX IMPLICATIONS: When states have rules that explicitly address the sourcing of partnership income, they often assume that partnerships are small, simple structures with a few individual partners and no tiers. As a result, the application of the sourcing rules to more complex structures is left unaddressed and this may create uncertainty or non-compliance.

2. Partners pay tax on partnership items in the year recognized by the partnership.

Tax on partnership income is paid by the partners in the year the income is recognized by the partnership, see IRC §§ 701-704, and not when partners receive distributions from the partnership. (See the treatment of distributions below.) This is the foundation of the pass-through system on which everything else is based.

STATE TAX IMPLICATIONS: States should be careful in the use of the terms “distribution” versus “distributive share” and should not assume that just because partners receive an allocation of distributive share income they will necessarily receive similar *distributions* in the tax year.

3. Partnerships determine the tax treatment (“character”) of items recognized.

When a partnership recognizes any item of income, expense, gain, or loss that has a specific treatment under the federal tax rules, the partnership will determine that tax treatment or “character” of the item by applying the same substantive tax rules applicable to individual taxpayers. This characterization of items is done based on the nature of the partnership’s activities giving rise to the items. See IRC § 703(a) and IRS Form 1065.

STATE TAX IMPLICATIONS: To the extent the federally determined character of any items also affects their state tax treatment, that character is determined at the partnership level based on its activities. Similarly, state tax characterization of items is presumed to be done at the partnership level—but see further discussion of the attribution principle in subsection I.F.

¹² Andrea Monroe, What We Talk About When We Talk About Tax Complexity, 5 Mich. Bus. & Entrepreneurial L. Rev. 193 (2016). Available at: <https://repository.law.umich.edu/cgi/viewcontent.cgi?article=1045&context=mbelr>.

¹³ Andrea Monroe, “What’s in a Name: Can the Partnership Anti-Abuse Rule Really Stop Partnership Tax Abuse?,” 60 Case W. Res. L. Rev. 401 (2010). Available at: https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1479609.

¹⁴ See IRC § 1361.

4. Federal sourcing is part of the character of items determined at the partnership level.

Whether partnership income or items are treated as domestic or foreign under federal sourcing rules is generally part of the character of those items which is, to a large extent, determined at the partnership level. See IRC § 875 and IRS Reg. § 1.702-1(a)(8)(ii). Note that there are also instances in which the partner's attributes may affect how the income is sourced federally.

STATE TAX IMPLICATIONS: States generally conform to the federal sourcing rules when determining whether income is domestic or foreign and will, therefore, generally conform to this partnership treatment as well. But this raises the question of whether *state* sourcing of multistate partnership income should be determined at the partnership level, at least in some cases.

5. The tax character of partnership items is attributed to direct and indirect partners.

Character of partnership items of income, expense, gain, or loss as determined by the partnership is attributed to the ultimate taxpaying partners along with their distributive share of those items. See IRC § 702 and IRS Form 1065 – Schedule K-1. It does not matter how many tiered entities the items may pass through—their character does not change. This general attribution (or “conduit”) principle, discussed further in the next section, prevents the use of partnerships to effectively strip the tax character from items or change their tax treatment.

STATE TAX IMPLICATION: At least to the extent state tax treatment of items is based on or related to their federal treatment, this determination of their state tax character would also presumably be made at the partnership level and attributed to the partners.

6. A partner's tax attributes also effect the amount of tax paid on partnership income.

Because each partner reports their share of partnership items as part of their own tax return, the partners' attributes are also taken into account in computing that tax—including the partners' effective or marginal federal tax rates, which may vary considerably.

STATE TAX IMPLICATIONS: The effect of partner attributes on state taxation of partnership income may be somewhat less pronounced than it is at the federal level—in part because state tax rates vary much less. But other partner attributes, such as income or loss from other sources, may still have a substantial effect on the ultimate state tax paid on partnership income.

7. Partners can share partnership items in various ways, with few limitations.

Subchapter K does not require partnership income or items to be shared or allocated pro rata according to the capital or ownership interests of the partners. Nor are different items required to be shared in the same proportions. Rather, partners' shares of partnership items are generally determined by their agreement. See IRC § 704(a). These sharing arrangements may also change over time. The primary limitation on this flexibility is the requirement that these so-called “special allocations” must have substantial economic effect under IRC § 704(b) and related regulations. But as will be discussed further in this white paper, the test for substantial economic effect focuses on whether the *federal* tax result reflects the economic substance of the allocations—not on whether this is true for *state* tax results.

STATE TAX IMPLICATIONS: Some state rules appear to assume a partner's ownership interest determines distributive share—or that all partnership items will be allocated to partners using the same ratio or share. This may limit the application of these rules or leave situations involving special allocations unaddressed. Some states have adopted a form of the substantial economic effect rule making clear that the same standard applicable for federal tax purposes also applies for state tax purposes.

8. Partnerships must follow complex tracking and information reporting rules.

Partners cannot properly compute their tax without essential information tracked and reported by the partnership. Therefore, in addition to requiring partnerships to properly follow the substantive tax rules in characterizing items, Subchapter K also imposes detailed requirements for tracking and reporting the effects of various events on the partners' own partnership capital and inside basis. See for example: IRC §§ 721-737 and 752-754.

In addition, as discussed above, the rules of Subchapter K attempt to match the tax effects with the actual economic effects. But these rules face a critical challenge—taxes are reported annually while the actual economic effects may not be known for years. This is because partners are not required to take distributions from the partnership each year—equivalent to their distributive share income—and partnership agreements may change over the course of time.

To address this fundamental problem, Subchapter K requires the partnership to engage in complex tracking, record-keeping, and reporting of information over time and that the partners agree that they will (ultimately) share in the economic results of the partnership according to these partnerships accounts.

This, in turn, creates a related challenge. When items of partnership income flow through complex multi-tiered structures, these same requirements must be followed by each entity through which the income or items flow. So it is impossible to know if the proper tax has been reported without knowing if each partnership has complied with the tracking and reporting requirements. And this has made it exceedingly difficult for the IRS to perform audits of large, complex partnerships.¹⁵

STATE TAX IMPLICATIONS: States may need to consider whether to make allowances for the inherent complexity of the pass-through system and create rules that take this complexity into account—rather than assuming that rules which can be applied in simple structures can necessarily be applied in more complex structures.

9. Each partnership is unique and the partnership agreement is critical.

Because partnerships can vary in size, structure, and the sharing of income and control, as well as the other roles partners may have in the partnership, the main source of critical information about the partnership will be the partnership agreement. Small general partnerships are not required to have a written agreement, but other forms of partnership must have a written agreement, in some form, in order to comply with general state statutes governing their formation. In addition, governing statutes may provide default rules or presumptions that apply if the agreement is silent.¹⁶

STATE TAX IMPLICATIONS: State rules should be careful not to assume that all partnerships have similar or common attributes. In drafting rules, states should consider how they will apply not only in more simple scenarios but also where there are complex structures or partner-partnership or other related party transactions. In addition, states may consider creating requirements or safe-harbors based on certain provisions included in partnership agreements.

¹⁵ Large Partnerships: With Growing Number of Partnerships, IRS Needs to Improve Audit Efficiency, U.S. Governmental Accountancy Office, GAO-14-732, Sep. 18, 2014, available here: <https://www.gao.gov/products/gao-14-732>.

¹⁶ See ULC Partnership Act, p. 2 – “The Uniform Partnership Act (1994) . . . gives supremacy to the partnership agreement in almost all situations. The Revised Act is, therefore, largely a series of “default rules” that govern the relations among partners in situations they have not addressed in a partnership agreement.”

Transactions Between Partners & Partnership or Other Related Entities

Transfers of property or other transactions between partners and partnerships can affect both federal and state taxes, including the application of state sourcing rules. As discussed further in subsection I.F. below, state tax sourcing rules for business income were developed in the context of taxable corporations. Most states have come to apply these rules to combined corporate groups that are engaged in one or more unitary businesses. By doing this, states avoid having to prescribe and ensure compliance with standards for pricing transactions between related entities, which can affect the income ultimately sourced to particular states.

But because the pass-through system imposes tax on the partners and because of the flexibility of partnership structures, it is not possible to simply require related partnerships to file combined returns. Therefore, the rules for these related-party transactions are given some additional attention here.

1. Recognition of built-in gain (loss) on contributed property is deferred.

Contributions to a partnership are generally non-recognition events—that is, they do not result in taxable income or loss at the time of contribution. This means that partners can generally contribute property with a “built-in” gain or loss—the difference between the property’s tax basis and its fair market value at the time of contribution—without recognizing and being taxed on that gain or loss until the partnership transfers the property.

To prevent partnerships from being used to effectively sell or transfer property without recognizing gain or loss or the shifting of that gain or loss to other taxpayers, Subchapter K’s rules require built-in gains or losses to be recognized and/or allocated back to the contributing partner in certain circumstances. See IRC § 704(c) and IRS Reg. § 1.707-3(b)(1).

The general deferral of the built-in gain (loss) may have implications for state tax sourcing. For example, assume State A has an income tax and State B does not.

- Smith is a resident of State B
- Smith owns property located in State A that has a tax basis of \$0 and a fair market value (FMV) of \$100,000.
- Year 1 – Smith contributes and delivers the property to Partnership, operating in State B.
- Year 3 – Partnership sells the property recognizing a total \$120,000 gain.

In Year 1, Smith is not required to recognize any gain. However, in Year 3, Smith will be allocated the \$100,000 built-in gain as part of his distributive share (regardless of any agreement between the partners to the contrary). See IRC § 704(c)(1)(B).

But note—if Partnership sources this gain as part of its income and then attributes that source to the its partners, along with their shares, Smith’s built-in gain, will be sourced to State B. But assume, instead, that Smith had simply sold the property and contributed the proceeds. Not only would the gain have been recognized at the time of contribution, but it would presumably have been sourced to State A.

STATE TAX IMPLICATIONS: States should consider whether the treatment of built-in gain (loss) under Subchapter K will necessarily dictate the sourcing of that gain (loss) once recognized or whether that gain (loss) may, instead, be sourced to where it would have been sourced at the time of the contribution—had it been recognized at that time. States may also consider whether to address this issue with a definitive rule or with some type of anti-abuse rule applicable only when there are indications that the contribution was done to avoid tax.

2. Recognition of built-in gain (loss) on distributed property is generally deferred.

Partnerships do not recognize gain (loss) on distributions. IRC § 731. A partner may recognize gains and, sometimes, losses (in the case of liquidating distributions)—but only in limited circumstances. So, with some exceptions, if a partnership distributes property with a built-in gain (loss)—where the partnership’s basis in the property is different from the property’s fair market value—the partner simply takes the partnership’s carryover basis, deferring any recognition of gain or loss until the partner later transfers the property. IRC § 732.

As with the treatment of built-in gain (loss) on contributed property (above), the deferral of recognition of built-in gain (loss) on distributed property can raise state sourcing issues—for example, where the gain or loss accrued while the partnership used the property in one state, but the distributee-partner receives and then sells the property in another state.

STATE TAX IMPLICATIONS: As with built-in gain (loss) on contributed property, states should consider whether the treatment of built-in gain (loss) on distributed property should dictate the sourcing of that gain (loss) once recognized or whether that gain (loss) may, instead, be sourced to where it would have been sourced at the time of the distribution—had it been recognized at that time. States should also consider whether to address this with a definitive rule for all such situations or with some type of anti-abuse rule applicable only when there are indications that the contribution was done to avoid tax.

3. Partners may receive guaranteed payments when acting in the capacity of partners.

Under IRC § 707(c), partners may receive so-called “guaranteed payments” for services or for the use of capital where the partner is acting in the capacity of a partner. Guaranteed payments are those payments that are determined without regard to the income of the partnership—that is—they do not represent a distributive share of that partnership income or items.

Guaranteed payments are subject to a type of “hybrid” treatment. They are treated as payments to unrelated parties for purposes of computing partnership income and the distributive shares of that income to the partners. For the partner receiving the guaranteed payment, they are treated as ordinary income. But in other respects, they are treated as distributive share and these payments are reported separately on the IRS Form 1065, Schedule K-1.

Guaranteed payments may raise state sourcing questions. The sourcing of guaranteed payments to individual partners for services is addressed in a separate white paper that can be found on the MTC project webpage – [HERE](#). But when these payments are made to corporate or tiered partners, the question is whether they should be included, in whole or in part, in the receipts factor for the partnership or the partner (separately or on a blended basis). In the corporate tax context, when income is combined, related-entity transactions are effectively eliminated from both the apportionable income and from the combined factor. But where the payments are between the partner and the partnership—there is no way to effectively eliminate them simply through some type of entity level combined filing.

STATE TAX IMPLICATIONS: Because states typically use formulary apportionment to source business income and since the apportionment formula includes receipts from services in the receipts factor, this raises the question of how guaranteed payments made to corporate or tiered partners should be treated when computing that factor—including when the blended apportionment method is used, and whether these payments might, in some cases, distort the receipts factor.

4. Partners may engage in transactions with partnerships as unrelated parties.

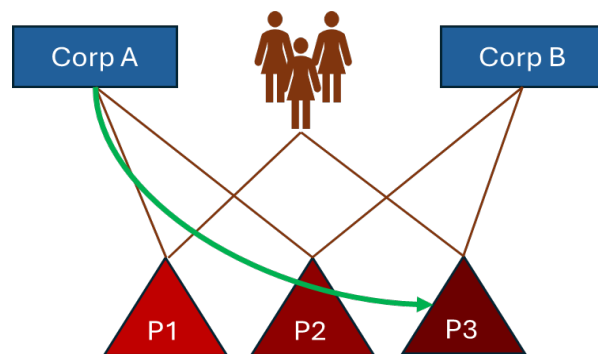
Under IRC §707(a), partners may also receive payments from transactions with partnerships where the partner is not acting in the capacity of a partner. For example, a partner might be engaged in a business that sells goods or services. That partner may provide those goods or services to the partnership in exchange for payment in the same way as to an unrelated person. In this case, the transactions would be treated as transactions between unrelated parties.

As with guaranteed payments, when these kinds of transactions and payments are made between partnerships and corporate or tiered partners, the question is whether they should be included, in whole or in part, in the receipts factor for the partnership or the partner (separately or on a blended basis).

STATE TAX IMPLICATIONS: As with guaranteed payments (above), since states typically use formulary apportionment to source business income and since the apportionment formula includes receipts from sales of property or services, this raises the question of how IRC §707(a) transactions should be treated when computing that factor—including when the blended apportionment method is used, and whether these payments might, in some cases, distort the receipts factor.

5. Partnerships can also engage in transactions with other indirectly related entities.

In addition to the partner-partnership transactions that may occur within the same ownership structure, there can be transactions between entities that are part of other partnership structures which may have common members. See, for example, the graphic to the right. Here, Corp A is not a direct or indirect partner in Partnership 3, with which it has a transaction, but is a partner in Partnerships 1 and 2 which have common owners with Partnership 3.



These related-entity structures and transactions are not uncommon today. And, as discussed further in the following subsection, IRC § 482 may give the IRS authority to “distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among” these related entities. However, application of that authority in situations like this is unclear. Corp A could argue that this authority does not apply since it and P3 are not “owned or controlled directly or indirectly by the same interests.”

STATE TAX IMPLICATIONS: It may be necessary for states to consider adopting authority similar to IRC § 482 and applicable specifically to transactions between partnerships that may have common partners in order to ensure that these transactions are not used solely to affect state tax sourcing.

NOTE: Section II below continues the discussion of these partner-partnership and other common related-entity transactions and their implications as well as approaches states might take in determining the effects of these transactions on state sourcing..

Conformity May Not Fully Incorporate Federal Anti-Abuse Provisions

Like the federal tax law generally, Subchapter K and related regulations contain numerous provisions to prevent certain unintended tax results including the use of artificial structures or transactions solely to obtain federal tax benefits. This white paper will refer to these various types of provisions broadly as “anti-abuse” provisions.

Because Subchapter K creates a very general, flexible framework, these kinds of anti-abuse provisions are essential to making the pass-through system work.¹⁷ In addition, the interaction of Subchapter K and other substantive tax provisions, particularly loss limitation rules, raise a number of potential issues and questions that are hard for lawmakers to anticipate or address in detail.

This white paper divides anti-abuse provisions into two broad categories:

- **Specific Rules:** Rules that impose specific limitations, conditions, or exception.
- **General Rules:** Rules that look to whether the federal tax results correspond with more generalized standards, including the economic effect of the activities or transactions.

The ability of conforming states to rely on general federal anti-abuse rules to address state tax issues is not always clear. It may depend on both the federal rule and whether the effect on state tax is direct or indirect. This is especially true where the state tax effect is only indirectly related to the proper application of federal tax rules—as with the state sourcing of partnership income. To the extent a federal anti-abuse rule focuses on the federal tax result, it leaves doubts as to how the rule might apply to separate or indirect state tax effects. And even where the application has a direct effect on the state tax result, the application of a general anti-abuse rule in a particular circumstance may be unclear or not addressed by other guidance. Finally, to the extent a general anti-abuse rule or the application of such a rule is set out in IRS regulations where there has been no explicit delegation of congressional authority, it’s validity may be subject to challenge under *Loper Bright*.¹⁸

Therefore, this white paper makes two assumptions as to the categories of anti-abuse rules applicable to partnership taxation. But note, these assumptions are to assist states in considering what anti-abuse rules they might need to specifically adopt, and do not necessarily reflect the official position of the MTC or its member states.

Assumption: States can rely on rules imposing specific limits or exceptions.

Federal tax statutes may impose specific limits on particular tax treatment or provide a general rule along with a list of detailed exceptions, or they may explicitly delegate to the IRS the authority to issue necessary regulations for determining some tax effect. To the extent that states conform to the proper federal reporting and treatment of the related tax items, it is generally assumed that they can rely on these specific limitations for that determination, whether the limitations are found in statutes or related regulations.

A number of provisions contained in Subchapter K fall into this general category, for example:

- **IRC § 704(c)** – The general rule under § 704 allows partnerships to allocate partnership items of income in any amounts to which the partners have agreed, subject to certain limits. One such limit is the specific exception found in § 704(c) which requires that the built-in gain (loss) on contributed property be allocated to the partner that contributed that property in certain specific instances. This rule was enacted to prevent partnerships from being used to avoid tax on gains or shift losses between partners. The IRS has also issued regulations providing guidance on the application of this requirement. See IRS Reg. 1.704-3.

¹⁷ See, for example, Cunningham and Cunningham, *supra* fn. 7, pp. 65, and 161-163.

¹⁸ *Loper Bright Enterprises v. Raimondo*, 603 U.S. 369 (2024) which overturned the *Chevron* deference standard for review of federal regulations by federal courts.

- IRC § 705(b) – The rules for calculating a partner’s basis in their partnership interest are found in § 705. In subsection (b), Congress also provided the IRS with the explicit authority to “prescribe by regulations the circumstances under which the adjusted basis of a partner’s interest in a partnership may be determined by reference to his proportionate share of the adjusted basis of partnership property upon a termination of the partnership.” Those regulations are found in IRS Reg. 1.705-1.

Assumption: State reliance on more general federal anti-abuse rules may be limited.

Some federal anti-abuse rules do not impose specific limitations or exceptions but instead apply broader conditions or requirements, often tied to whether the particular federal tax results were clearly intended or whether they match the economic effects of the purported activities or transactions. Often, the specific application of these general rules is found in regulations, case law, or other guidance, but sometimes there is no guidance for application in a particular circumstance.

This white paper assumes that states that generally conform to the federal tax rules can rely on these anti-abuse rules where the state tax effect at issue is directly related to the federal tax treatment. But where the state tax effect is only indirectly related to the federal tax treatment, or is only one element of that treatment, as with sourcing of multistate income, reliance on federal anti-abuse rules may be limited.

In the partnership context, the important anti-abuse rules in this category include:

IRC § 7701(o) - general economic substance rule –

The general federal tax economic substance rule is set out in IRC § 7701(o). It requires that for the tax benefits of purported activities and transactions to be respected, they must also affect the economic position of the taxpayer “in a meaningful way” and have a “substantial purpose” apart from the “Federal income tax effects.” This general rule also provides: “any State or local income tax effect which is related to a Federal income tax effect shall be treated in the same manner as a Federal income tax effect.” That is, taxpayers cannot argue that transactions have a meaningful economic effect solely on the basis of the related state tax effects. But this raises two questions:

- What if, under this rule, the state tax effect is not “related to” a federal income tax effect? It could be argued, for example, that the effect of applying state sourcing rules to multistate income is not “related to” any particular federal tax effect, at least directly.
- What about other anti-abuse rules that reference federal tax effects generally but are silent as to how to treat the state tax effects? Would the assumption be that state taxes are an *economic* effect that might justify the federal treatment?

IRC § 482 – transfer-pricing rules –

As noted above, partners and their partnerships can engage in transactions which would be not be treated as between a partner and a partnership. See IRC § 707(a). Under IRC § 482, the IRS has the authority to re-distribute items of income among businesses owned or controlled directly or indirectly by the same interests in order “to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses.” This “transfer-pricing” authority may also be applied to partner-partnership transactions.¹⁹ In addition, there may be instances in which § 482 is relevant to transactions between a partner, acting as a partner, and the partnership.²⁰ In general, however, there is far less federal guidance for applying § 482 in the partnership context.

¹⁹ See IRS Reg. 1.482-1 (a)(1); *Dolose v. Commissioner*, 811 F.2d 543 (10th Cir. 1987); and *Aladdin Indus., Inc. v. Commissioner*, 41 T.C.M. (CCH) 1515, 1519 (1981).

²⁰ One example is found in IRS T.D. 9814, REG-127203-15, and Notice 2015-54 proposing to make an exception to the nonrecognition rule pursuant to the explicit authority granted under IRC § 721(c) and expressing the relationship of this exception to the authority granted in IRC § 482 to determine the value of contributed property involving related entities.

As has long been demonstrated in the context of state corporate income tax, related-entity transactions can have significant effects on the sourcing of multistate income, especially where corporations are allowed to file as separate entities even though fully integrated into a unitary business. Some states have explicitly granted their administrative agencies authority similar to § 482.²¹ Without this explicit authority, it is not always clear how states might apply the federal rules where the only potential effects would be on *state* taxes.²²

IRS Reg. § 1.701-2 – general partnership anti-abuse rule –

The IRS promulgated Reg. § 1.701-2 in 1995 after recognizing the need for a general rule to address abusive tax planning using complex partnership structures and transactions.²³ This general anti-abuse rule provides that “the tax consequences under subchapter K . . . must accurately reflect the partners’ economic agreement and clearly reflect the partner’s income . . .” The authority for this rule has been questioned, with one expert noting that when it was first proposed: “practitioners responded venomously, displaying a level of anger and outrage rarely seen in the tax world” and that it “remains controversial, drawing visceral reactions from scholars and practitioners alike.”²⁴ The regulation has been used sparingly over the years, but was recently raised in litigation involving a purported “disguised sale” involving the Chicago Cubs.²⁵

Like the economic substance provision of IRC § 7701(o), discussed above, the general partnership anti-abuse regulation’s reference to “tax consequences” may be interpreted as including only federal tax consequences. But unlike § 7701(o), it is not clear whether the economic results would exclude effect on state taxes. Therefore, while states might rely on this regulation in determining the proper federal tax result to which they conform, it is questionable whether they could necessarily rely if the state tax effect is only indirect, as with sourcing.

IRC § 704(b) – requirement for allocations to have substantial economic effect –

Unlike § 704(c) (discussed above), which sets out a specific limitation on the ability of partners to choose how to allocate partnership income, § 704(b) imposes a general requirement that the allocations of partnership items have “substantial economic effect.” This term has been defined by extensive regulations as applied in various different contexts and in conjunction with other rules of Subchapter K. See IRS Reg. 1.704-1(b). In general, the regulations provide that there must be a reasonable possibility that the allocation of distributive share will affect substantially the dollar amounts to be received by the partner “independent of tax consequences.” As with other similar anti-abuse rules, it is not clear that this rule would serve to limit allocations that have an effect on the partners’ *state* tax results but not their federal tax results.

IRC § 6222 – consistency requirement –

In addition to the substantive anti-abuse rules discussed above, the federal administrative provisions also require that partners report items consistently with the partnership’s own reported information. See IRC § 6222. Failure to do so is treated as a math error on the partner’s return for which tax can be summarily assessed. Application of this consistency requirement to purely state-related information is uncertain and some states have provided their own consistency requirement as part of state tax statutes or regulations.²⁶

²¹ See for example Ala. Code § 40-2A-17, Allocation, etc., of gross income, deductions, etc., between entities controlled by the same interests; improper contingent fees.

²² See *Utah State Tax Comm’n v. See’s Candies, Inc.*, 2018 UT 57, 435 P.3d 147.

²³ See, for example, *ACM Partnership v. Comm’r*, 73 T.C.M. (CCH) 2189, 1997 WL 93314 (1997), aff’d in part and rev’d in part, 157 F.3d 231 (3d Cir. 1998), cert. denied, 526 U.S. 1017 (1999) and Marvin A. Chirelstein & Lawrence A. Zelenak, Tax Shelters and the Search for a Silver Bullet, 105 COLUM. L. REV. 1939, 1949–50 (2005), at 1962 (“[E]conomic substance doctrine is simply too weak a barrier to protect the collection of income tax from assault by abusive shelter planners.”).

²⁴ Andrea Monroe, What’s in a Name: Can the Partnership Anti-Abuse Rule Really Stop Partnership Tax Abuse?, *Case Western Reserve Law Review*, Vol. 60, Winter 2010.

²⁵ *Tribune Media Co. v. Commissioner*, No. 23-1135 (7th Cir.) (pending on cross-appeals).

²⁶ See, for example, Oregon Administrative Code, 2020, OAR Section 150-314-0475, Consistent Treatment of Partnership Items.

States may need additional anti-abuse rules to prevent the use of partnerships to shift income..

The nature of the pass-through system combined with the need to source the income from multistate business activities means that states may need to develop specialized anti-abuse rules to prevent income shifting or other unintended consequences. States that have adopted the Uniform Division of Income for Tax Purposes Act (UDITPA) or some version of that act have general authority under Section 18 to address situations where the application of the standard sourcing rules does not reflect the taxpayer's activity in the state. The MTC and states have also adopted special rules for implementing this authority.

OVERARCHING STATE TAX IMPLICATIONS - Anti-abuse rules are discussed further in Section II. E. of this whitepaper. The important implications here are:

- **The pass-through system created by Subchapter K includes a general framework of rules and a number of provisions that make exceptions to or put limitations on those general rules.**
- **For states that conform, specific limitations will have the same effect on state taxes as on federal taxes, especially to the extent that the state tax effect is directly related to the federal tax effect.**
- **Some anti-abuse rules which make a general reference to the effect on federal taxes of certain activities or transactions may also have a direct effect on state taxes for conforming states, but it is less clear the extent to which state may rely on these rules where the federal tax and state tax treatment of income are only indirectly related—as with sourcing of multistate income.**
- **Review of the important federal anti-abuse rules may provide states with information they can use in adopting similar rules or making explicit their intention to apply such rules in the state tax context.**

I.E. General State Sourcing Rules for Income of Businesses

This section has substantial revisions and additions—including a section on throw-back/throw-out rules.

NOTE: In this section in particular, the rules discussed have been summarized in an attempt to focus on the most important elements of those rules. Certain generalizations may have nuances that are not addressed here, unless it is clear that they would be relevant to the issues to be addressed.

The federal tax law applies detailed rules of assignment when determining whether items of income and expense have a domestic or foreign source. See IRC Subchapter N. While states may also use rules of assignment, they generally source net business income using formulary apportionment. In general, formulary apportionment seeks to represent the business income generated within a state and has been upheld as constitutionally appropriate.²⁷

State apportionment rules have been developed largely in the context of taxable corporations and almost all of the litigation as to the constitutional limits of state apportionment rules has been conducted in that same context. While states tax resident individuals and corporations differently in one important respect, summarized below, they generally apply the same sourcing rules whether the income is from a business conducted as a corporation or a proprietorship.

And, as the research summarized in Section III below shows, states also apply these same general sourcing and apportionment rules to the income of businesses conducted by partnerships—often embedding any partnership-specific provisions in the rules for individual or corporate taxes. This reflects a partnership-focused approach, which can limit the ability of states to respond to the sourcing issues raised by the pass-through tax system.

This subsection I.E. gives a brief overview of how the state sourcing rules apply to corporations and individuals. Section II, below, will then address these partnership-specific issues in greater detail.

State Sourcing Rules – Generally

Introductory Notes:

- **References to UDITPA and Sales (Receipts) Factor Sourcing:**

The standard approach to apportioning business income used by states is based on a model law—Uniform Division of Income for Tax Purposes Act (UDITPA)—adopted by the predecessor to the Uniform Law Commission in 1957.²⁸ An amended version of UDITPA, adopting a market-based sourcing approach for the sales (receipts) factor,²⁹ was drafted by the MTC and recommended to the states—see [HERE](#). To the extent specific rules are relevant for this discussion, this summary will reference the rules under UDITPA.

- **Use of the Term “Taxpayer”:**

UDITPA uses the term “taxpayer” but does not define that term. The Multistate Tax Compact, into which UDITPA was incorporated, defines “taxpayer” as: “any corporation, *partnership*, firm, association, governmental unit or agency or person acting as a business entity in more than one State.”

²⁷ As the U.S. Supreme Court noted in responding to an amicus brief of the United Kingdom complaining that California’s worldwide combined filing requirement improperly taxed the income of foreign entities with no presence or direct contacts with the state, and therefore violated constitutional limitations: “. . . the theory underlying unitary taxation is that ‘certain intangible flows of value within the unitary group serve to link the various members together as if they were essentially a single entity.’ . . . Formulary apportionment of the income of a multijurisdictional (but unitary) business enterprise, if fairly done, taxes only the ‘income generated within a State.’” *Barclays Bank PLC v. Franchise Tax Bd. of California*, 512 U.S. 298, 338 (1994)

²⁸ Subchapter K was enacted by Congress in 1954. It is clear that the drafters of UDITPA did not fully contemplate the issues involved in applying UDITPA to partnership income taxed under the pass-through system.

²⁹ The drafters of the original UDITPA applied a method of sourcing receipts from transactions involving services and intangibles to the state that had the “predominant cost of performance” of the “income-producing” activities. This was, obviously, a difficult standard to apply and has only become more difficult and uncertain with the growth in the service and intangible sectors of the economy since the 1950’s. Moreover, in some cases it failed to achieve the purpose of the sales (receipts) factor—which was to represent the market-state’s involvement in the production of business income.

(Multistate Tax Compact, Art. II.3.) Similarly, non-compact-member states use formulary apportionment generally based on UDITPA and make the rules applicable to businesses taxed on a pass-through basis. (See Section III.) In addition, states may apply the rules to separate entities or to combined groups of corporations. So the summary below may use the term “person” rather than “taxpayer” to avoid confusion.

General State Sourcing Approach

Step One: Identify the Nonbusiness (Non-apportionable) Items:

The first step in sourcing multistate income is to identify any nonbusiness (non-apportionable) items of income and related expense. In general, this is done by applying both constitutional precedent and statutory rules that seek to embody that precedent.

The original UDITPA Sec. 1.(a) provided that business income means:

“income arising from transactions and activity in the regular course of the taxpayer’s [person’s] trade or business and includes income from tangible and intangible property if the acquisition, management and disposition of the property constitute integral parts of the taxpayer’s [person’s] regular trade or business operations.”

State courts were divided over whether this definition included two separate tests. The revised version of UDITPA in the model Compact recommended to the states clarified this issue and changed the term to “apportionable” income, providing the following definition:

“Apportionable income” means:

(i) all income that is apportionable under the Constitution of the United States and is not allocated under the laws of this state, including:

(A) income arising from transactions and activity in the regular course of the taxpayer’s trade or business, and

(B) income arising from tangible and intangible property if the acquisition, management, employment, development or disposition of the property is or was related to the operation of the taxpayer’s trade or business; and

(ii) any income that would be allocable to this state under the Constitution of the United States, but that is apportioned rather than allocated pursuant to the laws of this state.

As these definitions both show, the critical issue is the relationship between the specific activity generating the item of income and the larger trade or business being conducted.

This, in turn, raises the constitutional concept of a “unitary business,” which, although not referenced by UDITPA, has become critical in setting a limit on the ability of states to include items in the net income base to which a single apportionment formula may be applied. Further discussion and information on the application of the unitary business principle to the taxation of partnership income is included in Sections II and III below.

The unitary business principle is often cited in the context of combining taxable corporations. (See the subsection on corporations below.) But when it comes to applying the unitary business principle for the purpose of identifying nonbusiness (non-apportionable) items, there are two points to keep in mind:

- *A Single Entity or Taxpayer Can Have Multiple Unitary Businesses:*

A single taxpayer or person may be engaged in activities generating income or expense that are related to multiple unitary businesses. In such cases, states generally recognize that certain items of the taxpayer’s income may be part of the net apportionable income of one business (and subject to formulary apportionment using factors related to that

business) whereas other items of the taxpayer's income would be part of another business (and subject to formulary apportionment using the factors for that business).³⁰

The implication for identifying items of nonbusiness (non-apportionable) income is this: Just because an item of income may not be part of the unitary business to which one apportionment formula would apply, does not mean that it is nonbusiness (non-apportionable) income. Rather, it may be subject to apportionment using a separate apportionment formula.

- *States May Apportion Less than 100% of the Income of the Unitary Business:*

There is no requirement that, in order for states to apply formulary apportionment, they must only do so to the entire net income of a unitary business. Rather, states regularly apply formulary apportionment to a portion of the income generated by a unitary business. For example, a minority of states allow corporations that are part of a single unitary business to apportion their income separately. And most states that require combined filing for corporations will exclude foreign entities even when they are part of the unitary business. These approaches will necessarily exclude part of the unitary business's income. (This is discussed further in the subsection on corporations below.)

The implication for identifying items of nonbusiness (non-apportionable) income is this: Just because a state applies an apportionment formula using factors related to part of the income of the unitary business does not mean that all the other related income is nonbusiness (non-apportionable) or must be sourced using rules of assignment.

And these implications are especially important when identifying items of nonbusiness (non-apportionable) income in the partnership context.

Step Two: Source the Nonbusiness (Non-apportionable) Items Using Rules of Assignment:

Once items of nonbusiness (non-apportionable) income have been identified, states apply rules of assignment to source those items. These rules generally look to the character of or the type of income (i.e., interest, royalties, gains from sales of real property, etc.). Certain items, including nonbusiness interest, dividends, and certain capital gains from sales of intangible property may be sourced to the person's commercial domicile. The expenses related to any items of income are also generally assigned to the state where that income would be assigned.

Also note that UDITPA—whether in its original form or in the revised form recommended by the MTC—does not appear to recognize the possibility that a partner's distributive share income from a partnership might be nonbusiness (non-apportionable) income nor do the rules for assigning nonbusiness (non-apportionable) income specifically provide rules for distributive share income. Therefore, to the extent that the distributive share income of a partnership is non-business (non-apportionable) income to the partnership, it is up to the states to provide the manner in which that income would be sourced.

Step Three: Determine the Net Business (Apportionable) Income to which an Apportionment Formula will be Applied:

³⁰ See Hellerstein supra fn. 4, ¶8.09: "It is established law and practice that separate businesses may not be included in an overall apportionment applied to a single corporation or to a group of affiliated corporations on a combined basis. The point is essentially definitional—if a business is "separate" it is not part of the "unit" that constitutes the enterprise whose tax base is apportionable. The point also reflects bedrock constitutional doctrine. As the U.S. Supreme Court observed in *Mobil*, "unrelated business activity" that constitutes a "discrete business enterprise" falls outside the definition of a unitary business. It is therefore understandable why state courts have often approached unitary business controversies in terms of whether a branch or subsidiary is engaged in a "separate business" from the rest of the enterprise." Also noting that: "The Multistate Tax Commission's (MTC's) apportionment and allocation regulations, which many states have adopted, also reflect this approach. The regulations recognize that a taxpayer may have more than one trade or business. MTC Reg. IV.1.(b)(1)(C) (as of July 25, 2018), . . . In such cases, it is necessary to determine the apportionable income attributable to each separate unitary business. . . . The income thus determined "is then apportioned by an apportionment formula that takes into consideration the in-state and out-of-state factors that relate to the respective unitary business whose income of is being apportioned."

As noted in Step One above, states have significant flexibility in determining the parameters of the activity to include in the net income subject to apportionment by a single formula, limited only by the general constitutional requirement that there be a sufficient relationship between the items of income to be included in the apportionable base and the factors of the formula used to apportion that base.³¹

States, therefore, need not apply a single apportionment formula to the entire net business (apportionable) income of a unitary business. Rather, they may limit the income and factors included to those derived from the activities of a single taxable entity or person or to certain members of a group of entities conducting a unitary businesses—provided that the apportionment factor used represents the activities of that entity or group and its portion of the unitary business's net income. And as noted above, states have also long recognized that a single taxable entity may be engaged in more than one unitary business—to which separate apportionment factors should be applied.

In short, the determination of the apportionable base used by the state—the unitary business's net income or the portion of that income to be taxed to a particular entity, person, or group—will also determine the factors to include in the formula. For example, assume State A allows corporate taxpayers to file separately. The unitary business in which one corporation is engaged may, therefore, also include activities and income of other corporations which will each source their own income separately. For each of those entities, the net apportionable income and the apportionment formula would be computed based on the particular entity's own activities and direct income.

Step Four: Determine and Source the Proper Apportionment Factors:

The apportionment formula is the ratio of certain factors (e.g., receipts, property, and/or payroll) related to the net business (apportionable) income and located in the state divided by the total of those factors located everywhere. The computation and sourcing of the apportionment factors varies somewhat by state.

Today most states use a single sales or receipts factor formula.³² A minority use a three-factor formula. Also the majority of states now source receipts from all activities to the location of the customer or the market. A minority of states source receipts other than receipts from sales of tangible personal property based on the location of the predominant cost-of-performance of the income producing activities.

Approximately half of the states will also apply so-called “throw-back” or “throw-out” rules.

³¹ See *Butler Bros. v. McColgan*, 315 U.S. 501, 509 (1942) Where the U.S. Supreme Court found in favor of the state's use of its formula saying “no showing has been made that income unconnected with the unitary business has been used in the formula.” See also *Container Corp. of America v. Franchise Tax Bd.*, 463 U.S. 159, 170 (1983), where the Court said: The first, and again obvious, component of fairness in an apportionment formula is what might be called internal consistency . . . The second and more difficult requirement is what might be called external consistency--the factor or factors used in the apportionment formula must actually reflect a reasonable sense of how income is generated.”

³² Some have criticized the use of a single sales (receipts) factor, but the U.S. Supreme Court has long accepted that sales activity in a state is a fair representation of the share of profits earned by a business. See *Bass, Ratcliff & Gretton, Ltd. v. State Tax Comm'n* where the court said: “So in the present case we are of opinion that, as the Company carried on the unitary business of manufacturing and selling ale, in which its profits were earned by a series of transactions beginning with the manufacture in England and ending in sales in New York and other places--*the process of manufacturing resulting in no profits until it ends in sales*--the State was justified in attributing to New York a just proportion of the profits earned by the Company from such unitary business.” 266 U.S. 271, 282 (1924)(emphasis added).

In addition, the property and payroll factors will apply differently to different businesses. The property factor has never included intangible property—nor would it be feasible to do so given that it would require valuing intangible property (prior to its sale), which businesses typically do not do for financial or tax purposes (because of the difficulty), and then locating that intangible property in a particular state—something that would also be exceedingly difficult if not impossible. So an apportionment formula which includes a property factor will treat those businesses dependent on physical property very differently from those that depend much more on intangible property. And while the payroll factor may be useful in determining where income of a service businesses is generated—in the modern economy and in other sectors where product development occurs over time, the payroll expense incurred in a particular tax year may not be directly related to income generated in that same year.

- Throw-back rules require receipts from sales of tangible personal property that are sourced to a state where the person is not “taxable” to be “thrown back,” that is, sourced to the state from which those sales originated.
- Throw-out rules require receipts other than from sales of tangible personal property to be “thrown out”, that is, removed entirely from the receipts factor if the person is not taxable in the source-state or if that source-state cannot be determined.

Whether the person is “taxable” in a state is generally dependent upon whether the state could, constitutionally, impose tax, not whether it does. (See further discussion of these rules below.)

Step Five: Compute State Sourced Income:

Finally, the apportionment formula(s) are applied to the net business (apportionable) income base(s) to determine the state apportioned income. That amount is then combined with any nonbusiness (non-apportionable) income sourced to the state.

Application of Throw-Back or Throw-Out Rules & P.L. 86-272

As noted above, about half of the states have throw-back and/or throw-out rules. Under these rules, the question is whether the taxpayer is “taxable” in the state to which the sales (receipts) would be sourced. In general—“taxable” means that the state in question has the authority to impose tax, whether or not it does so. State authority to tax may be limited by constitutional principles or federal statutory law, particularly P.L. 86-272. That federal law provides that states may not impose “a net income tax on the income derived within such State by any person from interstate commerce if the only business activities within such State by or on behalf of such person” are certain limited activities.

States with throw-back/throw-out rules will therefore apply P.L. 86-272’s protections to determine if a person selling into another state is “taxable” in that state. And, importantly, the state must also apply the protections consistently with the way in which it would apply the same protections when determining if an out-of-state businesses selling into that state would be protected from tax. So if the state would assert that, under particular facts and circumstances, an out-of-state business selling into the state is not protected by P.L. 86-272, then it must be consistent in determining whether an instate business selling into another state is “taxable” in that state.

This, in turn, has affected the application of throw-back/throw-out rules to combined groups of corporate entities. Under one combined filing method, typically referred to as the “Joyce” method, each separate corporate entity is generally defined as a taxpayer. In this context, states will also typically apply throw-back and throw-out rules based on whether the entity itself would be “taxable” in the state to which the sales (receipts) would be sourced, based solely on that entity’s activities. In other words—the state would treat each entity as the person on which tax is imposed and which is deriving the income under P.L. 86-272.

In contrast, some states have applied a different method, typically referred to as the “Finnigan” method. Under that method, the state will generally treat the combined group as the taxpayer. As a result, throw-back and throw-out rules are generally applied based on whether the group as a whole would be taxable in the state to which the sales (receipts) would be sourced, based on the activities of the group. In other words—the state would treat the group as the person on which tax is imposed and which is deriving income under P.L. 86-272.

But when it comes to the application of throw-back or throw-out rules to activities conducted by partnerships, the question is somewhat distinct. First, to the extent states conform to Subchapter K, no tax is imposed on the partnership. IRC § 701. Therefore, the partnership cannot be the “person” to which P.L. 86-272 refers. But more importantly, under Subchapter K, the partners are treated as if they realized their partnership distributive share “directly from the source from which [it is] realized by the partnership, or incurred in the same manner as incurred by the partnership.” IRC § 702(b). Therefore, if either the partner’s own activities or the activities of the partnership properly attributed to it exceed the protections of P.L. 86-272, the partner would be “taxable” in the state.

This is generally consistent with *Arizona Dept. of Revenue v. Central Newspapers, Inc.*, 222 Ariz. 626, 218 P.3d 1083 (App. Div. 1 2009), which is one of the only reported cases to address application of P.L. 86-272 to partnerships. There, the Arizona appeals court considered a case in which corporations who filed as part of a consolidated return were partners in a partnership making sales into the state. The taxpayer argued that no share of the partnership’s Arizona sales could be included in the group’s apportionment factor because the partnership’s activities in the state were protected under P.L. 86-272. It also argued that P.L. 86-272 effectively “exempted” the partnership’s income. The court, however, found that it is the partners, or in this case the consolidated group, that was responsible for paying tax on the partnership’s distributive share income and was therefore the “person” to which P.L. 86-272’s rules were applicable. And since the activities of the group (including certain partners) exceeded the protections, the share of the partnership’s in-state sales (receipts) could be properly included in the state tax return.³³

Subsection I.F. below further addresses how the attribution principle affects state taxation of partnerships.

Application of State Sourcing Methods – Taxable Corporations

Corporations, unlike partnerships, are taxable at the entity level. Therefore, separate corporate entities can be combined for tax purposes, even though the common ownership of entities within that group may be less than 100%. Because tax is paid at the entity level, there will be no need for the other owners of those entities to file or pay tax separately.

Because corporations can simply be combined for tax purposes, the portion of the unitary net business income that is apportioned may differ—and the manner in which the formula is computed may also differ. The following methods are currently used by states:

- **Separate Entity Filing**: States that allow separate filing will allow a corporate entity that has income which is part of the unitary business (apportionable) income earned by related entities to file separately—as a single taxpayer—reporting only that entity’s own direct income from its activities and apportioning by a formula including only its own factors related to that income.
- **The “Joyce” Method**: Under the so-called “Joyce” method, each entity filing as part of a combined return is still considered to be a separate taxpayer. The return may not include all corporations that are engaged in the unitary business (e.g., certain entities engaged in foreign activities). The entities included will combine their business (apportionable) income from the same unitary business and each member of the group will use an apportionment formula that divides that entity’s in-state factors by the group’s total factors everywhere. The sum of the in-state apportioned income of all the entities is the total state-apportioned income for the group. The entities would also source nonbusiness (non-apportionable) income based on the character and rules for assignment.
- **The “Finnigan” Method**: Under the so-called “Finnigan” method, it is the group that is generally defined as the taxpayer. So under Finnigan, certain entities engaged in the unitary business (again, excluding foreign entities in most cases) will combine both their net unitary business (apportionable) income and their apportionment factors related to that income. The combined income will then be apportioned using the group’s formula.

³³ The provisions of P.L. 86-272 have long been vague and ambiguous—creating risks for taxpayers and difficulties for state tax administrators in ensuring that the rules are applied equitably, especially as business activities have changed over time. Only the U.S. Supreme Court can tell taxpayers and administrators what the language of the statute means, definitively, or how it should be applied to various facts and circumstances. But litigation over the law’s provisions has been very limited—which is not surprising given how expensive it is to litigate a case all the way to the Supreme Court (assuming the Court would even take that case). Rather than subjecting taxpayers to the inherent uncertainty and related risk that the federal law poses, the MTC has recommended to states that they be explicit in their interpretation and application of its provisions and also provide a much clearer bright-line standard for businesses using a factor-presence approach. See the MTC’s recommended Statement of Information Concerning P.L. 86-272 – here: <https://www.mtc.gov/wp-content/uploads/2023/04/025-MTC-Statement-on-PL-86-272.pdf> as well as the MTC’s model factor-presence nexus standard – here: <https://www.mtc.gov/wp-content/uploads/MTCImages&Files/MTC/media/AUR/Factor-Presence.pdf>.

- **Federal Consolidated:** States may also allow corporate groups to file a state return including the same entities that are included in the federal consolidated return and apportioning the net consolidated income using an apportionment formula for the group with factors related to that income. Under this method, the net income apportioned may include income that is not part of the unitary business conducted by members of the group.

These commonly used filing methods for taxable corporations reflect the constitutional principle that in order for states require combined reporting of business (apportionable) net income to which a single apportionment factor will be applied, they must show that the items of income and expense to be included in that combined base is part of the same “unitary business” to which the apportionment factors are related.

But note, even if a corporate entity is engaged in a unitary business with other entities, states may allow that entity to file separately or may require certain entities to file a combined return excluding other entities engaged in the unitary business. In these cases, if there were a challenge to whether this approach is in line with the constitutional standard, the question would be whether the result is significantly more or less than if the entire unitary business net income were apportioned using the factors related to that business.

And, as noted in the summary of state sourcing rules above, an entity or group may have one or more businesses giving rise to income that may be netted and apportioned using separate apportionment formulas for each business. The determination of what activities are part of a particular unitary business for which a separate apportionment formula may be used is by applying the same general unitary business principle³⁴ and other state sourcing rules.

The unitary business principle will be discussed further in Section II below.

Application of State Sourcing Methods – Proprietorships

The primary difference between state taxation of corporations and individuals is that states generally tax resident individuals on 100% of their income and provide a credit for taxes paid to other states on that same income. So when it comes to business conducted by proprietorships—the following general approach is applied:

Nonresident Individuals

The nonresident individual would be taxed only on their state-sourced income applying the same general rules that are applied to corporations.

Resident Individuals

The resident individual would report 100% of their income and compute the state tax on that income. They would then be entitled to a credit for taxes paid to other states on the same income (as a nonresident). This credit is generally limited to the tax that would be owed using the resident-state’s tax rate and sourcing rules.

Application of State Sourcing Methods – Simple Partnerships

This section is based on research of existing state rules which is included in detail in Section III. States typically apply the same sourcing approaches to the income of businesses conducted by partnerships as they do to businesses conducted by individuals and corporations.

The following summarizes how these rules are generally applied in a simple, single-tiered structure with only non-resident individual partners:

1. The business(es) of the partnership are identified based on evaluating that entity’s activities.

³⁴ See Hellerstein, supra fn. 4, ¶8.09.

2. The rules for determining any non-apportionable income or items are applied at the entity level, based on partnership activities.
3. The rules of assignment are applied to the non-apportionable income or items to source those items.
4. The apportionable net taxable income to be attributed to the business(es) of the partnership is computed based on the character of the items determined at the entity level.
5. The apportionment formula(s) for the income of the business(es) of the partnership is determined by applying the state's general rules for determining and locating the factors.
6. The apportionment formula is applied to the apportionable net income of the related business to source that income and items.
7. The partners' shares of all state-sourced income and items are determined based on the partners' shares of those items under the federal rules. So, for example:
 - Partnership has \$1 million of ordinary income.
 - Partner is allocated 20% of the partnership's ordinary income for federal tax purposes.
 - Partnership apportions 40% of that ordinary income to State A
 - Partner's State A income is $20\% \times 40\% \times \$1 \text{ million} = \$80,000$.
8. Partners report their shares of state-sourced income and items on their individual tax returns—retaining the state source information and character of those items.

Section II of this white paper expands further on the application of state sourcing rules to complex partnership structures, including the use of “blended apportionment,” as well as the potential effects of special or mandatory allocations and related-entity transactions.

OVERARCHING STATE TAX IMPLICATIONS – States generally use consistent sourcing rules for income earned by businesses, whether the business is conducted by a corporation, individual, or partnership.

- The use of these general sourcing rules may have the advantage of putting different forms of business on the same level playing field—even though there may be some differences due to the use of “pure” apportionment for corporations versus the credit system used for resident individuals.
- In order for the rules to be applied properly in the case of businesses conducted by partnerships, certain sourcing-related determinations must be made by the partnership based on its own activities and that information must be provided to the partners.
- The unitary business principle may be implicated where the partnership engages in multiple businesses or where a partner and a partnership are engaged in or contributing to the same unitary business.
- States may want to clarify the types of determinations made at the partnership level or the kinds of information the partnership must provide to partners so that income can be sourced properly.
- **In particular, the application of throw-back and throw-out rules to partnerships should be clarified by states.**

I.F. Importance of the Attribution or “Conduit” Principle

When discussing partnerships two different theories—aggregate and entity—are often cited. As noted in subsection I.B. above, however, it is not possible to say one of these theories is necessarily controlling. Moreover, today, even the rules governing traditional partnerships have evolved so that they are based more in the entity theory than was true originally. Similarly, under the federal pass-through tax system, partnerships are sometimes treated as aggregates and sometimes as entities. This white paper therefore proposes that it is more useful to consider the fundamental principle underpinning the pass-through tax system, that is—the attribution or “conduit” principle.

Why the Attribution or “Conduit” Principle is Critical

The partnership pass-through system has been explained by experts as representing a kind of balancing of four important goals:

1. Achieving a single level of tax on the income,
2. Avoiding the unrestricted deferral of tax liability until income is distributed,
3. Retaining consistent substantive tax treatment of various items of partnership income, expense, gain, and loss under the rules that would apply to those items if recognized directly by individual or corporate taxpayers, and
4. Preventing the use of partnerships and the pass-through rules to change the tax results in unintended ways.³⁵

Achievement of these goals benefits taxpayers.

The partnership form of business and the pass-through system under which partnerships are taxed provides substantial benefits for partners. First, there is a single level of tax on the income generated. Second, there is the potential to offset income and loss from different sources, subject to certain limitations under the substantive tax rules. Then there is the treatment of partners’ shares of partnership income according to the partners’ own attributes—including their effective tax rates. And finally, there is the wide latitude given to partners as to how they share the economic and tax effects of different items, as provided under IRC § 704.

This system depends on the attribution principle.

The proper working of this pass-through system depends entirely on the attribution principle—also sometimes referred to as the “conduit” principle. That is, activities of the partnership and the tax effect of those activities on items of income—their tax character—are attributed from the partnership to the partners as part of their distributive share of those items. This is also what prevents partnerships from being used to, effectively, change the basic tax treatment of those items.

How Attribution Works in Practice

The pass-through system achieves attribution through the following framework (discussed in greater length in previous subsections):

- Partnerships determine the character of their taxable activities and any resulting tax items that may affect calculation of tax. IRC § 703.
- The character of the items is attributed along with the share of the items to the direct and indirect³⁶ partners. IRC §§ 702 and 704.
- Partners report their share of items, treating them consistently with the character as determined by the partnership, when calculating their own tax.³⁷

³⁵ See Cunningham, *supra* fn. 7, generally and pp. 19-21.

³⁶ See, for example, IRS Reg. § 1.704-3(a)(10).

³⁷ See IRC § 702(b) and rules for taking an inconsistent position under IRC § 6222 and related regulations as well as IRS Form 8082.

Federal Recognition of the Attribution Principle

In 2024, the U.S. Supreme Court handed down its decision in *Moore v. United States*,³⁸ which discussed the attribution principle at length, acknowledging that it had long been applied to partnership taxation. The Moores argued that they could not be taxed on income of a foreign corporation in which they were minority shareholders because the income had not actually been distributed to them, thus violating the Sixteenth Amendment which effectively recognizes the Art. I limit on Congress’s taxing authority. The Court rejected this argument along with the Moores’ attempt to distinguish the taxation of partnerships on the basis that partnerships are aggregates rather than entities—noting that this was not entirely true even for traditional partnerships.

In *Moore*, the Court noted that long-standing precedent has established that, regardless of how general state law might treat partnerships, lawmakers could choose how to tax the income of such “joint enterprises,” either at the entity level or at the level of the owners.³⁹ (It also found the same principle applied to corporations.) The Court also noted that states have, in the past, imposed taxes directly on partnership entities.⁴⁰

While *Moore* was concerned primarily with the Sixteenth Amendment, which does not apply to the states, it also touched on due process, saying: “To be clear, as we indicated earlier, the Due Process Clause proscribes arbitrary attribution,” citing footnote 4 where it noted: “The Government acknowledges that there are due process limits on attribution to ensure that the attribution is not arbitrary—for example, limits based on the taxpayer’s relationship to the underlying income” and also noting that the Moores had not raised such an arbitrary attribution issue in the case.⁴¹

The *Moore* case came about, as the Court noted, “as part of the complicated transition [of the federal government] to a more territorial system.” So, it can be argued, what was attributed to the Moores was not just the income but the character and source of the income as determined under the substantive rules set out in IRC §§ 965(a), (c), (d).⁴²

Attribution of an Item’s Domestic or Foreign Source

Federal sourcing rules have long depended on the characterization of items of income. When the items are earned or incurred by a partnership, that character is determined at the partnership level under IRC § 703 and the attribution of that tax character to partners under IRC § 702(b) determines how federal sourcing rules are generally applied to those items. This application of the attribution principle is also made explicit in the federal sourcing rules themselves. For example, IRC § 875 provides that: “a nonresident alien individual or foreign corporation shall be considered as being engaged in a trade or business within the United States if the partnership of which such individual or corporation is a member is so engaged.” In addition, the provisions of IRC §§ 897(c)(4)(B) and 958(a)(2) make clear that the federal rules for sourcing gains or losses from sale of real property or stock treat the assets held by a partnership as held proportionately by its partners.

Attribution Principle in the State Tax Context

To the extent that states conform to the federal IRC and to Subchapter K when imposing tax on partnership income, the attribution principle will also apply to determine the federal tax character of items which may affect the state tax treatment. (See further discussion of state conformity in subsection I.D. above.) However, as with anti-abuse rules, discussed above, it can be difficult to determine how the attribution principle applies when the question is the state tax character of items.

³⁸ 602 U.S. 572 (2024).

³⁹ *Moore*, at 585.

⁴⁰ *Id.*, at 594.

⁴¹ *Id.*, at 599.

⁴² *Id.*, at 580.

The attribution principle may apply generally in the state tax context.

An example of applying the attribution principle in a strictly state tax context is the decision of the Connecticut Supreme Court in *Bell Atl. NYNEX Mobile, Inc. v. Comm'r of Revenue Servs.*, 273 Conn. 240, 869 A.2d 611 (2005), where the court grappled with the question of attribution in a case involving a state tax credit for municipal taxes and whether that tax credit could be attributed to the corporate partners. There, the court explained:

Although we disagree that our precedents denote the general incorporation of federal tax principles into our state tax statutes, we conclude that the corporation business tax does incorporate the federal conduit treatment of partnership tax attributes through the adoption of the federal income tax definition of 'gross income.'

...

"That concept of 'gross income,' in turn, incorporates the conduit treatment of partnership tax attributes. In the Internal Revenue Code, 'gross income' includes income derived from a '[d]istributive share of partnership gross income. . . .' 26 U.S.C. 61 (a) (13). Section 702 (c) of the Internal Revenue Code further specifies that '[i]n any case where it is necessary to determine the gross income of a partner for purposes of this title, such amount shall include his distributive share of the gross income of the partnership.' 26 U.S.C. 702 (c). Consequently, in a partnership situation, the character of those items constituting a partner's distributive share of the partnership's gross income provides essential context to the concept of a partner's gross income. Section 702 (b) of the Internal Revenue Code provides that "[t]he character of any item of income, gain, loss, deduction, or credit included in a partner's distributive share . . . 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." 26 U.S.C. 702 (b). This provision results in the conduit treatment of partnership tax attributes in the federal tax code. . . . Thus, the incorporation of the federal conduit treatment of partnership tax attributes necessarily follows from the conclusion that the [state] corporation business tax incorporates the federal income tax concept of 'gross income.'

This treatment of partnership tax attributes agrees not only with the federal approach but with the approach of most other states. . . . II J. Hellerstein & W. Hellerstein, *State Taxation* (3d Ed. 2003) 20.08, p. 20-134.

Establishing that corporation business tax attributes pass through the partnership to the partners with the same character that they had at the partnership level, however, does not suffice to establish that [the partnership's] payment of the municipal property tax resulted in a credit that can be attributed to the partners. Under the conduit approach, "the character of [the tax attribute] is determined at the entity or partnership level before the item is passed through to the partners." . . . In the present case, [the partnership's] payment of the municipal property tax was just that, a payment, not a tax credit. Not every action taken by the partnership passes through to the partners as if they performed the act. "

What this case demonstrates is that while the character of items may be attributed from the partnership to the partners, whether or not the partners will therefore qualify for certain state tax treatment will also depend on the specific treatment in question.

Interaction of the attribution principle and the unitary business principle.

In the context of sourcing multistate income, states have long looked to the unitary business principle as setting limits on when income can be included in the apportionable income that will be apportioned using the taxpayer's apportionment factors. Cases raising the attribution principle in the context of state sourcing are far less common. Two cases summarized below demonstrate how states may grapple with the interaction between the attribution principle and the unitary business principle.

Albertson's

In *Albertson's, Inc. v. State, Dept. of Revenue*, 683 P.2d 846, 854 (Idaho 1984), the Idaho Supreme Court addressed the difference between the conduit principle and the unitary business principle in a case where the taxpayer argued partnership income could not be included in the taxpayer's combined return. There the court noted:

Accordingly, the trial court erred in its conclusion that "Albertson's, Inc. and Texas-Albertson's should not be considered unitary." Although the opinion of the trial court reflects that it understood and utilized the principles set forth above for ascertaining the existence of a unitary business operation, it reached an inappropriate result by virtue of its attempt to apply those principles as between Albertson's and the Skaggs-Albertson's partnership instead of between Albertson's, Inc. and Texas-Albertson's.

...

The tax treatment of partnerships is explained in Bittker & Eustice, *Federal Income Taxation of Corporations and Shareholders*, Section 1.07, p. 1-26 (4th Ed. 1979).

'Partnerships are not taxed as such (§ 701), but each partner is taxed on his share of the firm's income, whether it is distributed to him or not. Under the prevailing conduit theory, the character of such items as ordinary income, capital gains and losses, charitable contributions, tax exempt interests, etc., carries over to the partner (§ 702).'

Idaho Code § 63-3002 provides in part:

'Declaration of Intent.--It is the intent of the legislature by the adoption of this act, insofar as possible to make the provisions of the Idaho act identical to the provisions of the Federal Internal Revenue Code relating to the measurement of taxable income, ... by the application of the various provisions of the Federal Internal Revenue Code relating to ... taxation of trusts, estates, partnerships and corporations...'

The Tax Commission has never attempted to combine the Skaggs-Albertson's partnership with Albertson's, Inc. under the unitary principle. Only the wholly-owned subsidiary corporation was included in the Commission's combination. This is evidenced by the explanation of items contained in the Notice of Deficiency Determination and by the decision of the Tax Commission. The Tax Commission did not combine the partnership with Albertson's and include the partnership's income with Albertson's. The Tax Commission assigned Texas-Albertson's distributive share (50%) of the Partnership's income, deductions, and apportionment factors to Texas-Albertson's and this share of the income belonging to Texas-Albertson's was combined with Albertson's income, and apportioned under the UDITPA formula in order to accurately reflect Albertson's income in Idaho. The result thus reached is exactly what Albertson's would have paid in Idaho taxes had the subsidiary never been formed.

Or, to paraphrase the court, attribution is not the same as combination. And, moreover, the unitary business principle does not determine when attribution applies.

FJ Management

In the more recent case of *Virginia Dep't of Taxation v. FJ management Inc.*,⁴³ the court reached a different conclusion. There, the question was which of two methods of sourcing a partner's distributive share income should be applied: (1) allocation at the partner level using rules of assignment for non-apportionable income for that state—so that the income would be sourced the partner's domicile, or (2) inclusion in the partner's own apportionable income along with

⁴³ No. 0701-23-2 (Va. Ct. App., Nov. 12, 2024)(currently on appeal to the Virginia Supreme Court).

inclusion of a share of the partnership's factors in the partner's apportionment formula—blended apportionment. There was no argument made by the state that the income might be separately apportioned at the partnership level, attributing that sourcing of the income to the partner along with its distributive share. The Court agreed with the taxpayer that blended apportionment could not be used unless there was a unitary relationship and rejected the argument that the “business characteristics” of the partnership could be attributed to the partner.

The Court looked at the traditional elements of the unitary business principle as applied to entities: functional integration, centralized management, and economies of scale. The Court also noted there was no evidence in the record suggesting that the corporate partner used the income it earned from the partnership as part of its own working capital or for any other operational purpose. The Court rejected the argument that the state could treat the partnership and its partner as a unitary business for tax-apportionment purposes simply because the partner took an active role in the partnership. The Court also rejected the argument that the attribution principle embodied in state law was sufficient to support the use of blended apportionment. That law—Code § 58.1-391(B)—provides:

Each item of pass-through entity income, gain, loss or deduction shall have the same character for an owner under this chapter as for federal income tax purposes. Where an item is not characterized for federal income tax purposes, it shall have the same character for an owner as if realized directly from the source from which realized by the pass-through entity or incurred in the same manner by the pass-through entity.

The court distinguished what it called the character of the items of partnership income from the “business characteristics” of the entity itself, concluding that the statute does not require the owners of a pass-through entity to be treated as conducting the business operations of the pass-through entity as part of a unitary business.

As noted, this case did not address whether the partnership income could be sourced using separate apportionment at the partnership level using only the partnership's factors, with that sourcing information then attributed to the partner.

The possible application of the unitary business principle to the sourcing of partnership income and the use of blended apportionment is discussed further in this white paper.

Significance of the Attribution Principle to Sourcing of Income

Sourcing of income is done both under federal tax rules, to distinguish domestic and foreign-source income, and again under state tax rules when sourcing multistate income. The federal and state rules differ somewhat, but the character of the items and the activities giving rise to them matter under both sets of rules.

Federal Sourcing Rules and Attribution

The federal sourcing rules differ somewhat depending on whether the taxpayer is a corporation or individual and whether they are considered domestic (U.S.) or foreign. In general, the rules for U.S. individuals (or those taxed as individuals) tend more towards worldwide taxation of income with a credit for foreign taxes paid (assuming the income taxed by the foreign jurisdiction is properly sourced under applicable treaties), whereas the rules for corporations tend more towards source-based (territorial) taxation using rules of assignment for items of income. But there is substantial variation.⁴⁴

What is important for purposes of this white paper is that, as with income taxes generally, the ultimate tax result is a combination of the character of the activities and the particular item

⁴⁴ For example, IRC § 951A imposes tax on global intangible low-taxed income of corporations with a partial credit for foreign taxes paid.

income or expense to which they give rise as well as the taxpayer's own attributes. For purposes of this white paper we will refer to these two categories as:

- Taxpayer characteristics – which includes whether the taxpayer is an individual or corporation (or other entity that may have some effect on sourcing), U.S. or foreign person, etc. and also any characteristics that the taxpayer has, standing alone, separate from the items of income on which the taxpayer reports tax.
- Income characteristics – which includes the activities that give rise to items of income or expense including how and where those activities are conducted, and the nature of the income or expense themselves under the applicable tax rules (e.g., taxable or exempt; deductible, nondeductible, or capitalized and depreciated or amortized, etc.).

When the nature or character of the income is important to the federal tax sourcing regime—that is where tax is imposed on a source-basis (territorial approach) or when determining the ability of a taxpayer to take a credit for foreign taxes paid—the federal government generally uses rules of assignment to establish the source of the different items. See IRC Subchapter N.⁴⁵ Again, in determining the ultimate source, the taxpayer characteristic may also be taken into account. But, by-and large, the rules look to the income characteristics and the activities that gave rise to the income or expense as well as its treatment generally under the substantive tax rules.

States generally conform to the determination of whether income, including partnership income, is domestic or foreign-sourced. Consequently, if a foreign national has partnership income that, for federal tax purposes, would be sourced to the U.S.—because the partnership is conducting a trade or business in the U.S.—then conforming states may also treat that income as domestic income and subject it to state taxation as well.

Note, however, that even though states may recognize income as having a foreign source determined under federal rules, this does not necessarily dictate the extent to which they might treat the income as taxable when earned by state residents. See, for example, *Steiner v. Utah State Tax Comm'n*, 2019 UT 47, 449 P.3d 189. Utah, like most states, tax residents on 100% of their income, regardless of where it is earned. In *Steiner*, the Utah Supreme Court considered whether individual state residents were entitled to an off-setting credit for a portion of the foreign taxes paid on income from their pass-through business which was unused at the federal level—ultimately concluding they were not. Nevertheless, the *Steiner* court did not deny the character of the income recognized by the taxpayers or that it included income that was properly characterized as foreign-source income under federal tax rules.

When it comes to partnerships, Subchapter K's general attribution rules require that foreign partners pay tax on distributive share income as if the partner had realized the income in the same manner as realized by the partnership—and attribute the general character of that partnership income as well as its source, both determined at the partnership level, to the partner. See Reg. §1.702-1(b) and 1.702-1(a)(8)(ii). Note that the same sourcing approach for items of income and expense is generally used when determining if a U.S. partner is able to take a credit for foreign taxes paid to offset federal tax on their worldwide income. Therefore, the income characteristics (including source) must be attributed to the partners.

Attribution and State Sourcing Rules

As noted in subsection I.E. above, when sourcing the income in a simple partnership structure with individual partners, states generally apply the sourcing rules at the partnership level and attribute this sourcing information to the partners. Having said that, some state courts have recognized limits under state imposition laws (so-called “doing business” statutes) or federal

⁴⁵ But note that certain types of overhead expenses are generally apportioned based on the sourcing of items of income. See for example Reg. §1.861-8(a)(2) (general rule); Reg. §1.861-8 or §1.861-10T (certain interest expense); and Reg. §1.861-8T(c)(1) (certain rental expense).

constitutional principles that may apply to states' ability to tax non-resident partners on their shares of partnership income sourced to the state.

To the extent such limits are based on constitutional principles⁴⁶, it would appear that the majority of states would now say that there is no significant constitutional limit on taxing partners on the income from partnerships sourced to the state. In addition, many states have avoided this constitutional question by imposing withholding requirements on partnerships. This white paper assumes that states have jurisdiction to impose tax on non-resident or out-of-state partners for partnership income properly sourced to the state.⁴⁷

But when the partner is not an individual but another business entity—a corporation or tiered partner—then the application of sourcing rules may be applied to items of income recognized by the partnership as well as to the allocation of distributive share to the partner. For example, an item of income earned by a partnership may be determined to be business (apportionable) income under state rules but the distributive share of the partnership income might be determined to be nonbusiness (non-apportionable) income to the partner.

If, in that case, the income is apportioned at the partnership level and the sourcing then attributed to the partner, this would be consistent with the sourcing in the simple partnership structure with individual partners. If, however, the income is re-characterized as non-apportionable nonbusiness income at the partner level, this would override the attribution of the character of the income determined based on the partnership's business activities in the state.

It is also possible that, under state rules as applied to the partnership, the items of partnership income would be determined to be apportionable business income and under those same rules applied to the partner, the distributive share would also be determined to be apportionable business income to the partner. In that case, the question is whether the partnership's own factors should be used to source the items—attributing that sourcing to the partner, or the partner's own factors should be used to source the partner's distributive share (as part of its other apportionable income). But there is also a third approach—blended apportionment—that will be discussed in Section II.

OVERARCHING STATE TAX IMPLICATIONS –

- **It is not uncommon for states to reference the state tax sourcing rules used for corporations and other businesses when sourcing the income of partnerships. However, care should be taken to make clear how these rules will be applied where the partners are corporate entities or in the case of more complex tiered partnership structures—particularly when determining whether income is nonbusiness (non-apportionable) or business (apportionable).**
- **States should consider making explicit that the attribution principle applies when determining important state characteristics of partnership income, especially that income determined to be business (apportionable) income at the partnership level can properly be sourced using partnership factors and this separate apportionment information can then be attributed to the partners.**

⁴⁶ See the separate discussion of the limits imposed by P.L. 86-272 in subsection I.E above.

⁴⁷ See also Hellerstein, supra fn. 4, ¶ 20.08[2][a][ii].

I.G. Summary – Issues & Important Context - Lessons

This Section I focused on the larger context in which state taxes on partnership income are imposed and the implications of this context for state sourcing rules in particular. The overarching “lessons” from these implications are summarized below.

Lessons for Applying State Sourcing Rules to Partnership Income

In general, state sourcing rules should:

- Use certain general partnership terminology and concepts consistent with state governing laws or federal tax laws to which the state tax rules conform (unless state rules separately define those terms).
- NOT assume that:
 - Partnerships are primarily treated as aggregates under the law or the federal tax rules.
 - All partnerships are small, simple, uniform entities.
 - A partner’s ownership share or limited liability determine the partner’s role or share of income.
- Recognize critical elements of the federal pass-through tax system that have state sourcing implications, including:
 - That the tax character of items is determined at the partnership level, is attributed to direct and indirect partners, and includes information that affects federal sourcing of domestic or foreign income.
 - That the treatment of certain items under the pass-through system may raise sourcing questions—for example, the treatment of so-called built-in gains (losses) on contributed or distributed property.
 - That guaranteed payments and partner-partnership transactions may raise questions about the computation of the receipts factor used to apportion partnership income under the blended approach.
- Recognize the need to apply consistent sourcing treatment for income earned by businesses, whether the business is conducted by a corporation, individual, or partnership.
- Clarify the types of sourcing-related determinations made at the partnership level or the kinds of information the partnership must provide to partners so that income can be sourced properly.
- NOT assume that the attribution principle, on which the pass-through tax system is based, depends on whether the partnership and partner are unitary.
- Consider when and to what extent a partner’s own tax attributes will be taken into account when determining the sourcing of distributive share income.
- Recognize the unitary business principle may be implicated where the partnership engages in multiple businesses or where a partner and a partnership are engaged in or contributing to the same unitary business.

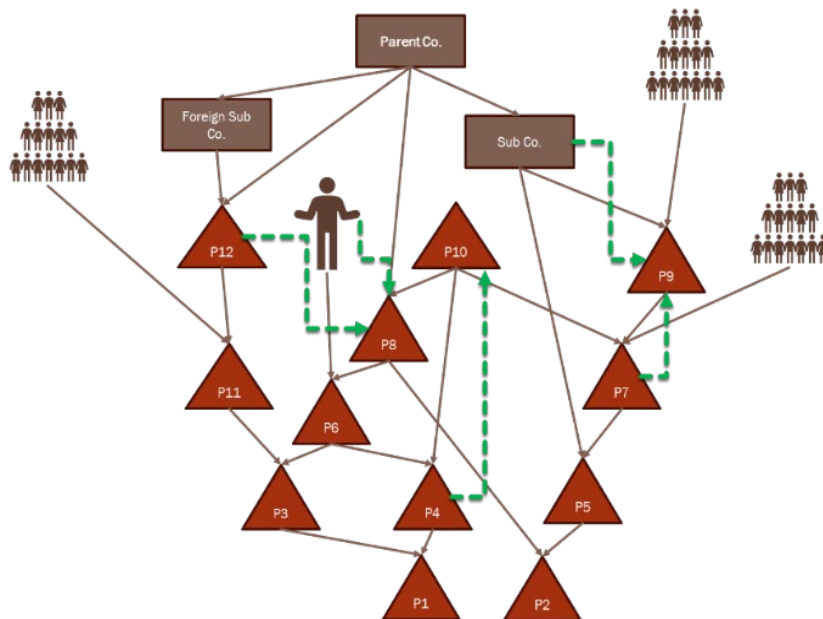
SECTION II: SOURCING PARTNERSHIP INCOME – PROPOSALS FOR ADDRESSING THE COMPLEX ISSUES

This Section II draws on the “lessons” from the important context discussed in Section I above, and the detailed research into existing state sourcing rules for complex partnerships summarized in Section III below.

First, this Section II sets out a general framework for sourcing partnership income, which the MTC work group has considered and appears to reflect the consensus as to the general application of state sourcing rules to partnerships. Then, it addresses particular sourcing issues for which rules may need to be more fully developed and proposes possible approaches to these issues.

Note: Balancing the Recognition of Complexity with the Need to Illustrate the Approaches

In considering the issues and approaches discussed in this section, it is important not to lose sight of the basic problem of pass-through taxation, which is the potential complexity of partnership structures today. The graphic (below) depicts a structure that is not especially complex, but demonstrates three very important realities.



- First, a partnership may have partners that are other partnerships or pass-through entities, or that may be corporations, including foreign corporations, or individuals, or (not shown here) non-profits or governmental organizations.
- Second, the distributive share income of a partnership may be allocated through a number of upper-tier partnerships before shares of that income (along with the distributive share income of those other partnerships) is allocated to the ultimate partners.
- Third, as shown by the dotted green lines here, partners and their partnerships and other commonly owned partnerships may engage in transactions with each other, which go into the determination of the entities own tax items and income.

While it is important to keep this reality in mind, it would not be possible to discuss different approaches in this section without using examples that simplify the factual scenarios, or focus on particular aspects of the approach and its application. Any implementation of these approaches will inevitably require considering other scenarios not illustrated in the examples used.

Note: Assumptions that are Essential to this Section

This Section II recognizes that the pass-through tax system poses certain jurisdictional and nexus questions that may not have clear answers and are beyond the scope of this white paper. This is especially true for complex partnership structures. Therefore, the following assumptions are made:

➤ *States have jurisdiction to impose tax information-reporting requirements on tiered partnerships.*

As with the proper tax characterization of partnership income generally, state sourcing of that income requires partnerships to properly track information and report it to the partners. This is true whether states source income using formulary apportionment or rules of assignment. And, as with other tax information, ensuring that sourcing information is properly tracked and reported is more difficult in complex partnership structures with tiered partners. Today, state reporting requirements may not fully address the information necessary for sourcing partnership income, especially where blended apportionment is used.

In complex tiered structures, partnership income from a lower tier may pass through several partnerships before it is allocated to a taxpaying partner. Some of these partnerships may have only an indirect connection to the state in which the income was initially derived. This raises questions as to whether states have jurisdiction to impose information reporting requirements on partnerships whose only connection with the state may be an indirect partner.

These questions have not been fully answered by the courts. And cases that deal with state regulatory jurisdiction more generally may be of limited application because of the unique nature of the pass-through tax system and the attribution principle on which it relies. (See subsection I.E. above.) Partnerships and their partners are on notice that the tax benefits supplied by this pass-through system will apply only to the extent that they properly comply with the system's requirements. And this, in turn provides the basis for imposing state reporting requirements.

➤ *States may assert nexus over partners for their state-sourced partnership income.*

A few state tax cases have held that nonresident partners cannot be subjected to tax on their state-sourced partnership income, whether due to a lack of constitutional nexus or because the state's statutory "doing business" standard was not met. Most of these decisions appear to have been based on the partner's passive role on in the partnership.⁴⁸ However, the basis for some of these cases is now questionable. Today, most states appear to assert nexus over partners to tax their distributive share income from a partnership doing business in the state, regardless of the nature or role of the partner.⁴⁹ Like the potential jurisdictional limits discussed above, it would be inconsistent with the attribution principle to assert that while the partnership itself has nexus with the state, the partners do not. Under the attribution principle, the partners are deemed to have engaged in the activity of the partnership which generated the tax items regardless of the partner's role in the partnership.

➤ *To the extent necessary, states may impose entity-level tax or withholding.*

To the extent states are concerned that their jurisdiction or nexus authority may be limited, they may impose entity-level taxes or withholding requirements on partnerships with activities in the state. These requirements may ease administrative burdens in addition to ensuring that tax is paid on distributive share income allocated to out-of-state partners. However, as with information reporting requirements, the entity-level taxes or withholding requirements used by states today may need to be modified to ensure that they also work for complex partnership structures.

⁴⁸ See the Project Issue Outline which summarizes various cases on this issue, available here: <https://www.mtc.gov/uniformity/project-on-state-taxation-of-partnerships/>.

⁴⁹ See Hellerstein supra fn. 4, ¶20.08.

II. A. General Framework for Sourcing Partnership Income

While this white paper is primarily focused on sourcing issues raised by complex partnership structures, before turning to those issues, this subsection II.A. sets out the general framework for sourcing partnership income which has been presented to and discussed by the work group.

General Framework

1. *Partnership Characterizes Items as Apportionable Business or non-Apportionable Nonbusiness Income*

State rules for determining whether items are apportionable or non-apportionable will be applied to items recognized or incurred by directly by the partnership. This “partnership-level” determination will then become part of the character of the item and, like the other tax characteristics of the item, is attributed to any direct or indirect partner that receives a distributive share of that item.

2. *Partnership Sources non-Apportionable Nonbusiness Items*

If the item is determined to be non-apportionable, it will be sourced applying state rules of assignment based on the partnership’s activities and information. This source will then be attributed to any direct or indirect partner that receives a distributive share of that item and will control the sourcing of the item, regardless of whether the partner’s distributive share of the partnership’s income would generally be considered apportionable or non-apportionable income to that partner.

3. *Partnership Sources Apportionable Business Items and Exception*

If the item is determined to be apportionable, it will be sourced applying state apportionment rules based on the partnership’s activities and information. This source will then be attributed to any direct or indirect partner that receives a distributive share of that item and will control the sourcing of the item, regardless of whether the partner’s distributive share of the partnership’s income would generally be considered apportionable or non-apportionable income to that partner, EXCEPT if:

- a) The item would properly be included in the partner’s own apportionable income; and
- b) The state rules provide for the use of blended apportionment under the circumstances.

Example 1

Assume:

- Corp X operates entirely in State 1
- Corp X is a partner in Partnership Y.
- Corp X has a 10% interest in Y and is allocated 10% of Y’s income.
- Partnership Y apportions 50% of its \$1 million income to State 2
- Corp X’s distributive share of Y’s income would generally be considered non-apportionable income to X

Corp X would source 50% of its 10% share of the \$1 million to State 2

Example 2

Assume the same facts as Example 1 except that Corp X’s distributive share of Y’s income would generally be considered apportionable income to X. In that case, X might use blended apportionment to source X’s share of Y’s income, provided State 2 allows blended apportionment and would apply that approach to X here.

Note that under this general framework a partner would not simply apply state sourcing rules to the distributive share income based on the partner’s own activities or information, nor would a partner simply source the income to the partner’s domicile or residence under any circumstances.

II.B. Use of Blended Apportionment

In general, “blended apportionment” uses an apportionment formula that combines the partner’s share of the partnership’s apportionment factors with the partner’s own factors. This blended formula is then applied to the partner’s total apportionable income, including its share of the partnership’s apportionable income. Discussion of this blended apportionment method will generally focus on the receipts factor, but its application to property and payroll factors would be similar.

Importantly, the sourcing results will vary depending on whether income of the partner and partnership is apportioned separately or whether blended apportionment is used. Therefore, states should clearly specify the use of blended apportionment.

Effect of Blended Apportionment – Simple Example

For example, assume Corporation is a partner in Partnership and is allocated 20% of the Partnership’s income. For State X, the income and apportionment factors are as follows:

	Corporation	Partnership
Income (Apportionable)	\$ 10,000,000	\$2,000,000
Receipts in State X	\$10,000,000	\$50,000,000
Receipts Everywhere	\$100,000,000	\$100,000,000
State X Receipts Factor	10%	50%

If Corporation and Partnership separately apportion their income using their own factors, the result would be:

	Result
Corporation’s own State X income (10% of \$10 million)	\$ 1,000,000
Corporation’s 20% share of Partnership’s State X income (50% of \$2 million)	\$200,000
Total State X income	\$1,200,000

But if Corporation uses blended apportionment, it would include its total share of Partnership’s income in its apportionable income and also include its share of Partnership’s factors in the apportionment formula. So the result would be:

	Separate Amounts	Blended Amounts
Corporation’s Own Income	\$10,000,000	
Corporation’s Share of Partnership Income (20%)	\$400,000	\$10,400,000
Corporation’s Receipts in State X	\$10,000,000	
Corporation’s Share of Partnership Receipts in State X (20%)	\$10,000,000	\$20,000,000
Corporation’s Everywhere Receipts	\$100,000,000	
Corporation’s Share of Partnership Everywhere Receipts (20%)	\$20,000,000	\$120,000,000
State X Blended Receipts Factor		16.666%
Corporation’s Income Sourced to State X		\$1,733,333

So, in this case, the income sourced to State X using blended apportionment would be 44% greater than using separate apportionment. In different scenarios, the amount sourced to State might be less than with separate apportionment. While the relative amounts of any differences may vary, the extent of the variation may be significant in some cases. One reason the effect may be significant is that the blended apportionment factor is not simply applied to the partner’s distributive share income from the partnership, but to that partner’s other income as well.

Application of blended apportionment in various scenarios.

The following examples give an overview of how blended apportionment would generally apply in certain common scenarios:

Example 1 – Combined Corporate Filing - Joyce:

- Corp X files in State 1 as part of a combined corporate group along with Corp Y.
- The group files on the so-called “Joyce” basis—with each entity using its own factors to apportion the combined income of the group.
- Corp X is a partner in Partnership Z.

In this example, the combined group apportionable income would include X’s distributive share of Z’s apportionable income. So both X and Y would use their own apportionment factors to apportion this combined group income including. But only X would include a share of Partnership Z’s factors in its own factors.⁵⁰

Example 2 – Combined Filing - Finnigan:

- Corp X files in State 1 as part of a combined corporate group along with Corp Y.
- The group files on the so-called “Finnigan” basis—using a single combined apportionment formula to apportion combined income.
- Corp X is a partner in Partnership Z.

In this example, the combined group apportionable income would include X’s distributive share of Z’s apportionable income. The group’s apportionment factor would also include a share of Partnership Z’s factors.⁵¹

Example 3 – Combined Corporate Filing – Joyce or Finnigan – Multiple Group Partners:

- Corp X files in State 1 as part of a combined corporate group along with Corp Y.
- Both Corp X and Corp Y are partners in Partnership Z.

In this example, the Joyce or Finnigan approach above would be used (depending on the state’s rule) but the combined group apportionable income would also include Y’s distributive share of Z’s apportionable income and Y’s (or the group’s) apportionment factor would also include Y’s share of Partnership Z’s factors.

Example 4 – Combined Filing – Joyce or Finnigan – Partner-Partnership Transactions:

- Corp X files in State 1 as part of a combined corporate group along with Corp Y.
- Corp X is a partner in Partnership Z.
- Corp X charges Partnership Z a fee which is treated as an IRC § 707(a) transaction between unrelated parties.

In this example, Partnership Z would record the fees charged by X as an expense in reporting its net distributive share income and items which would be allocated to its partners, including X. Assuming X receives a share of partnership income that includes a portion of this fee expense, X’s fee income from its charges to Z would be partially offset by its share of Z’s expense.

The same elimination may also be provided for the receipts factor used by X (Joyce) or the group (Finnigan) so that the factor would exclude X’s share of the fee receipts that it charged to Z. (See more discussion of this issue below.)

⁵⁰ See the MTC Model Statute for Combined Reporting – Joyce Method, here: [MTC Joyce Model](#).

⁵¹ See the MTC Model Statute for Combined Reporting – Finnigan Method, here: [MTC Finnigan Model](#).

Example 5 – Combined Corporate Filing – Multiple Partnerships:

- Corp X files in State 1 as part of a combined corporate group along with Corp Y.
- Corp X is a partner in two partnerships – P1 and P2.

In this example, the Joyce or Finnigan approach above would be used and the combined group apportionable income would also include X's distributive share of both P1 and P2's apportionable income and X's (or the group's) apportionment factor would also include X's share of P1 and P2 factors.

Example 6 – Combined Corporate Filing – Multiple Partnerships with Transactions:

- Corp X files in State 1 as part of a combined corporate group along with Corp Y.
- Corp X is a partner in two partnerships – P1 and P2.
- P1 sells services to P2.

In this example, P1's distributive share net income would include charges to P2 and P2's distributive share net income would include expense for amounts paid to P1. X's share of P1 and P2 income and items would be included in the group's income, offsetting the income and expense to the extent of X's share of each (which may differ).

As for the share of P1's factors to include in X's apportionment factor (Joyce) or the group factor (Finnigan), however, the question is whether X's share of the charges from P1 to P2 should be eliminated. (See more on this issue below.)

Example 7 – Tiered Partners:

Note – in this example, the income or factors listed for a particular entity are its own direct income and factors, without including its distributive share income or a share of the related partnership's factors. Also, the share of the partnership's factors included in the partner's own apportionment factor is based on the partner's distributive share. (This method is discussed further below.)

- Corp X (X) is a partner in Partnership 1 (P1) which is a partner in Partnership 2 (P2).
- X has its own ordinary income.
- P1 has its own ordinary income.
- P2 has its own ordinary income and a capital loss.
- P1's share of P2's distributive share net income is:
 - 20% of P2's ordinary income
 - 50% of P2's capital loss
 - 30% - total combined share of P2's net income and loss (where the loss is converted to absolute value)
- X's share of all P1's income and items including P1's share of P2's ordinary income and capital loss is 50%.
- Assuming all income is apportionable, X's apportionable income would be:
 - X's own apportionable income
 - +50% of P1's 20% of P2's ordinary income
 - +50% of P1's 50% of P2's capital loss
 - +50% of P1's own income
- X's apportionable factor would include:
 - X's own apportionment factors
 - +50% of P1's 30% of P2's total receipts
 - +50% of P1's own receipts

Note that in this example no. 7, while X includes its indirect shares of P2's ordinary income and capital loss in apportionable income, it does not distinguish the receipts giving rise to ordinary income versus the capital sale proceeds. Rather, the same share—30%—is used for both, based on X's share of P2's total distributive share income (using absolute values). But note that special allocations are addressed further in the following subsection.

Is blended apportionment necessary?

As these more complicated examples demonstrate, blended apportionment can create difficulties in reporting tax-related information and calculating tax. So one question is whether blended apportionment is necessary. As with combined corporate reporting, blended apportionment may mitigate the effects that separate-entity reporting can have on sourcing of multistate income as the simple example below demonstrates.

Example 1 - Assume:

- Corp has a subsidiary – Sub
- Corp and Sub are headquartered in State X, a non-tax state, but operate throughout the US
- Corp and Sub set up Partnership 1 (P1) in which they are 50/50 partners.
- P1's only receipts are from charges to both Corp and Sub for certain overhead services, reducing the income of both
- Under the rules in most states, the receipts from the fee charged by P1 would be sourced to State X.

If P1's income were apportioned separately at the entity level, it would all be sourced to State X—and so would Corp and Sub's shares of that income.

But if blended apportionment is used, Corp and Sub would include their shares of P1 income in their combined income, effectively eliminating or offsetting their own expense against that partnership income. Assuming that states also provide that the partners' shares of the fees charged by P1 are excluded from the apportionment factor, then the effect of these charges on that factor would also be eliminated.

In addition to this simple example, partnerships may be used in other ways to shift the sourcing of income of the partners and blended apportionment appears to address these other ways as well.

Example 2 - Individual Partner with Related Partnerships:

This is a very simple example designed to show that blending can also change the result where the partner is a direct, individual partner.

- There are three partnerships:
 - P1 operates entirely in State 1 - with \$1 million in sales and \$100,000 in income
 - P2 operates entirely in State 2 - with \$1 million in sales and \$100,000 in loss
 - P3 operates entirely in State 3 - with \$8 million in sales and \$200,000 in income
- Smith, an individual living in State 4, is a partner in each of these partnerships and receives a 20% share of the partnership income

If the partnerships each apportioned their income separately, the taxable income (loss) Smith would report to each state would be:

State 1: $100\% \times \$100,000 \times 20\% =$	\$20,000
State 2: $100\% \times (\$100,000) \times 20\% =$	(\$20,000)
State 3: $100\% \times \$200,000 \times 20\% =$	\$40,000
Total =	\$40,000

If, instead, Smith were to apportion the partnership income using a blended approach, the result would be:

$$20\% \text{ of } \$100,000 + 20\% (\$100,000) + 20\% \text{ of } (\$200,000) = \$40,000$$

$$\text{State 1 Apportionment Ratio} - \$1 \text{ million} / \$10 \text{ million} = 10\%$$

$$10\% \times \$40,000 = \$4,000$$

$$\text{State 2 Apportionment Ratio} - \$1 \text{ million} / \$10 \text{ million} = 10\%$$

$$10\% \times \$40,000 = \$4,000$$

$$\text{State 3 Apportionment Ratio} - \$8 \text{ million} / \$10 \text{ million} = 80\%$$

$$80\% \times \$40,000 = \$32,000$$

$$\text{Total} = \$40,000$$

How is the share of partnership factors to include determined?

The main question when applying blended apportionment is how to determine the share of partnership factors to be included in the partner's own apportionment factor. Only a minority of states that have explicitly provided for the use of blended apportionment have also specified how this share is determined. The share of partnership factors could be determined in using different approaches. Based on discussions with the work group and consideration of different examples, it appears that each of these approaches has particular problems that would need to be addressed.

1. Item-Based Approach: Directly attribute the receipts to particular partners based on the partnership items making up their distributive share.

The problem this approach is that partners may receive special allocations of items of partnership expense or loss separately from any items of income or gain—and the receipts that should be associated with these special allocations will be difficult if not impossible to determine.

2. Interest-Based Approach: Use a ratio of the partner's "interest in the partnership" (same as federal rules under 704(b)).

The problem with using the ratio of the partner's "interest in the partnership" is that, under IRS regulations, this is determined based on all facts and circumstances and is generally done at the federal level only when special allocations are determined to lack substantial economic effect. Therefore using this approach would likely involve significant uncertainty.

3. Capital Share-Based Approach: Use a ratio of the partner's share of capital.

The problem with using the partner's share of capital is that this may not reflect the share of income the partner is allocated in the particular tax year. This is true whenever there are special allocations of partnership items.

4. Distributive Share-Based Approach: Use a ratio of the partner's share of partnership net distributive share income.

The problem with using a ratio of the partner's share of partnership distributive share income is that special allocations may cause the partner to be allocated net losses while the partnership has positive income or vice versa. This problem can be solved by converting all items to absolute values.

The work group has considered each of these problems and some volunteers have also looked at the approach of using the partner's share of partnership income (no. 4) and converting items to absolute value. The result is that it appears this approach is the best method and can be workable in the greatest number of circumstances. (But see the discussion of special or mandatory allocations in subsection II. C. below where variations in this approach are considered.)

How should partner-partnership or related-entity transactions be treated?

Another important question in applying blended apportionment generally is how partner-partnership or related-entity transactions should be treated and when should their effects on apportionment factors be eliminated. As noted in subsection I.D. above, these transactions between partners and the partnership can take a number of different forms:

1. Contributions to and distributions from the partnership – These transfers of cash or property do not have an impact on receipts or income.
2. Guaranteed payments (under IRC § 707(c)) – These payments are generally made to partners for services or the use of capital. They can be made to both individual and corporate partners. Guaranteed payments have an effect on partnership distributive share income (and are generally treated as expenses) but their effect on receipts is unclear.
3. Transactions with partners not acting in the role of partner (under IRC § 707(a)) – These transactions are generally treated as transactions between unrelated parties and so may give rise to both income and receipts.
4. Transactions with indirectly related partners or partnerships and other entities – These transactions are generally not covered under Subchapter K or the pass-through tax treatment of partner or partnership income or receipts, but may have an effect on the calculation of state income and receipts factors.

Categories 2-3 above are the primary concern here.⁵² Category 4 is the subject of subsection II.D. below.

As noted in Section I.F. above, when combining the income of related corporations under combined or consolidated reporting systems, the related-entity transactions between members of the group are effectively eliminated in computing net income. In addition, states will not include the related-entity receipts in the receipts or sales factor of the group's or members' apportionment formula. To do otherwise would lead to distortion.

Blended apportionment generally has a similar effect on apportionable income—offsetting the income and expense—at least to the extent of the share of partnership income or items included in the blended income. But as with related corporations, if the same share of partner-partnership receipts is not also removed from factors in the blended apportionment calculation, this would potentially create distortion. About a dozen states which have explicitly addressed blended apportionment have also addressed the need to eliminate from the blended apportionment factor a share of any related-party receipts.

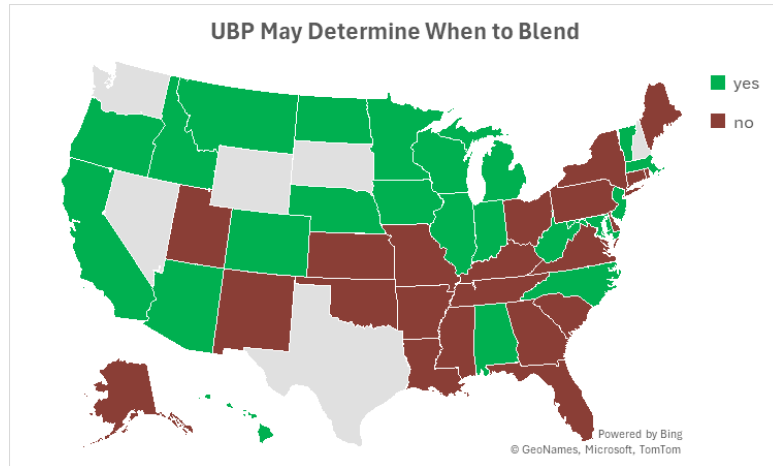
The primary question is whether these state rules are broad enough and whether they should explicitly address not just partner-partnership receipts under IRC 707(a), but also guaranteed payments for services or capital and related-entity charges where those charges would otherwise be included in the blended apportionment factor. (See Example 5 above.)

⁵² The treatment of IRC §§ 707(a) and 707(c) transfers is also addressed in the MTC white paper on the sourcing and state tax treatment of guaranteed payments for services, available on the MTC project webpage, here: [MTC Guaranteed Payment White Paper](#).

Note that blended apportionment with the rules discussed above may not be sufficient to address every possible state tax sourcing issue raised by the pass-through system. Other issues are covered in the following sections and may need to be combined with blended apportionment to handle these issues.

When should blended apportionment be used?

[NOTE – As of the date of this discussion draft, the work group has not considered the issues summarized in this part.]



The map at the left here shows the states (in green) that have explicitly adopted a limit on the use of blended apportionment to circumstances in which the partner and the partnership are part of the same unitary business.

In the context of combined corporate filing, states have generally looked to the unitary business principle in determining the members of the combined group. This raises the question of whether blended apportionment should also be limited to those partnerships and partners that are part of a unitary business. In addition, the application of blended apportionment in the pass-through system is more difficult and requires more information reporting than apportioning partnership income at the partnership level and simply retaining and attributing the income's source as it passes to direct and indirect partners. This difficulty, in turn, raises questions as to whether other limits on the use of blended apportionment should be adopted for administrative ease.

In considering these questions, the following information may be helpful.

Applying the unity business principle to partnerships is more difficult.

There are a number of U.S. Supreme Court cases that address the unitary business principle in the context of constitutional limitations on state taxation of multistate corporate income—implicating both the nexus to tax that income (or the corporation generating it) as well as whether that income can be fairly apportioned. In this context, the unitary business principle often looks to certain criteria in determining when related entities are engaged in a unitary business. These criteria include:

- functional integration,
- centralized management,
- economies of scale, and/or
- flow of "value".

These criteria may be more difficult to apply to partnerships. Take centralized management. As has been discussed throughout this white paper, partnerships are different from corporations in important ways. For corporations, ownership share generally determines ultimate control so that common control for a group of entities can be determined based simply on common ownership. This is not true in the case of partnerships—where control can be vested in minority

owners. In addition, partnership structures are so complicated that discerning common control over related entities may be impossible.

Also, partnerships are sometimes formed by partners to hold or develop certain assets. Today, those assets are more likely to be intangible property. In those instances, a partner might make substantial use of its interest in the partnership and the partnership's intangible assets without the kind of "functional integration" or "economies of scale" that might have been typical in more traditional businesses and their shared use of physical assets.

Some scholars believe that the unitary business principle involves another test that can be applied separately from the criteria above—where a taxpayer's investment in another entity or business serves an "operational function" in the taxpayer's own unitary business.⁵³ This operational function test appears better suited to application in the pass-through context, but is less developed so that there is little governing precedent.⁵⁴

The pass-through system is governed by the attribution principle.

In the case of partnerships and their partners, the pass-through tax system itself prescribes that:

"Persons carrying on business as partners shall be liable for income tax only in their separate or individual capacities." IRC § 701.

And –

"The character of any item of income, gain, loss, deduction, or credit included in a partner's distributive share . . . 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." IRC § 702(b)

State conformity to this pass-through system provides a benefit to the direct and indirect owners of partnerships. But this benefit is conditioned upon their implicit agreement to pay the tax imposed on the partnership income in the form in which it was earned by the partnership. This agreement is unconditional and does not depend on the partner's role in the partnership. Furthermore, as noted at the beginning of this Section II, the attribution principle effectively negates any argument that a state lacks nexus over the out-of-state partners of a partnership doing business in the state.

Fair apportionment is not entirely dependent on the unitary business principle.

The unitary business principle may serve to show that a state has nexus over the business and its income, but also that the income has a connection to the apportionment formula used. But as the Supreme Court said in *Container Corp. of America v. Franchise Tax Board*, that constitutional fairness standard is low:

. . . we will strike down the application of an apportionment formula if the taxpayer can prove "by 'clear and cogent evidence' that the income attributed to the State is in fact 'out of all appropriate proportions to the business transacted . . . in that State,' [Hans Rees' Sons, Inc.,] 283 U. S., at 135, or has 'led to a grossly distorted result,' [Norfolk & Western R. Co. v. State Tax Comm'n, 390 U. S. 317, 326 (1968)]." *Moorman Mfg. Co.*, supra, at 274.⁵⁵

The unitary business principle may still be used as a limit for blended apportionment.

The unitary business principle, while not clearly required for blended apportionment, could nevertheless provide a kind of standard for or limit to the use of blended apportionment. That

⁵³ Hellerstein, supra fn. 4, ¶8.07.

⁵⁴ But see *YAM Special Holdings, Inc. v. Commissioner*, No. 9122-R, 2019 BL 446234, 2019 WL 6213168 (Minn. Tax Ct. Nov. 12, 2019)(upheld by the state supreme court, 947 N.W.2d 438 (Minn. 2020)) upholding the application of the principle.

⁵⁵ 463 U.S. 159, 170 (1983).

said, because there is far less precedent and far fewer detailed rules for applying the principle in the context of the pass-through system, this standard should be modified where appropriate.

For example, some states that have used the unitary business principle to limit blended apportionment have provided that the ownership share of the partner does not affect whether the partner and partnership can be unitary—essentially recognizing that, with partnerships, control does not necessarily follow ownership. And, as noted above, the “operational function” test may work better for determining the relationship needed for the use of blended apportionment.

So, for example, states might adopt the following approach:

- Determine if the income or item is apportionable to the partnership that recognized it.
- If so, determine whether the partner and partnership meet certain of the criteria for unitary entities, or whether the partnership services an operational function in the partner’s unitary business.
- If either is true, blended apportionment may apply to the sourcing of the partner’s income, including the partnership distributive share.
- If neither is true, the distributive share income is assumed to be non-apportionable to the partner and would, instead, be apportioned separately applying the partnership’s own apportionment factors.

In addition to applying some form of the unitary business principle to limit the use of blended apportionment, states might also impose other limits for administrative ease or vary the application of blended apportionment as may be discussed further below.

II.C. Sourcing Special or Mandatory Allocations

As discussed in subsection I.D. above, partners may share partnership items in different proportions and Subchapter K may also mandate that certain items or shares of those items be allocated to certain partners. The application of these allocation rules along with state sourcing rules may, in some cases, enable taxpayers to change the sourcing of income or loss.

Special Allocations

Because of special allocations—partners may receive a greater share of income (loss) from some partnership activities and a lesser share from others. Nor do these allocations have to match the partner's capital ownership.

For example, assume:

- Partnership conducts two related businesses—technology consulting and product development.
- Each has its own operations and customers but they are part of a unitary business.
- Corp invests in Partnership in order to work in developing products.
- The Partnership's other partners agree that Corp will be allocated:
 - 20% of the income generated by its consulting operations, and
 - 60% of the income generated by its product development operations.
- Assume that Partnership can track the income and receipts of the consulting and product development operations separately and the results in Year 1 are:

	Technology Consulting	Product Development	Total Partnership
Income of Operations	\$30 million	\$10 million	\$40 million
Corp's Share	\$6 million	\$6 million	\$12 million
Receipts in State X	\$50 million	\$10 million	\$60 million
Total Receipts	\$100 million	\$100 million	\$200 million

- For simplicity—assume Corp has no receipts or income of its own.

The question is how Corp would blend Partnership's income and receipts. The possible options are:

- Method 1: Determine receipts using average distributive share:

Corp would calculate the share of factors to include using the average ratio of its total distributive share income divided by Partnership's total income = \$12 million ÷ \$40 million = 30%.

Corp would include 30% of total Partnership factors - \$18 million (30% of \$60 million) ÷ \$60 million (30% of \$200 million) = 30%

Corp's State X income would be 30% of \$12 million = \$3.6 million.
- Method 2: Determine receipts using distributive share of each business's income:

Corp would use its share of income from consulting (20%) and its share of income from product development (60%) to separately determine its share of receipts from those businesses.

	Technology Consulting	Corp's Share (20%)	Product Development	Corp's Share (60%)	Corp's Total Factors
Receipts in State X	\$50 million	\$10 million	\$10 million	\$6 million	\$16 million
Total Receipts	\$100 million	\$20 million	\$100 million	\$60 million	\$80 million
Corp's Factors		50%		10%	20%

Corp's State X income would be: 20% of \$12 million = \$2.4 million.

Note that under both the approaches above, the factor would apply to Corp's total distributive share income.

This example demonstrates that the result may be different depending on whether the share of partnership receipts for a partner to include in its factor is determined based on that partner's total distributive share income from the partnership or whether the partner uses its distributive share of particular partnership items or income to determine its share of receipts related to that income. While the latter approach may seem more "accurate" in some sense, it is likely to be impractical for use in complex partnership structures and would require significant additional information reporting by the partnership.

In addition, this approach might be viewed as contrary to the unitary business principle—which relates the receipts or apportionment factors of the business to the net income from that business. Here, while the partnership may have internal books and records tracking the income from the different operations, these operations are still part of the partnership's unitary business.

Nevertheless, there may be certain examples of special allocations that would demonstrate income is effectively being shifted for state tax reasons that are not related to any economic purpose or differences in economic results for the partner. These situations might be better addressed by anti-abuse rules, discussed further in subsection II.E. below.

Built-in Gains (Losses)

Mandatory allocations can raise issues similar to special allocations. Under IRC 704(c), built-in gains (losses) on contributed property may be required to be allocated to the contributing partner if the contributed property is later transferred by the partnership. This is to prevent partnerships from being used to effectively exchange property while avoiding recognition of accrued gains or to shift gains (losses) among partners. The state sourcing treatment of these built-in gains (losses) may be unclear and different approaches could have very different results.

For example, assume:

- State A has an income tax and State B does not.
- State A includes gains from sales of business assets in the receipts factor at net.
- Corp owns an office complex and other property in State A.
- Partnership manages real property in State B.
- In YEAR 1:
 - Corp contributes its office complex to Partnership and, at the point of contribution, it has a built-in gain of \$100 million (none of which is recognized).
 - Partnership manages the office complex as part of its properties.
 - Corp has \$100 million in total receipts and \$50 million in State A.
 - Corp's separate income = \$0.
- In YEAR 3:
 - Partnership sells the office complex in State A recognizing a \$120 million gain.
 - Partnership's total rents and gains = \$1.2 billion
 - Partnership's total distributive share income = \$200 million.
 - Corp is allocated the built-in gain of \$100 million as required under IRC § 704(c) as its total distributive share income from Partnership is \$150 million.
 - Corp has other receipts of \$100 million with \$10 million in State A.
 - Corp's separate income = \$0.

Assuming the gain is generally considered apportionable income and State A uses a receipts factor which would generally include such gains, possible sourcing outcomes include:

- Partnership-level apportionment:

Corp's income in State A:

$$\begin{aligned} & \$120 \text{ million (total gain) in State A} \div \$1.2 \text{ billion} = 10\% \text{ Factor} \\ & \times \$100 \text{ million} = \$10 \text{ million} \end{aligned}$$

➤ Blended apportionment:

Corp's determines share of receipts using total distributive share of \$150 million ÷ total Partnership income \$200 million = 75%

Corp's share Partnership receipts using 75% = \$90 million in State A and \$900 million total

Corp's total receipts = \$90 million + \$10 million = \$100 million in state A and \$900 million plus \$100 total = \$1 billion total

Corp's receipts factor = \$100 million ÷ 1 billion = 10%

Corp's income in State A = \$10 million

But this example also raises the question – rather than sourcing the built-in gain using factors in Year 3 (whether the Partnership's own separate factors or a blended factor), should the built-in gain be sourced using the Corp's factors from Year 1.

➤ Using Year 1 Corp factors to source the built-in gain:

Corp's Year 1 State A factor – as though the gain had been recognized in that year = \$50 million other receipts + \$100 gain ÷ \$100 million other receipts + \$100 million gain = 75%

Corp's State A income = 75% of \$100 million = \$75 million

(Note that Corp would presumably have no other State A income if the gain is sourced separately in this way.)

This approach does not raise some of the practical difficulties that are raised by using a different share of partnership receipts for special allocations. Rather, here, Corp would simply compute the factor to be used to apportion the gain based on its own information—its factors from Year 1 and the sourcing of the gain for purposes of computing that factor. If Partnership had other factors in State A, then Corp would exclude the gain from its use of blended apportionment for any other distributive share income from Partnership, but would otherwise source rest of its distributive share income using a blended factor for Year 3..

II.D. Other Related -Entity Transactions

It is not practical to require partnerships taxed on a pass-through basis to report income of related entities in some sort of combined return since, in complex structures, even related entities may have diverse indirect partners who are not owners of tiered or other related entities. Therefore, states should look to states that impose corporate income tax on a separate entity basis, which have generally adopted two kinds of anti-abuse rules to prevent the use of related party transactions to shift income.

Add-Back Statutes

States have long used so-called add-back statutes to effectively disallow the effects of certain inter-company or related-entity transactions involving easily transferrable intangible property. In some cases, even states that require combined filing have seen the need to maintain such add-back provisions. The MTC has a model add-back statute, available [HERE](#). That model requires an add-back of certain royalty and interest expenses incidental to the licensing by a related intangible holding company of the unitary business's trademarks and trade names. It also provides:

(vi) "Related entity" means . . . (1) a stockholder who is an individual, or a member of the stockholder's family set forth in section 318 of the Code [IRC] if the stockholder and the members of the stockholder's family own, directly, indirectly, beneficially or constructively, in the aggregate, at least 50 per cent of the value of the taxpayer's outstanding stock; (2) a stockholder, **or a stockholder's partnership, limited liability company, estate, trust or corporation**, if the stockholder and the stockholder's partnerships, limited liability companies, estates, trusts and corporations own directly, indirectly, beneficially or constructively, in the aggregate, at least 50 per cent of the value of the taxpayer's outstanding stock; or (3) a corporation, or a party related to the corporation in a manner that would require an attribution of stock from the corporation to the party or from the party to the corporation under the attribution rules of the Code if the taxpayer owns, directly, indirectly, beneficially or constructively, at least 50 per cent of the value of the corporation's outstanding stock. The attribution rules of the Code shall apply for purposes of determining whether the ownership requirements of this definition have been met.

Transfer-Pricing Authority

States that allow separate corporate filing have found it necessary to be able to determine if items of income and deduction resulting from related activities are properly valued and treated for tax purposes. This is similar to IRC § 482, discussed in subsection I.D. above, which provides:

In any case of two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Secretary may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses. In the case of any transfer (or license) of intangible property (within the meaning of section 367(d)(4)), the income with respect to such transfer or license shall be commensurate with the income attributable to the intangible. For purposes of this section, the Secretary shall require the valuation of transfers of intangible property (including intangible property transferred with other property or services) on an aggregate basis or the valuation of such a transfer on the basis of the realistic alternatives to such a transfer, if the Secretary determines that such basis is the most reliable means of valuation of such transfers.

This federal provision can provide a model for the states to adopt similar authority to be applied by the state in the context of partner-partnership transactions (under IRC § 707(a)) or transactions between related-partnerships. States may also find related IRS regulations helpful for this purpose.

II.E. Anti-Abuse Rules

States should consider other anti-abuse rules discussed in subsection I.D. above, based on provisions used for federal tax purposes:

IRC § 7701(o) - general economic substance rule

The general federal tax economic substance rule is set out in IRC § 7701(o). It requires that for the tax benefits of purported activities and transactions to be respected, they must also affect the economic position of the taxpayer “in a meaningful way” and have a “substantial purpose” apart from the “Federal income tax effects.” This general rule also provides: “any State or local income tax effect which is related to a Federal income tax effect shall be treated in the same manner as a Federal income tax effect.” That is, taxpayers cannot argue that transactions have a meaningful economic effect solely on the basis of the related state tax effects.

As discussed in subsection I.D., however, this rule may not give states authority to challenge the application of the general pass-through tax rules where the state tax effect is not “related to” a federal income tax effect. Therefore, states may wish to clarify that they will apply this type of economic substance rule where the only effect is on state tax or where that effect is only indirectly related to the federal tax treatment.

IRS Reg. § 1.701-2 – general partnership anti-abuse rule

Reg. § 1.701-2, also discussed in subsection I.D. above, refers to “tax consequences,” which may interpreted as including only federal tax consequences. Therefore, while states might rely on this regulation in determining the proper federal tax result to which they conform, it is questionable whether they could necessarily rely if the state tax effect is only indirect, as with sourcing. States may wish to provide explicitly that this same general anti-abuse rule will apply in those circumstances, including the sourcing of multistate partnership income.

IRC § 704(b) – substantial economic effect requirements

The requirement under § 704(b) that the allocations of partnership items have “substantial economic effect” has been defined and applied by extensive federal regulations. See IRS Reg. 1.704-1(b). In general, the regulations provide that there must be a reasonable possibility that the allocation of distributive share will affect substantially the dollar amounts to be received by the partner “independent of tax consequences.” As noted in subsection I.D. above, it is not clear that this rule would serve to limit allocations that have an effect on the partners’ *state* tax results but not their federal tax results. Some states have explicitly provided that this substantial economic effect requirement would also apply to the state tax effects of partnership allocations.⁵⁶

IRC § 6222 – consistency requirement

In addition to the substantive anti-abuse rules discussed above, the federal administrative provisions also require that partners report items consistently with the partnership’s own reported information. See IRC § 6222. Failure to do so is treated as a math error on the partner’s return for which tax can be summarily assessed. Application of this consistency requirement to purely state-related information is uncertain and some states have provided their own consistency requirement as part of state tax statutes or regulations.⁵⁷

⁵⁶ As the summary in Section III notes, those states include Connecticut, Kansas, Louisiana, Maine, Missouri, New York, Rhode Island, Virginia, West Virginia, and Wisconsin.

⁵⁷ See, for example, Oregon Administrative Code, 2020, OAR Section 150-314-0475, Consistent Treatment of Partnership Items.

III. SUMMARY OF MULTISTATE RESEARCH ON STATE TAX SOURCING FOR COMPLEX PARTNERSHIP STRUCTURES

Information in this section comes from state statutes, regulations, cases, form instructions, and guidance as of the date of this draft. This information should not be relied on as tax advice. For specific questions, taxpayers should contact the applicable state department of revenue or their tax advisor.

Since the federal partnership rules do not address state tax sourcing rules for complex partnership structures, state specific rules provide necessary clarity. This section summarizes the rules in states that have addressed sourcing in complex partnership structures specifically. But many of the states have not yet explicitly addressed these structures or provided clarity on the full range of potential issues.

III. A. Summary of Complex Partnership Structure Sourcing Issues Addressed by States

State sourcing rules for complex partnership structure take varying approaches with varying levels of detail and clarity. This subsection III. A. summarizes issues states have explicitly addressed in their sourcing rules for complex partnership structures and analyzes the current status of state rules on these issues. The specific state provisions are set forth in Section III. B. below.

Are attribution and conduit principles involved in state tax sourcing for complex partnership structures?

Most of the states conform to the federal partnership principals on attribution and the determination of an item's character at the partnership level. However, a few states, such as Massachusetts and California also have specific language clarifying that the determination of whether an item is apportionable or non-apportionable income takes place at the partnership level. Some states (such as Colorado, Indiana, Massachusetts, Montana, New York, and Virginia) further clarify that the partnership level attribution flows through multiple tiers of owners.

Have the states addressed sourcing when a complex partnership structure includes a corporate partner?

When a corporation owns an interest in a partnership structure, most states have specifically addressed how the corporation should source its share of income that is apportionable to the partnership. The majority of states (including Alabama, Arizona, California, Connecticut, Delaware, District of Columbia, Florida, Georgia, Hawaii, Indiana, Idaho, Illinois, Iowa, Kansas, Kentucky, Maine, Maryland, Massachusetts, Michigan, Minnesota, Montana, Nebraska, New Jersey, New York, North Carolina, North Dakota, Ohio, Oregon, Pennsylvania, Rhode Island, Tennessee, Utah, Vermont, Virginia, West Virginia, and Wisconsin) use formulary apportionment and blend the apportionment factors of the corporation with the corporation's pro rata share of the apportionment factors of the partnership. However, several states expressly limit blended apportionment to situations where there is a unitary relationship (California, Hawaii, Indiana, Illinois, Maryland, Massachusetts, Michigan, Minnesota, Montana, Nebraska, New Jersey, Vermont, West Virginia, Wisconsin); apportionable income (Idaho, North Carolina, North Dakota), or a business interest (Alabama – business interest, Arizona – business interest, Iowa - connection with the taxpayer's regular trade or business operations, Oregon - part of the corporation's overall business operations). For non-unitary partnerships in these states, the income is generally sourced at the partnership level and that sourcing is retained as it flows up without reapportionment. If the income is non-apportionable to the partnership, states generally source that income using rules of assignment at the entity level and that sourcing is then attributed to the partners.

Have the states addressed sourcing when a complex partnership structure includes multiple levels of partnerships?

When an upper-tier partnership owns an interest in a lower-tier partnership, only 15 states have specifically addressed how the upper-tier partnership should source its share of income that is apportionable to the lower-tier partnership. Twelve of these states (Arizona, California, Colorado, Florida, Illinois, Kentucky, Massachusetts, Ohio, Utah, Vermont, West Virginia, and Wisconsin) have express provisions using formulary apportionment and blending the apportionment factors of the upper-tier partnership with its pro rata share of the apportionment factors of any lower-tier partnerships. California, Colorado, Illinois, Massachusetts, Vermont, West Virginia, and Wisconsin limit the blended apportionment to situations involving a unitary relationship. For non-unitary partnerships in these states, the income is generally sourced at the lower-tier partnership level and that sourcing is retained as it flows up without reapportionment. New Jersey, New York, and Montana do not use blended apportionment when there are multiple levels of partnerships. Instead, the income is sourced at the level of the lower-tier partnership and that sourcing is retained as it flows through to the upper-tier partnerships. If the income is non-apportionable to the lower-tier partnership, states generally source that income using rules of assignment at the entity level and that sourcing information is then attributed to the partners.

Have the states defined what a pro rata share is for purposes of blended apportionment?

Only 6 states have expressly defined what a pro rata share is for purposes of blended apportionment. Massachusetts and Maine generally look to the profit and loss percentage but have exceptions for certain gains/losses and changes of interest. Idaho and West Virginia look to the distributive share of partnership income or losses. Oregon uses a ratio involving capital accounts and related entity debt. Finally, Pennsylvania indicates that the pro rata share of apportionment factors shall be determined under the partnership agreement and in accordance with the IRC.

Have the states addressed how related-entity transactions should be treated in the apportionment factor in complex partnership structures?

States vary on whether related-entity transactions must be eliminated from the apportionment factors in complicated structures. Some examples of states with express provisions where certain related-entity sales are excluded include California, Hawaii, Idaho, Indiana, Maine, Massachusetts, Michigan, Nebraska, New Jersey, and Oregon.

Have the states addressed how special allocations should be treated in complex partnership structures?

Most of the states conform to the federal partnership principals on substantial economic effect. Several states (Connecticut, Kansas, Louisiana, Maine, Missouri, New York, Rhode Island, Virginia, West Virginia, and Wisconsin) also expressly state that a special allocation will be disallowed if the principal purpose is to avoid or evade *state* tax.

Have the states addressed whether alternative apportionment applies when there are complex partnership structures?

Several states (Arkansas, Florida, Illinois, Kansas, Maryland, Massachusetts, New Jersey, North Carolina, Ohio, Rhode Island, Tennessee, Virginia and West Virginia) have alternative apportionment provisions that are expressly applicable when partnerships are involved and the requirements for alternative apportionment are otherwise met. In addition, some state alternative apportionment rules are applicable to “taxpayers.” If a state includes partnerships in their definition for taxpayers, alternative apportionment could be applicable if the statutory requirements are otherwise met.

III. B. State Rules for Complex Partnership Sourcing

This subsection III. B. sets forth the detailed rules in states that have explicitly addressed sourcing for complex partnership structures in statutes, regulations, cases, form instructions, or guidance.

Alabama

Ala. Admin Code r. 810-27-1-.09(3)

For taxpayers with a business interest in an unincorporated entity (e.g., partnership, unincorporated joint-venture, limited liability company taxed as a partnership, etc.), the apportionment formula shall include the pro rata share of the unincorporated entity's factor data.

Alaska

Alaska Form 6900 Instructions from 2022

A partnership is required to file Form 6900, even if the partnership itself does not conduct business in the state, but owns a partnership interest in a lower-tier partnership doing business in the state, because of the attribution rule . . . Nexus is sometimes referred to as “doing business” within the state. It is the act of conducting business activity within the state during the tax year. It may exist as a result of an entity’s direct activity, the activity of its employees or agents, or through its interest in a lower-tier partnership or LLC . . . A lower-tiered partnership is required to file Form 6900 if it has nexus in Alaska and any partner is a corporation or another partnership, even if the partners of the higher-level partnership are all natural persons or those effectively treated as natural persons . . . Indicate whether the partnership has an ownership interest in any foreign partnership. Attach a schedule showing the name, EIN, and the ownership percentage held of each foreign partnership. If the foreign partnership has an ownership interest in a foreign corporation, the ownership is attributed to the upper-tier partnership, including all tax attributes such as apportionment factor . . . If you answered yes to question 1c on page 1 of Form 6900, then the amounts in Schedule A, column A must include amounts attributed to the partnership from lower-tier partnerships.

Alaska Admin. Code tit. 15, § 20.320(a)

The income, expenses, assets, and apportionment factors of an enterprise involving undivided joint ownership must be attributed to the joint owners of that enterprise on the basis of their respective ownership interests, as may be modified by agreement among those joint owners. For purposes of this section, partnerships, joint ventures, trusts with joint beneficiaries and similar legal entities but not a single corporation, are enterprises involving undivided joint ownership.

Arizona

Ariz. Rev. Stat. Ann. § 43-306

The allocation and apportionment of income of a partnership that has nonresident partners shall be made pursuant to chapter 11, article 4 of this title.

Arizona Corporate Tax Ruling No. 93-9 (04/30/1993)

A multistate corporation that has a partnership interest in a partnership that is a partner in a tiered partnership must also report its ultimate distributive share of the tiered partnership's income or loss from Arizona activities.

Example:

Partnership A has a 50% apportionment ratio for its Arizona operations. Partnership B has a 25% interest in Partnership A. Corporation C has a 10% interest in Partnership B. Partnership B does not have any other connection with Arizona other than its partnership interest. Corporation C has business activities within and without Arizona in addition to its partnership interest in a partnership that is a partner in a tiered partnership.

Corporation C must file an Arizona corporate income tax return apportioning its income from business activities within and without Arizona. Corporation C must also report its ultimate distributive share of Partnership A's Arizona income, loss, gain and other items. If Corporation C has a business partnership interest in Partnership B, the corporation will apportion its income or loss from the tiered partnership. If Corporation C has a nonbusiness partnership interest in Partnership B, the corporation will allocate its income or loss from the tiered partnership.

Arizona Corporate Tax Ruling No. 93-10 (04/30/1993)

A corporation that does not have any connection with Arizona, other than a partnership interest in a partnership that is a partner in a tiered partnership, must apportion or allocate its ultimate distributive share of the tiered partnership's income or loss from Arizona activities. If the corporation's interest in the tiered partnership is business, the numerator and denominator of the corporation's apportionment factors in the Arizona tax return would include the corporation's distributive share of the tiered partnership's factors. The allocation of a tiered nonbusiness partnership's income or loss in the corporation's Arizona tax return would reflect the corporation's ultimate distributive share of the tiered partnership's Arizona activities.

A multistate corporation that has business activities within and without Arizona must apportion its income from such activities in addition to the apportionment or allocation of its ultimate distributive share of the tiered partnership's income or loss from Arizona activities. If the corporation's interest in the tiered partnership is business, the numerator and denominator of the corporation's apportionment factors in the Arizona tax return would include the corporation's distributive share of the tiered partnership's factors. The allocation of a tiered nonbusiness partnership's income or loss in the corporation's Arizona tax return would reflect the corporation's ultimate distributive share of the tiered partnership's Arizona activities.

Arizona DOR Publication No. 713 (2/1/2023)

Example of a Partnership Using a Special Allocation

The PTE Credit and PTE Taxes Paid are allocated to the partner based on his/her proportionate share of income that is attributable to that partner for Arizona tax purposes. For example, if the taxable income of a partner is 60% of the partnership's taxable income, that partner is entitled to 60% of the PTE Credit, and 60% of the PTE taxes paid by the partnership.

NOTE: The total of all PTE Credits or PTE taxes paid that is distributed to the partners cannot exceed the maximum amount of the credit or the total amount of PTE taxes paid.

EXAMPLE: A partnership has two partners, A & B. The partnership made the PTE election. Both partners, A & B did not opt out of the PTE election. The partnership's Arizona taxable income for the year is \$100,000. Due to a special allocation, Partner A's distribution of the partnership income is \$120,000. Partner B's distribution is (\$20,000). The partnership's PTE tax credit for the year is \$2,980 ($\$100,000 * 2.98\%$).

Partner A's pass-through PTE tax credit is \$2,980.

Partner B does not receive a pass-through of the PTE tax credit.

NOTE: If a partnership uses a special allocation to distribute partnership income rather than ownership share, complete Schedules D and E of Form 165 using that special allocation method for each partner.

Arkansas

Ark. Code Ann. § 26-51-802(c)

A partnership that files an Arkansas partnership return and has income from both within and without Arkansas shall apportion income to Arkansas under the Uniform Division of Income for Tax Purposes Act, § 26-51-701 et seq.

Subject to the provisions of § 26-51-202(e), all partnership income from activities within this state that is reflected on a partnership return shall be allocated to this state.

Ark. Corp. Inc. Tax Regs. 1.26-51-802(b)

Any taxpayer with an interest in a partnership which has gross income from sources within Arkansas must directly allocate the partnership's Arkansas income to Arkansas, rather than include partnership income and apportionment factors in the taxpayer's apportionment formula.

2023 Form AR1050 Instructions – Partnership Income Tax

If the allocation and apportionment provisions as set out above do not fairly represent the extent of the taxpayer's business activity in this State, the taxpayer may petition for, or the Commissioner of Revenue, Department of Finance and Administration may require in respect to all or any part of the taxpayer's business activity, if reasonable:

- A) Separate accounting
- B) The inclusion of one or more additional factors which will fairly represent the taxpayer's business activity in this State, or
- C) The employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer's income.

A petition must be a formal written request submitted to and approved by the Department of Finance and Administration prior to the filing of a return using the proposed method. The approval letter should be attached to all returns filed using the approved alternative apportionment method.

California

Cal. Code Regs. tit. 18, § 25137-1

When a taxpayer has an interest in a partnership as defined in Section 17008, Revenue and Taxation Code, the division of its distributive share of partnership items shall be determined in accordance with Chapter 10 of Part 10 of Division 2 of the Revenue and Taxation Code. The determination of the portion of such distributive share (constituting business and nonbusiness income) which has its source in this state or which is includible in the taxpayer's business income subject to apportionment, shall be made in accordance with these regulations provided that the taxpayer, or the partnership, or both, have income from sources within and without this state. The taxpayer in computing net income for its taxable year shall include its distributive share of partnership items referred to above for any partnership year ending within or with the taxpayer's taxable year. The same principle applies when a taxpayer has an interest in a partnership that itself owns an interest, directly or indirectly, in one or more other partnerships.

The first step is to determine which portion of the taxpayer's income and its distributive share of the partnership items constitute "business income" and "nonbusiness income" under Section 25120, Revenue and Taxation Code, and the regulations thereunder. The various items of nonbusiness income are then directly allocated to specific states pursuant to the provisions of Section 25124 to 25127, Revenue and Taxation Code. The taxpayer's distributive share of partnership business income is apportioned by the formula set forth in subsections (f) or (g), whichever is applicable. Even if the partnership's business and the taxpayer's business are not unitary, such that subsection (g) applies, the distributive share of income allocated to the taxpayer is from a separate trade or business of the taxpayer, not nonbusiness income of the taxpayer. The determination of whether an item of income is apportionable business income or allocable nonbusiness income is made at the partnership level based on the trade or business of the partnership. Revenue and Taxation Code section 23040 is not applicable. The sum of (1) the items of nonbusiness income directly allocated to this state, plus (2) the amount of business income attributed to this state is the portion of the taxpayer's entire net income which is subject to tax.

Income arising from transactions and activity in the regular course of the partnership's trade or business constitutes business income. Thus, a corporate-partner's distributive share of partnership business income constitutes business income to the corporate-partner, but the determination of whether the partnership's activities and the activities of the corporate-partner constitutes a single trade or business or more than one trade or business turns on the facts in each case. If the partnership's activities and the taxpayer's activities constitute a unitary business under established standards, disregarding ownership requirements, the taxpayer's share of the partnership's trade or business shall be combined with the taxpayer's trade or business as constituting a single trade or business . . . When the activities of the partnership and the taxpayer do not constitute a unitary business under established standards, disregarding ownership requirements, the taxpayer's share of the partnership's trade or business shall be treated as a separate trade or business of the taxpayer.

(f) If the partnership's activities and the taxpayer's activities constitute a unitary business under established standards, disregarding ownership requirements, the business income of such single trade or business attributable to this state shall be determined by an apportionment formula, pursuant to either Section 25128, Section 25128.5 or Section 25128.7, Revenue and Taxation Code, whichever is applicable, of the taxpayer and its share of the partnership's factors for any partnership taxable year ending within or with the taxpayer's taxable year . . .

(f)(3)(A) The partnership's sales which give rise to business income, shall be included in the denominator of the taxpayer's sales factor to the extent of the taxpayer's interest in the partnership. The amount of such sales attributable to this state shall also be

included in the numerator of the taxpayer's sales factor. Intercompany sales between the partnership, on the one hand, and the taxpayer or any member of the taxpayer's combined reporting group, on the other, shall be eliminated from the denominator of the taxpayer or the taxpayer's combined reporting group (if applicable), as well as the numerator of the taxpayer's sales factor or the numerator of another member of the taxpayer's combined reporting group, whomever made the sale to the partnership, as follows:

(i) Sales by the taxpayer, or any member of the taxpayer's combined reporting group, to the partnership to the extent of the taxpayer's interest in the partnership.

(ii) Sales by the partnership to the taxpayer, or any member of the taxpayer's combined reporting group, not to exceed the taxpayer's interest in all partnership sales.

(f)(3)(B) Notwithstanding any intercompany eliminations described in subparagraph (A) above, sales made to nonpartners, other than members of the partner taxpayer's combined reporting group, shall be included in the denominator of the taxpayer's sales factor in an amount equal to such taxpayer's interest in the partnership.

(f)(4) A taxpayer's partnership interest for the purpose of computing the portion of the partnership's property, payroll and sales to be included in the taxpayer's property, payroll or sales factor shall be determined by the taxpayer's "interest in the partnership". The taxpayer's interest in the partnership shall be determined by reference to its interest in profits of the partnership.

(f)(5) If a partnership and a corporation are engaged in a unitary business and their accounting periods are different, if necessary, in order to avoid distortion, the income and factors of the partnership will be determined on the basis of the corporate partner's accounting period.

(g) When the activities of the partnership and the taxpayer do not constitute a unitary business under established standards, disregarding ownership requirements, the taxpayer's share of the partnership's trade or business shall be treated as a separate trade or business of the taxpayer.

Cal. Code Regs. tit. 18, § 17951-4(d)

If a nonresident is a partner in a partnership which carries on a unitary business, trade or profession within and without this state, the source of the partner's distributive share of partnership income derived from sources within this state shall be determined in the manner described below.

- (1) Except as provided, the total business income of the partnership shall be apportioned at the partnership level in accordance with the apportionment rules of the Uniform Division of Income for Tax Purposes Act, Sections 25120 to 25139, Revenue and Taxation Code, and the regulations thereunder. Each partner's distributive share of the partnership business income apportioned to this state is income derived from sources within this state.
- (2) If the partnership and the business activity of the partner are part of one unitary business, then the rules of Title 18, Cal. Code Regs., § 25137-1(f) apply and the apportionment of the partnership business income is done at the partner level for the unitary partner or partners. Each partner's distributive share of the partnership business income apportioned to this state is income derived from sources within this state.
- (3) The source of guaranteed payments received by a nonresident partner from a partnership shall be determined as if the guaranteed payments were a distributive share of partnership business income.

- (4) The source of a partner's distributive share of items which do not constitute business income shall be determined in accordance with the sourcing rules of Sections 17951 through 17955, Revenue and Taxation Code, and the regulations thereunder, as if the income producing activity were undertaken by the partner in its individual capacity.
- (5) Except as provided in subsection (d)(6), the business activity of a partnership will not ordinarily be considered part of a unitary business with another business activity of one or more of its partners. However, if necessary to properly reflect the income or loss of the partnership or its partners, the Franchise Tax Board shall have the discretion to treat the business activity of a partnership and a business activity of one or more of its partners as part of a single unitary business, but only after conducting a comparable uncontrolled price examination in the manner provided by Section 23801(d)(1), Revenue and Taxation Code. For this purpose, the term "business activity" includes the partner's interest in the business activity of a sole proprietorship, another partnership, a limited liability company and an S corporation. If the Franchise Tax Board determines that unitary combination is appropriate under this subsection, the business income of the unitary activity shall be apportioned in accordance with the rules prescribed under subsection (d)(6)(A), without regard to the 20 percent limitation described therein.
- (6) Exception for 20 percent or more interests. Subsection (d)(5) shall not apply to partners who own, directly or indirectly, a 20 percent or more capital or profits interest in a partnership. For purposes of this section, the ownership of a capital or profits interest in a partnership shall be determined under the rules of subsection (d)(6)(B).

(A) If a partner owns a 20 percent or more interest, as described in subsection (d)(6), and the business activity of the partnership is unitary with another business activity of the partner as that phrase is described in subsection (d)(5), the income of the unitary activity shall be combined at the partner level and apportioned to this state under the provisions of the Uniform Division of Income for Tax Purposes Act, Sections 25120- 25139 inclusive, Revenue and Taxation Code, and the regulations thereunder. In determining the amount of business income apportioned to this state, the partner shall combine the business income from unitary sole proprietorships and its distributive or pro rata shares of business income from 20 percent or more interests in unitary partnerships and S corporations. For purposes of the preceding sentence, the combined business income of a unitary partnership or S corporation shall be limited to the distributive or pro rata share of business income of the partner or shareholder from interests actually (not constructively) owned. The combined unitary business income shall be apportioned to this state under the provisions of the Uniform Division of Income for Tax Purposes Act, Sections 25120-25139, Revenue and Taxation Code, and the regulations thereunder, at the partner level. For that purpose, the partner shall aggregate its payroll, property and sales from unitary sole proprietorships and its proportionate share of payroll, property, and sales, whichever is applicable, from unitary partnerships and S corporations in which the partner or shareholder owns a 20 percent or more interest to arrive at a single apportionment percentage. That percentage is applied to the combined unitary business income computed under this subsection to determine the partner's business income from sources within this state.

(B) For purposes of this subsection (d)(6), the actual or constructive ownership of a capital or profits interest in a partnership shall be determined in accordance with the following rules:

1. An interest in partnership capital or profits which is owned, directly or indirectly, by or for a corporation, partnership, estate, or trust shall be considered as being owned proportionately by or for its shareholders, partners, or beneficiaries.

2. An individual shall be considered as owning the interest in partnership capital or profits owned, directly or indirectly, by or for his or her family.
3. The family of an individual shall include only his or her brothers and sisters (whether by the whole or half blood), spouse, ancestors, and lineal descendants, and
4. An interest in partnership capital or profits constructively owned by a person by reason of the application of subsection (d)(6)(B)1. shall, for the purpose of applying subsections (d)(6)(B)1. or (d)(6)(B)2., be treated as actually owned by such person, but an interest in partnership capital or profits constructively owned by an individual by reason of the application of subsection (d)(6)(B)2. shall not be treated as owned by him for the purpose of again applying either of such subsections in order to make another the constructive owner of such interest in partnership capital or profits.

EXAMPLE: Individual X is engaged in a sole proprietorship with business income of \$100,000. In addition, X directly owns a 15% capital interest in Partnership P. X's sister Y also owns a 10% capital interest in P. X's distributive share of business income from P is \$30,000, and his sister's distributive share of business income from P is \$20,000. P and X's sole proprietorship are engaged in a unitary business. Under subsection (d)(6)(B), X is treated as constructively owning Y's interest in the partnership. Thus X's aggregate owned or constructively owned interest in P is 25%. Accordingly, X is subject to the apportionment provisions of subsection (d)(6)(A). However, under subsection (d)(6)(A), X will combine and apportion only the sum of his \$100,000 proprietorship income and his actual distributive share of business income of \$30,000 from P. The 20 percent test used to determine the applicability of subsection (d)(6) does not affect the amount of partnership income taken into account in computing income actually derived from sources within this state.

Appeal of Smith, California Office of Tax Appeals Decision No. 20036033 (Dec. 7, 2022)

Applies Cal. Code Regs. tit. 18, § 25137-1 to a tiered partnership. The partnership's apportionment factors flowed through to the pass-through holding company partner.

Matter of J. Blau, California Office of Tax Appeals Decision No. 21088383 (July 7, 2023, *rehearing denied* May 9, 2024) S

Involves the use of blended apportionment in a tiered partnership. “Appellant contends that the ‘TRC LP apportionment factor should flow[-]through to [appellant]’; therefore, FTB should use the California apportionment percentage of 9.2511 from TRC LP, as modified by appellant, to source the 1231 net gain business income. However, appellant has not provided any details as to the composition of the apportionment factors for Yukon and TRC LP. Also, appellant did not explain the discrepancy between the California apportionment percentages originally reported by Yukon, 10.0640 percent, and TRC LP, 12.1215 percent. In sum, appellant fails to show potentially relevant facts of how income and apportionment factors should flow-through from the various underlying pass-through entities to TRC LP and from TRC LP to Yukon. For example, appellant did not establish whether some or all of the underlying pass-through entities (where the various 1231 net gain transactions originated) were unitary with TRC LP and whether Yukon was unitary with TRC LP. As such, appellant has not shown the 1231 net gain (generated by the various underlying pass-through entities) is properly apportioned using TRC LP’s apportionment factors (modified to include the 1231 net gain transactions generated by the various underlying pass-through entities) without regard to Yukon’s apportionment factors. (See Cal. Code Regs., tit. 18, § 25137-1(f) and (g).) Therefore, appellant has not established any basis to rebut FTB’s determination

which used the reported California apportionment percentage from Yukon to source the 1231 net gain business income to California.”

California FTB Legal Ruling No. 2021-01

Analyzes whether pass-through entity holding companies are unitary with other pass-through entities in various situations.

“Lastly, one must not forget that, as discussed above, traditional tests for unity are not an exact fit in the context of pass-through entity holding companies. The traditional unitary tests were concerned with the extent to which the income and factors of disparate corporate affiliates could be combined and used to apportion income. In the corporate context, all factors and income of unitary entities are combined. However, with pass-through interests, an entity is unitary only to the extent of its interest in the pass-through entity. Therefore if a partner is unitary with a partnership and holds a 25 interest, the partner and 25 percent of the partnerships income and factors are combined. Thus, since not all of the income and factors of a unitary holding company are includable, attributes normally considered insignificant become critical. Therefore, in instances where a pass-through entity holding company holds less than a controlling interest in an operating entity, the holding company can still be unitary with the operating entity, to the extent of its ownership interest in the entity. This is because pass-through entities need not hold more than fifty percent of an entity to be unitary with that entity. As long as unitary indicia, as discussed above, exist, a pass-through entity holding company can be unitary with an operating entity. If a pass-through entity holding company provides value and support to the operating business, it will be properly treated as unitary with that business.”

Matter of the Appeal of: JOHN E. FRANTZ, California State Board of Equalization Decision No. 461562 (May 30, 2012) (finding substantial economic effect for an allocation of losses).

California Form 565 Instructions (2023)

For section 704(c) property use the California tax basis to determine section 704(c) built-in gain or loss.

Colorado

Colo. Rev. Stat. § 39-22-203(1)(a)

In determining Colorado nonresident federal taxable income of a nonresident partner of any partnership, there shall be included only the portion of such partner’s distributive share of items of partnership income, gain, loss, deduction, or credit derived from sources within Colorado determined in accordance with the provisions of section 39-22-109 or, at the partnership’s election, apportioned or allocated to this state pursuant to section 39-22-303.5, 39-22-303.6, or 39-22-303.7.

Colo. Code Regs. § 39-22-109(3)(c)

Distributive Share of a Member of a Pass-Through Entity. Income received as part of the Nonresident individual’s distributive share of a Pass-through entity income, gain, loss, or deduction is Colorado-source income to the extent that the Pass-through entity determines that income is Colorado-source income pursuant to § 39-22-203(1)(a), C.R.S., and the rules promulgated thereunder. These rules apply to all Members of a Pass-through entity regardless of the type of the entity (e.g., limited liability company,

limited liability partnership, limited liability limited partnership) or the status of the Member (e.g., limited or general).

(i) A Nonresident has Nexus with Colorado if the Nonresident is a Member of a Pass-through entity doing business in Colorado.

(ii) Character of Income. The activities of a Pass-through entity are attributable to its Members. Therefore, a Member is engaged in a Business in Colorado to the extent the Pass-through entity is engaged in Business in Colorado. The character of the item of income, loss, deduction or credit included in the Member's distributive share is determined as if the item was realized or incurred directly by the Member from the source from which the item was realized by the Pass-through entity or incurred in the same manner as the Pass-through entity. The principles of this paragraph apply in the case of an ownership chain that runs through multiple Pass-through entities.

(iii) A Nonresident Member of a Pass-through entity deriving income from within Colorado and elsewhere has Colorado-source income as determined by § 39-22-109, C.R.S., and this rule, or as determined by § 39-22-303.6, C.R.S., and the rules thereunder if the Pass-through entity elects under § 39-22-203(1)(a), C.R.S., to apportion its income pursuant to § 39-22-303.6, C.R.S.

(iv) A Nonresident Member's share of Colorado-source Business income of a Pass-through entity that elects to apportion its income pursuant to § 39-22-303.6, C.R.S. (including the special apportionment rules adopted thereunder), shall be based on the Member's pro rata share of such Pass-through entity's income multiplied by the Pass-through entity's apportionment percentage.

(v) In the case of a Nonresident who is a Member of a partnership ("first partnership"), which partnership is a partner in another partnership ("second partnership"), the following rules apply:

(A) Unitary Partnerships. In the case of unitary partnerships, the election made by the second partnership is irrelevant to the treatment of income of the first partnership.

(I) If the first partnership makes the election to apportion its income pursuant to § 39-22-303.6, C.R.S. (including the special apportionment rules adopted thereunder), and is unitary with the second partnership as determined by general unitary theory, then the Nonresident member of the first partnership's share of Colorado source income is the Member's pro rata share of the partnership's Colorado-source income as determined by § 39-22-303.6, C.R.S. The first and second partnerships are treated as a single entity for purposes of calculating apportionment under § 39-22-303.6, C.R.S.

(II) If the first partnership makes the election not to apportion its income pursuant to § 39-22-303.6, C.R.S., and is unitary with the second partnership, then the partnerships are treated as one partnership and the income is sourced in accordance with this rule.

(B) Non-Unitary Partnerships. In the case of non-unitary partnerships, the election made by the first partnership is irrelevant to the treatment of income of the second partnership.

(I) If the two partnerships are non-unitary, then regardless of the election made by the first partnership, the first partnership's pro-rata share of the second partnership's Colorado-source income is directly allocated by the first partnership to Colorado and is not apportioned. The pro-rata share of such income passes through to the Nonresident Member as Colorado-source income.

(vi) A Nonresident individual may include as a credit for taxes paid on their Nonresident individual income tax return any payment made on their behalf by a partnership

or Subchapter S corporation on a composite return. See §§ 39-22-601 (2.5) and (5), C.R.S. . . .

Connecticut

Conn. Gen. Stat. § 12-218(g)

- (1) Any company that is (A) a limited partner in a partnership, other than an investment partnership, that does business, owns or leases property or maintains an office within this state and (B) not otherwise carrying on or doing business in this state shall pay the tax imposed under section 12-214 solely on its distributive share as a partner of the income or loss of such partnership to the extent such income or loss is derived from or connected with sources within this state, except that, if the commissioner determines that the company and the partnership are, in substance, parts of a unitary business engaged in a single business enterprise or if the company is a member of a combined group that files a combined unitary tax return, the company shall be taxed in accordance with the provisions of subdivision (3) of this subsection and not in accordance with the provisions of this subdivision, provided, in lieu of the payment of tax based solely on its distributive share, such company may elect for any particular income year, on or before the due date or, if applicable the extended due date, of its corporation business tax return for such income year, to apportion its net income within and without the state under the provisions of this chapter.
- (2) Any company that is (A) a limited partner (i) in an investment partnership or (ii) in a limited partnership, other than an investment partnership, that does business, owns or leases property or maintains an office within this state and (B) otherwise carrying on or doing business in this state shall apportion its net income, including its distributive share as a partner of such partnership income or loss, within and without the state under the provisions of this chapter, except that the numerator and the denominator of its apportionment fraction shall include its proportionate part, as a partner, of the numerator and the denominator of such partnership's apportionment fraction. For purposes of this section, such partnership shall compute its apportionment fraction and the numerator and the denominator of its apportionment fraction as if it were a company taxable both within and without this state.
- (3) Any company that is a general partner in a partnership that does business, owns or leases property or maintains an office within this state shall, whether or not it is otherwise carrying on or doing business in this state, apportion its net income, including its distributive share as a partner of such partnership income or loss, within and without the state under the provisions of this chapter, except that the numerator and the denominator of its apportionment fraction shall include its proportionate part, as a partner, of the numerator and the denominator of such partnership's apportionment fraction. For purposes of this section, such partnership shall compute its apportionment fraction and the numerator and the denominator of its apportionment fraction as if it were a company taxable both within and without this state.

Conn. Gen. Stat. § 12-219a

- (b)(1) Any company that is (A) a limited partner in a partnership, other than an investment partnership, that does business, owns or leases property or maintains an office within this state and (B) not otherwise carrying on or doing business in this state shall apportion the average value of its partnership interest within and without this state under the provisions of subsection (a) of this section, except that the numerator and the denominator of its apportionment fraction shall be its proportionate part of the partnership's apportionment factors. For purposes of this section, the partnership shall

compute its apportionment fraction and the numerator and the denominator of its apportionment factors as if it were a company taxable both within and without this state. However, if the commissioner determines that the company and the partnership are, in substance, parts of a unitary business engaged in a single business enterprise, or, if the company is a member of a combined group that files a combined unitary tax return, the company shall be taxed in accordance with the provisions of subdivision (3) of this subsection and not in accordance with the provisions of this subdivision.

(b)(2) Any company that is (A) a limited partner (i) in an investment partnership or (ii) in a limited partnership, other than an investment partnership, that does business, owns or leases property or maintains an office within this state and (B) otherwise carrying on or doing business in this state shall apportion its additional tax base, including the average value of its partnership interest, within and without the state under the provisions of subsection (a) of this section, except that the numerator and the denominator of its apportionment factors shall include its proportionate part of the numerator and the denominator of the partnership's apportionment factors. For purposes of this section, the partnership shall compute its apportionment fraction and the numerator and the denominator of its apportionment factors, as if it were a company taxable both within and without this state.

(b)(3) Any company that is a general partner in a partnership that does business, owns or leases property or maintains an office within this state shall, whether or not it is otherwise carrying on or doing business in this state, apportion its additional tax base, including the average value of its partnership interest, within and without the state under the provisions of subsection (a) of this section, except that the numerator and the denominator of its apportionment factors shall include its proportionate part of the numerator and the denominator of the partnership's apportionment factors. For purposes of this section, the partnership shall compute its apportionment fraction and the numerator and the denominator of its apportionment factors, as if it were a company taxable both within and without this state.

(d) The additional tax base of taxable and nontaxable members of a combined group required to file a combined unitary tax return pursuant to section 12-222 shall be apportioned as provided in subsection (g) of section 12-218e.

Conn. Gen. Stat. § 12-213(a)(32)

(32) "Unitary business" means a single economic enterprise that is made up either of separate parts of a single business entity or of a group of business entities under common ownership, which enterprise is sufficiently interdependent, integrated or interrelated through its activities so as to provide mutual benefit and produce a significant sharing or exchange of value among such entities, or a significant flow of value among the separate parts. For purposes of this chapter, (A) any business conducted by a pass-through entity shall be treated as conducted by its members, whether directly held or indirectly held through a series of pass-through entities, to the extent of the member's distributive share of the pass-through entity's income, regardless of the percentage of the member's ownership interest or its distributive or any other share of pass-through entity income, and (B) any business conducted directly or indirectly by one corporation is unitary with that portion of a business conducted by another corporation through its direct or indirect interest in a pass-through entity if there is a mutual benefit and a significant sharing of exchange or flow of value between the two parts of the business and the two corporations are members of the same group of business entities under common ownership.

Conn. Agencies Regs. § 12-715(a)-1

- (c) The amount of any modification to be made by a partner with respect to a partnership item of income, gain, loss or deduction is to be determined as follows:
- (1) If a modification relates to any item subject to special allocation among the partners under the partnership agreement, which item is therefore accounted for separately for federal income tax purposes, the amount of each partner's share of the modification is determined by such partner's distributive share of such item for federal income tax purposes.
 - (2) If a modification relates to an item that is included in computing the partnership's taxable income or loss generally (i.e., that portion of federal adjusted gross income described in section 702(a)(8) of the Internal Revenue Code), other than an item subject to a special allocation among the partners under the partnership agreement that differs from the allocation of partnership taxable income or loss generally, each partner's modification relating to that item is determined by such partner's distributive share for federal income tax purposes of the taxable income or loss of the partnership required to be reported in accordance with said section 702(a)(8).
 - (3) If a modification relates to an item that is not taken into account for federal income tax purposes (such as interest income on bonds of other states) and such item is not one which is subject to a special allocation among the partners under the partnership agreement that differs from the allocation of partnership taxable income or loss generally, each partner's modification in respect to such an item is determined by such partner's distributive share for federal income tax purposes of the taxable income or loss of the partnership described in section 702(a)(8) of the Internal Revenue Code.
 - (4) If a modification relates to an item that is not taken into account for federal income tax purposes (such as interest income on bonds of other states) and such item is one which is subject to a special allocation among the partners under the partnership agreement that differs from the allocation of partnership taxable income or loss generally, each partner's modification in respect to such an item is determined by the allocation provided for in the partnership agreement.
- (d) The modifications covered by this section do not apply to any item attributable to the partner directly and not reflected on the Connecticut partnership informational return (Form CT-1065), such as a gain that the partner realizes on the sale of the partnership interest.

Conn. Agencies Regs. § 12-715(c)-1

- (a) If a partnership agreement provides for a special allocation among the partners of any item of partnership income, gain, loss or deduction, federal income tax law requires that such a provision be disregarded for federal income tax purposes, where its principal purpose is the avoidance or evasion of federal income tax. In such a case, each partner's distributive share of such item is determined by such partner's distributive share for federal income tax purposes of the taxable income or loss of the partnership as described in section 702(a)(8) of the Internal revenue Code. This treatment and distribution of the item is reflected in each partner's federal adjusted gross income and, therefore, in each partner's Connecticut adjusted gross income, even though in a particular case no Connecticut income tax avoidance or evasion may be involved.
- (b) In certain cases, however, a provision for special allocation does not have as its principal purpose the avoidance or evasion of federal income tax, but has as its principal purpose the avoidance or evasion of Connecticut income tax. In such an instance, any such provision shall be disregarded and each partner's share of the pertinent item of partnership income, gain, loss or deduction shall also be determined by the partner's distributive share for federal income tax purposes of the taxable income or loss of the partnership as described in section 702(a)(8) of the Internal Revenue Code.

(c) Whether the principal purpose of a special allocation of an item is the avoidance or evasion of Connecticut income tax depends on the surrounding facts and circumstances. Among the relevant facts to be considered are the following: whether the partnership or partner individually has a business purpose for the allocation; whether the allocation has substantial economic effect, as the term is used in section 704(b)(2) of the Internal Revenue Code (i.e., whether the allocation may actually affect the dollar amount of the partners' shares of the total partnership income or loss independently of Connecticut income tax consequences); whether related items of income, gain, loss or deduction from the same source are subject to the same allocation; whether the allocation was made without recognition of normal business factors and only after the amount of the specially allocated item could reasonably be estimated; the duration of the allocation; and the overall Connecticut income tax consequences of the allocation.

Example: A and B are equal partners. The partnership agreement, however, allocates to A, who has a higher effective rate of Connecticut income tax than B, all interest income on bonds of the State of Connecticut held by the partnership and allocates to B all interest income on bonds of other states. The partnership agreement also provides that any difference in the amounts of such interest income allocated to each partner is to be equalized out of other partnership income. Because the purpose and effect of this allocation is solely to reduce the Connecticut income tax of A without actually affecting the distributive shares of A and B in partnership income, such allocation is not recognized. Accordingly, in determining their respective Connecticut adjusted gross incomes, A and B each shall add to federal adjusted gross income one-half of the interest income from bonds of other states under § 12-701(a)(20)-2 of Part I.

(d) While this section pertains to Section 12-715(c) of the general statutes, for purposes of supplementary interpretation, as the phrase is used in Section 12-2 of the general statutes, the adoption of this section is authorized by Section 12-740(a) of the general statutes.

Delaware

Del. Code Ann. tit. 30, § 1622

Each item of the income, gain, loss or deduction of a pass-through entity shall have the same character for a member of such pass-through entity under this title as it has for federal income tax purposes. Where federal income tax rules and principles are not determinative of the character or of the source of an item of income, gain, loss or deduction for purposes of this title, such item shall have the same character or source for a member of the pass-through entity as if the item were realized directly by such member from the source from which realized by the pass-through entity or incurred in the same manner as incurred by the pass-through entity. A member's distributive share of any item of the income, gain, loss or deduction of a pass-through entity shall, solely for purposes of the immediately preceding sentence, be determined by application of the principles of § 704(b) of the Internal Revenue Code [26 U.S.C. § 704(b)], including, without limitation, the principles for determining whether an allocation of such item among the members of such pass-through entity has substantial economic effect.

Del. Code Ann. tit. 30, § 1623

(c) Corporate members of pass-through entities. — A corporation that is a member of a pass-through entity doing business or having real or tangible personal property in this State shall be subject to the provisions of Chapter 19 of this title; provided,

however, that this subsection shall not be interpreted as precluding a corporation that is a member of a pass-through entity from qualifying for exemption from taxation under Chapter 19 pursuant to § 1902(b)(8) of this title.

(d) Allocation and apportionment of income. — In determining the tax liability under Chapter 19 of this title of a corporation that is a member of a pass-through entity doing business or having real or tangible personal property in this State:

Such corporation's federal taxable income shall be increased or decreased, as the case may be, by its distributive share of such pass-through entity's items, if any, described in § 1903(a) of this title;

Such corporation's distributive share of any item of such pass-through entity that is described in any of § 1903(b)(1) through (5) of this title shall be included in the entire net income of such corporation only if such item is properly allocable to this State under such § 1903(b) of this title; and

In applying § 1903(b)(6) of this title to such corporation,

(1) The entire business of such corporation shall not be treated as having been transacted or conducted within this State if any part of the business of such pass-through entity was transacted or conducted outside this State; and

(2) The 3 ratios described in such § 1903(b)(6) of this title of such corporation shall be determined by including in each such ratio such corporation's distributive share of each relevant item of such pass-through entity.

In applying § 1903(b)(7) of this title to such corporation, the ratio described in such § 1903(b)(7) of this title of such corporation shall be determined by including in such ratio the corporation's distributive share of each relevant item of such pass-through entity.

District of Columbia

D.C. Code § 47-1801.4(55)(B)

For the purposes of this chapter, any business conducted by a partnership within the meaning of § 47-1808.06 shall be treated as conducted by its partners, whether directly held or indirectly held through a series of partnerships, to the extent of the partner's distributive share of the partnership's income, regardless of the percentage of the partner's ownership interest or its distributive or any other share of partnership income. A business conducted directly or indirectly by one person is unitary with that portion of a business conducted by another person through its direct or indirect interest in a partnership if there is a synergy and exchange and flow of value between the 2 parts of the business and the 2 persons are members of the same commonly controlled group.

D.C. Code § 47-1810.02

Allocation and apportionment. - The entire net income of any corporation, financial institution, or unincorporated business, or the unrelated business income of an exempt organization, derived from any trade or business carried on or engaged wholly within the District shall, for the purposes of this chapter, be deemed to be from sources within the District and shall, along with other income from sources within the District, be allocated to the District. If the net income of a corporation, financial institution, or unincorporated business, or the unrelated business income of an exempt organization, is

derived from sources within and without the District, the taxpayer shall apportion business income and allocate non-business income as provided in this section.

D.C. Code § 47-1810.04(c)(1)(B)(2)

If any member owns an interest in a partnership that is not an unincorporated business, as defined by § 47-1808.01, the income or loss of such partnership shall be apportioned to the District using the apportionment factor of the partnership, and the combined group member-partner's distributive share of such income shall be added to the combined group member-partner's income."

D.C. Mun. Regs. tit. 9, § 109.20(h)

The amounts of the property, payroll, and sales of a partnership are attributable to the partners or members of the joint venture. A corporation that is a partner in a partnership must add its share of the property, payroll, and sales to its own apportionment factors, regardless of whether the partnerships are District of Columbia partnerships. The affiliated group should include a separate schedule to show the distribution to each partner.

Agency Website

If a partner is a combined group member, the partner must include or exclude its distributive share of income or loss in the following manner:

(a) Starting point for a partner: A partner on the D-20 or D-30 generally starts with federal income and deduction items which are modified for District purposes. In this income, the distributive share of partnership interest should already have been included and modified for District tax purposes on the "Other income (loss)" line (currently line 9, on D-20 or D-30).

(b) Exclusion modification: If the distributive share has been reported by and taxed against any person, the partner's distributive share of this income or loss shall be excluded from the partner's return on line 9 of the D-20 or D-30 to prevent double taxation or double deduction (see also UB Worksheet A and B). The amount that should be excluded is that which has been apportioned to and taxed within the District and that portion which has been subject to apportionment and taxed outside the District.

(c) Treatment of distributive loss: If the distributive share of a partner is a loss and the entity which issued the distributive share is also filing a District return (stand-alone or combined), and the entity is carrying forward that loss to future years, the distributive share of that loss is not allowed on the partner's return to avoid double deduction of the loss because this loss is a loss of the entity and not of the partner.

(d) No flow through of factors: A partner shall not flow through its share of the UB or partnership's apportionment factors and combine them with its own factors. However, a single member entity, if disregarded for federal income tax purposes, shall be treated as disregarded for District income and franchise tax purposes, and all the income, deductions, and apportionment factors shall be included with and reported by the owner of the single member entity.

(e) Apportionment of partner's distributive share of UB or partnership: If the UB or partnership is both within and without the District, then any portion of the partner's distributive share from the K-1 (modified for District tax purposes) which has not been reported and taxed at the UB level on the combined report shall be included in the partner's income and apportioned, if it is business income.

(f) To calculate the apportionment factor to apply to the untaxed income as indicated in (e):

(1) Denominator. The denominator shall be the total net unreported and untaxed distributive share of the income which shall be added to the partner's sales factor.

(2) Numerator. The numerator shall be the unreported and untaxed portion of the distributive share multiplied by the UB's or partnership's apportionment percentage.

(3) Example: If the distributive share is \$200 and \$100 of that share was reported and taxed at the UB level, and the remaining \$100 (the net amount) was untaxed, that \$100 will be added to the partner's sales factor denominator. If the UB's apportionment factor is 50%, then \$50 will be added to the partner's sales factor numerator for purposes of apportioning the part which was not previously apportioned and taxed

(g) UB filing requirements: If a UB is a member of the combined group, the UB shall report all its income and apportionment factors on the combined report only and not file a stand-alone return.

Florida

Fla. Admin. Code Ann. r. 12C-1.015(10)

Partnerships. The amounts of the property, payroll, and sales of a partnership are attributable to the partners or members of the joint venture. A corporation that is a partner in a partnership must add its share of the property, payroll, and sales to its own apportionment factors, regardless of whether the partnerships are Florida partnerships. Form F-1065 is used in part to distribute to each partner subject to the tax its share of the apportionment factors of the partnership or joint venture.

Florida TAA # 11C1-001(February 2, 2011)

Whether the taxpayer's sales, payroll, and property factors of the apportionment formula should include the taxpayer's interest in various partnerships . . .

The Florida statutes and rules are clear that the activities of a partnership flow through the partnership to its partners. In its letter dated XXX, the taxpayer states that the partnerships it invests in contain multiple layers of ownership, and the lower tiered and middle tiered partnerships do not report apportionment information to the top tiered partnership because they are not required to do so in the states where they are located. Therefore, the upper tiered partnerships do not have any way to report the apportionment information from the middle and lower tiered partnerships to the corporate partner (in this case the taxpayer).

For federal income tax purposes, partnerships generally have no formal federal filing requirement other than information returns, and because a partnership is a conduit, items of partnership income, expense, gain, or loss pass through to the partners and are given tax effect at the partner level. For state income tax apportionment purposes, a particular state's approach in this area dictates the flow-through of partnership tax attributes up to the corporate partner.

Florida's approach conforms to the federal concept of the flow-through of partnership tax attributes up to the corporate partner. The apportionment rule, Rule 12C-1.015(10), F.A.C., governs the corporate income tax treatment of corporations that invest in partnerships. This rule provides that a corporation that is a partner in a

partnership must add its share of the partnership's property, payroll, and sales to its own apportionment factor. Based on the foregoing, the partnerships' property, payroll, and sales should be combined with the taxpayer's property, payroll, and sales, for purposes of determining the taxpayer's apportionment factor as provided by Rule 12C-1.0153(9), F.A.C., Rule 12C-1.0154(6), F.A.C., and Rule 12C-1.0155(4), F.A.C.

The taxpayer asserts that the tiered partnerships do not provide the taxpayer with their respective apportionment factors. Therefore, the taxpayer does not have the required apportionment information to correctly apportion its income in accordance with Rule 12C-1.015(10), F.A.C. However, the Florida statutes and rules are clear that the activities of a partnership flow through the partnership to its partners. Therefore, the activities of the partnership are attributable to the partners and, contrary to the statement in the taxpayer's letter, are unitary to the partners.

Florida TAA # 23C1-012 (October 3, 2023)

In the case of a flow-through entity (i.e., whose income flows through to Taxpayer, Taxpayer's portion of the sales factor provided to it by ____ for inclusion in Taxpayer's own factors should reflect the proper sourcing of the ____ based on the location of ____ customers.

Florida TAA # (November 10, 2014)

While section 220.152, F.S., authorizes a taxpayer to petition the Department to use an alternative apportionment method if the methods of sections 220.15 and 220.151, F.S., do not fairly represent the taxpayer's tax base attributable to Florida, the taxpayer is also required to show that use of the apportionment method provided by section 220.15, F.S., causes its tax base attributable to Florida to be unfairly represented. Here, Florida law requires the taxpayer to include its share of the LLC's property, payroll, and sales, with its own, in computing its Florida apportionment factor. The taxpayer has not shown that using this apportionment method causes its tax base attributable to Florida to be unfairly represented. Therefore, the Department cannot approve an alternative apportionment method.

CONCLUSION

Based on the discussion above, Florida law requires the taxpayer to include its share of the LLC's property, payroll, and sales, when determining the taxpayer's apportionment factor. Additionally, as the taxpayer has failed to show that use of the apportionment method provided by section 220.15, F.S., causes its tax base attributable to Florida to be unreasonably and arbitrarily represented, the taxpayer is required to use the apportionment method provided by section 220.15, F.S., in apportioning its income to Florida.

Florida Form F-1065: Partnership Information Return Instructions (2022)

Each partner's share of the apportionment factors is determined by multiplying the amount in Part III-A, on Lines 1, 2, and 3 by the percentage interest of each partner. Amounts determined should be added to each partner's apportionment factors included on its Florida Form F-1120. Partnerships subject to a special industry apportionment fraction (for example, those engaged mainly in transportation services) should adjust this schedule to report each partner's share of the special apportionment fraction (for example, revenue miles for transportation).

Georgia

Ga. Comp. R. & Regs. § 560-7-7-.03(4)(e) and 5(f)

A corporation that is involved in a business joint venture, is a member of a limited liability company or similar nontaxable entity not treated as a corporation for federal income tax purposes, or is a partner in a business partnership, must include its pro rata share of the entity's property, payroll, and gross receipts in its own apportionment formula. In determining its income, the corporation includes its share of the entity's income before the entity apportions and allocates its income.

Ga. Code Ann. § 48-7-53(c)(3)(C) (in audit situation)

Determine the total distributive share of all final federal adjustments and positive reallocation adjustments as modified by this title and apportion and allocate such adjustments as provided in Code Section 48-7-31 for such electing partnership or such electing tiered partner and determine the total distributive share of such amounts that are allocated to all corporate partners, all tiered partners, all exempt partners and that is unrelated business income, all nonresident individual partners, and all nonresident fiduciary partners. If the commissioner determines that a partnership or tiered partner fraudulently underreported its income on a return, the commissioner shall treat any income attributable to a tiered partner of such partnership or tiered partner as being apportioned and allocated entirely to Georgia to the extent the direct and indirect partners of such tiered partner are resident partners.

Hawaii

Haw. Code R. § 18-235-29-04

(a) If a taxpayer is a partner in a partnership, and the partnership's activities and the taxpayer's activities constitute a unitary business:

(1) The taxpayer's share of the partnership's trade or business shall be combined with the taxpayer's trade or business;

(2) The property, payroll, and sales factors, or other applicable factors, of the taxpayer and the partnership shall be combined; and

(3) Intercompany items shall be eliminated, under the principles set forth in section 18-235-22-03.

Example 1: Corporation A's distributive share of income in partnership P is 20 per cent. Corporation A manufactures toys which are sold in the seven western states by partnership P. Corporation A's business income for the year was \$1,000,000 and partnership P's business income for the same year was \$800,000. The business income of corporation A is \$1,160,000 (\$1,000,000 plus 20 per cent of \$800,000).

Example 2: The facts are the same as in Example 1. Partnership P owns a building with an original cost of \$100,000 which is rented to corporation A for \$12,000 per year. Corporation A shall include \$20,000 (20 per cent of \$100,000) in its property factor because of its interest in partnership P. In addition, Corporation A shall take into account \$9,600 (\$12,000 less 20 percent of \$12,000) of rental expense into its property factor in order to include in the property factor the rented building used in Corporation A's operation. Thus, Corporation A shall include \$76,800 (\$9,600 multiplied by 8, pursuant to section 235-31, HRS) for the rent paid, and \$20,000 for its interest in the building

through Partnership P, in its property factor, totaling \$96,800 attributable to the building.

(b) If a taxpayer is a partner in a partnership, and the partnership's activities and the taxpayer's activities do not constitute a unitary business, the partnership shall allocate and apportion its income at the partnership level. The taxpayer's distributive share of the partnership's income allocated or apportioned to this State shall not be subject to further apportionment by the taxpayer.

Example: Corporation A's distributive share of income in partnership P is 20 per cent. Corporation A manufactures and sells toys in the seven western states. Partnership P operates farms within and without this State. Both corporation A and partnership P earn exclusively business income, except for distributions from Partnership P. Corporation A's business income for the year is \$1,000,000 and partnership P's income is \$800,000 for the same year. Because corporation A and partnership P are engaged in two different trades or businesses, corporation A shall apportion its \$1,000,000 income on the basis of its own apportionment formula. Partnership P shall apportion its business income of \$800,000 on the basis of its own apportionment formula. Corporation A's apportionment factors are determined without regard to Partnership P's apportionment factors, and vice versa. Assume that corporation A's apportionment percentage determined under section 18-235-29-01 is 35 per cent, and that partnership P's apportionment percentage is 10 per cent. Partnership P's Hawaii income is 10 per cent of the income from its farming business ($\$80,000 = 10 \text{ per cent} \times \$800,000$). Corporation A is taxable in this State upon 35 per cent of the income from its toy manufacturing business ($\$350,000 = 35 \text{ per cent} \times \$1,000,000$) plus its full distributive share of the partnership income attributed to this State ($\$16,000 = 20 \text{ per cent} \times \$80,000$), or \$366,000.

Idaho

Idaho Admin. Code r. 35.01.01.620

01. In General. If a corporation required to file an Idaho income tax return is a member of an operating partnership, the corporation is to report its Idaho taxable income, including its share of income from the partnership, in accordance with this rule. For purposes of this rule, the term partnership includes a joint venture.

02. Transacting Business. A corporation is transacting business in Idaho if it is a partner in a partnership that is transacting business in Idaho even though the corporation has no other contact with Idaho. In this case, both the partnership and the corporation have an Idaho filing requirement.

03. Multistate Partnerships. If a partnership operates in more than one state, its income is to be apportioned and allocated on the partnership return as if the partnership were a corporation. The allocation and apportionment rules of Section 63-3027, Idaho Code, and related rules apply to the partnership.

04. Partnership Income as Apportionable Income of the Partner.

a. Income. If the income or loss of a partnership is apportionable income or loss to a corporate partner, its share of this net apportionable income or loss is to be apportioned together with all other net apportionable income or loss of the corporation. Apportionable income or loss is defined by Section 63-3027(1)(a), Idaho Code, and Rules 330 through 336 of these rules.

b. Factors. A corporate partner's share of the partnership property, payroll, and sales after intercompany eliminations, is to be included in the numerators and the denominators of the partner's property, payroll, and sales factors when computing its apportionment formula. The partner's share of the partnership's property, payroll, and sales is determined by attributing the partnership's property, payroll, and sales to the partner in the same proportion as its distributive share of partnership income if reporting net income for the taxable year or in the same proportion as its distributive share of partnership losses if reporting a net loss for the taxable year. Generally, the partnership's property, payroll, and sales includable in the corporation's factor computations is determined in accordance with Section 63-3027, Idaho Code, and related rules. To determine how the sales attribution rules of Sections 63-3027(12) and (13), Idaho Code, apply to the sales factor of the corporate partner, the sales of the partnership are treated as if they were sales of the corporation.

05. Partnership Income as Non-apportionable Income of Partner.

a. Income. If the partnership income or loss is not apportionable income to a corporate partner, the income is non-apportionable income as defined in Section 63-3027(1)(h), Idaho Code, and Rules 335 through 339 of these rules. The corporate partner is to allocate the non-apportionable income to the state in which it was earned. The corporate partner, on its Idaho corporation income tax return, is to specifically allocate to Idaho its share of the non-apportionable income attributable to Idaho.

b. Factors. If the partnership income or loss is non-apportionable income to the corporate partner, none of the partnership property, payroll, or sales may be included in the computation of the factors of the corporation.

Idaho Admin. Code r. 35.01.01.785(01)(d) (01/01/2006)

Idaho credits may not pass through to partners or owners based on special allocations.

Anheuser-Busch InBev Worldwide, Inc. v. Idaho State Tax Commission, No. CV01-23-3452 (Idaho District Ct. 07/08/2024)

Holding that Idaho correctly flowed through the partnership's apportionment factors to the corporate partner.

Illinois

35 Ill. Comp. Stat. 5/305

(a) Allocation of partnership business income by partners other than residents. The respective shares of partners other than residents in so much of the business income of the partnership as is allocated or apportioned to this State in the possession of the partnership shall be taken into account by such partners pro rata in accordance with their respective distributive shares of such partnership income for the partnership's taxable year and allocated to this State.

(b) Allocation of partnership nonbusiness income by partners other than residents. The respective shares of partners other than residents in the items of partnership income and deduction not taken into account in computing the business income of a partnership shall be taken into account by such partners pro rata in accordance with their respective distributive shares of such partnership income for the partnership's taxable year, and allocated as if such items had been paid, incurred or accrued directly to such partners in their separate capacities.

(c) Allocation or apportionment of base income by partnership. Base income of a partnership shall be allocated or apportioned to this State pursuant to Article 3, in the same manner as it is allocated or apportioned for any other nonresident . . .

Ill. Admin. Code tit. 86, § 100.3500(d)

Allocation and Apportionment of Base Income by Nonresident Partners

a) In General.

1) This Section provides guidance for allocation and apportionment of base income by nonresidents. All base income of a resident is allocated to Illinois pursuant to IITA Section 301(a) . . .

3) Unitary partners. This Section shall not apply to the apportionment of business income of a nonresident partner who is engaged in a unitary business with the partnership. Such partners shall apportion their unitary business income derived from the partnership in accordance with IITA Section 304(e) and Section 100.3380(d) of this Part.

4) Except as provided in this subsection (a), all items of base income of a partner that are derived from the partnership shall be allocated or apportioned pursuant to this Section, including all items required to be separately stated to the partner under IRC section 703(a)(1), all guaranteed payments under IRC section 707(c), and all addition and subtraction modifications, but excluding items described in IRC section 707(a).

b) Business Income. The respective shares of partners other than residents in so much of the business income of the partnership as is apportioned to this State in the possession of the partnership shall be taken into account by such partners pro rata in accordance with their respective distributive shares of such partnership income for the partnership's taxable year and allocated to this State. (IITA Section 305(a))

1) For purposes of this subsection (b), the determination of whether an item of base income is business income or nonbusiness income shall be based on the facts and circumstances of the partnership itself. Trade or business activities of a partner or of any related party are irrelevant.

2) Business income of the partnership shall be apportioned to this State pursuant to IITA Section 304, in the same manner as it is allocated or apportioned for any other nonresident. (IITA Section 305(c))

3) Lower-tier partnerships. In the case of a partnership that is itself a partner in a second partnership, a partner in the first partnership shall include in net income its partnership share of the first partnership's share of the items of business income of the second partnership, as apportioned to Illinois by that second partnership. If the second partnership is itself a partner in a third partnership, a partner in the first partnership shall include in net income its partnership share of the first partnership's share of the items of business income of the third partnership as determined under the preceding sentence, and so on through all partnerships that are themselves partners in other partnerships.

c) Nonbusiness Income. The respective shares of partners other than residents in the items of partnership income and deduction not taken into account in computing the business income of a partnership shall be taken into account by such partners pro rata in accordance with their respective distributive shares of such partnership income for

the partnership's taxable year, and allocated as if such items had been paid, incurred or accrued directly to such partners in their separate capacities. (IITA Section 305(b))

Ill. Admin. Code tit. 86, § 100.3380(d)

Unitary Partners: Inclusion of Shares of Partnership Unitary Business Income and Factors in Combined Unitary Business Income and Factors of Partners

1) IITA Section 304(e) provides that whenever 2 or more persons are engaged in a unitary business as described in IITA Section 1501(a)(27), a part of which is conducted in this State by one or more members of the group, the business income attributable to this State by any member or members shall be apportioned by means of the combined apportionment method. Because partnerships may be members of a unitary business group within the meaning of IITA Section 1501(a)(27), this provision requires a partnership to use combined apportionment when it is engaged in a unitary business with one or more of its partners. However, partners who are not engaged in a unitary business with the partnership shall include their shares of the partnership's business income apportioned to Illinois in their Illinois net incomes under IITA Section 305(a), and those partners' business activities or share of the partnership's market in Illinois would not be represented fairly by their shares of partnership income computed by combining the business income and apportionment factors of the partnership with the business income and apportionment factors of its unitary partners.

2) Accordingly, except in a case in which substantially all of the interests in the partnership (other than a publicly-traded partnership under IRC section 7704) are owned or controlled by members of the same unitary business group, when the business activities of a partnership and any of its partners' business activities constitute a unitary business:

A) The partner's distributive share of the business income and apportionment factors of the partnership shall be included in that partner's business income and apportionment factors. Also, for taxable years ending on or after December 31, 2017, the partner's distributive share of the everywhere sales of the partnership shall be included in the partner's everywhere sales for purposes of applying Section 100.3600. In determining the business income of the partnership, transactions between the unitary partner (or members of its unitary business group) and the partnership shall not be eliminated. However, all transactions between the unitary business group and the partnership shall be eliminated for purposes of computing the apportionment factors of the partner and of any other member of the unitary business group.

EXAMPLE: Partner and Partnership are engaged in a unitary business. Partner owns a 20% interest in Partnership. Partnership has \$10,000,000 in sales everywhere, \$3,000,000 of which are to Partner, and \$4,000,000 in Illinois sales, \$1,000,000 of which are to Partner. In computing its apportionment factor, Partner shall include \$1,400,000 from Partnership in its everywhere sales (20% of Partnership's \$10,000,000 in everywhere sales, after eliminating the \$3,000,000 in sales to Partner) and \$600,000 from Partnership in its Illinois sales (20% of Partnership's \$4,000,000 in Illinois sales, after eliminating the \$1,000,000 in sales to Partner). Also, Partner must eliminate any sales it made to Partnership.

B) If a partnership and one of its partners are engaged in a unitary business and the partnership is itself a partner in a second partnership:

i) If the partner is not engaged in a unitary business with the second partnership, the partner's share of the first partnership's share of the business income and apportionment factors of the second partnership shall not be included in the partner's business income and apportionment factors. Instead, the partner's share of the first

partnership's share of the base income apportioned to Illinois by the second partnership shall be included in the partner's Illinois net income.

ii) If the partner is engaged in a unitary business with the second partnership, the partner's share of the first partnership's share of the business income and apportionment factors of the second partnership shall be included in the partner's business income and apportionment factors.

C) If, for taxable years ending on or after December 31, 2017, a partner and a partnership engaged in a unitary business apportion their business income using different apportionment formulas under IITA Section 304:

i) The apportionment percentage of the partnership shall be computed under Section 100.3600 by treating the partnership as a member of the unitary business group, but using only that partner's distributive share of the partnership's apportionment factors and sales. That partner's apportionment percentage is equal to that partner's apportionment percentage computed under Section 100.3600 plus the partnership's apportionment percentage computed under Section 100.3600.

ii) If a partnership has more than one partner in the same unitary business group, and the partnership uses a different apportionment formula than one or more of the partners, each partner that uses the same apportionment formula as the partnership shall compute its apportionment factor as provided in subsection (d)(2)(A) and each partner that uses a different apportionment formula shall compute its apportionment factor as provided in subsection (d)(2)(C)(i).

3) This subsection (d) does not apply to a partner's shares of business income and apportionment factors from any partnership that cannot be included in a unitary business group with that partner.

A) This subsection (d) does not apply because:

i) for taxable years ending prior to December 31, 2017, the partner and the partnership are required to apportion their business income using different apportionment formulas under IITA Section 304, and therefore cannot be members of a unitary business group under IITA Section 1501(a)(27); or

ii) the business activities of either the partner or the partnership outside the United States are equal to or greater than 80% of the total worldwide business activities of that partner or partnership, as determined under IITA Section 1502(a)(27). In applying this 80/20 test to a taxpayer, no apportionment factors of any partnership shall be included in the apportionment factors of that taxpayer pursuant to this subsection (d).

B) For taxable years ending prior to December 31, 2017, if the partnership is itself a partner in a second partnership, and one of its partners is engaged in a unitary business with the second partnership and is not prohibited from being a member of a unitary business group that includes the second partnership under subsection (d)(3)(A)(i) or (ii), that partner shall include in its business income and apportionment factors its share of the partnership's share of the second partnership's business income and apportionment factors.

4) If substantially all of the interests in a partnership (other than a publicly-traded partnership under IRC section 7704) are owned or controlled by members of the same unitary business group as the partnership, the partnership shall be treated as a member of the unitary business group for all purposes, and, for purposes of applying IITA Section 305(a) to any nonresident partner who is not a member of the same unitary business group, the business income of the partnership apportioned to this State shall be determined using the combined apportionment method prescribed by IITA Section

304(e). For purposes of this subsection (d), substantially all of the interests in a partnership are owned or controlled by members of the same unitary business group if more than 90% of the federal taxable income of the partnership is allocable to one or more of the following persons:

A) any member of the unitary business group;

B) any person who would be a member of the unitary business group if not for the fact that 80% or more of that person's business activities are conducted outside the United States;

C) any person who would be a member of the unitary business group except for the fact that the person and the partnership apportion their business incomes under different subsections of IITA Section 304 and, therefore, for taxable years ending prior to December 31, 2017, would be excluded from a unitary business group in which the partnership is a member; or

D) any person who would be disallowed a deduction for losses by IRC section 267(b), (c) and (f)(1) by virtue of being related to any person described in subsection (d)(4)(A), (B) or (C), as well as any partnership in which a person described in subsection (d)(4)(A), (B) or (C) is a partner.

5) Examples

EXAMPLE 1: Corporation A owns a 50% interest in P-1, a partnership. Corporation A and P-1 are engaged in a unitary business within the meaning of IITA Section 1501(a)(27). P-1 itself conducts no business activities in Illinois, and the Illinois numerator of its apportionment factor is zero. P-1 holds a 50% interest in P-2, a partnership doing business exclusively in Illinois. P-1 has \$1.4 million of taxable business income, not including any income from P-2. P-2 has base income of \$1 million, all of which is business income, and on a separate-entity basis, all of its business income would be apportioned to Illinois.

EXAMPLE 2: If Corporation A and P-2 are not members of the same unitary business group, Corporation A would compute its business income apportioned to Illinois by including \$700,000 (50% of \$1.4 million) of P-1's business income in Corporation A's business income, and 50% of P-1's apportionment factors in its apportionment factors. Corporation A also would include in its Illinois net income its 50% share of P-1's 50% share of the base of P-2 apportionable to Illinois, or \$250,000 (50% of 50% of \$1 million).

EXAMPLE 3: If Corporation A, P-1 and P-2 are members of the same unitary business group, P-1 shall include 50% of P-2's business income and 50% of P-2's apportionment factors in its own business income and apportionment factors. Accordingly, P-1's business income will be \$1.9 million (the \$1.4 million it earned directly plus its 50% share of P-2's \$1 million in business income). Corporation A will then compute its business income apportioned to Illinois by including its 50% share of P-1's business income, or \$950,000 (50% of \$1.9 million) with its business income and its 50% share of P-1's apportionment factors (which will include P-1's share of P-2's apportionment factors) in its apportionment factors.

EXAMPLE 4: If Corporation A, P-1 and P-2 are unitary, but P-1 is excluded from the unitary business group of Corporation A and P-2 because those entities apportion their business income under IITA Section 304(a) and P-1 is a financial organization that apportions its business income under IITA Section 304(c) and the taxable year ends prior to December 31, 2017, Corporation A shall include in its business income and apportionment factors its 50% share of P-1's 50% share of the business income and

apportionment factors of P-2. Also, Corporation A's Illinois net income includes 50% of the business income of P-1 apportioned to Illinois by P-1 using its own apportionment factors. Because, in this example, P-1 is not doing business in Illinois, none of its business income is included in Corporation A's Illinois net income . . .

IT 24-0002-GIL (03/18/2024) (denial of a partnership's request for alternative apportionment)

Because your request merely states that separate accounting for the taxpayer's Illinois income more accurately reflects its Illinois activity, your petition for alternative apportionment does not meet the regulatory requirement and cannot be granted at this time.

IT 93-0107-PLR (05/11/1993)

The above-named partnership is filing this petition to seek permission from the Department of Revenue to use an alternative apportionment method as allowed under IITA Section 304(f). The partnership believes that the allocation and apportionment provisions of IITA Section 304(a) through (d) do not fairly represent the partnership's business activity in Illinois.

The partnership believes the use of the standard formulary apportionment will significantly distort its income or loss from its activities in this state. Since this partnership's business activity is the ownership and management of rental real property located in various states, this partnership believes that a separate reporting of income or loss to each state based on the rental activity occurring in the state is the most equitable method for reporting corporate income . . .

We have reviewed your letter and are unable to conclude that you have met the burden of demonstrating that the three factor formula operates unreasonably and arbitrarily in attributing to Illinois a percentage of income that is out of all proportion to the business transacted in this State.

Rockwood Holding Co. v. Department of Revenue, 728 N.E.2d 519 (App. 1st Dist. 2000) (denying alternative apportionment in connection with a partnership loss deduction).

The plain language of section 304(f) seeks to achieve a fair representation of "the extent of a person's business activity" in Illinois. It does not address the calculation of the taxpayer's tax liability.

Illinois IL-1065 Instructions(2022)

Partnerships may not join in the filing of a combined return. However, you may be required to file a separate unitary return, and file a Schedule UB, Combined Apportionment for Unitary Business Group, to apportion your business income. If the following applies, do not file a Schedule UB: If a partnership is engaged in a unitary business with one or more of its partners, but the unitary partners do not own substantially all of the interest in the partnership, the partnership should not be included on a Schedule UB with the partners. Substantial ownership is defined as owning more than 90 percent of all the interest in the partnership. If a Schedule UB should not be filed, each unitary partner must determine the portion of its business income taxed by Illinois by adding its share of that partnership's business income and apportionment factors (Illinois and everywhere) to its own business income and apportionment factors (Illinois and everywhere). This rule applies to you if you are unitary with one or more of your partners or if you are a partner in another partnership and are engaged in a unitary business with that partnership. See 86 Ill. Adm. Code Section 100.3380(d), for more information.

If the following applies, you must file a Schedule UB: If you are a partnership who is a shareholder in a corporation and are engaged in a unitary business with that corporation, or if you are owned more than 90 percent by members of your unitary business group (determined without regard to the rule prohibiting taxpayers who use different apportionment formulas from being included in a unitary business group and the rule prohibiting taxpayers conducting 80 percent or more of their business activities outside the United States from being included in a unitary business group), and you:

- use the same taxable year as a combined group that includes your partners or your subsidiary, you should use the Schedule UB prepared by the combined group in completing your Form IL-1065;
- use a different taxable year from the combined group that includes your partners or your subsidiary, or there is no combined group, you must complete your own Schedule UB using your own taxable year.

Indiana

Ind. Code § 6-3-2-2(a)

Income from a pass through entity shall be characterized in a manner consistent with the income's characterization for federal income tax purposes and shall be considered Indiana source income as if the person, corporation, or pass through entity that received the income had directly engaged in the income producing activity. Income that is derived from one (1) pass through entity and is considered to pass through to another pass through entity does not change these characteristics or attribution provisions. In the case of nonbusiness income described in subsection (g), only so much of such income as is allocated to this state under the provisions of subsections (h) through (k) shall be deemed to be derived from sources within Indiana. In the case of business income, only so much of such income as is apportioned to this state under the provision of subsection (b) shall be deemed to be derived from sources within the state of Indiana. In the case of compensation of a team member (as defined in section 2.7 of this chapter), only the portion of income determined to be Indiana income under section 2.7 of this chapter is considered derived from sources within Indiana. In the case of a corporation that is a life insurance company (as defined in Section 816(a) of the Internal Revenue Code) or an insurance company that is subject to tax under Section 831 of the Internal Revenue Code, only so much of the income as is apportioned to Indiana under subsection (s) is considered derived from sources within Indiana. Income derived from Indiana shall be taxable to the fullest extent permitted by the Constitution of the United States and federal law, regardless of whether the taxpayer has a physical presence in Indiana.

45 Ind. Admin. Code 3.1-1-106(b)(2)

The distributive share of a nonresident partner will be reported after apportionment to determine the partnership income derived from sources within Indiana. This determination will be accomplished by use of the apportionment formula described in IC 6-3-2-2(b).

45 Ind. Admin. Code 3.1-1-153

(a) A corporate partner's share of profit or loss from a partnership will be included in its federal taxable income and therefore generally subject to the same rules as any other adjusted gross income.

(b) If the corporate partner's activities and the partnership's activities constitute a unitary business under established standards, disregarding ownership requirements, the business income of the unitary business attributable to Indiana shall be determined by a three (3) factor formula consisting of property, payroll, and sales of the corporate partner and its share of the partnership's factors for any partnership year ending within or with the corporate partner's income year, with the following modifications:

(b)(1) The value of property which is rented or leased by the corporate partner to the partnership or vice versa shall, with respect to the corporate partner, be excluded from the property factor of the partnership or eliminated to the extent of the corporate partner's interest in the partnership, whichever the case may be, in order to avoid duplication.

(b)(2) Intercompany sales between the corporate partner and the partnership shall be eliminated from the corporate partner's sales factor as follows:

(b)(2)(A) Sales by the corporate partner to the partnership to the extent of the corporate partner's interest in the partnership.

(b)(2)(B) Sales by the partnership to the corporate partner not to exceed the corporate partner's interest in all partnership sales.

(c) If the corporate partner's activities and the partnership's activities do not constitute a unitary business under established standards, disregarding ownership requirements, the corporate partner's share of the partnership income attributable to Indiana shall be determined as follows:

(c)(1) If the partnership derives business income from sources within and without Indiana, the business income derived from sources within Indiana shall be determined by a three (3) factor formula consisting of property, payroll, and sales of the partnership.

(c)(2) If the partnership derives business income from sources entirely within Indiana, or entirely without Indiana, such income shall not be subject to formula apportionment.

(d) A partner's distributive share of income will be adjusted by the partner's proportionate share of the partnership's income that is exempt from taxation under the Constitution and statutes of the United States and by the partner's proportionate share of the partnership's deductions allowed or allowable under Section 63 of the Internal Revenue Code for taxes based on or measured by income and levied at the state level by any state of the United States or for taxes on property levied by any subdivision of any state of the United States.

(e) After determining the amount of business income attributable to Indiana under subsection (c), the corporate partner's distributive share of such income shall be added to the corporate partner's other business income apportioned to Indiana and its nonbusiness income, if any, allocable to Indiana, in determining the corporate partner's total taxable income.

Indiana Letters of Findings: 02-20130024 (October 29, 2014)

The Indiana Supreme Court discussed such a form-over-function situation in *Park 100 Dev. Co. v. Ind. Dep't of State Revenue*, 429 N.E.2d 220 (Ind. 1981). In *Park 100*, the Indiana Supreme Court was faced with a situation in which a partnership was itself a partner in a partnership and, on that ground sought to avoid Indiana taxes. *Id.* at 223. In other words, one pass-through entity was owned by another pass-through entity. The Indiana Supreme Court held that a partnership could not avoid its Indiana tax obligations by becoming a partner in a different partnership (essentially stacking

partnerships to avoid tax) and funneling the business receipts through these pass-through entities. *Id.* at 223. Thus, using tiered pass-through entities to funnel income to another partner did not obviate the taxpayer's tax obligation. *Id.* The court reasoned that passing income through multiple layers of partnerships does not cancel the tax liability associated with the original partnership's income. *Id.* As the court explained, "[T]he legislature did not intend for a corporation to escape the corporate tax liability indirectly by forming a two-tiered partnership when it did not allow a corporation to escape that liability as a direct or first-tier partner." *Id.*

Like the taxpayer in *Riverboat Development, Inc.*, the taxpayers in *Park 100* owned a minority ownership interest in the pass-through entity generating the taxable income. Nevertheless, the tax liability still passed through to the owners. Moreover, the court was not persuaded by the fact that the tax liability stemmed from the taxpayer's intangible interest in a partnership. The court's ultimate concern was avoiding the creation of law that would lead to untenable results, such as avoiding tax liabilities by funneling income through a partnership. At no point in the *Park 100* decision did the court suggest that the character of the income, and resulting tax liability, was dependent upon whether the taxpayer's ownership interest in the partnership was tangible or intangible in nature. Nor was there any reason for the court to consider the tangible or intangible nature of the ownership, because the focus was the character of the business income earned by the pass-through entity.

Additionally, in *Five Star Concrete, L.L.C. v. Klink, Inc.* 693 N.E.2d 583 (Ind. Ct. App. 1998), the Indiana Court of Appeals explained that LLCs are like partnerships, and like partnerships the "income 'passes through' the entity and is taxed to the member, an owner of an interest in the company." *Id.* at 586. The court was very specific—LLCs, like partnerships, pass-through income to their members to be taxed in the same manner as partnerships. The court also noted that there was no dispute that the company properly passed its income and tax liability to its owners. *Id.* Therefore, like the *Park 100* decision, the end result is that the income and the related tax liability of flow through entities that are taxed as partnerships are the responsibility of the partners/members, and the manner in which the taxpayer chooses to define its ownership interest in the company is not relevant for purposes of applying the tax liability . . .

In conclusion, the Department adjusted Taxpayer's adjusted gross income tax return because Taxpayer had failed to include the activities from the two Indiana fabrication plants (one operated by Taxpayer's Division and the other operated by Partnership) in its apportionment factors. Taxpayer, as the reporting entity for Taxpayer's Division, must include the income and activities of the Indiana fabrication plant operated by Taxpayer's Division in its adjusted gross income tax return, including the apportionment factors. IC § 6-3-2-2. In addition, Taxpayer, as the reporting entity for Taxpayer's Division, is a corporate partner in Partnership. Taxpayer, as the corporate partner, is liable for Partnership's adjusted gross income tax in its separate or individual capacity and is required to report its portion of Partnership's Indiana business activity on Taxpayer's Indiana adjusted gross income tax return, pursuant to IC § 6-3-4-11(a). Since Taxpayer owns ninety-nine percent of Partnership, Taxpayer is required to report its ninety-nine percent partner share of Partnership's income and activities in its apportionment factors, as provided in 45 IAC 3.1-1-153. Therefore, Taxpayer's protest of the Department's adjustments to its return to include the operational business income and activities of the two Indiana fabrication plants in Taxpayer's apportionment factors is denied.

Indiana Letters of Findings: 02-20241179 (August 30, 2024)

An out of state LLC that was a partner in an Indiana partnership was required to file a composite return in Indiana.

Indiana Revenue Ruling 2001-04IT (February 19, 2001)

It is clear from the above regulations that all of a partnership's income is subject to apportionment. Portfolio interest, net Internal Revenue Code Section 1231 loss, long-term capital gain from the sale of securities and from the sale or exchange of goodwill and going concern value, as components of partnership income, therefore, are subject to apportionment at the partnership level.

Indiana Letter of Findings 06-0524 (01/01/2006)

Taxpayer properly deducted "704(c) property" depreciation in reporting its distributive share of partnership income.

Iowa

Iowa Admin. Code r. 701-503.6(5)

A corporation's distributive share of net income or loss from a joint venture, limited liability company, or partnership is subject to apportionment within and without the state. If the income of the partnership, limited liability company, or joint venture is received in connection with the taxpayer's regular trade or business operations, the partnership, limited liability company, or joint venture income shall be apportioned within and without Iowa on the basis of the taxpayer's business activity ratio. The corporation's distributive share of the gross receipts of the partnership, limited liability company, or joint venture shall be included in the computation of the business activity ratio in accordance with the provisions of this chapter.

EXAMPLE 1: A, a corporation with a commercial domicile in State X, is engaged in business within and without Iowa whereby A sells tangible personal property. A also has an interest in a limited partnership whose business is conducted within and without Iowa. Five percent of the limited partnership's gross receipts are derived from the sale of tangible personal property to Iowa purchasers and 95 percent are derived from sales and deliveries to purchasers outside of Iowa. A will include 5 percent of its distributive share of the gross receipts of the partnership in the numerator along with A's destination Iowa sales in calculating its business activity ratio. A will include 100 percent of its distributive share of the gross receipts in the denominator along with A's total sales in calculating its business activity ratio.

EXAMPLE 2: B, a corporation with a commercial domicile in State X, has no physical presence in the state of Iowa. B's only contact with Iowa is B's interest in a limited partnership whose business is conducted within and without Iowa. Ten percent of the limited partnership's gross receipts are derived from the sale of tangible personal property to Iowa purchasers and 90 percent are derived from sales and deliveries to purchasers outside of Iowa. B will include 10 percent of its distributive share of the gross receipts of the partnership in the numerator in calculating its business activity ratio. B will include 100 percent of its distributive share of the gross receipts in the denominator along with B's total sales in calculating its business activity ratio.

Iowa Admin. Code r. 701-302.12

Residents engaged in a partnership or limited liability company, even if located or doing business outside the state of Iowa, are taxable upon their distributive share of net income of such partnership or limited liability company, whether distributed or not,

and are required to include such distributive share in their return. A nonresident individual who is a member of a partnership or limited liability company doing business in Iowa is taxable on that portion of net income which is applicable to the Iowa business activity whether distributed or not. See 701—Chapter 401.

Iowa Admin. Code r. 701-302.16(4)(a)

If a nonresident, or a partnership or trust with a nonresident member, transacts business both within and without the state, the net income must be so apportioned as to allocate to Iowa a portion of the income on a fair and equitable basis, in accordance with approved methods of accounting.

Iowa Admin. Code r. 701-302.16(6)

When a partnership derives income from sources within this state as determined in 302.16(3) through 302.16(5), the nonresident members of the partnership are taxable only upon that portion of their distributive share of the partnership income which is derived from sources within this state.

Iowa Admin. Code r. 701-302.16(9)(b)

When a nonresident of Iowa sells or exchanges the individual's interest in a partnership, the nonresident is actually selling an intangible since the partnership can continue without the nonresident partner and the assets used by the partnership are legally owned by the partnership and an individual retains only an equitable interest in the assets of the partnership by virtue of the partner's ownership interest in the partnership. However, because of the unique attributes of partnerships, the owner's interest in a partnership is considered to be localized or "sourced" at the situs of the partnership's activities as a matter of law. *Arizona Tractor Co. v. Arizona State Tax Com'n.*, 566 P.2d 1348, 1350 (Ariz. App. 1997); Iowa Code chapter 486 (unique attributes of a partnership defined). Therefore, if a partnership conducts all of its business in Iowa, 100 percent of the gain on the sale or exchange of a partnership interest would be attributable to Iowa. On the other hand, if the partnership conducts 100 percent of its business outside of Iowa, none of the gain would be attributable to Iowa for purposes of the Iowa income tax. In the situation where a partnership conducts business both in and out of Iowa, the capital gain from the sale or exchange of an interest in the partnership would be allocated or apportioned in and out of Iowa based upon the partnership's activities in and out of Iowa in the year of the sale or exchange.

Kansas

Kan. Stat. Ann. § 79-32, 133

For purposes of this act, a partner's distributive share of partnership income or of any item of income, gain, loss or deduction shall be determined in accordance with his or her distributive share of such item or items as determined for federal income tax purposes: Provided, however, That where a partner's distributive share of an item of partnership income, gain, loss, deduction, or credit is determined for federal income tax purposes by special provision of the partnership agreement with respect to such item, and where the principal purpose of such provision is the avoidance or evasion of tax under this act, the partner's distributive share of such item, and any modification required with respect thereto, shall be determined as if the partnership agreement made no special provision with respect to such item.

Kan. Stat. Ann. § 79-3272

Any taxpayer having income from business activity which is taxable both within and without this state, other than activity as a financial organization or the rendering of purely personal services by an individual, shall allocate and apportion net income as provided in this act.

Kan. Admin. Regs. § 92-12-83

All business income of each trade or business of the taxpayer shall be apportioned to this state by use of the apportionment formula set forth in K.S.A. 79-3279 and 79-4301, article IV.9. The elements of the apportionment formula are the property factor, the payroll factor and the sales factor of the trade or business of the taxpayer.

Kansas Department of Revenue Website

Information given to the partners receiving income should also include the partner's share of the Kansas and everywhere property, payroll and sales factors of the partnership making the distribution. This information is necessary so the partner receiving the distribution can include those factors with their Kansas and everywhere property, payroll and sales factors in order to properly apportion income to Kansas in their returns when filed.

Kansas Department of Revenue Website and Instructions to Form K-120S

Business income is apportioned to Kansas generally using the average of the three factors of property, payroll, and sales. For instance, business income received from another partnership is included in your apportionable income and your share of that partnership is multiplied times the property, payroll and sales both in Kansas and everywhere of that partnership to add to your entity's property, payroll and sales both in Kansas and everywhere. The apportionable income is then multiplied by the resulting factor. Any deviation from using the three factor method requires alternative qualifications. All the apportionment methods are listed in this section.

K.S.A. 79-3279 provides that the use of the three-factor method formula of property, payroll, and sales be used to apportion income to Kansas. Direct or segregated accounting methods will not be allowed unless the taxpayer has petitioned the Secretary of Revenue for use of direct or segregated accounting, and the petition is approved. Direct or segregated accounting will not be allowed only because that is the method used in another state or because partnership income is received from other entity.

Kentucky

Ky. Rev. Stat. Ann. § 141.206

(8) In determining the tax under this chapter, a nonresident individual, estate, or trust that is a partner, member, or shareholder in a pass-through entity required to file a return under subsection (1) of this section shall take into account: (a) 1. If the pass-through entity is doing business only in this state, the partner's, member's, or shareholder's total distributive share of the passthrough entity's items of income, loss, and deduction; or 2. If the pass-through entity is doing business both within and without this state, the partner's, member's, or shareholder's distributive share of the pass-through entity's items of income, loss, and deduction multiplied by the apportionment fraction of the pass-through entity as prescribed in subsection (11) of this section; and (b) The partner's, member's, or shareholder's total distributive share of credits of the pass-through entity.

(9) A corporation that is subject to tax under KRS 141.040 and is a partner or member in a pass-through entity shall take into account the corporation's distributive share of the pass-through entity's items of income, loss, and deduction and:

(a)

1. For taxable years beginning on or after January 1, 2007, but prior to January 1, 2018, shall include the proportionate share of the sales, property, and payroll of the limited liability pass-through entity or general partnership in computing its own apportionment factor; and

2. For taxable years beginning on or after January 1, 2018, shall include the proportionate share of the sales of the limited liability pass-through entity or general partnership in computing its own apportionment factor; and

(b) Credits from the partnership.

(10)

(a) If a pass-through entity is doing business both within and without this state, the pass-through entity shall compute and furnish to each partner, member, or shareholder the numerator and denominator of each factor of the apportionment fraction determined in accordance with subsection (11) of this section.

(b) For purposes of determining an apportionment fraction under paragraph (a) of this subsection, if the pass-through entity is: 1. Doing business both within and without this state; and 2. A partner or member in another pass-through entity; then the pass-through entity shall be deemed to own the pro rata share of the property owned or leased by the other pass-through entity, and shall also include its pro rata share of the other pass-through entity's payroll and sales.

(c) The phrases "a partner or member in another pass-through entity" and "doing business both within and without this state" shall extend to each level of multiple-tiered pass-through entities.

(d) The attribution to the pass-through entity of the pro rata share of property, payroll and sales from its role as a partner or member in another pass-through entity will also apply when determining the pass-through entity's ultimate apportionment factor for property, payroll and sales as required under subsection (11) of this section.

(11)

(a) For taxable years beginning prior to January 1, 2018, a pass-through entity doing business within and without the state shall compute an apportionment fraction, the numerator of which is the property factor, representing twenty-five percent (25%) of the fraction, plus the payroll factor, representing twenty-five percent (25%) of the fraction, plus the sales factor, representing fifty percent (50%) of the fraction, with each factor determined in the same manner as provided in KRS 141.901, and the denominator of which is four (4), reduced by the number of factors, if any, having no denominator, provided that if the sales factor has no denominator, then the denominator shall be reduced by two (2).

(b) For taxable years beginning on or after January 1, 2018, a pass-through entity doing business within and without the state shall compute an apportionment fraction as provided in KRS 141.120.

Ky. Rev. Stat. Ann. § 141.121(6)

A corporation:

- (a) That owns an interest in a limited liability pass-through entity; or
- (b) That owns an interest in a general partnership;

shall include the proportionate share of receipts of the limited liability pass-through entity or general partnership when apportioning income. The phrases “an interest in a limited liability pass-through entity” and “an interest in a general partnership” shall extend to each level of multiple-tiered pass-through entities.

Louisiana

La. Rev. Stat. Ann. § 47:243(A)(6)

Estates, trusts and partnerships having a non-resident individual or a corporation as a member or beneficiary shall allocate and apportion their income within and without this state in accordance with the processes and formulas prescribed in this Part, and the share of any such non-resident or corporation member or beneficiary in the net income from sources in this state as so computed, shall be allocated to this state in the return of such member or beneficiary.

La. Rev. Stat. Ann. § 47:287.93(A)(5)

For purposes of this Part only, estates, trusts, and partnerships having a corporation as a member or beneficiary shall compute, allocate, and apportion their income or loss within and without this state in accordance with the processes and formulas prescribed by this Part, and the share of any corporation member or beneficiary in the net income or loss from sources in this state so computed shall be allocated to this state in the return of such corporation.

La. Rev. Stat. Ann. § 47:287.92

A. All items of gross income, not otherwise exempt, shall be segregated into two general classes designated as allocable income and apportionable income.

B. Allocable income. The class of gross income to be designated as "allocable income" shall include only the following:

- (1) Rents and royalties from immovable or corporeal movable property.
- (2) Royalties or similar revenue from the use of patents, trademarks, copyrights, secret processes, and other similar intangible rights.
- (3) Income from estates, trusts, and partnerships.
- (4) Income from construction, repair, or other similar services.

C. Apportionable income. The class of income to be designated as "apportionable income" shall include all items of gross income which are not properly includable in allocable income as defined in this Section.

La. Rev. Stat. Ann. § 47:202(B)

The character of any item of income, gain, loss, deduction, or credit included in a partner's distributive share under subsection A(1) through A(3) of this section 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.

La. Rev. Stat. Ann. § 47:204

A. Effect of partnership agreement. A partner's distributive share of income, gain, loss, deduction, or credit shall, except as otherwise provided in this section, be determined by the partnership agreement.

B. Distributive share determined by income or loss ratio. A partner's distributive share of any item of income, gain, loss, or deduction shall be determined in accordance with his distributive share of taxable income or loss of the partnership, as described in R.S. 47:202A(4), for the taxable year, if:

(1) the partnership agreement does not provide as to the partner's distributive share of such item, or

(2) the principal purpose of any provision in the partnership agreement with respect to the partner's distributive share of such item is the avoidance or evasion of any tax imposed by this chapter.

C. Contributed property.

(1) General rule. In determining a partner's distributive share of items described in R.S. 47:202A, depreciation, depletion, or gain or loss with respect to property contributed to the partnership by a partner shall, except to the extent otherwise provided in subsection C.(2) or C.(3) of this section be allocated among the partners in the same manner as if such property had been purchased by the partnership.

(2) If the partnership agreement so provides, depreciation, depletion, or gain or loss with respect to property contributed to the partnership by a partner shall, under regulations prescribed by the Collector, be shared among the partners so as to take account of the variation between the basis of the property to the partnership and its fair market value at the time of contribution.

(3) Undivided interests. If the partnership agreement does not provide otherwise, depreciation, depletion, or gain or loss with respect to undivided interests in property contributed to a partnership shall be determined as though such undivided interests had not been contributed to the partnership. This paragraph shall apply only if all of the partners had undivided interests in such property prior to making the contribution and their interests in the capital and profits of the partnership correspond with such undivided interests.

D. Limitation on allowance of losses. A partner's distributive share partnership loss (including capital loss) shall be allowed only to the extent of the adjusted basis of such partner's interest in the partnership at the end of the partnership year in which such loss occurred. Any excess of such loss over such basis shall be allowed as a deduction at the end of the partnership year in which such excess is repaid to the partnership.

Maine

Me. Stat. tit. 36, § 5191(2)

Each item of partnership income, gain, loss or deduction shall have the same character for a partner under this Part as it has for federal income tax purposes. Where an item

is not characterized for federal income tax purposes, it shall have the same character for a partner as if realized directly from the source from which realized by the partnership or incurred in the same manner as incurred by the partnership.

Me. Stat. tit. 36, § 5191(3)

If a partner's distributive share of an item of partnership income, gain, loss or deduction is determined for federal income tax purposes by a special provision in the partnership agreement, the principal purpose of which is the avoidance or evasion of tax under this Part, the partner's distributive share of that item and any modification required with respect to that item must be determined in accordance with the partner's distributive share of the taxable income or loss of the partnership generally, exclusive of items that must be separately computed under the Code, Section 702.

Me. Stat. tit. 36, § 5192(6)

A nonresident partner's distributive share of items of income, gain, loss or deduction shall be determined under section 5191, subsection 1. The character of partnership items for a nonresident partner shall be determined under section 5191, subsection 2. The effect of a special provision in a partnership agreement, other than a provision referred to in subsection 3, having as a principal purpose the avoidance or evasion of tax under this Part shall be determined under section 5191, subsection 3.

Me. Stat. tit. 36, § 5211(1)

Any taxpayer, other than a resident individual, estate, or trust, having income from business activity which is taxable both within and without this State, other than the rendering of purely personal services by an individual, shall apportion his net income as provided in this section. Any taxpayer having income solely from business activity taxable within this State shall apportion his entire net income to this State.

18-125 Me. Code R. 801 § .07

A. Generally. A corporation with an interest in a pass-through entity, such as a partnership, limited partnership, limited liability partnership, limited liability company, S corporation, or other similar entity must include its distributive share of the pass-through entity income, loss, or deduction in calculating its income, in accordance with the Internal Revenue Code and 36 M.R.S. § 5102(8), and must apportion its income pursuant to paragraph D below. The character of any item included in the distributive share is determined as if it were realized or incurred directly by the corporation. The business of the pass-through entity is treated as the business of the corporation.

B. Taxable in Maine. A corporation that is not otherwise subject to Maine's tax jurisdiction is nevertheless taxable in Maine if it is a partner, shareholder or member in a pass-through entity whose activities, if conducted directly by the corporation, would subject the corporation to the Maine corporate income tax.

C. Taxable in another state. A corporation is taxable in another state within the meaning of section .04 above if the corporation is a partner, shareholder or member in a passthrough entity with activities in that state that cause the pass-through entity or its partner, shareholder or member to be taxable in that state under the rules described in section .04 above.

D. Apportionment rules. In general, if a corporate partner, shareholder or member is taxable in another state, it must apportion its taxable net income using the sales factor in 36 M.R.S. § 5211(8).

(1) Sales factor. In determining the denominator of its sales factor, a corporate partner, shareholder or member must include its pro rata share of the passthrough entity's total sales during the pass-through entity's taxable year. In determining the numerator of its sales factor, a corporate partner, shareholder or member must include its pro rata share of such sales in Maine. To avoid duplication, however, the following sales must be eliminated from both the numerator and denominator of the sales factor:

(a) Sales by the corporation to the pass-through entity in an amount equal to the total of such sales multiplied by the corporation's interest in the passthrough entity; and

(b) Sales by the pass-through entity to the corporation in an amount not to exceed the total of all sales made by the pass-through entity multiplied by the corporation's interest in the pass-through entity.

(2) Pro rata share. For purposes of this section, a corporate partner's, shareholder's or member's pro rata share of a pass-through entity's sales shall be its percentage interest in pass-through entity profit or loss for the taxable year, as stated on the partner's, shareholder's or member's Schedule K-1. However, if, under the pass-through entity agreement, a partner's, shareholder's or member's share of gain or loss from the sale of particular pass-through entity assets is different from its profit or loss ratio stated on Schedule K-1, gross receipts from sales of such assets shall be attributed to its sales factor in the same proportion as the partner's, shareholder's or member's interest in gain or loss from the sale. In the event of a termination or other change in a partner's, shareholder's or member's interest during the taxable year, the partner's, shareholder's or member's pro rata share of sales must be modified to reflect pass-through entity sales during the actual period that the partner, shareholder or member held its interest.

Maryland

Maryland Income Tax Administrative Release No. 12 (2008)

Corporate partners that are unitary businesses and have nexus with Maryland are required to allocate their share of partnership income using an appropriate apportionment method. The apportionment method applies if either the corporate partner or the partnership is conducting business in Maryland.

In general, the partnership share of income is apportioned in the same manner as other income allocable to this State. For example, a corporation using a three-factor apportionment formula includes in both the numerator and denominator of each of the factors not only its own property, payroll, and sales, but also adds to such amounts its share of the partnership's property, payroll, and sales. The sales factor is double weighted in the three-factor apportionment formula. The income allocation is then determined by applying the average of the ratios of all property, payroll, and sales (both corporate and partnership) to the corporation's Maryland net income. In this manner, the corporation arrives at its Maryland taxable income attributable to business conducted in Maryland.

The above procedure applies if either the corporation or the partnership is conducting business in this State. For example, a foreign corporation, whose only connection with Maryland is a partnership interest in a partnership that is doing business in Maryland, will report on its Maryland tax return its federal taxable income and compute its

Maryland taxable income by use of the apportionment formula that includes the foreign corporation's share of the partnership's apportionment factors, both numerator (Maryland) and denominator (everywhere).

Similarly, a corporation (whether foreign or domestic) that carries on its trade or business in Maryland will compute its apportionment formula by adding to both the numerator and denominator of the corporation's property, payroll, and sales, the corporate partnership share of the partnership's property, payroll, and sales.

Md. Code Regs. 03.04.03.08(F)(2)

A corporation's share of partnership or joint venture receipts, property, and wages shall be included in the apportionment formula:

- (a) To the extent of the factors required; and
- (b) In the same manner as if they were direct receipts, property, and wages of the corporation.

Md. Code Regs. 03.04.07.02(D)(1)

A multi-state pass-through entity that is a partnership (including a limited liability company taxed as a partnership and a business trust taxed as a partnership) shall allocate income to this State using:

- (a) The apportionment formula for corporations under COMAR 03.04.03.08A—E; or
- (b) Separate accounting.

Md. Code Ann., Tax-Gen § 10-401

In computing the adjustments under §§ 10-206 and 10-210 of this title, a nonresident shall allocate to the State income, losses, or adjustments derived in connection with a business that is carried on both in and out of the State and of which the nonresident is a partner, shareholder of an S corporation, or proprietor, or in connection with an occupation, profession, or trade carried on both in and out of the State by:

- (1) separate accounting, if the Comptroller allows; or
- (2) the method that the Comptroller requires to determine fairly the part of the income derived from or reasonably attributable to the trade, business, profession, or occupation carried on in the State.

Form 511 - Electing Pass-through Entity Income Tax Return Instructions (2023)

Alternative Apportionment: If the apportionment formula does not fairly represent the extent of the PTE's activity within Maryland, the Revenue Administration Division may alter the formula or components accordingly. The corporation may also request the Comptroller's approval to use an Alternative Apportionment Formula.

Massachusetts

830 Mass. Code Regs. 63.38.1

(1)(b) General Rule. All of a taxpayer's taxable net income is allocated to Massachusetts if the taxpayer does not have income from business activity which is taxable in another

state. If a taxpayer has income from business activity which is taxable both in Massachusetts and in another state, then the part of its net income derived from business carried on in Massachusetts is determined by multiplying all of its taxable net income by the three factor apportionment percentage as provided in M.G.L. c. 63, § 38(c) through (g) and 830 CMR 63.38.1. If a taxpayer with a Massachusetts commercial domicile has income from business activity which is taxable both in Massachusetts and in another state but also has an income stream that is prohibited from being taxed in another non-domiciliary state by reason of the U.S. Constitution, that income stream shall be allocated in full to Massachusetts.

(4)(c) Burden of Proof. Except as provided in 830 CMR 63.38.1(4)(d) (relating to corporate limited partners), all income of a single taxpayer (whether derived directly or through agents, partnerships, or other entities whose activities are attributed to the taxpayer) is presumed to be income from related business activities until the contrary is established. Either the taxpayer or the Commissioner may assert that an item of a taxpayer's income is derived from unrelated business activities. The party making such an assertion must prove by clear and cogent evidence that, in the aggregate, the related business factors at 830 CMR 63.38.1(4)(b), do not reasonably warrant a finding that the business activities are related. To demonstrate that income from cash, cash equivalents, or short-term securities is derived from unrelated business activities, a taxpayer must prove by clear and cogent evidence that the underlying assets and their acquisition, maintenance, and management were, in fact, unrelated to the taxpayer's business activities in the Commonwealth.

(4)(d) Presumption of Unrelated Business Activity of Corporate Limited Partners. In cases where a corporate limited partner owns, either directly or indirectly (including all interests of any party whose direct or indirect stock ownership would be attributed to the corporate limited partner under the provisions of 26 U.S. Code § 318), less than 50% of either the capital or profit interests of a partnership and the business activity of the limited partnership is attributed to the corporate limited partner under 830 CMR 63.39.1(8), the business activity of the limited partnership is presumed to be unrelated to the corporation's other business activities unless the Commissioner or the taxpayer rebuts this presumption. If the business activities of the partnership and the corporate limited partner are unrelated, then the corporate limited partner must separately account for its income from the holding or disposition of its limited partnership interest and its other business income and must separately apportion to Massachusetts income from each unrelated activity (to the extent that Massachusetts has jurisdiction to tax income from each such activity), using only the apportionment factors applicable to that activity. The separate accounting shall apply both to the determination of income subject to apportionment under M.G.L. c. 63, § 2A, 38 or 42, and to the determination of the non-income measure under M.G.L. c. 63, § 39(a)(1).

Either the Commissioner or a taxpayer may rebut the presumption of unrelated business activity by demonstrating that the corporate limited partner and the partnership are engaged in a unitary business. If a corporate limited partner has engaged in a unitary business with the partnership in one or more taxable years, the corporate limited partner may not separately account in any such taxable year for the income it derives from the partnership. Instead, the corporate limited partner shall apportion to Massachusetts all income derived from business activity carried on within the commonwealth, including income derived from its partnership interest, in accordance with the rules of M.G.L. c. 63, § 2A, 38 or 42 using the corporate limited partner's own property, payroll, and sales plus its pro rata portion of the partnership's property, payroll, and sales to determine an apportionment percentage.

Example 1. Corporation A, which is domiciled outside of Massachusetts, owns a minority limited partnership interest in Partnership A. Partnership A conducts business in

Massachusetts. Apart from this partnership holding, Corporation A does not conduct business in Massachusetts. Neither Corporation A nor the Commissioner rebuts the presumption that the business activities of Corporation A and Partnership A are unrelated. Corporation A must separately apportion to Massachusetts income from the holding or disposition of its interest in Partnership A, using the apportionment factors derived from the partnership's activity. Income from Corporation A's other activities is not subject to Massachusetts tax jurisdiction and is excluded from the Corporation's taxable net income.

Example 2. Corporation B, which is domiciled outside of Massachusetts, conducts business in Massachusetts and, in addition, owns a minority limited partnership interest in Partnership B. Partnership B does not conduct business in Massachusetts. Neither Corporation B nor the Commissioner rebuts the presumption that the business activities of Corporation B and Partnership B are unrelated. Income from Corporation B's holding or disposition of its interest in Partnership B is not subject to Massachusetts tax jurisdiction and is excluded from the Corporation's taxable net income. Corporation B must apportion the balance of its income to Massachusetts using the apportionment factors derived from its other activities.

Example 3. Corporation C is domiciled in Massachusetts and holds a minority limited partnership interest in Partnership C. Partnership C may or may not be engaged in business in Massachusetts. Neither Corporation C nor the Commissioner rebuts the presumption that the activities of Corporation C and Partnership C are unrelated. Corporation C must separately apportion to Massachusetts income derived from its interest in Partnership C, using the apportionment factors derived from the partnership's activity. Corporation C must apportion the balance of its income to Massachusetts using the apportionment factors derived from its other activities. The taxable net income of Corporation C is the sum of these separately apportioned amounts.

(12) Corporate Partners. A corporation with an interest in a partnership must include its distributive share of the partnership income, loss, or deduction in calculating its income, in accordance with 26 U.S. Code and M.G.L. c. 63. The character of any item included in the distributive share is determined as if it were realized or incurred directly by the corporation. Except as otherwise provided, the trade or business of the partnership is treated as the trade or business of the corporation. For purposes of determining whether the corporation is a mutual fund service corporation or a Section 38 manufacturer, the corporation's pro rata share (as defined in 830 CMR 63.38.1(12)(f)) of all of the partnership's items, factors and activities shall be taken into account to the extent relevant to the determination, whether or not the corporation and the partnership are engaged in related business activities. If the partnership and corporate partner are engaged in related business activities, the corporation's pro rata share (as defined in 830 CMR 63.38.1(12)(f)) of partnership property, payroll, and sales are included in the partner's apportionment factors, subject to the special rules provided in 830 CMR 63.38.1(12)(d). (Except as otherwise expressly stated, the partnership rules provided in 830 CMR 63.38.1(12) presume that a partnership and corporate partner are engaged in related business activities.)

(a) Taxable in Massachusetts.

1. A corporation that is not otherwise subject to Massachusetts tax jurisdiction is nevertheless taxable in Massachusetts if it is a general partner in a partnership whose activities, if conducted directly by the corporation, would subject the corporation to the excise under M.G.L. c. 63, § 39. See 830 CMR 63.39.1(8).

2. In general, a corporation that is not otherwise subject to Massachusetts tax jurisdiction is taxable in Massachusetts if it is a limited partner in a partnership whose

activities, if conducted directly by the corporation, would subject the corporation to the excise under M.G.L. c. 63, § 39. However, as provided in 830 CMR 63.38.1(4)(d), the business activities of the partnership and the corporate limited partner are, in certain circumstances, presumed to be unrelated, so that unless the presumption is rebutted, such partner is taxable in Massachusetts only with respect to the partnership activity. Moreover, under the circumstances described in 830 CMR 63.39.1(8)(b) through (d) (relating to certain partnerships dealing in securities, publicly traded partnerships, and certain de minimis limited partnership holdings), the activities of the partnership are not attributed to the corporation, and the corporation is not taxable in Massachusetts merely by virtue of holding such a limited partnership interest.

(b) Taxable in Another State. A corporation is taxable in another state within the meaning of 830 CMR 63.38.1(5) if the corporation is a general partner in a partnership with business activities in that state that cause either the partnership or its partners to be taxable in that state described in 830 CMR 63.38.1(5). A corporation that is a limited partner in a partnership with business activity in another state is taxable in another state within the meaning of 830 CMR 63.38.1(5) if and to the extent that the corporation would be taxed in Massachusetts under the same facts and circumstances that exist in the other state. A corporation holding a limited partnership interest in a partnership that does business in another state is taxable in the other state for purposes of apportioning its partnership income, but not for purposes of apportioning income from its other business activities, unless the corporate partner and the partnership are engaged in related business activities, or unless the corporate partner is separately taxable in the other state on the basis of its other (unrelated) business activities.

(c) Income Measure of the Excise. When computing its net income for the taxable year, a corporation must include its distributive share of partnership items for any partnership year ending with or within its taxable year. The following examples illustrate the application of 830 CMR 63.38.1(12)(c):

1. Corporation C holds a 20% profits interest in Partnership P. C's income for the year was \$1,000,000 and P's income for the same year was \$800,000. The income of C is \$1,160,000 (\$1,000,000 plus 20% of \$800,000).

2. Corporation C holds a 90% profits interest in Partnership P. C incurred a loss of \$500,000 for the year but P's income was \$1,000,000. The income of C is \$400,000 (90% of \$1,000,000 = \$900,000 less the loss of \$500,000).

(d) Special Apportionment Rules. In general, if a corporate partner is taxable in another state, it must apportion its taxable net income using the apportionment percentage in M.G.L. c. 63, § 38. However, the following shall apply:

1. Property Factor. In determining the denominator of its property factor, a corporate partner must include its pro rata share of the total value of the partnership's real and tangible personal property, owned or rented, used during the partnership's taxable year. In determining the numerator of its property factor, a corporate partner must include its pro rata share of the value of such property located in Massachusetts.

a. In order to avoid duplication, however, certain adjustments must be made to the value of any property leased or rented by the corporation to the partnership or vice versa.

i. Where a corporation rents property to the partnership, it must include the original cost of the property in its property factor. No portion of the value of this property as rental property of the partnership is included.

ii. Where the partnership rents property to the corporation, the corporation includes in its property factor the sum of:

A. the original cost of the property multiplied by the corporation's percentage of interest in the partnership; plus

B. eight times the net annual rental rate of the property, multiplied by the difference between 100% and the corporation's percentage of interest in the partnership.

b. The following examples illustrate the application of 830 CMR 63.38.1(12)(d)1.:

i. Corporation C has a 20% profits interest in Partnership P. C owns a building (original cost \$100,000) which it rents to Pat a fair market rate of \$12,000 per year. C must include the \$100,000 original cost of the building in its property factor. No portion of the value of the property as rental property of the partnership is included in C's property factor.

ii. The facts are the same as in the previous example except that P owns the building and rents it to C. C will include \$20,000 (20% of \$100,000) in its property factor because of its interest in P. C will also include \$76,800 ($[\$12,000 \times 8] \times 80\%$) in its property factor to account for the rented building used in its operations. Thus, the building's value in C's property factor is \$96,800 (\$20,000, plus \$76,800).

2. Payroll Factor. In determining the denominator of its payroll factor, a corporate partner must include its pro rata share of the total compensation paid by the partnership during the partnership's taxable year. In determining the numerator of its payroll factor, a corporate partner must include its pro rata share of such compensation paid in Massachusetts during the taxable year. The following example illustrates the application of 830 CMR 63.38.1(12)(d)2.:

Corporation C has a 20% profits interest in Partnership P. C's own payroll is \$1,000,000, half of which is attributable to Massachusetts employees, and P's payroll is \$800,000, one quarter of which is attributable to Massachusetts employees. The denominator of C's payroll factor is \$1,160,000 (\$1,000,000, plus 20% of \$800,000, or \$160,000). The numerator of C's payroll factor is \$540,000 (50% of \$1,000,000 plus 25% of \$160,000).

3. Sales Factor. In determining the denominator of its sales factor, a corporate partner must include its pro rata share of the partnership's total sales during the partnership's taxable year. In determining the numerator of its sales factor, a corporate partner must include its pro rata share of such sales in Massachusetts.

a. In order to avoid duplication, however, the following sales must be eliminated from both the numerator and denominator of the sales factor:

- i. sales by the corporation to the partnership in an amount equal to the total of such sales multiplied by the corporation's profits interest in the partnership; and
- ii. sales by the partnership to the corporation in an amount not to exceed the total of all sales made by the partnership multiplied by the corporation's profits interest in the partnership . . .

(f) Pro Rata Share. For purposes of 830 CMR 63.38.1(12), a partner's pro rata share of a partnership's items, factors and activities shall be its percentage interest in partnership profit or loss for the taxable year, as stated on the partner's Schedule K-1, provided however, that if, under the partnership agreement, a partner's share of gain or loss from the sale of particular partnership assets is specially allocated in a manner different from its profit or loss ratio stated on Schedule K-1, and such special allocation has "substantial economic effect" as defined in Treas. Reg. § 1.704-1(b)(2), gross receipts from sales of such assets shall be assigned to its sales factor in the same proportion as the partner's interest in gain or loss from the sale. In the event of a termination or other change in a partner's interest during the taxable year, the partner's pro rata share of payroll and sales must be modified to reflect partnership payroll and sales during the actual period that the partner held its interest.

830 Mass. Code Regs. 62.5A.1(1)

The income of a pass-through entity that derives from or is effectively connected with the conduct of a trade or business or the ownership of real or tangible personal property in Massachusetts retains its character as it passes through a tiered structure of pass-through entities before becoming income to the non-resident. Thus, income that is derived from a trade or business does not convert to non-business-related income as it passes through a series of entities. Similarly, Massachusetts source income of any pass-through entities engaged in a unitary business that conducts a trade or business

in Massachusetts is taxable to a non-resident member to the extent it would be taxable if received directly by the non-resident.

In the case of multi-tiered unitary businesses where at least one entity in the structure is engaged in the conduct of a trade or business or the ownership of real or tangible personal property in Massachusetts, and income derived from one or more members of the unitary business is taxable in another state, the group of entities must apportion its income, as determined under this regulation.

830 Mass. Code Regs. 62.5A.1(2)

Tiered Structure, a pass-through entity that has a pass-through entity as a member. As between two entities, the pass-through entity that is a member is the upper-tier entity, and the entity of which it is a member is the lower-tier entity. A tiered pass-through entity arrangement may have two or more tiers; in such cases, a single entity can be both a lower-tier and an upper-tier entity.

830 Mass. Code Regs. 62.5A.1(3)

The Massachusetts income tax is imposed on the Massachusetts source income earned or derived by non-residents. Massachusetts source income includes the following types of income, but excludes items of income set forth in 830 CMR 62.5A.1(4):

(a) Income Derived from or Effectively Connected with a Trade or Business, Including Any Employment Carried on in Massachusetts. This income is defined as the income that is earned by, credited to, accumulated for or otherwise attributable to the taxpayer's trade or business in the Commonwealth in any year or part thereof, regardless of the year in which the income is actually received by the taxpayer and regardless of the taxpayer's residence or domicile in the year it is received. All types of income, including investment income, derived from or effectively connected with the carrying on of a trade or business within Massachusetts are Massachusetts source income. The term may include gain from the sale of a business or an interest in a business, distributive share income, separation, sick or vacation pay, deferred compensation and nonqualified pension income not prevented from state taxation by the laws of the United States, and income from a covenant not to compete.

1. "Trade or business, including any employment."

a. General Rule. Subject to the exception that applies to presence for business that is casual, isolated, or inconsequential, described at section 830 CMR 62.5A.1(3)(h), below, a non-resident has a trade or business, including any employment carried on in Massachusetts:

i. If the non-resident, directly or through representatives or employees, maintains or operates or shares in maintaining or operating any place in Massachusetts where business affairs are systematically and regularly conducted;

ii. If the non-resident owns an interest in a pass-through entity that, directly or through representatives or employees, or through other pass-through entities, maintains or operates or shares in maintaining or operating any place in Massachusetts where its business affairs are systematically and regularly conducted;

iii. If the non-resident, directly or through representatives or employees, is present for business in Massachusetts either as an employee or as a sole proprietor or other self-employed individual, or if the non-resident owns an interest in a pass-through entity that, directly or through representatives or employees or through other pass-through entities, is present for business. All activities that are considered a "trade or business,"

including employment, under Massachusetts and/or federal tax law are subject to taxation in Massachusetts under G.L. c. 62, § 5A. Income from a trade or business generally includes that gross income against which trade or business expense deductions are allowable under sections 62 and 162 of the Code. See G.L. c. 62, § 1(l), IRC §§ 62, 162, Treas. Reg. §§ 1.161-1 - 1.162-29;

iv. If the non-resident licenses intangibles, including trademarks or patents, directly or through representatives or employees, for use in Massachusetts on an ongoing basis...

(b) Income from a Pass-Through Entity that is Derived from or Effectively Connected with a Trade or Business, Including Any Employment Carried on in Massachusetts.

1. General rule. The activities of a pass-through entity are attributed to its individual members. A non-resident member of a pass-through entity is therefore engaged in the conduct of the trade or business of the pass-through entity of which it is a member, and thus is taxable on the Massachusetts source income of the entity. The character of any item of income, loss, deduction or credit included in the member's distributive share is determined as if it were realized directly by the member from the source from which realized by the pass-through entity, or incurred in the same manner as incurred by the pass-through entity. The principles in this paragraph shall apply in the case of an ownership chain that runs through multiple pass-through entities. For example, if a non-resident individual is a member of a pass-through entity that, in turn, is a member of a lower-tier pass-through entity that is engaged in a trade or business in Massachusetts, then the non-resident will be taxable on its share of the Massachusetts source income derived from the trade or business conducted by the lower-tier entity.

The income derived by a non-resident limited partner of a Massachusetts limited partnership engaged exclusively in buying, selling, dealing in or holding securities on its own behalf and not as a broker, is not subject to the Massachusetts income tax. See G.L. c. 62, § 17(b). The Massachusetts source income derived by a non-resident general partner of such a partnership is subject to Massachusetts income tax, provided the partnership is engaged in the conduct of a trade or business in the Commonwealth, or owns or leases real property in the Commonwealth.

2. Multiple pass-through entities that are not engaged in a unitary business. In the case of multiple pass-through entities that are not engaged in a unitary business, the pass-through entities must identify the Massachusetts income or loss, reporting that amount to its members, allocated or apportioned as appropriate pursuant to 830 CMR 62.5A.1(6). That income must retain its identity as Massachusetts source income, and be reported as such to members as it passes through multiple pass-through entities, without further apportionment.

Example (3)(b)(2). Florida domiciled LLC ("Florida LLC") has three non-resident members. Florida LLC owns a Massachusetts domiciled LLC ("Massachusetts LLC") that invests in securities on its own behalf and is not engaged in a trade or business. Florida LLC owns a New York domiciled LLC ("New York LLC") that has an office in Boston that offers management services and advice to Massachusetts LLC and receives a fee from Massachusetts LLC based on a percentage of the portfolio value of Massachusetts LLC. Florida LLC also owns Real Estate LLC, commercially domiciled in Utah, but which owns an office tower in Boston and collects rents on that. Real Estate LLC is not engaged in a unitary business with the other members of the group.

Taxation of non-resident members of Florida LLC. The Massachusetts source income of Real Estate LLC, determined pursuant to the allocation and apportionment rules of 830 CMR 62.5A.1(6), is identified and reported to Florida LLC, and is taxable to the non-resident members. It is not subject to further apportionment under 830 CMR 62.5A.1(6) at the level of Florida LLC. Income from Massachusetts LLC is not subject to

Massachusetts taxation to the non-resident members, because Massachusetts LLC only invests in securities on its own behalf. The Massachusetts source income derived from New York LLC, determined pursuant to the allocation and apportionment rules of 830 CMR 62.5A.1(6)(a), is taxable because the management company is engaged in the conduct of a trade or business in Massachusetts. The income of the group is not subject to the apportionment provisions described at 830 CMR 62.5A.1(6)(b), below, because the entities subject to Massachusetts taxation are not engaged in a unitary business.

3. Multiple pass-through entities engaged in a unitary business. In the case of multiple pass-through entities that are engaged in a unitary business, the income of any entity in the structure that derives from or is effectively connected with the conduct of a trade or business or the ownership of real or tangible personal property in Massachusetts retains its character as it passes through the structure. Thus, business income of a pass-through entity does not convert to non-business income as it passes through a series of pass-through entities engaged in related business activities, as that term is defined in 830 CMR 62.5A.1(2), and is further explained in 830 CMR 62.5A.1(6). Investment income of a pass-through entity that would be taxable as business income if received directly by a non-resident member engaged in business in Massachusetts is treated as taxable income of the non-resident. Note that business income can include investment income that the pass-through entity or entities derives from an operational function.

Example (3)(b)(3). A non-resident is a member of a Nevada LLC. The Nevada LLC sells computer software, and has an 80% ownership interest in a Partnership that develops computer software in Massachusetts. The partnership is treated as a partnership for federal and Massachusetts tax purposes. The income of the Partnership flows through the LLC to non-resident members. The LLC and the Partnership are functionally integrated, and are a unitary business. Subject to the apportionment rules found at 830 CMR 62.5A.1(6), below, the income of the Partnership that is passed through to the non-resident shareholders is Massachusetts source income.

(c) Specific types of Massachusetts source income. If a non-resident has a trade or business, including any employment, carried on in Massachusetts, Massachusetts source income includes, among other things . . .

830 Mass. Code Regs. 62.5A.1(6) Rules for Allocation or Apportionment of Income to Massachusetts for Non-Resident Members of Pass-Through Entities

A pass-through entity that earns or derives income from sources both within Massachusetts and elsewhere must either allocate or apportion the income to determine the amount of Massachusetts source income of its non-resident members, using the following allocation and apportionment provisions. These rules apply to pass-through entities with non-resident members that have Massachusetts source income. Non-resident individuals use the rules at 830 CMR 62.5A.1(5). The Commissioner may by rule or other public statement create alternate allocation and apportionment methods.

(a) General. A pass-through entity that has income that is taxable both within and outside of Massachusetts must report the member's apportioned share of income to the member. To arrive at the apportioned income figure, the pass-through entity must multiply its taxable net income by the apportionment percentage determined under G.L. c. 63, §38 and 830 CMR 63.38.1. For taxable years beginning on or after January 1, 2025, the apportionment percentage is equal to the sales factor except as otherwise required under G.L. c. 63, §38. For Massachusetts purposes, the pass-through entity's income subject to apportionment is its entire net income derived from its related business activities, as that term is defined at 830 CMR 62.5A.1(2), and further described at 830 CMR 62.5A.1(6)(d), within and outside of Massachusetts. The entity's income subject to Massachusetts tax is its apportioned net income derived from its related business activities, plus any other income subject to the tax jurisdiction of Massachusetts.

Guaranteed payments made to pass-through entity members are treated as other income of the pass-through entity is treated, and are subject to the apportionment rules in this paragraph.

(b) Treatment of multiple pass-through entities engaged in a unitary business. If a pass-through entity has Massachusetts source income and is related to one or more other pass-through entities in a unitary business, including non-Massachusetts businesses that are in a unitary relationship, the entire income derived from the related activities of the members of the unitary business is subject to Massachusetts apportionment. The method of apportionment is to take the pro rata share of the applicable apportionment factor or factors of each entity in the unitary structure, and to aggregate the result for the entire group. The non-resident members will report as Massachusetts source income their apportioned share of income of the entire unitary business.

Example (6)(b)(1.1). In a taxable year beginning before January 1, 2025, General Partnership (General) has a 50% interest in Subsidiary Partnership (Subsidiary); the entities are engaged in a unitary business. General has the following apportionment factors attributable to Massachusetts, presented as a fraction of Massachusetts activity divided by activity everywhere: Property, 25/100; Payroll, 50/100; Sales, 1000/10,000. General has income of \$1,000. Subsidiary has the following apportionment factors, presented as a fraction of Massachusetts activity divided by activity everywhere: Property, 10/100; Payroll, 50/100; Sales, 1000/10,000. Subsidiary has a loss of \$500. The Massachusetts income of the unitary group is calculated as follows: Income = \$1,000 (General's income) - \$250 (representing half the loss of Subsidiary; half because General has a 50% interest in Subsidiary) = \$750. The \$750 income figure must be multiplied by the blended apportionment factors. The blended factors are determined by adding the full factor of General to half the value of Subsidiary's factors (again, because of the 50% ownership). Thus the blended property factor is $(25 + 5)/(100 + 50) = 30/150$; the blended payroll factor is $(50 + 25)/(100 + 50) = 75/150$; the blended sales factor (to be counted twice according to the double weighted sales factor rule) is $[(1000 + 500)/(10,000 + 5,000)] = 1,500/15,000$; the sum of these factors is then divided by four to yield the following result: $.2 + .5 + .1 + .1 = .9 / 4 = .225$.

Example (6)(b)(1.2). Assume the same facts as in Example (6)(b)(1.1), except that the taxable year begins on or after January 1, 2025. In this case, the \$750 income figure must be multiplied by the blended sales factor. The blended sales factor is determined by adding the full sales factor of General to half the value of Subsidiary's sales factor (again, because of the 50% ownership). Thus, the blended sales factor is $[(1000 + 500)/(10,000 + 5,000)] = 1,500/15,000 = .1$.

(c) Treatment of income derived from unrelated activities. If the unitary business subject to Massachusetts apportionment has income derived from unrelated business activities, as determined under 830 CMR 62.5A.1(6) (d), these items of income will be excluded from the taxpayer's taxable net income and will not be apportioned to Massachusetts if Massachusetts does not have jurisdiction to tax the items of income under the Constitution of the United States. Income derived from unrelated business activities will be allocated to Massachusetts when the entity's commercial domicile is Massachusetts. The unitary business must report to the non-resident taxpayer, and the non-resident taxpayer must disclose on his or her return, the nature and amount of any item of income that is derived from unrelated business activities and is excluded from (or is excludable from) taxable net income. The taxpayer must also disclose and exclude expenses allocable in whole or part to such unrelated business activities. Any property, payroll, or sales derived from unrelated business activity are excluded from the taxpayer's applicable apportionment factor or factors.

Example (6)(c)(1). In a taxable year beginning before January 1, 2025, Massachusetts LLC owns a commercial real estate property that it leases, both to its parent, a Partnership that gives investment advice to clients, and to other unrelated tenants. The Partnership, in turn, is owned by three Owner LLCs, all of which have a commercial domicile in other states. The Owner LLCs own the interests in the Partnership, as well as other business ventures, such as a manufacturing corporation in South Carolina and a public utility corporation in North Dakota. The manufacturing corporation and the utility corporation are not in a unitary business with other entities, nor do they have any contacts with Massachusetts. The Massachusetts LLC and the Partnership have centralization of management and a flow of value between the entities, and comprise a unitary business. In determining the Massachusetts source income of the Owner LLC members, the Massachusetts LLC and the Partnership must combine their taxable net income and calculate the Massachusetts apportionment percentage based on their combined property, payroll, and sales. The unitary business will exclude the income of the manufacturing corporation and the public utility corporation from this determination, and will not take into account any of the property, payroll, or sales of the two corporations in calculating the Massachusetts apportionment percentage of the unitary business.

Example (6)(c)(2). Assume the same facts as in Example (6)(c)(1), except that the taxable year begins on or after January 1, 2025. In this case, the Massachusetts source income of the Owner LLC members, the Massachusetts LLC and the Partnership is determined by combining their taxable net income and calculating the Massachusetts apportionment percentage based on their combined sales. The unitary business will exclude the income of the manufacturing corporation and the public utility corporation from this determination, and will not take into account any of the sales of the two corporations in calculating the Massachusetts apportionment percentage of the unitary business.

(d) Related Business Activities.

1. Definition.

a. General Rule. Related business activities are activities where there is a sharing or exchange of value between the segments of a single entity or multiple entities such that the activities are mutually beneficial, interdependent, integrated, or such that they otherwise contribute to one another, as generally described under the discussion of the unitary business principle in *Allied-Signal, Inc. v. Director, Division of Taxation*, 504 U.S. 768 (1992). The rules that apply to corporations, found at 830 CMR 63.38.1(4), generally apply to pass-through entities as they are applicable, with certain modifications set forth in this regulation. In general, any two segments or activities of a single pass-through entity are related business activities unless the two segments or activities are not unitary. In addition, the following activities are related business activities notwithstanding the absence of a unitary relationship:

i. the short term investment of capital in a non-unitary business segment or activity; and

ii. any other investment of capital that serves an operational function.

b. Income from Cash, Cash Equivalents, and Short-Term Securities. Interest or other income from cash deposits, cash equivalents, and short-term securities is considered related business income if such capital serves or performs an operational function. Without limitation, examples of operational functions include: the use or holding of funds as working capital or reserves; the use or holding of funds to maintain a favorable credit rating (e.g. by maintaining a strong current or quick asset ratio); the use or holding of funds to self-insure against business risks; and the interim investment of funds pending their future use in the taxpayer's business.

2. Burden of Proof. Except as provided in 830 CMR 62.5A.1(6)(d)(3) (relating to pass-through entity limited partners), all income of a single pass-through entity (whether derived directly or through representatives, or other pass-through entities) is presumed to be income from related business activities until the contrary is established. Either the taxpayer or the Commissioner may assert that an item of a taxpayer's income is derived from unrelated business activities. The party making such an assertion must prove by clear and cogent evidence that the business activities do not reasonably warrant a finding that the business activities are related. To demonstrate that income from cash, cash equivalents, or short-term securities is derived from unrelated business activities, a taxpayer must prove by clear and cogent evidence that the underlying assets and their acquisition, maintenance, and management were, in fact, unrelated to the pass-through entity's business activities in the Commonwealth.

3. Presumption of Unrelated Business Activity of Pass-Through Entity Limited Partners. In cases where a pass-through entity limited partner owns no more than 50% of the capital interests of a partnership, income that the pass-through entity limited partner derives from the holding or disposition of its limited partnership interest is presumed to be unrelated to the pass-through entity's other business activities unless the Commissioner or the taxpayer rebuts this presumption, as provided (and applicable) in 830 CMR 63.39.1(8)(f). If the business activities of the pass-through entity limited partner and the limited partnership are unrelated, then the pass-through entity limited partner must separately account for its limited partnership income and its other business income and must separately apportion to Massachusetts income from each unrelated activity (to the extent that Massachusetts has jurisdiction to tax income from each such activity), using only the apportionment factor or factors applicable to that activity.

Example (6)(d)(3.1). Texas LLC owns a minority limited partnership interest in Partnership A. Partnership A conducts business in Massachusetts. Apart from this partnership holding, Texas LLC does not conduct business in Massachusetts. Texas LLC does conduct business in other jurisdictions, either directly or through ownership of other pass-through entities. Neither Texas LLC nor the Commissioner rebuts the presumption that the business activities of Texas LLC and Partnership A are unrelated. Texas LLC must separately apportion to Massachusetts income from the holding or disposition of its interest in Partnership A, using the apportionment factor or factors derived from the partnership's activity. Income from Texas LLC's other activities is not subject to Massachusetts tax jurisdiction and is excluded from the Massachusetts source income that it reports to its members.

(e) Special apportionment rules for the gain on the sale of an ownership interest in a partnership that holds real property in Massachusetts.

1. Partnerships that are carrying on a trade or business in Massachusetts. A non-resident partner who sells an interest in a partnership that both holds an interest in real property in Massachusetts and is carrying on a trade or business in Massachusetts is subject to the general rule at 830 CMR 62.5A.1(3)(c)(8), particularly as illustrated at 830 CMR 62.5A.1, Example (3)(c)(8.2).

2. Partnerships that are not carrying on a trade or business in Massachusetts. A non-resident partner who sells an interest in a partnership that holds an interest in real property in Massachusetts but is not carrying on a trade or business in Massachusetts should apply the following rule. The non-resident partner selling his or her interest in the partnership must multiply the gain by a fraction, the numerator of which is the value of the Massachusetts real property and the denominator of which is the total value of the partnership. The value of real property to be used in the fraction is the current fair market value of the property reduced by the value of any lien or encumbrance remaining thereon at the time the partner sells his or her interest in the partnership.

Example (6)(e)(2). Non-resident is a partner in LandHold, a partnership that purchases land in several states and holds the land for subsequent sale to developers. The partnership was formed with an initial capital contribution from its partners, but was not engaged in the conduct of a trade or business in Massachusetts during the year that Non-resident sells his interest in the partnership. The Massachusetts source income derived from the sale is the total gain from the sale, multiplied by fraction set forth in 830 CMR 62.5A.1(6)(e)(2).

830 Mass. Code Regs. 63.39.1(7)(a)

Except as provided by 830 CMR 63.39.1(7)(b), *infra*, a business corporation is subject to the excise under M.G.L. c. 63, §§ 2, 2A or 39, if the corporation is a general or limited partner in a partnership whose activities, if conducted directly by the business corporation, would subject that corporation to the corporate excise under the provisions of M.G.L. c. 63, §§ 2, 2A or 39. In the case of a tiered partnership arrangement the activities of the partnership(s) occupying the lower tier(s) are imputed to all partners holding interests in partnership(s) occupying higher tier(s). In applying this provision, the Commissioner will consider whether the assertion of jurisdiction is limited by the provisions of the U.S Constitution or federal law.

Michigan

Mich. Comp. Laws § 206.661(2)

The tax base of a taxpayer whose business activities are confined solely to this state shall be allocated to this state. The tax base of a taxpayer whose business activities are subject to tax both within and outside of this state shall be apportioned to this state by multiplying the tax base by the sales factor calculated under section 663. For a taxpayer that has a direct, or indirect through 1 or more other flow-through entities, ownership interest or beneficial interest in a flow-through entity, the taxpayer's business income that is directly attributable to the business activity of the flow-through entity shall be apportioned to this state using an apportionment factor determined under section 663 based on the business activity of the flow-through entity unless the flow-through entity is unitary with the taxpayer for apportionment purposes as provided under section 663.

Mich. Comp. Laws § 206.663

(1) Except as otherwise provided in subsection (2) and section 669, the sales factor is a fraction, the numerator of which is the total sales of the taxpayer in this state during the tax year and the denominator of which is the total sales of the taxpayer everywhere during the tax year. The numerator of a taxpayer shall include its proportionate share of the total sales in this state of a flow-through entity that is unitary with the taxpayer. The denominator of a taxpayer shall include its proportionate share of the total sales everywhere of a flow-through entity that is unitary with the taxpayer. A flow-through entity is unitary with a taxpayer when that taxpayer owns or controls, directly or indirectly, more than 50% of the ownership interests with voting rights or ownership interests that confer comparable rights to voting rights of the flow-through entity, and that has business activities or operations which result in a flow of value between the taxpayer and the flow-through entity, or between the flow-through entity and another flow-through entity unitary with the taxpayer, or has business activities or operations that are integrated with, are dependent upon, or contribute to each other.

- (2) Except as otherwise provided under this subsection, for a taxpayer that is a unitary business group, sales include sales in this state of every person included in the unitary business group without regard to whether the person has nexus in this state. Sales between persons included in a unitary business group must be eliminated in calculating the sales factor. Sales between a taxpayer and a flow-through entity unitary with that taxpayer shall, to the extent of the taxpayer's interest in the flow-through entity, be eliminated in calculating the sales factor. Sales between a flow-through entity unitary with a taxpayer and another flow-through entity unitary with that same taxpayer shall, to the extent of the taxpayer's interest in the selling flow-through entity, be eliminated in calculating the sales factor.
- (3) It is the intent of the legislature that the tax base of a taxpayer is apportioned to this state by multiplying the tax base by the sales factor multiplied by 100% and that apportionment shall not be based on property, payroll, or any other factor notwithstanding section 1 of 1969 PA 343, MCL 205.581.

Malpass v. Dep't of Treasury, 833 N.W.2d 272 (Mich. 2013)

The Michigan Supreme Court held “that the ITA does not prohibit individual taxpayers from combining the profits and losses from unitary flow-through businesses and then apportioning that income on the basis of the businesses' combined apportionment factors. Moreover, we hold that the ITA did not limit apportionment of income to domestic businesses during the 1994 and 1995 tax years, and that the apportionment could properly be applied to a foreign entity to the extent that the foreign entity and the individual taxpayer's in-state business were unitary.” This case allows individuals the freedom to choose combined or separate apportionment on a year-by-year basis.

Minnesota

Minn. Stat. § 290.014

Subd. 4: Except as provided in section 290.015, a partnership is subject to the return filing requirements and to tax as provided in this chapter if the income of the partnership is:

- (1) allocable to this state under section 290.17, 290.191, or 290.20;
- (2) taxed to the partnership under the Internal Revenue Code (or not taxed under the Internal Revenue Code by reason of its character but of a character which is taxable under this chapter) in its capacity as a beneficiary of an estate with income allocable to this state under section 290.17, 290.191, or 290.20 and the income, taking into account the income character provisions of section 662(b) of the Internal Revenue Code, would be allocable to this state under section 290.17, 290.191, or 290.20 if realized by the partnership directly from the source from which realized by the estate;
- (3) taxed to the partnership under the Internal Revenue Code (or not taxed under the Internal Revenue Code by reason of its character but of a character which is taxable under this chapter) in its capacity as a beneficiary or grantor or other person treated as a substantial owner of a trust with income allocable to this state under section 290.17, 290.191, or 290.20 and the income, taking into account the income character provisions of section 652(b), 662(b), or 664(b) of the Internal Revenue Code, would be allocable to this state under section 290.17, 290.191, or 290.20 if realized by the partnership directly from the source from which realized by the trust; or
- (4) taxed to the partnership under the Internal Revenue Code (or not taxed under the Internal Revenue Code by reason of its character but of a character which is taxable under this chapter) in its capacity as a limited or general partner in a partnership with

income allocable to this state under section 290.17, 290.191, or 290.20 and the income, taking into account the income character provisions of section 702(b) of the Internal Revenue Code, would be allocable to this state under section 290.17, 290.191, or 290.20 if realized by the second tier partnership directly from the source from which realized by the first tier partnership.

Subd. 5: Except as provided in section 290.015, corporations are subject to the return filing requirements and to tax as provided in this chapter if the corporation so exercises its franchise as to engage in such contacts with this state as to cause part of the income of the corporation to be:

(1) allocable to this state under section 290.17, 290.191, 290.20, or 290.36;

(2) taxed to the corporation under the Internal Revenue Code (or not taxed under the Internal Revenue Code by reason of its character but of a character which is taxable under this chapter) in its capacity as a beneficiary of an estate with income allocable to this state under section 290.17, 290.191, or 290.20 and the income, taking into account the income character provisions of section 662(b) of the Internal Revenue Code, would be allocable to this state under section 290.17, 290.191, or 290.20 if realized by the corporation directly from the source from which realized by the estate;

(3) taxed to the corporation under the Internal Revenue Code (or not taxed under the Internal Revenue Code by reason of its character but of a character which is taxable under this chapter) in its capacity as a beneficiary or grantor or other person treated as a substantial owner of a trust with income allocable to this state under section 290.17, 290.191, or 290.20 and the income, taking into account the income character provisions of section 652(b), 662(b), or 664(b) of the Internal Revenue Code, would be allocable to this state under section 290.17, 290.191, or 290.20 if realized by the corporation directly from the source from which realized by the trust; or

(4) taxed to the corporation under the Internal Revenue Code (or not taxed under the Internal Revenue Code by reason of its character but of a character which is taxable under this chapter) in its capacity as a limited or general partner in a partnership with income allocable to this state under section 290.17, 290.191, or 290.20 and the income, taking into account the income character provisions of section 702(b) of the Internal Revenue Code, would be allocable to this state under section 290.17, 290.191, or 290.20 if realized by the corporation directly from the source from which realized by the partnership.

Minn. Stat. § 290.17

Subd. 1(a) The income of resident individuals is not subject to allocation outside this state. The allocation rules apply to nonresident individuals, estates, trusts, nonresident partners of partnerships, nonresident shareholders of corporations treated as "S" corporations under section 290.9725, and all corporations not having such an election in effect. If a partnership or corporation would not otherwise be subject to the allocation rules, but conducts a trade or business that is part of a unitary business involving another legal entity that is subject to the allocation rules, the partnership or corporation is subject to the allocation rules.

Subd 4(b) The term "unitary business" means business activities or operations which result in a flow of value between them. The term may be applied within a single legal entity or between multiple entities and without regard to whether each entity is a sole proprietorship, a corporation, a partnership or a trust.

Subd 4(g) For purposes of determining the net income of a unitary business and the factors to be used in the apportionment of net income pursuant to section 290.191 or

290.20, there must be included only the income and apportionment factors of domestic corporations or other domestic entities that are determined to be part of the unitary business pursuant to this subdivision, notwithstanding that foreign corporations or other foreign entities might be included in the unitary business; except that the income and apportionment factors of a foreign entity, other than an entity treated as a C corporation for federal income tax purposes, that is included in the federal taxable income, as defined in section 63 of the Internal Revenue Code as amended through the date named in section 290.01, subdivision 19, of a domestic corporation, domestic entity, or individual must be included in determining net income and the factors to be used in the apportionment of net income pursuant to section 290.191 or 290.20.

Minn. Stat. § 290.0922, subd. 4 (Minimum Fee)

For the purposes of this section, a partner's pro rata share of a partnership's property, payroll, and sales or receipts is not included in the property, payroll, and sales or receipts of the partner.

Minnesota Revenue Notice 08-03 (February 19, 2008)

Partnership income is included in the corporate partner's Minnesota income in one of two ways.

Partnership income is subject to apportionment as business income of the unitary business when a unitary business relationship exists between the corporation and the partnership. The determination of the existence of a unitary business must be made under Minnesota Statutes, section 290.17, subdivision 4, except that a corporation need not own more than 50% direct ownership in the partnership to be included in the unitary business. When a corporation and a partnership are engaged in a unitary business, the corporation must include its partnership income in its apportionable business income. The corporation must also include its pro-rata share of the partnership's property, payroll, and sales/receipts located within and outside Minnesota in the corporation's property, payroll, and sales/receipts numerator and denominator.

If the corporation and partnership are not engaged in a unitary business, the corporation must report its partnership income or loss as separately stated income or loss. If the partnership's business is conducted wholly within Minnesota, the corporate partner's share of partnership income or loss must be assigned entirely to Minnesota by the corporate partner. If the partnership business is conducted wholly outside Minnesota, the corporate partner's share of partnership income or loss must be assigned entirely outside Minnesota. If the partnership conducts its business both within and without Minnesota, the corporate partner's share of partnership income or loss is assigned to Minnesota based on the partnership's property, payroll, and sales/receipts apportionment factors.

Mississippi

Miss. Code Ann. § 27-7-23(b)(2)

Income derived from trade, business or other commercial activity shall be taxed to the extent that it is derived from such activity within this state. Mississippi net income shall be determined in the manner prescribed by the commissioner for the allocation and/or apportionment of income of foreign corporations having income from sources both within and without the state.

Miss. Code Ann. § 27-7-23(2)(2)(A)

Except as provided in Sections 27-7-24, 27-7-24.1, 27-7-24.3, 27-7-24.5, 27-7-24.7, 27-7-24.8 and 27-7-24.9, Mississippi Code of 1972, any corporation or organization having business income from business activity which is taxable both within and without this state shall allocate and apportion its net business income as prescribed by regulations enacted by the commissioner. If the business income of the corporation is derived solely from property owned or business done in this state and the corporation is not taxable in another state, the entire business income shall be allocated to this state. A corporation is taxable in another state if, in that state the corporation is subject to a net income tax, or a franchise tax measured by net income, or if that state has jurisdiction to subject the corporation to a net income tax regardless of whether the state does or does not subject the corporation to a net income tax

tit. no. 35 - pt. 3, subpt. 08, ch. 06, Miss. Code R. 302.01(8)

Royalty income from mineral production must be allocated to the state where production occurred. Partnership income is allocated directly to the state where the partnership gross income or loss occurred.

tit. no. 35 - pt. 3, subpt. 08, ch. 06, Miss. Code R. § 401.04

If the business activity in respect to any trade or business of a taxpayer occurs both within and without this state, and if by reason of such business activity the taxpayer in another state, portion of the net income (or net loss) arising from such trade or business which is derived from sources within this state shall be determined by apportionment in accordance with the further provisions of this regulation, where direct or separate accounting of net income or loss is not feasible.

Missouri

Mo. Rev. Stat. § 143.421

- (1) In determining the adjusted gross income of a nonresident partner of any partnership, there shall be included only that part derived from or connected with sources in this state of the partner's distributive share of items of partnership income, gain, loss, and deduction entering into his federal adjusted gross income, as such part is determined under regulations prescribed by the director of revenue in accordance with the general rules in section 143.181 . . .
- (4) The director of revenue may, on application, authorize the use of such other methods of determining a nonresident partner's portion of partnership items derived from or connected with sources in this state, and the modifications related thereto, as may be appropriate and equitable, on such terms and conditions as he may require.

Mo Rev. Stat. § 143.411(2)

Each item of partnership income, gain, loss, or deduction shall have the same character for a partner under sections [143.005 to 143.998](#) as it has for federal income tax purposes. Where an item is not characterized for federal income tax purposes, it shall have the same character for a partner as if realized directly from the source from which realized by the partnership or incurred in the same manner as incurred by the partnership.

Mo. Code Regs. Ann. tit. 12, § 10-2.190(2)(B)

The partnership return or S corporation return shall reflect the total income of the partnership or S corporation from all sources and allocate to Missouri that portion of the total income which is derived from or connected with sources in Missouri by using the apportionment formula in sections 32.200 or 143.451, RSMo. The ratio with a numerator of that portion of the total income which is derived from or connected with sources in Missouri and a denominator of the total income of the partnership or S corporation shall be the basis of allocation of each nonresident partner's or nonresident shareholder's income to Missouri by applying that percentage to the total distributable income of each nonresident partner or shareholder based upon his/her percentage of interest in the partnership or S corporation.

Missouri Private Letter Ruling No. LR 4970 (08/05/2008)

By statutory definition, to be a partnership in Missouri, the entity has to be carrying on a business. Here, the Partnership's trade or business is investing in securities such as stocks, mutual funds, bonds and other investments, even if it has a contractual relationship with a bank to do so. The Partnership incurs income from carrying on its trade or business of investing in Missouri. This income is thus Missouri source income. Because a partnership is a flow-through entity, partners are deemed to be carrying on the trade or business of the partnership. Therefore, income from the Partnership's trade, investing, is Missouri source income for the partners, including Applicant.

Here, Applicant is a nonresident and general partner in the Partnership. As a general partner, Applicant is deemed to be in the Partnership's trade or business. The income Applicant received as a partner is income derived from sources within this state, is attributable to a business carried on in this state, and is thus Missouri source income.

Missouri Private Letter Ruling No. LR 2664 (12/21/2000)

Applicant is based in Texas. Applicant is a limited partner in a limited partnership (Limited Partnership A), which in turn is a limited partner in another limited partnership (Limited Partnership B), which owns an interest in a hotel in Missouri. Over 99% of Applicant's income comes from Limited Partnership A, which does no business in Missouri. Different general partners manage Limited Partnership A and Limited Partnership B, and none of the general partners are located in Missouri.

ISSUE:

May Applicant apportion income to Missouri based on the actual amount of income generated in Missouri?

RESPONSE:

Applicant may not apportion income to Missouri based on the actual amount of income generated in Missouri.

The use of an apportionment formula within a special method that is predicated upon separate accounting is an inherent conflict of theories. Applicant states in its letter that over 99 percent of Applicant's income comes from Limited Partnership A, which does no business in Missouri. While on the surface, this contention makes separate accounting seem very reasonable, experience shows that the application of standard formula apportionment methods on a consistent year-in-year-out basis not only results in the fairest long-term treatment of a taxpayer, but results in the most equitable apportionment of the tax burden among the various taxpayers doing business within Missouri and other states.

Missouri Department of Revenue Partnership Tax FAQ

What is considered Missouri source income?

Items of income, gain, loss and deduction derived from, or connected with, sources within Missouri are those items attributable to (1) the ownership or disposition of any interests in real or tangible personal property in Missouri or (2) a business, trade, profession or occupation carried on in Missouri. Income from intangible personal property, to the extent that such property is employed in a business, trade, profession or occupation carried on in Missouri, constitutes income derived from sources within Missouri.

Mo Rev. Stat. § 143.411(3)

Where a partner's distributive share of an item of partnership income, gain, loss, or deduction is determined for federal income tax purposes by a special provision in the partnership agreement with respect to such item, and the principal purpose of such provision is the avoidance of tax under sections 143.005 to 143.998, the partner's distributive share of such item and any modification required with respect thereto shall be determined in accordance with his distributive share of the taxable income or loss of the partnership generally (that is, exclusive of those items requiring separate computation under the provisions of Section 702 of the Internal Revenue Code).

Montana

Mont. Code Ann. § 15-30-3302

(2) Except as otherwise provided, each partner of a partnership described in subsection (1)(a), each shareholder of an S. corporation described in subsection (1)(b), and each partner, shareholder, member, or other owner of an entity described in subsection (1)(c), the first-tier pass-through entity, is subject to the taxes provided in this chapter, if an individual, trust, or estate, and to the taxes provided in Title 15, chapter 31, if a C. corporation. If a partner, shareholder, member, or other owner of an entity described in subsection (1) is itself a pass-through entity, any individual, trust, or estate to which the first-tier pass-through entity's Montana source income is directly or indirectly passed through is subject to the taxes provided in this chapter and any C. corporation to which the first-tier pass-through entity's Montana source income is directly or indirectly passed through is subject to the taxes provided in Title 15, chapter 31 . . .

(5) For purposes of this part:

(a) a partnership or S. corporation with business activity occurring both within and outside of this state shall calculate its Montana source income pursuant to the allocation and apportionment provisions contained in Title 15, chapter 31, part 3; and

(b) a disregarded entity that is not owned by an individual, estate, or trust and that has business activity occurring both within and outside of this state shall calculate its Montana source income pursuant to the allocation and apportionment provisions contained in Title 15, chapter 31, part 3.

Mont. Admin. R. 42.9.107

(1) A pass-through entity may have, in addition to income from its own operations or activities, income from one or more other pass-through entities. This rule describes how the pass-through entity must classify its income from its own operations or activities as apportionable or non-apportionable income and how it must report its income from other pass-through entities. For purposes of this rule, "operations income" means the income of a pass-through entity from its own operations or activities and "flow-

through income" means its separately and nonseparately stated distributable share of income from other pass-through entities.

(2) Except as provided in (5), each pass-through entity has to separately determine whether its operations income is apportionable or non-apportionable income as those terms are defined in ARM 42.26.206. Once a pass-through entity determines the apportionable or non-apportionable character of its operations income, the entity must then determine what part of this apportionable and/or non-apportionable income is Montana source income. Except as provided in (5) and (6), the operations income retains its character as apportionable or non-apportionable income and as Montana source income regardless of how many other tiers of pass-through entities through which the income is passed.

(3) Except as provided in (5) and (6), flow-through income of a pass-through entity, determined as provided in (1), retains its character as apportionable and/or non-apportionable income and its character as Montana source income.

(4) An entity in a multi-tiered pass-through entity structure may have flow-through income sourced to Montana under the subsections of the definition of "Montana source income" in 15-30-2101, MCA, that address partnership or S corporation income derived from Montana activity or property, reportable on Montana Schedule K-1, and also operations income sourced to Montana as a result of its own business activity under other subsections of that definition of "Montana source income," such as net income from a business, profession, or farming activities carried on in the state. If this occurs the entity must allocate to Montana the flow-through income sourced to Montana and the entity must determine the portion of its operations income that is sourced to Montana as provided in (1) and allocate or apportion that Montana source income under the provisions of ARM 42.9.112.

(5) This rule does not apply to a partnership or disregarded entity whose operations are unitary with the business operations of a corporate partner or disregarded entity owner that is a C corporation whose apportionment factors are included in the computation of the C corporation's apportionment factors as provided in ARM 42.26.228.

(6) Nothing in this rule prevents the department from determining the apportionable or non-apportionable character of an entity's operations income or the Montana source character of its Montana flow-through income sourced to Montana.

Mont. Admin. R. 42.9.112(5) *Sourcing*

A partnership whose operations are unitary with the business operations of a direct or indirect corporate partner and whose apportionment factors are included in the computation of that corporate partner's apportionment factors, pursuant to ARM 42.26.228, are considered a part of the corporate group for the purpose of applying the Finnigan Rule described in ARM 42.26.260.

Mont. Admin. R. 42.26.228

(1) If the operations of a partnership or disregarded entity are unitary with the business operations of a corporate partner or disregarded entity owner, the corporate partner's or owner's pro rata share of the property, payroll, and sales of the partnership or disregarded entity will be included in the computation of the apportionment factors.

(2) The definition of unitary will be the same as the definition of a unitary business as outlined in 15-31-301, MCA. However, the corporate partner or disregarded entity owner need not own in excess of 50% of the partnership or disregarded entity for the partnership or disregarded entity to be unitary.

A partnership or disregarded entity that is not part of a unitary business operation of a corporate partner or disregarded entity owner will be treated as follows:

- (a) The corporate partner's or disregarded entity owner's share of partnership or disregarded entity income will not be included in apportionable income to be apportioned, but allocated to the states where the partnership or disregarded entity operates based upon the apportionment formula outlined in 15-31-305, MCA.

Pioneer News Group, Co. and Subsidiaries v. State of Montana Dep't of Revenue, Montana Tax Appeal Board Case No. IT-2020-40 (January 20, 2022)

Under the facts of the case, the Board permitted the taxpayer to use the apportionment provisions of the Multistate Tax Compact to source pass-through income in a tiered structure. The Board noted “[w]hile ARM 42.9.107 may be applicable in other situations not at issue here, this Board declines to read this rule in a manner that contradicts or adds to the Compact.”

MT common-errors-to-avoid-when-filing-Form-PTE 030824

Schedule K-1

Special Allocations. Special allocations must be specified on the Schedule K-1 for partners with a special allocation. Mark the Special Allocation checkbox on the Schedule K-1 for any partner that has a special allocation for income/loss that does not follow the profit/loss percentage.

Nebraska

Neb. Rev. Stat. § 77-2728

Each item of partnership income, gain, loss, or deduction shall have the same character for a partner under the provisions of the Nebraska Revenue Act of 1967 as it has for federal income tax purposes. Where an item is not characterized for federal income tax purposes, it shall have the same character for a partner as if realized directly from the source from which realized by the partnership or incurred in the same manner as incurred by the partnership.

316 Neb. Admin. Code § 24-301

301.01 In General

A business entity or unitary group generating income from a business activity that is taxable within Nebraska and subject to tax in at least one other state must apportion its income. The income is apportioned using the sales factor only, as provided in Reg-24-301 through Reg-24-350.

301.02 Apportionable Income

The entire federal taxable income of a corporation, a unitary group, or a partnership is presumed to be apportionable income. The apportionable income includes income arising from transactions and activity of the business, and income arising from tangible and intangible property if the acquisition, management, employment, development, or disposition of the property was related to the operation of the business entity's trade or business.

316 Neb. Admin. Code § 24-305

305.01 Corporations or Partnerships; Apportionment Formula

The federal taxable income, as adjusted under Reg-24-155, Nebraska Adjustments to Taxable Income, of a corporation or partnership operating both within and outside Nebraska is apportioned to Nebraska by using the sales factor of the corporation or partnership. The income of the taxpayer apportioned to Nebraska is determined by calculating the ratio of the taxpayer's sales in Nebraska compared to the total sales of the taxpayer and applying the computed ratio to the federal taxable income, as adjusted, of the taxpayer.

316 Neb. Admin. Code § 24-315

315.01 A business entity which is required to apportion income and has income from a partnership or joint venture (partnership), will calculate its Nebraska sales factor under this regulation. The entire federal taxable income of a corporate taxpayer is subject to apportionment in this state. Nebraska apportionable income includes any income or loss received due to a business entity's interest in a partnership. If neither the corporation nor the partnership is subject to tax in another state, the entire federal taxable income of the business entity is subject to Nebraska tax and will not be apportioned.

315.02 When a business entity is an owner in a partnership, the business entity's apportionment factor must be calculated based on whether or not the business entity and partnership are considered unitary. A unitary determination must be made for each business entity.

315.02A When a partnership has sufficient contacts with a business entity to be considered unitary if it were a corporation, the partnership will be considered unitary with the business entity regardless of the ownership share of the business entity.

315.02A(1) When a business entity and a partnership are considered unitary, the sales factor of the business entity must include the business entity's share of the partnership's sales determined by multiplying the partnership's sales factor numerator and denominator by the business entity's ownership percentage.

315.02A(2) Intercompany sales will be eliminated using calculations made in the following order:

315.02A(2)(a) Intercompany sales will be eliminated based on the percentage of the business entity's ownership of the partnership; except that sales from the partnership to the business entity or members of the unitary group will be eliminated only to the extent of the business entity's or unitary group's share of total sales of the partnership (See Reg-24-315.02A(4)); and

315.02A(2)(b) If all of the sales from the partnership to the business entity or unitary group are not eliminated based on Reg-24-315.02A(2)(a), the remaining sales in each state will be the same percentage of the sales in the state before any eliminations. (See Reg-24-315.02A(6))

315.02A(2)(c) Any partnership agreements that identify particular activities to a specific owner will not be considered when determining the income of each owner subject to tax in Nebraska . . .

315.02B When a partnership does not have sufficient contacts with a business entity to be considered unitary, the business entity's sales factor must include its share of income from the partnership. The net income distributed from the partnership to the business entity will be included in the denominator and the Nebraska source net

income distributed from the partnership to the business entity will be included in the numerator . . .

315.02B(2) The business entity's sales factor does not include sales made by the partnership. Therefore, the business entity's sales factor is not adjusted to eliminate sales made between the business entity and the partnership.

Nebraska Return of Partnership Instructions (2022)

Nebraska source income is determined by apportioning the partnership or LLC income using a single, sales-only factor. Apportionment refers to the division of income between states by the use of a formula containing one or more apportionment factors . . . For partnerships that are only subject to income tax in Nebraska, the amounts entered on lines 1-14 will come directly from the partner's Federal Schedule K-1. For partnerships that are subject to income tax in another state, the amounts entered on lines 1-14 will be the result of the Federal Schedule K-1 amounts multiplied by the partnership's Nebraska apportionment factor.

New Hampshire

New Hampshire taxes partnership income at the entity level, rather than allocating each partner their distributive share.

N.H. Constitution, Part II, Art. 5 Requirements:

“And farther, full power and authority are hereby given and granted to the said general court, from time to time...to impose and levy proportional and reasonable assessments, rates, and taxes, upon all the inhabitants of, and residents within, the said state; and upon all estates within the same....”

Opinion of the Justices, 111 N.H. 206, 209 (1971).

“[I]t is our view that if corporations are to be taxed upon the receipt of income, the tax burden must be shared by others enjoying like privileges.”

N.H. Rev. Stat. Ann. § 77-A:1, I

“Business organization” means any enterprise, whether corporation, partnership, limited liability company, proprietorship, association, business trust, real estate trust or other form of organization....

N.H. Rev. Stat. Ann. § 77-A:3, III

When 2 or more related business organizations are engaged in a unitary business, as defined in RSA 77-A:1, XIV, a part of which is conducted in this state by one or more members of the group, the income attributable to this state shall be determined by means of the applicable combined apportionment factors of the unitary business group in accordance with paragraphs I and II.

New Hampshire Department of Revenue Website

For taxable periods ending on or after December 31, 2023, a 7.5% tax is assessed on income from conducting business activity within the State of New Hampshire. For taxable periods ending on or after December 31, 2022, a business organization deriving

gross business profits from business activity both within and outside of the State shall apportion gross business profits using the single sales factor. Organizations operating a unitary business must use combined reporting in filing their New Hampshire business tax return.

New Jersey

N.J. Admin. Code § 18:35-1.3(d)(6)

A tiered partnership shall take into account its distributive share of partnership income from any partnership of which it is a member. Once income has been allocated by a partnership, it shall not be reallocated by the partners.

N.J. Admin. Code § 18:7-7.6

(g) For purposes of apportionment (allocation) of corporate income, where the subject corporation and the partnership are not part of a single unitary business, including a business carried on directly by the foreign corporate partner, separate accounting apportionment should be used to arrive at corporate income. If the New Jersey business of the partnership is part of a single unitary business including a business carried on directly by the foreign corporate partner, flow through accounting apportionment should be used with respect to the incomes of the two entities.

(1) Separate accounting apportionment, for purposes of this subsection only, means use of the following method: The corporation's distributive share of the partnership's business income would be apportioned to New Jersey by computing the applicable N.J.S.A. 54:10A-6 apportionment factor for that business by only taking into account the corporate partner's share of the receipts of the business that the partnership carries on directly. Second, the corporation's entire net income, excluding its distributive share of the partnership's income is apportioned to New Jersey by computing the applicable N.J.S.A. 54:10A-6 apportionment factor for that business by only taking into account the receipts (excluding receipts from the partnership namely, receipts from intercompany transactions) of the business that the corporation carries on directly. Third, these two amounts would be added together to arrive at the corporation's entire net income apportioned to New Jersey.

(2) "Flow through accounting apportionment," for the purpose of this section only, means use of the following method: Taxpayer shall separately compute the receipts fractions attributable to the partnership activity. The taxpayer next computes the receipts fractions attributable to the corporate activity. An allocation factor combining the factors of the corporation and the partnership is then applied to the corporation's entire net income including its distributive share of the partnership's income.

(3) Facts that either singly or in combination may suggest that the corporation and partnership are part of a unitary business and hence that a flow through approach may be appropriate include, without limitation thereto:

- i. Substantial intercompany-partnership transactions;
- ii. The partnership interest is the only or the most substantial asset of the corporation;
- iii. The partnership interest produces all or most of the income of the corporation;
- iv. The corporation and the partnership are in the same line of business;

v. There is substantial overlapping of employees and offices; and/or

vi. There is sharing of operational facilities, technology, and/or know-how.

(4) For further information about combined returns and unitary businesses, see N.J.A.C. 18:7-21.

(h) The accounting methods described at (g) above are also applied to domestic corporate partners. If a domestic corporation is a partner in a foreign partnership that does not conduct business in New Jersey, and the corporation's own business and that of the partnership are not unitary, then the corporation's income from the partnership shall not be included in the corporation's tax base, and the partnership's receipts, payroll, and property shall not be considered in determining the apportionment factor to apply to the corporation's income from its own business. If, however, the two businesses are unitary, then the flow through method should be used in apportioning the corporation's income. For further information about combined returns and unitary businesses, see N.J.A.C. 18:7-21 .

(1) Solely for purposes of this section, each regular place of business of a partnership that is unitary with a corporate partner is to be treated as a regular place of business of the corporate partner. Relief pursuant to N.J.A.C. 18:7-8.3 is permitted to domestic partners with respect to partnership income duplicated on a return of a domestic corporate partner filed with another state. By virtue of its subjectivity under the Corporation Business Tax Act, a corporate partner may seek relief under N.J.S.A. 54:10A-8 if the taxpayer believes that tax computed does not result in a fair apportionment.

(i) A “tiered partnership,” for the purposes of this section, is a partnership whose partners are partnerships. A corporation that is a partner in a partnership that in turn is a partner in yet another partnership is not immune from New Jersey taxation simply because of the tiered partnership. The ultimate tax burden and loss benefit falls on the corporate partner. The corporation shall file a New Jersey corporation business tax return taking account of its ultimate distributive share of the tiered partnership's income or loss from New Jersey activities.

(j) The classification of partnership items of income, expense, or loss as operational or nonoperational is to be determined in accordance with N.J.S.A. 54:10A-6.1. Whether or not a partnership is unitary or nonunitary with its corporate partner is a different issue from the issue of taxability of operational or nonoperational income or the deductibility of operational or nonoperational expenses or losses.

New Jersey Technical Bulletin 112(R) (May 3, 2024) *Sourcing*

Tiered Partnerships

A tiered partnership in which the lower-tiered partnership is unitary with the upper-tiered partnership (as outlined in N.J.A.C. 18:7-21.2) must use the flow-through method of accounting and sourcing for unitary partnerships as described in N.J.A.C. 18:7-7.6. For a unitary relationship to exist, there must be common ownership between the entities whereby the ownership in the entities, directly or indirectly, is more than a 50% ownership interest. A tiered partnership that is a nonunitary business uses the separate method of accounting and sourcing for nonunitary partnerships as described in N.J.A.C. 18:7-7.6.

New Mexico

NMSA 1978 § 7-4-10(a)

Except as provided in Subsections B and C of this section, all business income shall be apportioned to this state by multiplying the income by a fraction, the numerator of which is the property factor plus the payroll factor plus the sales factor and the denominator of which is three.

N.M. Code R. § 3.3.11.12

B. A taxpayer's distributive share of nonbusiness and business income shall be allocated and apportioned in accordance with this section (3.3.11.12 NMAC) to determine the portion of the distributive share of income taxable under the New Mexico Income Tax Act unless the taxpayer is qualified to elect, and has elected, to report the income in accordance with 3.3.11.8 NMAC . . .

D. The taxpayer shall apportion the taxpayer's distributive share of the unincorporated business entity's business income to New Mexico by multiplying the taxpayer's distributive share times the New Mexico apportionment percentage determined by application of the Uniform Division of Income for Tax Purposes Act to the entire business income of the unincorporated business entity. If the unincorporated business entity fails to provide the taxpayer with the necessary New Mexico apportionment percentage or information sufficient to enable the taxpayer to calculate the percentage, the taxpayer shall apportion the taxpayer's entire distributive share of business income as if all of the entity's activities, property, payroll and sales were in New Mexico.

New York

N.Y. Tax Law § 210(3)

A corporation that is a partner in a partnership shall compute tax under this article using the aggregate method as defined in the regulations of the commissioner, unless another method for computing such tax is required or allowed by such regulations. Under the aggregate method, a corporation that is a partner in a partnership is viewed as having an undivided interest in the partnership's assets, liabilities, and items of receipts, income, gain, loss and deduction. Under the aggregate method, the corporation that is a partner in a partnership is treated as participating in the partnership's transactions and activities.

N.Y. Comp. Codes R. & Regs. tit. 20, § 9-2.3

(a)(1) Under the aggregate method, the corporation's distributive share (see IRC section 704) of each partnership item of receipts, income, gain, loss, and deduction and the corporation's proportionate part of each partnership asset and liability and each partnership activity are included in the computation of the corporation's business income base, capital base, and the fixed dollar minimum tax and will have the same source and character in the hands of the corporate partner for article 9-A purposes as such item has in the hands of the partnership for Federal income tax purposes. Where an item, amount or activity of the partnership is not characterized for Federal income tax purposes or is not required to be taken into account for Federal income tax purposes, the source and character of each item, amount or activity of the partnership will be determined as if such item, amount or activity realized, incurred or experienced by the partnership were realized, incurred or experienced directly by the corporate partner . . .

(a)(4) Where a corporation is a partner in an upper tier partnership that is a partner in a lower tier partnership, the source and character of such corporation's distributive share or proportionate part, as the case may be, of each partnership item of receipts,

income, gain, loss, deduction, asset, liability, and activity of the upper tier partnership that is attributable to the lower tier partnership retains the source and character determined at the level of the lower tier partnership. Such source and character are not changed by reason of the fact that such item flows through the upper tier partnership to such partner . . .

(b) Business income base. The corporation's distributive share of each partnership item of income, gain, loss, and deduction must be taken into account in the computation of entire net income and the business income base. These amounts must be taken into account in determining the corporation's business income, investment income, and other exempt income.

(c) Capital base. The corporation's proportionate part of each asset and liability of the partnership must be taken into account in the computation of the capital base. These amounts must be taken into account when determining business capital and investment capital. The capital base does not include any amount with respect to the corporation's interest in the partnership itself . . .

(f)(1) A corporation must include its distributive share of the partnership's business receipts when computing its BAF. Its distributive share of the partnership's business receipts during the applicable partnership year should be combined with the corporation's own receipts for the taxable year. The corporation must apportion such combined amounts using the rules specified in section 210-A and of this Subchapter. To the extent an apportionment rule uses a fraction to determine the amount of New York receipts, a corporation must include the distributive share or proportionate parts of any partnership amounts with the corporation's own amounts in such fraction. In addition, netting of gains and losses must be computed on the combined corporation and partnership amounts.

(f)(2) Where a corporation has receipts from sales to a partnership in which it is a partner, the corporation must reduce its receipts from its sales to the partnership by its distributive share of such purchases by the partnership. Where a partnership has receipts from sales to a corporation that is a partner in the partnership, the corporation does not include its distributive share of the partnership receipts from sales to the corporation in its BAF.

(f)(4) In instances where an apportionment rule requires the use of a fraction to compute New York receipts, the corporation must use the sum of its own amounts for the taxable year and its distributive share or proportionate part, as the case may be, of partnership amounts during the applicable partnership year when computing such fractions

N.Y. Comp. Codes R. & Regs. tit. 20, § 9-2.2(c)

If a corporation is a partner in a partnership ("upper tier partnership") and such partnership is a partner in another partnership ("lower tier partnership") and the corporation has the necessary information to use the aggregate method with respect to the items of receipts, income, gain, loss, deduction, assets and 374 liabilities, and activities of the upper tier partnership that are not attributable to the lower tier partnership, but does not have the necessary information to use the aggregate method with respect to such items that are attributable to the lower tier partnership, then such corporation must use the aggregate method with respect to the items of receipts, income, gain, loss, deduction, assets and liabilities, and activities of the upper tier partnership that are not attributable to the lower tier partnership and must use the entity method with respect to such items that are attributable to the lower tier partnership. If there are additional tiers of partnerships, this methodology must be employed at each tier. The corporation

will be presumed to have access to the necessary information with respect to a lower tier partnership and will be subject to the provisions of paragraph (2) of subdivision (b) of this section with respect to a lower tier partnership if one or more of the presumptions set forth in subdivision (a) of this section are met at each tier. If the corporation does not meet any of the presumptions set forth in subdivision (a) of this section and does not have access to the necessary information with respect to a lower tier partnership the provisions of paragraph (1) of subdivision (b) of this section will apply.

N.Y. Comp. Codes R. & Regs. tit. 20, § 9-2.4(e) Computation of tax under the entity method.

A corporation must apportion its distributive share of partnership items of income, gain, loss and deduction included in its business income and its interest in the partnership included in its business capital by its BAF determined under Part 4 of this Subchapter, computed without regard to its distributive share of any partnership items of income, gain, loss or deduction.

Recent New York Regulations providing more detail on aggregate and entity methods

<https://www.tax.ny.gov/pdf/rulemaking/dec1123/corpreform/text.pdf>

New York Instructions for Form IT-204 (2024)

Tiered partnerships (Regulation section 137.6)

If your partnership is a partner in another partnership (a lower-tier partnership), the source and character of the distributive share of each item of your partnership to any partner of your partnership that is attributable to the lower-tier partnership retains the source and character determined at the level of the lower-tier partnership. Any such item that flows through your partnership to such partner does not change the source and character of that item.

Example: Partnership A was a partner in another partnership, B. A is referred to as the upper tier partnership while B is referred to as the lower-tier partnership. P was a non-resident individual partner of A.

Partnership A was not engaged in a trade or business in New York, but partnership B was. Even though partnership A was not carrying on business in New York, it had New York source income from the distributive shares it received from partnership B. The source and character of each item that partnership A received from partnership B retains the source and character determined at the level of partnership B. For instance, if P was a partner of A, and A was a partner of B, nonresident individual partner P would allocate its share of the NY income from B at B's business allocation percentage. Further, if A was engaged in a trade or business in NY, then P would allocate its share of A's income using A's business allocation percentage and P would allocate its share of B's income (which flows to A) at B's business allocation percentage. This allocation method should be reflected on Forms IT-204 and IT-204-IP.

N.Y. Tax Law § 617(c)

(c) New York tax avoidance or evasion. Where a partner's distributive share of an item of partnership income, gain, loss or deduction is determined for federal income tax purposes by special provision in the partnership agreement with respect to such item, and where the principal purpose of such provision is the avoidance or evasion of tax under this article, the partner's distributive share of such item, and any modification required with respect thereto, shall be determined as if the partnership agreement made no special provision with respect to such item.

N.Y. Comp. Codes R. & Regs. Tit. 20 § 117.5

(a) If a partnership agreement provides for an allocation of any item of partnership income, gain, loss or deduction to a partner but the allocation does not have substantial economic effect in accordance with section 704(b) of the Internal Revenue Code, the allocation shall be disregarded for Federal income tax purposes. In such a case, a partner's distributive share of such item is determined in accordance with the partner's interest in the partnership (determined by taking into account all facts and circumstances). This treatment and distribution of the item is reflected in each partner's Federal adjusted gross income and therefore in each partner's New York adjusted gross income, even if no New York State personal income tax avoidance or evasion may be involved.

(b) An allocation of an item, amount or activity, even if recognized for Federal income tax purposes, will not be recognized where it has as a principal purpose the avoidance or evasion of New York State personal income tax. Where an allocation is not recognized, the partner's distributive share shall be determined in accordance with the partner's interest in the partnership (determined by taking into account all facts and circumstances).

(c) The determination of whether a principal purpose of an allocation of an item, amount or activity is the avoidance or evasion of New York State personal income tax depends on all the surrounding facts and circumstances. Among the relevant circumstances to be considered are the following:

(1) whether the partnership or a partner individually has a business purpose for the allocation;

(2) whether the allocation has substantial economic effect, that is, whether the allocation may actually affect the dollar amount of the partners' shares of the total partnership income or loss independently of the New York State personal income tax consequences;

(3) whether the related items of partnership income, gain, loss or deduction from the same source are subject to the same allocation;

(4) whether the allocation was made without recognition of normal business factors and only after the amount of the allocated item could reasonably be estimated;

(5) the duration of the allocation; and

(6) the overall New York State personal income tax consequences of the allocation.

N.Y. Comp. Codes R. & Regs. Tit. 20 § 137.5

(c) Where a special provision in a partnership agreement (other than the provision referred to in section 137.2 of this Part) has as its principal purpose the avoidance or evasion of New York State personal income tax, each partner's distributive share must be determined in accordance with the provisions of section 117.5 of this Title.

New York TSB-A-09(7)C (May 13, 2009)

If Petitioner's special allocation of 99.99% of the depreciation deductions to Investor has substantial economic effect and is valid for federal and state tax purposes, then the same allocation of the tangible property component of the Brownfield Redevelopment Tax Credit to Investor is a valid allocation.

North Carolina

N.C. Gen. Stat. § 105-153.4(d)

In order to calculate the numerator of the fraction provided in subsection (b) of this section for a partner in a partnership or a member of another unincorporated business that has one or more nonresident partners or members and operates in one or more other states, the amount of the partner's or member's distributive share of the total net income of the business, as modified in G.S. 105-153.5 and G.S. 105-153.6, plus any guaranteed payments made to a partner from the partnership that is includable in the numerator is determined in accordance with the provisions of G.S. 105-130.4. As used in this subsection, total net income means the entire gross income of the business less all expenses, taxes, interest, and other deductions allowable under the Code that were incurred in the operation of the business.

17 N.C. Admin. Code 5C.1701

A corporation which is a member of a partnership or joint venture doing business in North Carolina is subject to North Carolina income tax and is required to include in the total net income subject to apportionment and allocation its share of the partnership's net income or net loss to the same extent required for federal income tax purposes.

17 N.C. Admin. Code 05C .1702

Income shall be classified as non-apportionable income where the corporate partner limits its connection to the partnership to the investment of funds or property and does not regularly or materially participate in the day-to-day operation of the partnership. Where the business of the partnership is directly or integrally related to the business of the corporate partner, the corporate partner's share of the partnership net income is classified as apportionable income. When classified as apportionable income, the corporate partner's apportionment factors shall include its proportionate share of the partnership's property, payroll, and sales. If the income is classified as non-apportionable income, it shall be included in the corporate partner's net taxable income and allocated in accordance with the allocation provisions of G.S. 105-130.4.

North Carolina Administrative Decision No. 97-548 (April 24, 1998)

Similar to most states, our law and rules do not distinguish between general and limited partners of a partnership. Furthermore, the rules are applicable for all tiers of the partnership structure. Hence, a corporate partner, which otherwise has no activities in this State, is subject to a corporate income and franchise tax on its distributive share of the partnership income if the partnership is "doing business" in North Carolina. The facts of this case clearly establish that the taxpayer is "doing business" in this State under the Department's rules. Here, [Limited Partnership One] is "doing business" in North Carolina by virtue of its ownership interest in [Limited Partnership Two] which operates in this State. The taxpayer, in turn, is "doing business" in North Carolina by virtue of its ownership interest in the [Limited Partnership One] partnership and is therefore subject to the corporate franchise and income tax imposed under G.S. 105-122 and G.S. 105-130.3, respectively.

Regarding the second issue, I find that the pass-through income derived from [Limited Partnership One] is properly classified as apportionable business income to the taxpayer. N.C. ADMIN. CODE tit. 17, r. 5C.1702 states, in pertinent part, that: "... Where the business of the partnership is directly or integrally related to the business of the corporate partner, the corporate partner's share of the partnership net income is classified as business income. When classified as business income, the corporate partner's

apportionment factors shall include its proportionate share of the partnership's property, payrolls and sales.”

The taxpayer asserts that, in the event a filing requirement is established, the business of [Limited Partnership One] is not directly or integrally related to its business because the taxpayer does not have a unitary relationship with the general partner of the partnership, [Limited Partnership Two], and therefore, the income is properly classified as nonbusiness income. The evidence of record clearly shows that the taxpayer is a passive holding company with a [percentage] limited partnership interest in [Limited Partnership One] and a [percentage] ownership in [Corporation One], the general partner of [Limited Partnership One] and [Limited Partnership Two]. The evidence also shows that [Limited Partnership One] owns a [percentage] limited partnership interest in the operating partnership, [Limited Partnership Two], which owns and operates restaurants in North Carolina. Therefore, the taxpayer and [Limited Partnership One] are directly and integrally related by common ownership. The issues of whether the corporate partner manages the operations of the partnership, or whether the general partner and the limited partner have a unitary relationship are irrelevant to the question of whether the businesses of the taxpayer and [Limited Partnership One] are directly or integrally related. I find that the businesses of the taxpayer and [Limited Partnership One] are directly or integrally related and therefore the income from [Limited Partnership One] constitutes business income to the taxpayer.

The taxpayer further asserts that its pro-rata share of [Limited Partnership One]'s net income should be classified as nonbusiness income allocable to [state other than North Carolina], the state of its commercial domicile, because it limits its connection to [Limited Partnership One] to the mere investment of funds and does not materially participate in the day-to-day operations of the partnerships. However, I am unpersuaded by this argument, which implies that a passive holding company is not a business and does not produce any business income anywhere. A company of this type engages in no other business activity apart from its ownership interest in its investments. Therefore, its principal business activity is its investments, and income derived from those investments is business income.

In any event, under no circumstance would the income from [Limited Partnership One] be allocated to the commercial domicile of the taxpayer as it contends. N.C. ADMIN. CODE tit. 17, r. 5C.1702 provides that the corporate partner's net taxable income be apportioned and/or allocated to this State in accordance with the apportionment and allocation provisions of G.S. 105-130.4. Section (h) of the statute states that: “The income less related expenses from any other nonbusiness activities or investments not otherwise specified in this section is allocable to this State if the business situs of the activities or investments are located in this State.” Therefore, even if such income were classified as nonbusiness income to the taxpayer, it would be at least partly allocable to this State and subject to taxation in this State because the situs of some of the restaurants giving rise to the pass-through income is in North Carolina. Under the applicable statute and rules, however, the income from [Limited Partnership One] is clearly apportionable business income.

Finally, the Department submitted an Attorney General's Opinion dated January 7, 1947 as evidence and support of its long-standing position concerning its treatment of the corporate partner and the identification of the pass-through income of a partnership “doing business” in this State. In addition, the Department has formulated and issued rules to instruct the corporate partner of a partnership “doing business” in this State of its filing requirements and the proper treatment of the pass-through income from the partnership. These rules clearly establish that the taxpayer is required to file corporate franchise and income tax returns and apportion its business income to this State. Therefore, I find that the denial of the refunds requested on the amended

corporate franchise and income tax returns and the proposed assessment for unpaid franchise tax were proper under the facts and law.

North Carolina Corporate Income Tax Directive PD-14-02 (October 10, 2014)

The Department has recently reviewed its position on apportionment and allocation of partnership income. The Department has determined that the requirement in G.S. 105-153.4(d) to use the ratio calculated under the corporate apportionment formula in G.S. 105-130.4 necessarily includes use of an alternative apportionment method approved by the Secretary as well as use of the statutory apportionment formulas set out in G.S. 105-130.4(i) and G.S. 105-130.4(m) through (s1). The Department has also concluded that it imprudently exercised its authority under G.S. 105-262 and G.S. 105-264 when it required or allowed partnerships to separately account for business activities that were segregated from other business activities. Finally, the Department has determined that in many cases a partnership misconstrued the Department's guidance by segregating a portion of its apportionable income because it employed a method of accounting that clearly reflected the income of a specific activity.

As a result of the review, the Department will revise its partnership income tax return form and instructions for 2014 to remove provisions for reporting income from segregated activities. The Department believes that, under a constitutionally sound apportionment method, income from unitary business activities is apportionable and income from an activity that is not part of the unitary business activities is allocated to the business situs of the activity. Consequently, the partnership tax return form will also be revised to include a line for reporting non-apportionable income from North Carolina sources and a line for reporting apportionable income subject to North Carolina's apportionment factor.

If a partnership believes that the statutory apportionment formula attributes a greater portion of its income to North Carolina tax than is reasonably attributable to its business in this State, it may make a written request with the Secretary of Revenue for permission to use an apportionment formula that it believes is a better method to attribute its income to North Carolina. The procedures set forth in administrative rule T17 NCAC Chapter 5D .0107 through .0115 for a corporation to request an alternative apportionment formula will also apply to a partnership seeking an alternative apportionment formula.

North Carolina Form D-403A Instructions (2022)

A partnership with one or more nonresident partners whose business activities in N.C. are unified and integrated with its business activities in other states is required to apportion its partnership income to N.C. by multiplying the income by a fraction, the numerator of which is the total sales of the partnership within N.C., and the denominator of which is the total sales of the partnership everywhere during the income year.

North Dakota

N.D. Cent. Code § 57-38-08.1

- (1) A partnership that carries on its business activity entirely within this state shall report all of its income or loss to this state. A partnership that carries on its business activity within and without this state shall allocate and apportion its income or loss to this state in the same manner as the income or loss of a corporation is allocated and apportioned to the state under chapter 57-38.1.

- (2) Resident partners, limited to individuals, estates, and trusts, must report their entire distributive share to this state as provided in subdivision b of subsection 6 of section 57-38-04, and may claim a credit for taxes paid to another state on that portion of their distributive share attributable to and taxed by another state, as provided in subdivision j of subsection 1 of section 57-38-30.
- (3) (a) In determining the gross income of a nonresident partner, limited to individuals, estates, and trusts, there must be included only that part derived from or connected with sources in this state of the partner's distributive share of items of partnership income, gain, loss and deduction, or item thereof, entering into the federal taxable income of the partner, as determined under section 57-38-04 . . .
- (c) Any modification to federal taxable income described in this chapter that relates to an item of partnership income, gain, loss, or deduction, or item thereof, must be made in accordance with the partner's distributive share, for federal income tax purposes, of the item to which the modification relates, but limited to the partner's portion of the item derived from or connected with sources in this state.
- (d) On application, the commissioner may authorize the use of other methods of determining a nonresident partner's portion of partnership items derived from or connected with sources in this state, and the related modifications, as may be appropriate and equitable, on the terms and conditions as it may require.

N.D. Cent. Code § 57-38-04

(4) Income derived from business activity carried on by an individual as a sole proprietorship, or through a partnership, subchapter S corporation, or other passthrough entity, must be assigned to this state without regard to the residence of the individual if the business activity is conducted wholly within this state. Income derived from gaming activity carried on in this state by an individual must be assigned to this state without regard to the residence of the individual.

(5) Whenever business activity is carried on partly within and partly without this state by a nonresident of this state as a sole proprietorship, or through a partnership, subchapter S corporation, or other passthrough entity, the entire income therefrom must be allocated to this state and to other states, according to the provisions of chapter [57-38.1](#) but only according to the apportionment method provided under subsection 1 of section [57-38.1-09](#), providing for allocation and apportionment of income of corporations doing business within and without this state.

(6)

(a) Income and gains received by a resident of this state from tangible property not employed in the business and from tangible property employed in the business of the taxpayer, if the business consists principally of the holding of the property and the collection of income and gains from the business, must be assigned to this state without regard to the situs of the property.

(b) Income derived from business activity carried on by residents of this state, whether the business activity is conducted as a sole proprietorship, or through a partnership, subchapter S corporation, or other passthrough entity, must be assigned to this state without regard to where the business activity is conducted, and the provisions of chapter [57-38.1](#) do not apply. If the taxpayer believes the operation of this subdivision with respect to the taxpayer's income is unjust, the taxpayer may petition the tax commissioner who may allow use of another method of reporting income, including separate accounting.

N.D. Admin. Code 81-03-05.3-03(2)(d) (worldwide)

When apportionable income includes income from a corporation's ownership interest in a general partnership, the corporate partner's share of the partnership's property, payroll, and sales must be included in the group's apportionment factors.

Administrative Practice: For ND, it is our administrative practice that flow through factors should be included in any situation where the passthrough income is considered apportionable business income to the partner/owner. Our interpretation is that the administrative rule above (which identifies a general partnership interest) is but one example of when flow through factors would be appropriate, but not the only circumstance. Our practice is that the propriety of flow through apportionment does not hinge on the “form” of arrangement (general partner versus limited partner), but rather the specific facts and circumstances. As a result, ownership interests in limited partnerships and LLCs may also require flow through apportionment.

North Dakota Tax Website

Apportionment - All income derived from the partnership’s activity is business income and is subject to apportionment. For the definitions of business and nonbusiness income, see North Dakota Administrative Code § 81-03-09. North Dakota does not allow for separate accounting.

Ohio

Ohio Rev. Code Ann. § 5733.05(B)

The sum of the corporation's net income during the corporation's taxable year, allocated or apportioned to this state as prescribed in divisions (B)(1) and (2) of this section, and subject to sections 5733.052, 5733.053, 5733.057, 5733.058, 5733.059, and 5733.0510 of the Revised Code:

(1) The net nonbusiness income allocated or apportioned to this state as provided by section 5733.051 of the Revised Code.

(2) The amount of Ohio apportioned net business income, which shall be calculated by multiplying the corporation's net business income by a fraction. The numerator of the fraction is the sum of the following products: the property factor multiplied by twenty, the payroll factor multiplied by twenty, and the sales factor multiplied by sixty. The denominator of the fraction is one hundred, provided that the denominator shall be reduced by twenty if the property factor has a denominator of zero, by twenty if the payroll factor has a denominator of zero, and by sixty if the sales factor has a denominator of zero.

The property, payroll, and sales factors shall be determined as follows, but the numerator and the denominator of the factors shall not include the portion of any property, payroll, and sales otherwise includible in the factors to the extent that the portion relates to, or is used in connection with, the production of nonbusiness income allocated under section 5733.051 of the Revised Code . . .

Ohio Rev. Code Ann. § 5733.057

As used in this section, "adjusted qualifying amount" has the same meaning as in section 5733.40 of the Revised Code.

This section does not apply to divisions (E) and (F) of section 5733.051 of the Revised Code.

Except as otherwise provided in divisions (A) and (B) of section 5733.401 and in sections 5733.058 and 5747.401 of the Revised Code, in making all apportionment,

allocation, income, gain, loss, deduction, tax, and credit computations under this chapter and under sections 5747.41 and 5747.43 of the Revised Code, each person shall include in that person's items of business income, nonbusiness income, adjusted qualifying amounts, allocable income or loss, if any, apportionable income or loss, property, compensation, and sales, the person's entire distributive share or proportionate share of the items of business income, nonbusiness income, adjusted qualifying amounts, allocable income or loss, apportionable income or loss, property, compensation, and sales of any pass-through entity in which the person has a direct or indirect ownership interest at any time during the pass-through entity's calendar or fiscal year ending within, or with the last day of the person's taxable year. A pass-through entity's direct or indirect distributive share or proportionate share of any other pass-through entity's items of business income, nonbusiness income, adjusted qualifying amounts, allocable income or loss, apportionable income or loss, property, compensation, and sales shall be included for the purposes of computing the person's distributive share or proportionate share of the pass-through entity's items of business income, nonbusiness income, adjusted qualifying amounts, allocable income or loss, apportionable income or loss, property, compensation, and sales under this section. Those items shall be in the same form as was recognized by the pass-through entity.

Ohio Rev. Code Ann. § 5747.21

(B) Except as otherwise provided under section 5747.212 of the Revised Code, all items of business income and business deduction shall be apportioned to this state by multiplying business income by the fraction calculated under division (B)(2) of section 5733.05 and section 5733.057 of the Revised Code as if the taxpayer's business were a corporation subject to the tax imposed by section 5733.06 of the Revised Code.

(C) If the allocation and apportionment provisions of sections 5747.20 to 5747.23 of the Revised Code or of any rule adopted by the tax commissioner, do not fairly represent the extent of business activity in this state of a taxpayer or pass-through entity, the taxpayer or pass-through entity may request, which request must be in writing accompanying a timely filed return or timely filed amended return, or the tax commissioner may require, in respect of all or any part of the business activity, if reasonable, any one or more of the following

- (1) Separate accounting;
- (2) The exclusion of one or more factors;
- (3) The inclusion of one or more additional factors which will fairly represent the business activity in this state;
- (4) The employment of any other method to effectuate an equitable allocation and apportionment of such business in this state. An alternative method will be effective only with approval of the tax commissioner.

The tax commissioner may adopt rules in the manner provided by [sections 5703.14](#) and [5747.18](#) of the Revised Code providing for alternative methods of calculating business income and nonbusiness income applicable to all taxpayers and pass-through entities, to classes of taxpayers and pass-through entities, or only to taxpayers and pass-through entities within a certain industry

Ohio Rev. Code Ann. § 5747.231

For As used in this section, "adjusted qualifying amount" has the same meaning as in section 5733.40 of the Revised Code.

This section does not apply to division (AA)(5)(a)(ii) of section 5747.01 of the Revised Code.

Except as set forth in this section and except as otherwise provided in divisions (A) and (B) of section 5733.401 of the Revised Code, in making all apportionment, allocation, income, gain, loss, deduction, tax, and credit computations under this chapter, each person shall include in that person's items of business income, nonbusiness income, adjusted qualifying amounts, allocable income or loss, apportionable income or loss, property, compensation, and sales, the person's entire distributive share or proportionate share of the items of business income, nonbusiness income, adjusted qualifying amounts, allocable income or loss, *apportionable income or loss, property, compensation, and sales of any pass-through entity in which the person has a direct or indirect ownership interest at any time during the person's taxable year. A pass-through entity's direct or indirect distributive share or proportionate share of any other pass-through entity's items of business income, nonbusiness income, adjusted qualifying amounts, allocable income or loss, apportionable income or loss, property, compensation, and sales shall be included for the purposes of computing the person's distributive share or proportionate share of the pass-through entity's items of business income, nonbusiness income, adjusted qualifying amounts, allocable income or loss, apportionable income or loss, property, compensation, and sales under this section. Those items shall be in the same form as was recognized by the pass-through entity.

Oklahoma

Okla. Stat. tit. 68, § 2358(A)

(4)(c) income or loss from a business activity which is not a part of business carried on within or without the state of a unitary character shall be separately allocated to the state in which such activity is conducted . . .

(5) The net income or loss remaining after the separate allocation in paragraph 4 of this subsection, being that which is derived from a unitary business enterprise, shall be apportioned to this state on the basis of the arithmetical average of three factors consisting of property, payroll and sales or gross revenue enumerated as subparagraphs a, b and c of this paragraph.

Okla. Admin. Code § 710:50-19-1(a)

(1) Oklahoma source income or loss. When a partnership has source income or loss then that partnership must file a return showing the income or loss applicable to Oklahoma. The partnership shall also furnish a detailed schedule stating the amount of income distributable to each partner from Oklahoma sources.

(2) Duty to file and report; determination of shares. All resident partners must file individual income tax returns with Oklahoma if they are required to file individual Federal Income Tax Returns. All nonresident partners that have gross income of \$1,000.00 must file an Oklahoma Return even though their net may actually be a loss. The partnership income for Oklahoma may be apportioned using the three factor formula unless its operations are from real and tangible personal property, such as rents, oil and mining production or royalties, and gains or losses from sales of such property; then the income or loss shall be allocated in accordance with the situs of such property. The partner's distributive share of Oklahoma income or loss shall be the same proportion to the partner's distributive share of income or loss shown on the Federal Partnership Return.

Okla. Admin. Code § 710:50-19-1(a)(15)

(A) Partnership income or loss shall be separately allocated. [See: 68 O.S. § 2358(A)(4)]

(B) The Oklahoma distributive share of partnership income as determined under 68 O.S. § 2358 and 68 O.S. § 2362 shall be allocated to Oklahoma.

Oregon

Or. Rev. Stat. § 316.124

- (1) In determining the adjusted gross income of a nonresident partner of any partnership, there shall be included only that part derived from or connected with sources in this state of the partner's distributive share of items of partnership income, gain, loss and deduction (or item thereof) entering into the federal adjusted gross income of the partner, as such part is determined under rules adopted by the department in accordance with the general rules in ORS 316.127 . . .
- (4) The department may, on application, authorize the use of such other methods of determining a nonresident partner's portion of partnership items derived from or connected with sources in this state, and the modifications related thereto, as may be appropriate and equitable, on such terms and conditions as it may require.

Or. Rev. Stat. § 314.714(1)

Each item of partnership income, gain, loss or deduction has the same character for a partner as it has for federal income tax purposes. If an item is not characterized for federal income tax purposes, it has the same character for a partner as if realized directly from the source from which realized by the partnership or incurred in the same manner as incurred by the partnership.

Or. Admin. R. 150-314-0385

- 8) The apportionment factors of a corporation that is a member of a partnership, limited liability company treated as a partnership, or unincorporated joint venture (i.e. the "related entity"), that is a part of the corporation's overall business operations, must include the corporation's share of the property, payroll, and sales of the related entity. For the purpose of computing the apportionment factors, transactions between the corporation and the related entity must be eliminated to the extent of the corporation's percentage of interest in the related entity. The corporation's share of the related entity's property, payroll, and sales are based on its percentage of interest in the related entity that is equal to the ratio of its capital account plus its share of the related entity's debt to the total of the capital accounts of all members of the related entity plus total related entity debt. The capital accounts of the members must reflect the average of the accounts for the period of the tax return. The average of the capital accounts may be computed by averaging the beginning and ending balances or monthly balances. Capital accounts of a related entity must be adjusted to reflect a member's adjusted basis in contributed property, rather than fair market value. The corporation's share of a related entity's debt is determined under IRC 752(a) and 752(b) and the regulations thereunder, irrespective of whether or not the related entity is a true partnership.
- 9) For the purpose of computing the apportionment factors for a consolidated Oregon return, intercompany transactions between a unitary affiliate of a partner or member and the related entity described in section (8) of this rule are treated the same as intercompany transactions directly between the affiliated corporations, to the extent of the corporate partner's or member's ownership share of the related entity. Intercompany transactions between affiliated corporations filing a

consolidated Oregon return are eliminated as provided in section (3) of OAR 150-317-0620.

Example: Corporations A, B, and C file a consolidated Oregon return. A and B each own 50 percent of partnership P. P is part of the overall business operations of the three corporations. P buys 80 percent of its raw materials from C. The intercompany sales between P and C must be eliminated from the apportionment formula for the consolidated Oregon return of the corporations. Transactions between C and P are considered to be directly between the three corporations.

Or. Admin. R. 150-314-0510(7)

"Oregon-source distributive income" means the portion of the PTE's modified distributive income that is derived from or connected with Oregon sources. For PTEs operating in Oregon and one or more other states, Oregon-source distributive income is determined by attributing to Oregon sources that portion of the modified distributive income of the PTE, as defined in section (6) of this rule, determined in accordance with the allocation and apportionment provisions of ORS 314.280 or ORS 314.610 to 314.675.

Oregon Revenue Bulletin 2010-02 (March 29, 2010)

Tiered entities: A partnership that isn't otherwise doing business in Oregon may owe the partnership minimum tax if it owns an interest in another partnership—including an LLC classified as a partnership—that is doing business in Oregon. If the partnership is involved in the Oregon business or acts on behalf of the Oregon business, the partnership is doing business in Oregon and subject to the partnership minimum tax. Generally, limited partners aren't involved in a partnership's activities and don't act on behalf of the partnership. Each partnership must look at the facts and circumstances to determine if it's doing business in Oregon for a particular tax year.

Example 4: Albany Associates is a limited partnership doing business in Oregon. Phoenix LLC is classified as a partnership and owns 20 percent of Albany Associates as a limited partner. Phoenix LLC has no other activity, property, or ties to Oregon and doesn't own an interest in any other entity doing business in Oregon. Phoenix LLC isn't involved in the operation of Albany Associates and doesn't perform any actions on behalf of Albany Associates. Phoenix LLC is not doing business in Oregon. Although Phoenix LLC still has Oregon-source income taxable to its owners and must file an Oregon partnership return, it doesn't owe the partnership minimum tax.

Example 5: Detroit LLC owns a 40-percent stake in Ontario Enterprises, an Oregon partnership doing business in Oregon. Detroit LLC files as a partnership and is involved in the operation of Ontario Enterprises. Detroit LLC owes the partnership minimum tax. Bend Associates owns 20 percent of Detroit LLC and manages Detroit LLC's affairs, including its actions as a general partner of Ontario Enterprises. Bend Associates is involved in the activities of Ontario Enterprises; therefore, Bend Associates also owes the partnership minimum tax.

Example 6: Pittsburgh LLC owns 40 percent of Waldport LLC, an Oregon LLC classified as a partnership and doing business in Oregon. Pittsburgh LLC has no involvement in Waldport LLC, which is operated by the other owners. Pittsburgh LLC is not otherwise doing business in Oregon. Pittsburgh LLC doesn't owe the partnership minimum tax. However, Pittsburgh LLC must file a partnership return for Oregon because it has Oregon-source income that flows through to its owners.

Cook v. Oregon Dept. of Rev., No. TC 5298 (Or. Tax Ct. Aug. 17, 2018).

"The obligation for the PTE to withhold is triggered when the PTE has "distributive income from Oregon sources." That, of course, requires the entity to determine, at the entity level, whether it has income from Oregon sources. The entity cannot rely on some later recalculation by an owner or an auditor, done at the owner level, to determine if the owner has distributive income from Oregon sources in respect of which it has a withholding obligation . . . Nothing in the rule addresses the critical step in the department's method that combines incomes and apportionment factors. In the case of corporate partners, the combination of income and factors from partnerships with other income and factors [*28] occurs, if at all, based on the combination requirements effectively included in [ORS 317.705 to 317.715](#). However, as discussed, such combination requires statutory authority beyond UDITPA and no such statutory authority exists in respect of nonresident individuals . . . The court has considered the text of the partnership tax statutes, the context of those statutes, especially the provisions of the PTE statutes and rules, the history of combined reporting in Oregon and the text and context of UDITPA. None of these is consistent with the department position in this case—a position requiring what is essentially combined reporting and apportionment at the owner level.

Pennsylvania

72 P.S. § 7402.2(a)

Except as set forth in subsection (b), for purposes of this article, a corporation's interest in an entity which is not a corporation shall be considered a direct ownership interest in the assets of the entity rather than an intangible interest.

61 Pa. Code § 153.29

(a)(1) When a taxpayer has an interest in a partnership, joint venture, association or other unincorporated enterprise (hereinafter referred to in this section as partnership), the amount of its distributive share of partnership income shall be determined in accordance with the IRC. The taxpayer's interest in the partnership shall, for purposes of Commonwealth corporate taxation, be considered a direct interest in the assets of the partnership rather than an intangible interest. Accordingly, the taxpayer's share of the partnership's payroll, property and sales—as hereafter determined—shall be included in the apportionment factors of the taxpayer unless otherwise excluded by this section.

(a)(2) A taxpayer's partnership interest for the purpose of computing the portion of the partnership's property, payroll and sales to be included in the taxpayer's property, payroll and sales factors shall be determined under the partnership agreement and in accordance with the IRC.

(b)(1) If the separate activities of the taxpayer or the activities of the partnership are sufficient to meet the conditions of section 401(1) of the TRC (72 P.S. § 7404(1)) relating to doing business, carrying on activities, having capital or property employed or used or owning property within this Commonwealth, then the taxpayer will be subject to corporate taxation by the Commonwealth.

(b)(2) If the separate activities of the taxpayer or the activities of the partnership are sufficient to constitute transacting business outside this Commonwealth and render the taxpayer taxable to another state under section 401(3)2.(a)(2) and (3) of the TRC (72 P.S. § 7401(3)2.(a)(2) and (3)), then the taxpayer will be allowed to apportion and allocate its income.

(c)(1) Income arising from transactions and activity in the regular course of the taxpayer's trade or business constitutes business income. The determination of whether a corporate partner's distributive share of partnership income is business income depends upon whether the income arose in the regular course of the taxpayer's trade or business, determined in accordance with § 153.24 (reserved). The taxpayer's trade or business shall include activities performed in partnership.

(c)(2) The classification of income by the labels customarily given such as interest, rents, royalties, and capital gains, is of no aid in determining whether distributive partnership income is business or nonbusiness income. The income is determined to be either business or nonbusiness income depending upon the relationship to the trade or business of the corporate partner, not of the partnership, as determined by paragraph (1).

(d) A corporate partner entitled to apportionment under subsection (b)(2) shall determine the business income attributable to this Commonwealth by use of a three-factor formula consisting of property, payroll, and sales of the taxpayer including its share of the partnership's property, payroll, and sales for a partnership year ending within or with the taxpayer's tax year as follows. . .

61 Pa. Code § 109.5(a)

If a nonresident individual, or a partnership of which a nonresident individual is a member, carries on a business, trade, profession, or occupation both within and without this Commonwealth, the items of income, gain, loss and deduction attributable to such business, trade, profession, or occupation shall be apportioned and allocated to this Commonwealth on a fair and equitable basis in accordance with approved methods of accounting.

IN RE: Global Equity Shareholder, Pennsylvania Board of Finance and Revenue Decision No. 1617207 (April 9, 2021)

"Petitioner filed the instant petition for review of reassessment at the Board of Finance and Revenue on November 28, 2016, again, claiming the above-listed issue. Petitioner contends that its apportionment factor should be [REDACTED]% because it does not conduct any activities or employ anyone in Pennsylvania. Petitioner explains that its ownership in publicly traded pass-through partnerships that do business in Pennsylvania is minimal but it is unable to obtain Pennsylvania-related property and payroll factors.

Conclusion

Petitioner's request for relief is denied because Petitioner failed to meet its burden of proof pursuant to 72 P.S. § 9705.

If a corporation carries on a business both within and without Pennsylvania, the items of income, gain, loss and deduction attributable to such business can be apportioned and allocated to Pennsylvania on a fair and equitable basis in accordance with approved methods of accounting. *See* 72 P.S. § 7401 (3)(2)(a)(2)-(3); 61 Pa. Code § 109.5. Corporations having income from business activity within and without the state are entitled to use three-factor apportionment. *Id.*

When a taxpayer has an interest in a partnership, joint venture, association or other unincorporated enterprise the interest in the partnership shall be considered a direct interest in the assets of the partnership rather than an intangible interest. *See* 72 P.S. § 7602.6; 61 Pa. Code § 153.29. Accordingly, the taxpayer's share of the partnership's

payroll, property, and sales shall be included in the apportionment factors of the taxpayers. *Id.*

Every petition for refund or review filed with the Board shall set forth the facts and points of law which the petitioner relies and Petitioner has the burden of proof to supply sufficient evidence to support its claim. 72 P.S. § 9705. Petitioner has not submitted the proportionate share of the property, payroll, and sales factors of all of its investee partnerships in which it has an ownership interest. Therefore, there is not sufficient evidence to grant this claim.”

IN RE: Starfire Holding Corporation, Pennsylvania Board of Finance and Revenue Decision No. 2004864 (April 9, 2021)

“Petitioner's lower-tier entity income share is not entitled to nonbusiness income treatment. Under the transactional test, the pass-through income is business income because this income was derived from transactions in which Petitioner regularly engaged, investment in securities and in pass-through entities. *Welded Tube Company of America v. Com.*, 101 Pa. Commw. 32, 515 A.2d 988 (1986); 61 Pa. Code § 153.29(c)(1) (taxpayer's regular trade or business include those performed in a partnership). When deriving income from lower-tier entities is viewed in light of Petitioner's past business history, the lower-tier income was derived from the conduct of Petitioner's regular business. *Ross-Araco Corp. v. Com.*, 165 Pa. Commw. 49, 644 A.2d 235 (1994), *aff'd*, 544 Pa. 74, 674 A.2d 691 (1996) (holding that gain from land sale was nonbusiness income when transaction was only land sale by taxpayer; gain was used to buy government bonds; and land was used only to obtain performance bid bonds, but did not directly produce business income). Petitioner regularly engaged in investment including the acquisition of partnerships and limited liability companies to accomplish Petitioner's business purposes.

Petitioner did not prove that the acquisition and management of the lower-tier entities producing the income at issue were not integral parts of Petitioner's investment trade or business. Under the clarified functional test, the lower-tier income was business income because the acquisition and management of other entities constituted an integral part of Petitioner's regular trade or business. See 72 P.S. § 7401(3)2.(a)(1)(A); *Glatfelter Pulpwood Company v. Com.*, 61 A.3d 993 (Pa. 2013) (affirming the Commonwealth Court decision). These lower-tier entities were acquired or formed because of Petitioner's investment business and when sold, the gains remained business income.

Petitioner has not shown that it is entitled to multiform/unrelated income treatment. When multistate businesses are conducted in a way that some of the business operations outside Pennsylvania are independent of and do not contribute to the business operations within Pennsylvania, the business may exclude the factors attributable to the outside activity. *Com. v. ACF Indus., Inc.*, 271 A.2d 273, at 280 (Pa. 1970). The burden of proof in a multiform/unrelated income case lies with the taxpayer who must clearly show the unrelated nature of the income it seeks to exclude. See *Container Corp. of America v. Franchise Tax Bd. of Cal.*, 463 U.S. 159, at 180-81 (1983). Petitioner has not demonstrated it is a multiform business and has not proved how its share of lower-tier entity income was unrelated to its Pennsylvania income when these entities were also Petitioner's investments and, thus, Petitioner's request for multiform/unrelated income treatment is denied. See *id.*”

IN RE: New SR Capital Associates LLC, Pennsylvania Board of Finance and Revenue Decision No. 1513962 (July 13, 2016)

The Petitioner held an interest in more than 150 tiered partnerships or limited liability companies. Five of those entities had Pennsylvania-sourced income. Petitioner

appealed the assessment to the Board of Appeals claiming that it did not conduct business in Pennsylvania. Petitioner argued that, although it is had an ownership interest in five entities with Pennsylvania sourced income and expenses, it did not own or rent property or have any employees in the Commonwealth. Consequently, Petitioner argued, it properly reported its apportionment.

The Board ruled “[i]n the instant case, Petitioner indicates it has interests in five entities with Pennsylvania source income. Two of these entities are partnerships. However, Petitioner failed to include the source income amounts from these partnerships in its apportionment factors. While Petitioner has submitted a revised RCT-101, amending the denominators of its three apportionment factors from “[REDACTED]” to “[REDACTED],” this Board finds that Petitioner has failed to prove its proposed apportionment factor denominator of “[REDACTED].” Importantly, Petitioner has failed to provide federal returns of investee entities to support its proposal. Petitioner failed to provide source documents to reconcile the difference between the factors reported on its two RCT-101’s, or any supporting documentation with respect to its total property, payroll or sales figures. Consequently, this Board finds that Petitioner has failed to satisfy its burden of proof pursuant to 72 P.S. § 9705.”

Pennsylvania Personal Income Tax Guide – Pass Through Entities

§ 704(b) Special allocations with substantial economic effect. Pennsylvania follows federal treatment.

§ 704(c) Allocations with respect to pre-contribution gain inherent in contributed assets. Pennsylvania follows federal treatment.

Rhode Island

R.I. Gen. Laws § 44-30-15(a)

Partners’ modifications. In determining Rhode Island income of a resident partner, any modification described in subsection (b), (c), or (d) of § 44-30-12, which related to an item of partnership income or deduction shall be made in accordance with the partner’s distributive share, for federal income tax purposes, of the item to which the modification relates. Where a partner’s distributive share of any item is not required to be taken into account separately for federal income tax purposes, the partner’s distributive share of the item shall be determined in accordance with his distributive share for federal income tax purposes of partnership taxable income or loss generally.

R.I. Gen. Laws § 44-30-15(b)

Each item of partnership income or deduction shall have the same character for a partner as for federal income tax purposes. Where an item is not characterized for federal income tax purposes, it shall have the same character for a partner as if realized directly from the source from which realized by the partnership or incurred in the same manner as incurred by the partnership.

R.I. Gen. Laws § 44-30-15(c)

Where an owner's distributive shares of an item of pass-through entity income, gain, loss or deduction is determined for federal income tax purposes by special provision in the pass-through entity agreement with respect to such item, and where the principal purpose of such provision is the avoidance or evasion of tax under this chapter, the

owner's distributive share of such item, and any modification required with respect thereto, shall be determined as if the pass-through entity agreement made no special provision with respect to such item.

R.I. Gen. Laws § 44-30-34(a)

In determining Rhode Island income of a nonresident partner of any partnership, there shall be included only the portion derived from or connected with Rhode Island sources of the partner's distributive share of items of partnership income and deduction entering into his or her federal adjusted gross income, as such portion shall be determined under regulations of the tax administrator consistent with the applicable rules of § 44-30-32.

R.I. Gen. Laws § 44-30-34(c)

Partner's modifications. Any modification described in subsection (b) or (c) of § 44-30-12 which relates to an item of partnership income or deduction, shall be made in accordance with the partner's distributive share for federal income tax purposes of the item to which the modification relates, but limited to the portion of the item derived from or connected with Rhode Island sources.

R.I. Gen. Laws § 44-30-34(d)

Alternate methods. The tax administrator may, on application, authorize the use of any other methods of determining a nonresident's portion of partnership items derived from or connected with Rhode Island sources, and the modifications related thereto, that may be appropriate and equitable, on any terms and conditions that the tax administrator may require.

R.I. Gen. Laws § 44-30-34(e)

Application of rules for resident partners to nonresident partners.

(1) A partner's distributive share of items shall be determined under § 44-30-15(a).

(2) The character of partnership items for a nonresident partner shall be determined under § 44-30-15(b).

(3) The effect of a special provision in a partnership agreement having the principal purpose of avoidance or evasion of Rhode Island personal income tax shall be determined under § 44-30-15(c).

R.I. Gen. Laws § 7-16-73(c)(1)

Any member of the limited liability company during any part of the limited liability company's taxable year shall file a Rhode Island income tax return and shall include in Rhode Island gross income that portion of the limited liability company's Rhode Island income allocable to the member's interest in the limited liability company.

R.I. Gen. Laws § 7-16-73(c)(4)

A non-resident member is required to file a Rhode Island income tax return even though the member's only source of Rhode Island income was that member's share of the limited liability company's income that was derived from or attributable to sources within this state, and the amount of remittance by the limited liability company on behalf of the non-resident member shall be allowed as a credit against that member's Rhode Island income tax liability.

Homart Development Co. v. Norberg, 529 A2d 115 (R.I. 1987)

“The inclusion of this income in Homart’s net-income calculation for apportionment purposes necessarily requires that the payroll, property, and receipt factors that gave rise to it be included in the apportionment equation also. Otherwise, the net income is subject to an apportionment ratio that reflects only Homart’s in-state and everywhere business activity when, in fact, this income did not arise from Homart’s corporate business activity but instead arose out of the partnerships’ business activities that were not reflected in the apportionment ratio. Such an inherent and manifest distortion as applied to this taxpayer should have been acknowledged and remedied by the tax administrator as provided for under § 44-11-15.”

280 R.I. Code R. § 20-25-9.7(B)

Treatment of C Corporation's Pass-Through Entity Income. When a partnership or other pass-through entity does not elect to be taxed as a corporation for federal tax purposes and is directly or indirectly held by a corporation, including any member in a combined group, then the business conducted by the partnership or pass-through entity shall be considered the business of the corporation to the extent of the corporation's distributive share of the partnership or pass-through entity income. Such distributive share shall be included in the net income calculations of the corporation and the combined group, and shall be apportioned to Rhode Island for corporate income tax purposes as set forth in this Regulation, consistent with the decision reached by the Rhode Island Supreme Court in *Homart Dev. Co. v. Norberg*, 529 A.2d 115 (R.I. 1987).

South Carolina

S.C. Code Ann. § 12-6-600

An entity treated as a partnership for federal income tax purposes is not subject to tax under this chapter. Each partner shall include its share of South Carolina partnership income on the partner's respective income tax return. All of the provisions of the Internal Revenue Code apply to determine the gross income, adjusted gross income, and taxable income of a partnership and its partners, subject to the modifications provided in Article 9 of this chapter and subject to allocation and apportionment as provided in Article 17 of this chapter.

S.C. Code Ann. Regs. 117-705.1

Income or loss realized by resident individuals or partnerships from an established business, or from the lease or rental of tangible personal property or real property, the situs of which is in another state, shall be allocated to the state in which the business or property is located. Except, income of a resident individual or partnership, derived from personal services, is allocated to this State as provided in Section 12-6-2220(6).

However, in the case of a resident individual or partnership, conducting a business of a unitary or homogenous nature, partly within and partly without this State, such income or loss is apportioned in accordance with the provisions of Sections 12-6-2250 through 12-6-3360.

Ellis v. S. C. Tax Comm'n, 309 S.E.2d 761 (S.C. 1983)

By reason of the "pass through" rule, the character of any item of income, gain, loss deduction or credit included in a partner's distributive share of gains and losses shall be the same as if such item was realized directly from the source from which realized

or incurred by the partnership. In other words, each item of income, gain, [**763] loss, deduction or credit is treated as if it were realized or incurred by the partner directly from the source without ever having passed through the partnership. If this were not the case, then partners in real estate or other business ventures could not take advantage of depreciation write-offs and other operating expenses or losses.

South Carolina Private Letter Ruling #24-1 (February 21, 2024)

How should the Taxpayer's sale of an interest in a multistate partnership that does business in South Carolina be reported to South Carolina for income tax purposes . . .

The Taxpayer, a South Carolina resident individual, was an active owner of a tiered pass through entity structure comprised of two limited liability companies that are treated as partnerships for tax purposes. The Taxpayer was a partner in "Management Partnership," which owned 49% of "Operating Partnership" ("Management Partnership" and "Operating Partnership" are together referred to as the "Partnerships") . . .

The Partnerships conducted business in multiple states, including South Carolina. Operating Partnership was in the business of buying and selling metal alloys. Management Partnership was responsible for carrying out managerial functions for Operating Partnership's business. These functions included business performance reviews; strategic planning; personnel development; and managing supplier and customer relations. Management Partnership received pass through income from Operating Partnership, which was in turn passed through to its partners (including the Taxpayer).

The Taxpayer worked full time as president and executive officer of Management Partnership until he retired at the end of 2013. After retirement, he continued to take part in certain managerial functions on a more limited basis until 2021. In 2021, the Taxpayer sold his interest in Management Partnership. As a result of the sale, the Taxpayer reported a \$2.6 million long term capital gain entirely to South Carolina.

In the year of the sale, the Partnerships' South Carolina apportionment ratio was 2.4%. No information was provided about the assets the Partnerships owned at the time of the sale.

The Taxpayer asks if the entire \$2.6 million gain on the sale of his partnership interest is a South Carolina gain, or whether a portion of the gain is "out-of-state income/gain." . . .

As a partner, the Taxpayer is in the business of the partnership by reason of the pass through principle. Under this principle, partnership income or loss is not taxed at the entity level, but is passed through to the partners to be included on the partners' returns. The court in *Ellis v. South Carolina Tax Commission* relied on the pass through principle and held " . . .the character of any item of income, gain, loss deduction or credit included in a partner's distributive share of gains and losses shall be the same as if such item was realized directly from the source from which realized or incurred by the partnership. In other words, each item . . . is treated as if it were realized or incurred by the partner directly from the source without ever having passed through the partnership." The partnership interest therefore was connected with the Taxpayer's business. Accordingly, the gain from the sale is not allocated to South Carolina under S.C. Code Ann. § 126-2220(5).

It is not possible to determine whether any part of the gain is otherwise allocable under S.C. Code Ann. §§ 12-6-2220 and -2230 because no information is available about the nature of the assets owned by the Partnerships. However, any amount of gain that is not allocated should be apportioned among the states where the business was conducted, including South Carolina, as required by S.C. Code Ann. § 12-6-2240.

The proportion of the business carried on within this State was 2.4% in the year of the sale, so the Taxpayer should apportion 2.4% of the non-allocated gain on the sale of his partnership interest to South Carolina.

Tennessee

Tenn. Code Ann. § 67-4-2012

(a)(3) Except as otherwise provided in this part, for tax years ending on or after December 31, 2023, but before December 31, 2024, net earnings must be apportioned to this state by multiplying the earnings by a fraction, the numerator of which is the property factor plus the payroll factor plus five (5) times the receipts factor, and the denominator of the fraction is seven (7).

(a)(4) Except as otherwise provided in this part, for tax years ending on or after December 31, 2024, but before December 31, 2025, net earnings must be apportioned to this state by multiplying the earnings by a fraction, the numerator of which is the property factor plus the payroll factor plus eleven (11) times the receipts factor, and the denominator of the fraction is thirteen (13).

(a)(5) Except as otherwise provided in this part, for tax years ending on or after December 31, 2025, net earnings must be apportioned to this state by multiplying the earnings by the receipts factor only.

(a)(6) If the application of subdivision (a)(3), (a)(4), or (a)(5) to a tax year results in a lower apportionment ratio than under the application of the apportionment method in subdivision (a)(2) as it applied to tax years ending before December 31, 2023, then a taxpayer may annually elect to apply the apportionment method in subdivision (a)(2) as it applied to tax years ending before December 31, 2023; provided, however, the election must result in a higher apportionment ratio for the tax year, and the taxpayer must have net earnings, rather than a net loss, for that tax year as computed under § 67-4-2006 . . .

(b) The property factor is a fraction, the numerator of which is the average value of the taxpayer's real and tangible personal property owned or rented and used in this state during the tax period, and the denominator of which is the average value of all the taxpayer's real and tangible personal property owned or rented and used during the tax period. For this purpose, "property" includes a taxpayer's ownership share of the real or tangible property owned or rented by any general partnership, or entity treated as a general partnership for federal income tax purposes, in which such taxpayer has an ownership interest. A return being filed by a limited liability company that has a general partnership as its single member shall include in its property factor only the real and tangible property owned or used by the limited liability company. "Property" also includes a taxpayer's ownership share of the real or tangible property owned or rented by any limited partnership, subchapter S corporation, limited liability company or other entity treated as a partnership for federal income tax purposes, in which the taxpayer has an ownership interest, directly or indirectly through one (1) or more such entities, and that is not doing business in Tennessee and, therefore, is not subject to Tennessee excise tax. The cost value or rental value of such property shall be determined from the books and records of the entity in which the taxpayer has an interest and such property shall be valued in accordance with subsection (c) . . .

(e) The payroll factor is a fraction, the numerator of which is the total amount paid in this state during the tax period by the taxpayer for compensation, and the denominator of which is the total compensation paid everywhere during the tax period. For this

purpose, "compensation" includes a taxpayer's ownership share of the compensation of any general partnership, or entity treated as a general partnership for federal income tax purposes, in which such taxpayer has an ownership interest. A return being filed by a limited liability company that has a general partnership as its single member shall include in its payroll factor only the compensation attributed to the limited liability company. "Compensation" also includes a taxpayer's share of any specific compensation of any limited partnership, subchapter S corporation, limited liability company or other entity treated as a partnership for federal income tax purposes, in which the taxpayer has an ownership interest, directly or indirectly through one (1) or more such entities, and which is not doing business in Tennessee and thus is not subject to Tennessee excise tax . . .

(g) The receipts factor is a fraction, the numerator of which is the total receipts of the taxpayer in this state during the tax period, and the denominator of which is the total receipts of the taxpayer everywhere during the tax period. For this purpose, "gross receipts" includes a taxpayer's ownership share of the gross receipts of any general partnership, or entity treated as a general partnership for federal income tax purposes, in which such taxpayer has an ownership interest. A return being filed by a limited liability company that has a general partnership as its single member shall include in its receipts factor only the gross receipts attributed to the limited liability company. "Gross receipts" also includes a taxpayer's ownership share of gross receipts of any limited partnership, subchapter S corporation, limited liability company, or other entity treated as a partnership for federal income tax purposes, in which the taxpayer has an ownership interest, directly or indirectly through one (1) or more such entities, and that is not doing business in Tennessee and thus is not subject to Tennessee excise tax.

Tennessee Revenue Ruling No. 06-06 (March 14, 2006)

For Application of Franchise, Excise Tax Apportionment Formula Statutes to [LP2]

If [LP2] also has tax nexus in another state(s), it will apportion its net earnings and net worth to Tennessee for franchise, excise tax purposes using the property, payroll compensation and receipts apportionment formula previously described.

In addition to its own property, payroll compensation and receipts, [LP2] will include in its apportionment formula for franchise, excise tax purposes, its ownership share of the property, payroll compensation and gross receipts of any limited partnership, subchapter S corporation, limited liability company, or other entity treated as a partnership for federal income tax purposes, in which the taxpayer has an ownership interest, directly or indirectly through one (1) or more such entities, and that is not doing business in Tennessee and thus is not subject to Tennessee franchise, excise tax.

Application of Franchise, Excise Tax Apportionment Formula Statutes to [LP1]

The facts presented state that [LP1] has no Tennessee tax nexus. Therefore, it is not subject to franchise, excise tax and will not compute an apportionment formula.

Application of Franchise, Excise Tax Apportionment Formula Statutes to the Taxpayer

If the Taxpayer also has tax nexus in another state(s), it will apportion its net earnings and net worth to Tennessee for franchise, excise tax purposes using the property, payroll compensation and receipts apportionment formula previously described.

In addition to its own property, payroll compensation and receipts, the Taxpayer will include in its apportionment formula for franchise, excise tax purposes, its ownership

share of the property, payroll compensation and gross receipts of any limited partnership, subchapter S corporation, limited liability company, or other entity treated as a partnership for federal income tax purposes, in which the taxpayer has an ownership interest, directly or indirectly through one (1) or more such entities, and that is not doing business in Tennessee and thus is not subject to Tennessee franchise excise tax.

This will include the following:

1. 100% of its own property, payroll compensation and receipts.
2. 49.49% of [LP1's] property, payroll compensation and receipts.
3. 49.49% of property, payroll compensation and gross receipts passed-through to [LP1] by any limited partnership, subchapter S corporation, limited liability company, or other entity treated as a partnership for federal income tax purposes, in which the Taxpayer has an ownership interest, directly or indirectly through [LP1] and that is not doing business in Tennessee and thus is not subject to Tennessee franchise excise tax.

It is important to note that the Taxpayer's indirect ownership share (49.49% of 99%) of property, payroll compensation and receipts of [LP2] will be excluded from the Taxpayer's apportionment formula because, although the Taxpayer indirectly has an ownership interest in [LP2] through [LP1], [LP2] is doing business in Tennessee and is subject to Tennessee franchise, excise tax. Thus, none of [LP2's] property, payroll compensation and receipts are passed-through to the Taxpayer.

Vodafone Americas Holdings, Inc. v. Roberts, 486 SW3d 496 (Tenn. 2016) (applying alternative apportionment to a corporate partner).

Texas

Tex. Tax Code Ann. § 171.106(a)

Except as provided by this section, a taxable entity's margin is apportioned to this state to determine the amount of tax imposed under Section 171.002 by multiplying the margin by a fraction, the numerator of which is the taxable entity's gross receipts from business done in this state, as determined under Section 171.103, and the denominator of which is the taxable entity's gross receipts from its entire business, as determined under Section 171.105.

Tex. Tax Code § 171.1015

- (a) In this section, "tiered partnership arrangement" means an ownership structure in which any of the interests in one taxable entity treated as a partnership or an S corporation for federal income tax purposes (a "lower tier entity") are owned by one or more other taxable entities (an "upper tier entity"). A tiered partnership arrangement may have two or more tiers.
- (b) In addition to the tax it is required to pay under this chapter on its own taxable margin, a taxable entity that is an upper tier entity may include, for purposes of calculating its own taxable margin, the total revenue of a lower tier entity if the lower tier entity submits a report to the comptroller showing the amount of total revenue that each upper tier entity that owns it should include within the upper tier entity's own taxable margin calculation, according to the ownership interest of the upper tier entity.
- (c) This section does not apply to that percentage of the total revenue attributable to an upper tier entity by a lower tier entity if the upper tier entity is not subject to

the tax under this chapter. In this case, the lower tier entity is liable for the tax on its taxable margin.

(d) Section 171.002(d) does not apply to an upper tier entity if, before the attribution of any total revenue by a lower tier entity to an upper tier entity under this section, the lower tier entity does not meet the criteria of Section 171.002(d)(1) or (d)(2).

(e) The comptroller shall adopt rules to administer this section.

34 Tex. Admin. Code § 3.591(e)(20)

The net distributive income or loss from a passive entity that is included in total revenue is sourced to the principal place of business of the passive entity.

Texas Comptroller's Letter No. 202104018L (April 14, 2021)

Tiered Partnership Provisions

Can a lower tier entity exclude from total revenue the amount of total revenue that it reports to an upper tier entity under the tiered partnership provisions?

Yes. However, a lower tier entity may not report total revenue to an upper tier entity if the upper tier entity is not subject to the franchise tax. (Texas Tax Code (TTC) 171.1015.)

Are there any special reports that must be filed if the tiered partnership provision is used?

Each entity (lower and upper tier) that is filing under the tiered partnership provision must submit, along with its franchise tax report, Form 05-175, Texas Franchise Tax Tiered Partnership Report, to show the amount of total revenue that each upper tier entity should include with the upper tier entity's own total revenue.

Is an upper tier entity eligible for the E-Z computation or no tax due report?

The no tax due thresholds and the E-Z computation do not apply to an upper or lower tier entity if, before the attribution of any total revenue by a lower tier entity to an upper tier entity, the lower tier entity does not meet the criteria.

Do the tiered partnership provisions apply if some of the entities in the tiered partnership arrangement are part of a combined group?

The tiered partnership provision is not available if the lower tier entity is included in a combined group.

Do upper tiers and lower tiers have to have the same accounting period to make the tiered partnership election?

No, but the revenue must be allocated to the accounting period on which the report is based.

Is the tiered partnership election in TTC 171.1015 mandatory?

No.

Is the tiered partnership election in TTC 171.1015 an alternative to combined reporting?

No. Combined reporting is mandatory for taxable entities that meet the ownership and unitary criteria. The tiered partnership provisions are not available if the lower tier entity is included in a combined group.

If the tiered partnership election in TTC 171.1015 is made, does the lower tier partnership have to report all revenue to all upper tier entities?

No, a lower tier entity that is not part of a combined group may choose to report total revenue to any or all of its upper tier entities. If the lower tier entity chooses to report total revenue to an upper tier entity, the lower tier entity must report total revenue to the upper tier entity according to the ownership interest of the upper tier entity. A lower tier entity may not report total revenue to an upper tier entity if the upper tier entity is not subject to the franchise tax.

34 Tex. Admin. Code § 3.590

(b)(2)(D) Eligible pass-through entities including partnerships, limited liability companies taxed as partnerships under federal law, limited liability companies that are disregarded under federal law and S corporations are included in a combined group . . .

(b)(2)(E) Passive entities are not included in the combined group; however, the pro rata share of net income from a passive entity shall be included in total revenue to the extent it was not generated by the margin of another taxable entity . . .

(b)(4)(A) Controlling interest means . . .

(ii) for a partnership, association, trust or other entity other than a limited liability company, more than 50%, owned directly or indirectly, of the capital, profits, or beneficial interest in the partnership, association, trust, or other entity

(iii) for a limited liability company, either more than 50%, owned directly or indirectly, of the total membership interest of the limited liability company or more than 50%, owned directly or indirectly, of the beneficial ownership interest in the membership interest of the limited liability company.

(b)(4)(B) Examples are as follows. . .

(iii) Individual A owns 100% of 10 corporations, each of which owns 10% of Partnership B. Individual A has a controlling interest in each of the ten corporations and in Partnership B.

(iv) Corporation A holds a 70% interest in Partnership B that owns 60% of Limited Liability Company C. Corporation A owns the remaining 40% of Limited Liability Company C. Corporation A owns a controlling interest in Partnership B and, taking into account Company A's direct and indirect ownership of Limited Liability Company C, a 100% controlling interest in Limited Liability Company C.

(v) Corporation A owns 10% of Limited Liability Company C and 45% of Corporation B, which owns 90% of Limited Liability Company C. Corporation A would hold a 10% interest in Limited Liability Company C which would not constitute a controlling interest. Corporation B has a controlling interest in Limited Liability Company C.

(vi) Partnership P is owned equally by Limited Liability Company A, Limited Liability Company B and Limited Liability Company C. Three unrelated individuals each wholly owns one of the limited liability companies. None of the limited liability companies owns more than 50% of Partnership P. There is no controlling interest.

(vii) Individual A and Individual B each owns 50% of Partnership X. Individual A and Individual B each also owns 50% of Partnership Y. Individual A and Individual B are not husband and wife. Since neither individual owns more than 50% of each partnership, neither individual has a controlling interest in the partnerships.

(b)(4)(F) Membership in more than one group. If an entity is a member of more than one affiliated group, the entity is treated as a member of the affiliated group (or part thereof) with respect to which it has a unitary relationship. If the entity has a unitary relationship with more than one of those affiliated groups, it shall elect to be treated as a member of only one group. The election shall remain in effect until the unitary business relationship between the entity and the other members ceases, or unless revoked with approval of the comptroller.

Utah

Utah Code Ann. § 59-10-1404

Regardless of whether or how an item of income, gain, loss, deduction, or credit is characterized for federal income tax purposes, that item of income, gain, loss, deduction, or credit is from the same source and incurred in the same manner for a pass-through entity taxpayer as if the item of income, gain, loss, deduction, or credit is:

- (1) realized directly from the source from which the item of income, gain, loss, deduction, or credit is realized by the pass-through entity; or
- (2) incurred in the same manner as incurred by the pass-through entity.

Utah Code Ann. § 59-10-117(1)(d)

a share of income, gain, loss, deduction, or credit of a nonresident pass-through entity taxpayer, as defined in Section 59-10-1402, derived from or connected with Utah sources shall be determined in accordance with Section 59-10-118 . . .

Utah Code Ann. § 59-10-1402(6)

"Derived from or connected with Utah sources" means:

- (a) if a pass-through entity taxpayer is classified as a C corporation for federal income tax purposes, derived from or connected with Utah sources in accordance with Chapter 7, Part 3, Allocation and Apportionment of Income - Utah UDITPA Provisions; or
- (b) if a pass-through entity or pass-through entity taxpayer is classified as an estate, individual, partnership, S corporation, or a trust for federal income tax purposes, derived from or connected with Utah sources in accordance with Sections 59-10-117 and 59-10-118.

Utah Admin. Code R865-9I-13(1)

(b) the nonbusiness income of the pass-through entity derived from or connected with Utah sources.

(i) "Nonbusiness income of the pass-through entity derived from or connected with Utah sources" does not include portfolio income if the income would not be reportable to Utah on the pass-through entity taxpayer's Utah state tax return or the Utah state tax return of any downstream pass-through entity taxpayer.

(ii) "Downstream pass-through entity taxpayer" means a pass-through entity taxpayer that is a pass-through entity taxpayer of any entity that is itself a pass-through entity taxpayer.

Utah Admin. Code R865-6F-8(11)(f)

Income or loss from partnership or joint venture interests shall be included in income and apportioned to Utah through application of the three-factor formula consisting of property, payroll and sales. For apportionment purposes, the portion of partnership or joint venture property, payroll and sales to be included in the corporation's property, payroll and sales factors shall be computed on the basis of the corporation's ownership interest in the partnership or joint venture, and otherwise in accordance with other applicable provisions of this rule.

Form TC-65 Utah Instructions (2023)

Upper-tier Pass-through Entity. An upper-tier pass-through entity is a pass-through entity in which this partnership has an ownership interest and from whom this partnership receives an allocation of income, gain, loss, deduction, or credit on a Utah Schedule K-1 . . .

If a partnership has an interest in another partnership, that upper-tier partnership must withhold Utah income tax on Utah income allocated to the lower-tier partnership. The upper-tier partnership must provide a Utah Schedule K-1 showing the amount of Utah withholding tax paid on behalf of the lower-tier partnership. The lower-tier partnership must report this withholding tax on form TC-250 and then allocate it to its partners, who will claim the withholding tax on their returns. Enter this previous pass-through entity withholding tax for each partner on Schedules K and K-1 . . .

If a corporation holds direct and indirect ownership interests in tiered pass-through entities, it must include its pro rata share of the apportionment factors (property, payroll and sales) of the pass-through entities, applying the respective ownership percentages. For example, a corporation that holds 50 percent interest in Partnership A that in turn holds 20 percent interest in Partnership B would include 50 percent of the factors of Partnership A, and 10 percent (50 percent of 20 percent) of the factors of Partnership B . . .

If this partnership owns an interest in another pass-through entity, that pass-through entity must withhold Utah income tax on any income attributable to this partnership. The pass-through entity must provide a Utah Schedule K-1 showing the amount of Utah withholding paid on behalf of this partnership. This partnership then distributes the credit for the pass-through entity withholding tax to its partners. Complete TC-250, Part 2, and then enter and allocate the total upper-tier (previous) pass-through entity withholding tax using code 36. Do not include Utah Schedule K-1 the partnership received showing this credit when filing this partnership's return . . .

Enter the amount of any pass-through entity withholding tax paid by an upper-tier (previous) pass-through entity, attributable to this partnership, and allocated to the pass-through entity taxpayer. The credit for upper-tier pass-through entity withholding tax reduces the amount of Utah withholding tax calculated for this partner on Schedule N. Also report the credit on line 19 of Schedule K-1 for this partner . . .

Vermont

Vt. Stat. Ann. tit. 32, § 5920(a)

A partnership or limited liability company, which engages in activities in Vermont that would subject a C corporation to the requirement to file a return under section 5862 of this title, shall file with the Commissioner an annual return, in the form prescribed by the Commissioner, on or before the due date prescribed for the filing of the entity's federal return. The return shall set forth the name, address, and Social Security or federal identification number of each partner or member; the partnership or limited liability company income attributable to Vermont and the income not attributable to Vermont with respect to each partner or member as determined under this chapter; and such other information as the Commissioner may by rule prescribe. The partnership or limited liability company shall, on or before the day on which such return is filed, furnish to each person who was a partner or member during the year a copy of such information shown on the return as the Commissioner may by rule prescribe.

Vt. Code R. § 10 060 040 [REG. Section 1.5862(d)]

Section 4(b)(4) Pass-through entities, including partnerships, limited liability companies taxed as partnerships under federal law, and S corporations are not themselves members of the affiliated group. However, a pro rata share of such entity's income and sales, payroll and property is assigned to the unitary group member that holds an ownership interest in such pass-through entity . . .

Section 4(d)(2) voting stock owned by a partnership, other than a limited partnership, is indirectly owned by a partner in proportion to the partner's capital interest in the partnership. For this purpose, a partnership other than a limited partnership is treated as owning proportionately the stock owned by any other partnership or limited partnership in which it has a tiered interest. Voting stock owned by a limited partnership is indirectly owned by the general partner who has authority to determine how the stock is voted . . .

Section 7(d)(2) the taxpayer member's apportionment percentage, determined under Reg. § 1.5833. including in the numerator the taxpayer's property, payroll and sales associated with the combined group's unitary business in Vermont, and including in the denominator the property, payroll and sale of all members of the combined group, including the taxpayer, which property, payroll and sales are associated with the combined group's unitary business wherever located. 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 the partnership's unitary income included in the income of the combined group in accordance with (e)(3) . . .

Section 7(e)(3) If the unitary business includes income from a partnership, the income to be included in the total income of the combined group shall be the member of the combined group's direct and indirect distributive share of the partnership's unitary business income . . .

Draft Changes for Reg. §1.5862(d)

Ex. 2) Same facts as Example 1, but Office Co. enters into an agreement to purchase a 30% interest in Partnership P. The partnership agreement provides that Office Co.'s income distribution from P is also 30%. P is used as Office Co. and Insurance Co.'s main supplier of paper. P engages in unitary activities with the affiliated group. Office Co. is imputed to have engaged in the activities of P. The pro rata net income of P must be included in the combined report as well as the net income of Insurance Co. The pro rata share of apportionment factors of P should be included in Office Co.'s data according to the percentage of income distributed . . .

A unitary business includes that part of the business that meets the definition in this Section 5(a) and is conducted by a taxpayer through the taxpayer's interest in a partnership, whether the interest in that partnership is held directly or indirectly through a series of partnerships or other pass-through entities.

Vermont Formal Ruling No. 88-18 (January 6, 1989)

You have requested a formal ruling on the application of Vermont's tax laws to partnership income earned by a corporation. This letter relies on representations contained in your letter dated [Date].

Corporation A is an Illinois corporation which owns and operates movie theaters within and without Illinois. Corporation A is a 50% general partner in Partnership Z which owns and operates several theaters in the State of Vermont. Corporation A and Partnership Z are unitary in all respects other than ownership.

The question is whether Corporation A's partnership income is to be reported as business or nonbusiness income and further if the income is to be reported as business income by Corporation A, whether this income is apportioned by Corporation A on the basis of its own apportionment factors or whether the apportionment factors of the partnership are also used.

The same questions are asked assuming Corporation A is a limited partner in Partnership Z and does not participate in the management of Partnership Z.

Because a partnership is not a taxable entity, but is rather an aggregate of distinct partners, each partner is considered as directly conducting the business and owning the assets of the partnership in the state. Thus, income and losses flow through to the partners and are reported on the partners' returns. However, the tax character of any item is determined at the partnership level. IRC § 702(b) provides that the character of any item of income, gain, loss, deduction or credit included in a partner's share shall be determined as if such item were realized by the partnership or incurred in the same manner as incurred by the partnership.

Partnership Z owns and operates theaters in Vermont. The partners thereof are deemed to be conducting this business and are therefore within the taxing jurisdiction of the state. The result does not change where Corporation A is a limited partner in Partnership Z. In either case, the partnership is merely a conduit for business income taxable to the partners.

For Vermont income tax purposes, a corporation's apportionable income is its federal taxable income, with certain adjustments not relevant here. 32 V.S.A. §§ 5811(18), 32 V.S.A. §5833. Vermont statutes are otherwise silent as to the treatment of a corporate partner and specifically as to whether the partnership apportionment factors are to be reflected in those of the corporate partner.

A partnership is not a separate tax-paying entity. Partners are required to report their share of each item of partnership income or loss regardless of whether the partnership makes actual distributions to them. IRC Sec. 702(a). Since partnership income (loss), generated by partnership sales, payroll and property, is included in the corporate partner's income, it follows that the partnership apportionment factors should be reflected in the denominator of the corporate partner's apportionment formula. Stated otherwise, each partner is treated as paying its proportionate share of partnership payroll, incurring its share of partnership depreciation and receiving its share of partnership sales, and these items also should be reflected in the partner's apportionment factors. Thus, to the extent that partnership income is reported by the corporation, the partnership's apportionment factors should also be reflected.

Vermont Instructions to Schedule BA-402 (2024)

If this entity holds an interest in a unitary pass-through entity, then the pro-rata share of the passthrough entity's apportionment factors must be added to Lines 3 through 12. If the pass-through entity is not unitary then the distributed income is reported on Lines 1A and 1B, and the pro-rata share of pass-through entity's apportionment factors are excluded from Lines 2 through 20.

Vermont Instructions to Schedule BI-477 (2024)

While Schedule BI-477 is designed for pass-through businesses and generally applies the rules and methods for sourcing income for nonresident individuals, it relies on principles of corporate apportionment to source apportionable business income . . .

Note for Tiered Pass-Throughs: Vermont conforms to the Internal Revenue Code Subchapter K. Included in that conformity is the understanding that an owner's share of income/loss from an entity's activities pass through and are treated as if directly recognized by that partner or member, retaining their character as determined at the entity level. For example, if a pass-through recognizes a capital gain from the sale of real estate, each partner will be treated as if they sold a share of the real property themselves. If the unitary business principle is satisfied, the filing pass-through must combine all the items of income received with its own unitary activity on the appropriate lines in Parts I-IV. The unitary business principle is satisfied if a single economic enterprise exists, which is made up either of separate parts of a single business entity or of a commonly controlled group of business entities that are sufficiently interdependent, integrated, and interrelated through their activities so as to provide a synergy and mutual benefit that produces a sharing or exchange of value among them and a significant flow of value to the separate parts. The unitary business principle can exist for a taxpayer as a result of the taxpayer's interest in that partnership, whether the interest in that partnership is held directly or indirectly through a series of partnerships or other pass-through entities.

The filing pass-through must attach workpapers that mimic BI-477, with Parts I-IV complete, for each discrete unitary business represented.

Part V reports items of taxable income received from lower-tier pass-throughs **which are not unitary with this business and therefore would not be included in Parts I-IV.**

Each discrete business undertaken by a lower-tier pass-through is attributable to the filing passthrough. If no unitary business principle exists between these attributed (lower tier) activities and the activities of the filing pass-through entity, the sourcing of income will not change between levels. Income and factors should not be blended, but rather the net income/loss should be reported here.

Part VI calculates the Vermont income adjustment required by 32 V.S.A. § 5822(e) to arrive at the filing pass-through's Vermont income.

Part VII applies the single sales factor methodology to apportionable business income for entities that have ordinary business income derived in Vermont and at least one other state. The resulting percentage will be used in Part IV, Income From Business or Trade. The calculation is identical to apportionment of income for corporate income tax. Effective Jan. 1, 2023, Vermont uses the single sales factor method to calculate apportionment, replacing three factor apportionment.

Part VIII reports property and wage factors, which will be used by owners who are C-Corporations and are required to include property and wage factors from flow-through

activity on the apportionment schedules attached to their Vermont corporate income tax returns . . .

The taxpayer should utilize Part V to report its share of non-unitary business activity from lower-tier pass-throughs. Although nonresident withholding and composite returns collect taxes on the entity level, pass-throughs remain a conduit for their owners under Vermont law. Each discrete unitary business undertaken by a lower-tier pass-through, therefore, will be attributable to the taxpayer. The taxpayer should only blend income and factors (passed through to it from lower tiers in Parts I-IV of Schedule BI-477) with its own income and factors if the unitary business principle is satisfied. If the unitary business principle is not satisfied, report the net income or loss in Part V.

There should be one separate worksheet attached combining the lower-tier values passed through to the taxpayer for each discrete business activity included in Part V. Each attached worksheet should closely follow the structure and ordering of Schedule BI-477 Parts I-IV.

Note: If the taxpayer receives items of income reported in Parts I-IV from lower-tier pass-throughs that do not satisfy the unitary business principle, then the values reported on Lines 1A through 16 will not equal the values on the federal 1065 Schedule K. Rather, each item of income reported in Parts I-IV will only tie-out to federal 1065 Schedule K when it is combined with the corresponding lower-tier values on the worksheets . . .

Note: For tiered pass-throughs, proportional shares of numerator and denominator factors from lower tiers should only be included if the unitary business principle is met. See the Note for Tiered Pass-Throughs in the “General Information” section above for details . . .

Factors from pass-through entities: Where the unitary business principle is satisfied between the activities of the taxpayer and a lower-tier partnership, take the sum of all the “Everywhere” sales factors indicated on Line 15 all Schedules K-1VT issued to you (i.e., this filing entity) by these entities and enter that total here. Maintain workpapers detailing all the components for this entry . . .

Factors from pass-through entities: Where the unitary business principle is satisfied between the activities of the taxpayer and a lower-tier partnership, take the sum of all the Vermont sales factors indicated on Line 15 all Schedules K-1VT issued to you (i.e., this filing entity) by these entities and enter that total here. Maintain workpapers detailing all the components for this entry.

Virginia

Va. Code Ann. § 58.1-391(B)

Each item of pass-through entity income, gain, loss or deduction shall have the same character for an owner under this chapter as for federal income tax purposes. Where an item is not characterized for federal income tax purposes, it shall have the same character for an owner as if realized directly from the source from which realized by the pass-through entity or incurred in the same manner by the pass-through entity.

Va. Code Ann. § 58.1-391(C)

Where an owner's distributive shares of an item of pass-through entity income, gain, loss or deduction is determined for federal income tax purposes by special provision in

the pass-through entity agreement with respect to such item, and where the principal purpose of such provision is the avoidance or evasion of tax under this chapter, the owner's distributive share of such item, and any modification required with respect thereto, shall be determined as if the pass-through entity agreement made no special provision with respect to such item.

Virginia Ruling of the Commissioner PD 15-240 (April 26, 2007)

If the entire business of a pass-through entity is not deemed to have been transacted or conducted within the Commonwealth, then "income from Virginia sources" means that portion of the pass-through entity's income that has been allocated and apportioned to Virginia in the same manner as corporations.

Virginia Ruling of the Commissioner PD 07-50 (April 26, 2007)

A partnership (the "Partnership"), located in ***** (State A), has two 50% equity partners. The general partner is an individual who resides in ***** (State B). The limited partner is a State B corporation. The partnership purchased commercial property in Virginia under a triple net lease. Neither the partnership nor the partners conduct any other business in Virginia other than the ownership of the Virginia commercial property. You request a ruling as to whether any of the parties are required to file Virginia income tax returns.

Virginia Code § 58.1-392 requires every pass-through entity doing business in Virginia or having income from Virginia sources to file an annual information return with the Department of Taxation setting forth its income and a list of owners, effective for taxable years beginning on or after January 1, 2004. Pursuant to Va. Code § 58.1-302, an entity has income from Virginia sources if it has any income, gain, loss or deduction attributable to the ownership in real property located in Virginia. As such, because the Partnership owns income-producing real property in Virginia, it must file an informational return.

Public Law (P.L.) 86-272, codified at 15 U.S.C. §§ 381-384, prohibits a state from imposing a net income tax where the only contacts with a state are a narrowly defined set of activities constituting solicitation of orders for sales of tangible personal property. The Department also applies P.L. 86-272 to the solicitation of sales of other than tangible personal property. See Public Document (P. D.) 93-75 (3/17/93). The Department limits the scope of P.L. 86-272 to only those activities that constitute solicitation, are ancillary to solicitation, or are de minimis in nature. See *Wisconsin Department of Revenue v. William Wrigley, Jr., Co.*, 505 U.S. 214 (1992). The Partnership's ownership of commercial property in Virginia clearly exceeds the protection provided by P.L. 86-272.

Virginia generally conforms to the federal treatment of partnerships. A partnership, as such, is not subject to income tax. Any income tax arising from the income of the partnership is the liability of the partners. Internal Revenue Code § 702(b) states, "The character of any item of income, gain, loss, deduction, or credit included in a partner's distributive share . . . 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." Each item of pass-through entity income, gain, loss or deduction has the same character for an owner for Virginia income tax purposes as for federal income tax purposes. See Va. Code § 58.1-391 B.

Thus, if a partnership operates a business in Virginia, any item of partnership income, gain, loss, deduction, or credit will retain its Virginia source character no matter how many partnerships it passes through. The pass through of Virginia source income will

continue to occur from partnership to partner until the income is passed through to a partner that is a taxable entity.

In the situation you present, the income generated by the commercial property will retain its character as Virginia source income and pass through to both the general and limited partners, which are taxable entities. As such, the general partner will need to file a nonresident Virginia individual income tax return and the limited partner will need to file a Virginia corporate income tax return apportioning income in accordance with Va. Code §§ 58.1-408 through 58.1-421. See Public Document (P.D.) 88-165 (6/29/88).

This ruling is based on the facts presented as summarized above. Any change in facts or the introduction of new facts may lead to a different result.

The Code of Virginia sections and public document cited are available on-line at www.tax.virginia.gov in the Tax Policy Library section of the Department's web site. If you have any questions regarding this ruling, please contact ***** in the Office of Policy and Administration, Appeals and Rulings, at *****.

Commonwealth Of Virginia, Department Of Taxation V. FJ Management, Inc., d/b/a FJI, Inc., No. 0701-23-2 (Va. Ct. App. 11/12/2024)

Finding that the application of blended apportionment to a corporate partner is unconstitutional without a unitary relationship.

The Virginia Form 502 Instructions (2023)

If a PTE's entire business is conducted within Virginia, then all of its income is Virginia source income; no income is allocated to another state, and the entity's Virginia apportionment is 100%. If a PTE conducts its business in Virginia and elsewhere in a manner such that its income would be subject to a tax on net income in Virginia and at least one other state, the entity must allocate and apportion its income in the same manner that is provided in Virginia law for corporations. This applies to all types of pass-through entities (partnerships, LLPs, LLCs, and S corporations). Dividends received are to be allocated to the state of commercial domicile, but all other income must be apportioned. An entity may not apportion its income based on divisional or separate accounting, or any other alternate method unless it has requested and received permission to do so in advance from the Department.

The effect of the PTE's apportionment may vary from one owner to another, depending on the entity types of the owners. For instance:

- a Virginia resident individual owner is taxable on all of his or her PTE income regardless of the entity's apportionment;
- a nonresident individual owner uses the entity's Virginia apportioned income in determining his or her own Virginia nonresident percentage; and
- a corporate owner may need to include the PTE's property, payroll, and sales factors in determining its own apportionment percentage.

Virginia Public Document Ruling No. 88-161 (06/27/1998)

If a Virginia modification is related to an item specially allocated by the partnership agreement, then the partner's distributive share of the Virginia modification shall be the same as the partner's distributive share for federal income tax purposes of the item to which the modification relates.

Virginia Public Document Ruling No. 94-285 (09/20/1994)

Neither the special allocations provisions of the Partnership's partnership agreement nor the manner in which the Corporation reports the percentage of tax-exempt income to its shareholders may operate in such a manner as to shift tax-exempt income among taxpayers solely for the purpose of reducing Virginia income taxes.

West Virginia

W. Va. Code § 11-21-17(b)

Each item of partnership income, gain, loss, or deduction shall have the same character for a partner under this article as for federal income tax purposes. Where an item is not characterized for federal income tax purposes, it shall have the same character for a partner as if realized directly from the source from which realized by the partnership, or incurred in the same manner as incurred by the partnership.

W. Va. Code § 11-21-17(c)

West Virginia tax avoidance or evasion. — Where a partner's distributive share of an item of partnership income, gain, loss or deduction is determined for federal income tax purposes by special provision in the partnership agreement with respect to such item, and where the principal purpose of such provision is the avoidance or evasion of tax under this article, the partner's distributive share of such item, and any modification required with respect thereto shall be determined as if the partnership agreement made no special provision with respect to such item.

W. Va. Code § 11-21-37

(a) In determining West Virginia source income of a nonresident partner of any partnership, there shall be included only the portion derived from or connected with West Virginia sources of such partner's distributive share, for federal income tax purposes, of items of partnership income, gain, loss and deduction, as such portion shall be determined under regulations of the tax commissioner consistent with the applicable rules of section thirty-two [§ 11-21-32].

(b) Special rules as to West Virginia sources. -- In determining the sources of a nonresident partner's income, no effect shall be given to a provision of the partnership agreement which:

(1) Characterizes payments to the partner as being for services or for the use of capital; or

(2) Allocates to the partner, as income or gain from sources outside West Virginia, a greater proportion of his or her distributive share of partnership income or gain than the ratio of partnership income or gain from sources outside West Virginia to partnership income or gain from all sources, except as authorized in subsection (d); or

(3) Allocates to the partner a greater proportion of a partnership item of loss or deduction connected with West Virginia sources than his or her proportionate share, for federal income tax purposes, of partnership loss or deduction generally, except as authorized in subsection (c).

(c) Alternative methods. -- The Tax Commissioner may, on written application filed on or before the due date of the partner's or S corporation shareholder's return under this article for that taxable year determined without regard to any extension of time for filing, authorize the use of such other method or methods of determining the

nonresident partner's portion of partnership items, or the nonresident S corporation shareholder's portion of S corporation items, derived from or connected with West Virginia sources, and the modifications related thereto, as may be appropriate and equitable, on such terms and conditions as the commissioner may require.

(d) Application of rules for resident partners to nonresident partners and shareholders.

(1) For a partner's distributive share of items, see subsection (a) of section seventeen of this article.

(2) The character of partnership items for a nonresident partner shall be determined under subsection (b) of section seventeen of this article.

(3) The effect of a special provision in a partnership agreement, other than a provision referred to in subsection (b) of this section, having the principal purpose of avoidance or evasion of tax under this article shall be determined under subsection (c) of section seventeen of this article.

W. Va. Code § 11-21-37A

(a) Notwithstanding any provision of §11-21-37 of this code to the contrary, a business doing business in West Virginia and in one or more other states shall allocate its non-business income as provided in §11-21-37a(c) of this code and shall apportion its business income as provided in §11-21-37a(f) of this code to determine the West Virginia source income of its nonresident partners and nonresident S corporation shareholders for purposes of this article. For purposes of this section:

(1) The term "business entity" includes a partnership, limited partnership, joint venture, corporation, S corporation, and any other group or combination acting as a unit, but does not include a sole proprietorship; and

(2) The term "engaging in business" or "doing business" means any activity of a business entity which enjoys the benefits and protection of government and laws in this state. . . .

(j)(A) Allocation and apportionment on and after January 1, 2022. - For tax years beginning on and after January 1, 2022, income of flow-through entities allocated and apportioned under this section and §11-21-32 of this code, shall be allocated and apportioned in the same manner and to the same extent as the income of corporations and entities taxable under §11-24-1 et seq. of this code are allocated and apportioned under §11-24-7 of this code. Apportioned income shall be apportioned pursuant to application of a single sales factor to the same extent as the income of corporations and entities taxable under §11-24-1 et seq. of this code are apportioned under §11-24-7 of this code. Allocated income shall be allocated in the same manner and to the same extent as the income of corporations and entities taxable under §11-24-1 et seq. of this code are apportioned under §11-24-7 of this code.

(B) For purposes of this article the provisions of §11-21-12K, §11-21-37b and §11-21-37c of this code remain unchanged by this section.

(C) For purposes of this article, "flow-through entity", "conduit entity" or "pass through entity" means an S corporation, partnership, limited partnership, limited liability partnership, or limited liability company. The term "flow-through entity," "conduit entity" or "pass through entity" includes a publicly traded partnership as that term is defined in section 7704 of the Internal Revenue Code that has equity securities registered with the Securities and Exchange Commission under Section 12 of Title I of the Securities Exchange Act of 1934, 15 USC 78l .

(D) Allocation of flow-through income to recipients. - Income of a flow-through entity allocated and apportioned under this section or any other provision of this article is allocated income in the hands of a shareholder, interest owner, partner, member or other recipient of flow-through income, and taxable to such recipient as income allocated to this state under the provisions of this article, or in the case of recipients of such flow through income that are taxable under the provisions of §11-24-1 et seq. of this code, such income is taxable to such recipient as income allocated to this state under the provisions of §11-24-1 et seq. of this code.

W. Va. Code § 11-24-7(d)(5)

(A) Persons carrying on business as partners in a partnership, as defined in Section 761 of the Internal Revenue Code of 1986, as amended, are liable for income tax only in their separate or individual capacities.

(B) A corporate partner's distributive share of income, gain, loss, deduction or credit of a partnership shall be modified as provided in section six of this article for each partnership. For taxable years beginning on or after December 31, 1998, the distributive share shall then be allocated and apportioned as provided in this section using the partnership's property, payroll and sales factors. The sum of that portion of the distributive share allocated and apportioned to this state shall then be treated as distributive share allocated to this state; and that portion of distributive share allocated or apportioned outside this state shall be treated as distributive share allocated outside this state, unless the taxpayer requests or the Tax Commissioner, under subsection (h) of this section requires that the distributive share be treated differently.

(C) This subdivision shall be null and void and of no force or effect for tax years beginning on or after January 1, 2009.

W. Va. Code § 11-24-13c

(c)(2) 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 thirteen-d of this article and the denominator of which is the amount of the partnership's total unitary income.

W. Va. Code R. § 110-24-6 Example 3

When a partnership owned in part by a corporation has taxable nexus in one or more states into which the corporation sells tangible personal property, but the corporation does not otherwise have taxable nexus with those states. A combined group engaged in unitary business activity consists of Corporations A, B, C and D. The combined group makes sales to customers in States 1, 2, 3, 4, 5 and 6. However, Corporations A and C do not sell tangible personal property to customers in all of those states or, in some of the states, Corporations A and C are not subject to an income tax because of application of Public Law 86-272. Corporations A and C each own an interest in partnerships engaged in unitary business activity with the combined group. These partnerships have taxable nexus with states into which Corporations A and C sell tangible personal property and in which Corporations A and C do not have taxable nexus if their partnership interests are disregarded. Each corporation's share of sales reflected in the apportionment factors of the partnerships are included in the apportionment factors of Corporation A and C, which are the corporate owners of the partnerships. As a consequence, all members of the combined group have taxable nexus with all of the states into which they sell tangible personal property, and the no throw does not apply to this combined group.

West Virginia Form PTE-100 Instructions

Pass through entity owners of pass through entities should allocate income received from a Pass Through Entity unless such entities are engaged in a unitary business. If a unitary relationship exists, a Pass Through Entity owner of a pass through entity may reapportion its WV income, including the appropriate factors of the subsidiary.

West Virginia Taxpayer Services Division Publications No. TSD-392 (May 1, 2020)

A corporate partner's distributive share of partnership income, gain, loss, deduction or credit is apportionable to West Virginia. State law presumes that a corporate partner's distributive share of partnership income is apportionable business income.

West Virginia Taxpayer Services Division Publications No. TSD-423 (11/01/2011)

West Virginia Business Franchise Tax - If the nonresident law firm is a corporation or partnership, the law firm would be liable for the West Virginia business franchise tax. The amount of tax payable would be calculated based upon the apportioned capital base of the firm. W. Va. Code § 11-23. Apportionment is typically based upon the West Virginia four factor formula consisting of a property factor, a payroll factor and a double weighted sales factor. However, should it appear that the statutory apportionment method does not accurately reflect the extent of the business activity in West Virginia, the Tax Commissioner may require use of, or the taxpayer may petition for, an alternative apportionment method.

Should the nonresident law firm wish to do so, the firm could apply to the West Virginia State Tax Department for use specific accounting to apportion its tax base to the State of West Virginia instead of the typically applied four factor formula. The taxpayer would be required to apply for authorization to use specific accounting to apportion its tax base before the unextended due date of the annual franchise tax return for the tax year for which West Virginia reporting is required.

Wisconsin

Published Guidance:

- [Wisconsin Schedule 3K-1 Instructions \(2023\)](#)

[Excerpt, pages 8 and 9:](#)

Determining the Wisconsin Income of Nonresident Partners

Apportionable Income:

A partnership that is engaged in a unitary business in Wisconsin and at least one other state or foreign country (known as "nexus") must determine the amount of income/loss attributable to Wisconsin for purposes of figuring the share of partnership income/loss taxable to partners that are nonresident or part-year resident individuals or fiduciaries. See sec. Tax 2.82, Wis. Adm. Code, to determine what constitutes nexus and sec. Tax 2.62, Wis. Adm. Code, for a description of what constitutes a unitary business.

All business income of a partnership is apportionable income, except as provided in the section below titled, *Income Not Subject to Apportionment Formula*. All apportionable business income is taxable to nonresident partners based on the apportionment formula regardless of whether the nonresident partner performs services in Wisconsin.

The Wisconsin source amount in column (e) is the amount from column (d) multiplied by the partnership's apportionment percentage from the Wisconsin apportionment Schedules A-01 through A-11. Include this schedule when filing Form 3, *Wisconsin Partnership Return*.

Income Not Subject to Apportionment Formula:

For items of business income not subject to apportionment under sec. 71.04(4), Wis. Stats., a nonresident partner's distributive share of partnership income from the following sources is attributable to Wisconsin as described below:

- Income derived from rentals and royalties from business or nonbusiness real estate or tangible personal property, or from the operation of any farm, mine or quarry, or from the sale of business or nonbusiness real property or tangible personal property, are allocated to the location of the property from which derived.
- Intangible income such as interest and dividends, and gains and losses resulting from the sale of intangible property such as stocks, bonds, and securities which are passed through to nonresident partners aren't taxable by Wisconsin because the income follows the residence of the individual.
- All income that is realized from the sale of or purchase and subsequent sale or redemption of lottery prizes if the winning tickets were originally bought in Wisconsin are allocated to Wisconsin.
- Income derived from casinos, bingo halls, and pari-mutuel winnings in Wisconsin are allocated to Wisconsin.
- Income derived from a covenant not to compete is taxable to the extent that the covenant was based on a Wisconsin based activity.
- Partnership income derived from personal services, including income from professions, follow the location of the services:
 - Partnership income derived from personal services, including professional services, is taxable to a nonresident partner only if the nonresident partner personally performs services in Wisconsin. The amount of personal service income attributable to the nonresident partner's services performed in Wisconsin is taxable.
 - If the partnership derives its income from personal services, a nonresident partner's Wisconsin source amount in column (e) is equal to the value of the services the partner personally performed in Wisconsin. If the nonresident partner didn't personally perform any services in Wisconsin, the Wisconsin source amount in column (e) for that partner is zero. If a partnership derives business income from services other than personal and professional services, nonresident partners must apportion their distributive share of such income to Wisconsin using the partnership's apportionment formula.

The Wisconsin source amount of column (d) is determined similarly for general partners and limited partners. The following examples illustrate the rules described above:

Example 1: Two nonresident individuals are partners of a partnership that does business only in Wisconsin. Both nonresidents are taxed on their entire share of the partnership income for Wisconsin income tax purposes.

Example 2: A nonresident is one of two equal partners of a partnership that does business in Wisconsin and Illinois. Using the

apportionment formula, the partnership derives 40% of its income from business activities in Wisconsin. The Wisconsin resident is taxed on one-half of the total partnership income for Wisconsin income tax purposes. The nonresident is taxed on one-half of the 40% of the partnership income attributable to business activities in Wisconsin.

Example 3: A nonresident is a limited partner, with a 1% interest in partnership profits, of a partnership that derives income from real estate located in Wisconsin and in other states. The nonresident limited partner is taxed on 1% of the partnership income attributable to the real estate located in Wisconsin.

Example 4: A nonresident is a partner, with a 10% interest in partnership profits, of a certified public accounting firm that operates in and outside Wisconsin. One-fourth of the partnership's income is attributable to professional services performed in Wisconsin and three-fourths is attributable to professional services performed in other states. The nonresident partner doesn't personally perform any services in Wisconsin. The nonresident isn't subject to Wisconsin income tax on their proportionate share of the partnership income earned in Wisconsin.

- A partnership engaged in a nonunitary business (one in which the operations in Wisconsin are not dependent upon or contributory to the operations outside Wisconsin) in and outside Wisconsin must determine the amount of income attributable to Wisconsin by separate accounting. Under separate accounting, the partnership must keep separate records of the sales, cost of sales, and expenses for the Wisconsin business. Use Form C, *Wisconsin Allocation and Separate Accounting Data*, to compute the income allocable in and outside Wisconsin. Include the schedule when filing Form 3, *Wisconsin Partnership Return*.
 - Except for nonunitary income, and except for income/loss items not requiring apportionment as explained above, a unitary business may use separate accounting only with the approval of the department. A request for approval must set forth in detail the reasons why separate accounting will more clearly reflect the partnership's Wisconsin net income. It should be mailed to the Wisconsin Department of Revenue, Mail Stop 3-107, PO Box 8906, Madison, WI 53708-8906 before the end of the taxable year for which the use of separate accounting is desired.

Excerpt, page 17:

Part IV – Partner's Share of Apportionment Factors:

Partnerships, corporations, and tax-option (S) corporations must generally include their share of the numerator and denominator of the partnership's apportionment factors in the numerator and denominator of their apportionment factors, even if the election to pay tax at the entity level was made. Include these amounts using the Wisconsin apportionment Schedules A-01 through A-11, as appropriate. For a corporation or another partnership that is a partner, enter on line 25 or lines 26 through 28 the partner's proportionate share of the partnership's apportionment factors from the Wisconsin apportionment Schedule A-01 through A-11 (if applicable).

- [Wisconsin Tax Bulletin No. 197](#) (April 2017), page 4

Apportionment for Partnerships and Partners

A partnership engaged in a unitary business both in and outside Wisconsin is a “multi-state partnership”. A multi-state partnership will generally use Form A-1, *Wisconsin Apportionment Data for Single Factor Formulas*, or Form A-2, *Wisconsin Apportionment Data for Multiple Factor Formulas*, to determine the portion of income attributable to Wisconsin.

The information the partnership provides to a partner on Schedule 3K-1, Partner's Share of Income, Deductions, Credits, etc., to report their share of income depends on the type of partner:

- A. Individual: A partner that is a nonresident individual reports his or her share of the partnership income after apportionment. The partnership reports this “Wis. source amount” in column (e) on Schedule 3K-1.
- B. C-Corporation: A partner that is a C-Corporation reports its share of income, before apportionment, from the partnership. The partnership reports this amount in column (d), “Amount under Wis. law”, of Schedule 3K-1. The partnership must also report the corporation's share of the partnership's apportionment factors in Part IV of Schedule 3K-1, Partner's Share of Apportionment Factors. The corporation combines the amounts from Part IV with its own apportionment factors on its Form A-1 or Form A- 2.
- C. Partnership or Tax-Option (S) Corporation: A partner that is a partnership or tax-option (S) corporation reports its share of income, before apportionment, from the partnership. The partnership reports this amount in column (d), “Amount under Wis. law”, of Schedule 3K-1. The partnership must also report the partner's share of the partnership's apportionment factors in Part IV of Schedule 3K-1, Partner's Share of Apportionment Factors. The partnership or tax-option (S) corporation partner combines the amounts from Part IV with its own apportionment factors on its Form A-1 or Form A- 2.

See full article for an example.

- [Wisconsin Tax Bulletin No. 208 \(2023\)](#)

Wisconsin Sourced Income of Multi-Tiered Partnership Electing to Pay Tax at Entity Level

A partnership that makes the election to pay tax at the entity level for Wisconsin under sec. 71.21(6)(a), Wis. Stats., must determine income, loss and deductions attributable to Wisconsin pursuant to sec. 71.04, 71.14, 71.25, 71.362, or 71.45, Wis. Stats., as if the election was not made.

If the electing partnership is part of a multi-tiered entity structure (i.e., another partnership owns a percentage of the capital and profits of the electing partnership), the electing partnership must look through all the tiers of the multi-tiered entity to determine income, loss and deductions attributable to Wisconsin. For additional detail, see example 2 under Column (c) of the Schedule 3-ET Instructions.

- [Wisconsin Tax Bulletin No. 209](#) (April 2020), page 11

Apportionment – Allocating Partnership Sales to Corporate Partners Who are Members of a Combined Group

A partnership engaged in a unitary business both in and outside Wisconsin is a “multi-state partnership”. To determine the portion of income attributable to Wisconsin, a multi-state partnership will generally use Schedule A-01, *Wisconsin Single Sales Factor Apportionment Data for Nonspecialized Industries*, unless one of the industry specific

Schedules A-02 through A-11 apply. For additional information on computing apportionment for partnerships and partners, see Wisconsin Tax Bulletin 197 (April 2017).

A multistate partnership must provide each corporate partner a Schedule 3K-1, *Partner's Share of Income, Deductions, Credits, etc.*, and complete Part IV, *Partner's Share of Apportionment Factors*. Part IV of Schedule 3K-1 must include the corporate partner's distributive share of both Wisconsin gross sales and total company gross sales.

Corporations, including members of combined groups, add their distributive share of the partnership's gross sales (from Schedule 3K-1, Part IV) to their own gross sales and report the amounts on their own apportionment schedule (e.g., Schedule A-01).

See full article for an example illustrating the computation and reporting for corporate partners that are members of a combined group (secs. 71.20(1m) and 71.255(5)(a)6, Wis. Stats., and sec. Tax 2.61(7)e, Wis. Adm. Code)

- [Wisconsin Schedule A-01 Instructions \(2023\)](#)

Excerpt, page 1:

Corporations, partnerships, tax-option (S) corporations and nonresident estates, trusts, and individuals that are engaged in a unitary business both in and outside Wisconsin generally use Schedule A-01 to compute the factors that will determine their Wisconsin share of income from a unitary business.

Excerpt, page 2:

Partnerships, corporations, and tax-option (S) corporations must generally include their share of the numerator and denominator of a partnership's apportionment factors in the numerator and denominator of their apportionment factors. Include these amounts using the Wisconsin apportionment Schedules A-01 through A-11, as appropriate.

Excerpt, page 5:

Sales to Pass-Through Entities Owned by Combined Group Members. If a combined group member makes a sale to a pass-through entity which is more than 50 percent owned, directly or indirectly, by members of the combined group, the member must eliminate an amount equal to the gross receipts of the sale multiplied by the sum of all combined group members' interests in the pass-through entity as of the date of the sale.

Excerpt, page 6:

Sales by Pass-Through Entities Owned by Combined Group Members. If a pass-through entity makes a sale to a combined group member and more than 50 percent of the pass-through entity is directly or indirectly owned by members of the combined group, each member with an interest in the pass-through entity must subtract from its sales factor numerator and denominator any amount that would otherwise be included attributable to the sale.

- [Pass-Through Entity-Level Tax: Partnership Determining Income and Computing Tax common questions](#)

[See common question number one. How does an electing partnership determine the situs of income?](#)

- [Pass-Through Entity Withholding common questions](#)

Common question number 16, *What happens when a pass-through entity is in a "tiered" structure, where it owns another pass-through entity?*

If a pass-through entity (called an "upper-tier entity") owns another pass-through entity (called a "lower-tier" entity), the lower-tier entity is required to withhold on the Wisconsin income allocable to the upper-tier entity. The upper-tier entity may then take credit for tax already withheld by the lower-tier entity when it withholds on behalf of its own nonresident members.

Alternatively, the upper-tier entity may file an exemption affidavit (Form PW-2) to elect out of withholding from the lower-tier entity. In this case, the upper-tier entity would pay the withholding on its total Wisconsin income allocable to its nonresident members even if that income is from the lower-tier entity.

Statutory References:

- [Wis. Stat. § 71.04](#) *Situs of income; allocation and apportionment.* (individuals, estates, and trusts)
- [Wis. Stat. § 71.14](#) *Situs of income.* (estates and trusts)
- [Wis. Stat. § 71.21\(6\)\(d\)1.](#) *Situs of income.* (partnerships electing to pay tax at the entity level)
- [Wis. Stat. § 71.25](#) *Situs of income; allocation and apportionment.* (corporations)
- [Wis. Stat. § 71.255\(1\)\(n\)](#) *Combined reporting. Unitary business.* (combined reporting of pass-through entities owned directly or indirectly by a corporation)
- [Wis. Stat. § 71.255\(5\)\(a\)6.](#) *Member's share of business income of the combined group.* (combined reporting of pass-through entities owned directly or indirectly by a corporation)
- [Wis. Stat. § 71.362](#) *Situs of income.* (tax-option (S) corporations)
- [Wis. Stat. § 71.775](#) *Withholding from nonresident members of pass-through entities.*

Administrative Code References:

- [Wis. Adm. Code Tax § 2.39](#) *Apportionment method.*
- [Wis. Adm. Code Tax § 2.41](#) *Separate accounting method.*
- [Wis. Adm. Code Tax § 2.61\(7\)\(e\)](#) *Combined reporting. Pass-through entities.*
- [Wis. Adm. Code Tax § 2.62\(7\)](#) *Unitary business. Passive holding companies.*
- [Wis. Adm. Code Tax § 2.62\(8\)](#) *Unitary business. Pass-through entities.*

Wis. Stat. § 71.04(3)(c)

In computing taxes under this chapter a partner or member shall disregard, for purposes of determining the situs of partnership income of partners, all provisions in partnership or limited liability company agreements that do any of the following:

1. Characterize the consideration for payments to the partner or member as services or the use of capital.
2. Allocate to the partner or member, as income from or gain from sources outside this state, a greater proportion of the partner's or member's distributive share of partnership or limited liability company income or gain than the ratio of partnership or company income or gain from sources outside this state to partnership or company income or gain from all sources.

3. Allocate to a partner or member a greater proportion of a partnership or limited liability company item of loss or deduction from sources in this state than the partner's or member's proportionate share of total partnership or company loss or deduction.
4. Determine a partner's or member's distributive share of an item of partnership or limited liability company income, gain, loss or deduction for federal income tax purposes if the principal purpose of that determination is to avoid or evade the tax under this chapter.

McQuide v. Wisconsin Department of Revenue, Wisconsin Tax Appeals Commission, Case No. 93-I-532; 93-I-632-SC; 94-I-171 (December 12, 1995).

In light of the foregoing, it is clear that the special allocations of paragraph 10 lacked economic effect under Treas. Reg. § 1.704-1(b)(2)(ii)(a), because the allocation was inconsistent with the underlying economic arrangement of the Mascaris and McQuides, and no downward adjustments were ever made to the capital account of the McQuides to reflect those deductions which were specially allocable to them. Having determined that the special allocations failed the first tier of the test of “substantial economic effect” we need not reach the question of substantiality under Treas. Reg. § 1.704-1(b)(2)(iii).

Wall v. Wisconsin Department of Revenue, Wisconsin Tax Appeals Commission, Case No. 87-I-70 (November 3, 1998).

Petitioner did not bear the entire economic burden for the losses allocated to him, as is evidenced by the partnership agreement's failure to require liquidation proceeds to be distributed in accordance with the partners' capital account balances, and capital account deficits to be restored upon liquidation. In addition, the capital contributions made to the partnership by Barbara Wall were not properly reflected in her capital account. Consequently, the loss allocation to petitioner lacked substantial economic effect . . . The respondent properly allocated the partnership losses between Thomas and Barbara Wall on the basis of their interests in the partnership.

III. C. Examples of Cases and Commentary on Unitary Issues in the State Tax Sourcing of Partnership Income

This Subsection presents examples of state tax cases and commentary that have explicitly addressed unitary issues in the state tax sourcing of partnership income. This is not an exhaustive list and does not include many of the cases involving the sale of partnership interests, which will be addressed in a later phase of the project. These examples illustrate the added complexity of the unitary analysis when a partnership is involved, as well as the varying approaches states have taken to the ownership issue.

Hellerstein, Hellerstein & Appleby: State Taxation, ¶9.15[6] (WG&L).

Partnerships are treated as pass-through entities for tax purposes. For purposes of determining its distributive share of partnership income, the partner's interest in the partnership is therefore generally considered to be a direct interest in the operations of the partnership rather than an intangible interest.⁹⁶² If the corporate partner includes a distributive share of partnership income in its apportionable tax base, it should likewise include an equivalent share of the partnership's factors in its apportionment formula.⁹⁶³ In fact, this is the practice followed in most states⁹⁶⁴ and, at least historically, was "consistent with the [Multistate Tax Commission] practice."⁹⁶⁵

The precise manner in which the partnership's factors are reflected in the corporate partner's apportionment formula, however, can vary depending on the relationship of the corporate partner to the partnership. If the partner and the partnership are engaged in a unitary business,⁹⁶⁶ a number of states apportion the partnership income along with the corporation's other income from the unitary business and essentially combine the partner's factors with the partner's share of the partnership's factors, eliminating intercompany transactions for purposes of the sales and property factors.⁹⁶⁷ On the other hand, if the partner and partnership are not engaged in a unitary business, the partner's share of the partnership's trade or business may be considered to be a separate trade or business of the taxpayer, and the partner's distributive share of income from such trade or business is separately apportioned to the state by the partnership's own factors.⁹⁶⁸

Albertson's Inc. v. State, Dept. of Revenue, 683 P.2d 846 (Idaho 1984).

Summary: In this case, the corporation's wholly-owned subsidiary owned an interest in a partnership. The Court focused on whether there was a unitary relationship between the corporation and subsidiary, rather than between the partnership and corporation.

Each criterion suggested by the Supreme Court in *Container* before a unitary business can be found is met by the close operational relationship which existed between Albertson's and Texas-Albertson's.

Accordingly, the trial court erred in its conclusion that "Albertson's, Inc. and Texas-Albertson's should not be considered unitary." Although the opinion of the trial court reflects that it understood and utilized the principles set forth above for ascertaining the existence of a unitary business operation, it reached an inappropriate result by virtue of its attempt to apply those principles as between Albertson's and the Skaggs-Albertson's partnership instead of between Albertson's, Inc. and Texas-Albertson's. Internal Revenue Code, 26 U.S.C. § 701 provides:

§ 701. Partners, not partnership, subject to tax

A partnership as such shall not be subject to the income tax imposed by this chapter. Persons carrying on business as partners shall be liable for income tax only in their separate or individual capacities.

The tax treatment of partnerships is explained in Bittker & Eustice, *Federal Income Taxation of Corporations and Shareholders*, Section 1.07, p. 1-26 (4th Ed. 1979).

Partnerships are not taxed as such (§ 701), but each partner is taxed on his share of the firm's income, whether it is distributed to him or not. Under the prevailing conduit theory, the character of such items as ordinary income, capital gains and losses, charitable contributions, tax exempt interests, etc., carries over to the partner (§ 702).

Idaho Code § 63-3002 provides in part:

Declaration of Intent.--It is the intent of the legislature by the adoption of this act, insofar as possible to make the provisions of the Idaho act identical to the provisions of the Federal Internal Revenue Code relating to the measurement of taxable income, ... by the application of the various provisions of the Federal Internal Revenue Code relating to ... taxation of trusts, estates, partnerships and corporations....

The Tax Commission has never attempted to combine the Skaggs-Albertson's partnership with Albertson's, Inc. under the unitary principle. Only the wholly-owned subsidiary corporation was included in the Commission's combination. This is evidenced by the explanation of items contained in the Notice of Deficiency Determination and by the decision of the Tax Commission. The Tax Commission did not combine the partnership with Albertson's and include the partnership's income with Albertson's. The Tax Commission assigned Texas-Albertson's distributive share (50%) of the Partnership's income, deductions, and apportionment factors to Texas-Albertson's and this share of the income belonging to Texas-Albertson's was combined with Albertson's income, and apportioned under the UDITPA formula in order to accurately reflect Albertson's income in Idaho. The result thus reached is exactly what Albertson's would have paid in Idaho taxes had the subsidiary never been formed.

[Appeal of Albertson's Inc, No. 82-SBE-211 \(Cal. State Bd. of Equalization Sept. 21, 1982\).](#)

Summary: This is an example of California finding the existence of a unitary relationship while disregarding ownership requirements, noting that interests in partnerships are treated somewhat differently. The Board also noted that lack of control over the partnership business, by itself, does not preclude unitary treatment of a partner and its share of the partnership business.

Under the UDITPA regulations, interests in partnerships are treated somewhat differently. Subdivision (e) of regulation 25937 provides that if the partnership's activities and the taxpayer's activities constitute a unitary business under established standards, disregarding ownership requirements, the taxpayer's share of partnership income and apportionment factors is included in the taxpayer's combined report, (Cal. Admin. Code, tit. 98, reg. 25937, subd. (e) (art. 2.5).) We have previously decided that the provisions of this regulation should be used in apportioning and allocating partnership income for all years to which UDITPA is applicable. (Appeal of Saga Corporation, Cal. St. Bd. of Equal., June 29, 1982.)

The burden is on appellant to prove by a preponderance of the evidence that the unitary connections present were, in the aggregate, so trivial and insubstantial as to require a holding that a single unitary business did not exist. (Appeal of Saga Corporation, supra.) Appellant has failed to carry that burden.

Appellant contends that its own activities and those of the partnership do not constitute a unitary business under either of the two tests for unity. It argues that appellant did not control the partnership, the two entities were engaged in distinct kinds of business, there was no integration of executive forces, no sharing of significant knowledge, and no intercompany product flow or centralized purchasing. Appellant maintains that it was simply an investor and that the partnership operated independently of the partners.

Although agreeing that regulation 25137, subdivision (e) does not require more than 50 percent ownership of the partnership, appellant argues that control of the partnership by the taxpayer is still necessary for a finding of unity. It urges that only where one partner dominates the partnership, either through the terms of the partnership agreement, economic power, or otherwise, may that partner and the partnership be considered unitary. Because appellant and Skaggs have

equal control over the partnership, appellant concludes that it cannot be found to be unitary with the partnership,

The ownership requirement for unity contemplates an element of controlling ownership over all parts of the business. (Appeal of Revere Copper and Brass, Inc., *supra*.) The concept of control over the entire business is fundamental in the case of affiliated corporations because where unity is found between such corporations, all the income and apportionment factors of each corporation are combined to determine the California taxable income. Partnerships are appropriately treated differently because they are not taxable entities and only the partner's distributive share of partnership income and apportionment factors will be included in the combined report. We believe that in stating that unity is to be determined without regard to ownership requirements, regulation 25137, subdivision (e), refers not merely to percentage ownership requirements, but also to controlling ownership over the business. We conclude, therefore, that lack of control over the partnership business, by itself, does not preclude unitary treatment of a partner and its share of the partnership business.

Appellant argues that it was engaged in a very different type of business from that of the partnership, pointing out the differences in concept, trade areas, and merchandising approach. The similarities between the types of business engaged in, however, are obvious and significant. Appellant was in the business of selling groceries and some general merchandise, the latter receiving increasing emphasis during the appeal years. The partnership sold both groceries and general merchandise, apparently devoting a larger portion of floor space to general merchandise than did appellant. This difference in proportion of the type of goods sold does not detract to any great extent from the basic similarity in at least the grocery business in which both entities engaged. It is neither unfair nor unwarranted to conclude that the two were, to a significant degree, engaged in similar types of businesses.

The integration of executive forces was manifest in the instant situation, with the chief officers of appellant at all times serving on the partnership's administrative committee. Integration of top executive forces is an influential factor in determining unity; for the partnership "to have the assistance and direction of high executive authority of such a corporation ... is an invaluable resource." (Chase Brass and Copper Co. v. Franchise Tax Board, 10 Cal.App.3d496, 504 (87 Cal.Rptr. 239) (1970).) The partnership had not only the assistance and direction of the particular executives of appellant who served on the administrative committee, but also that of appellant's entire decision-making executive force, since the partners themselves approved such major decisions as substantial asset commitments and long-range objectives.

Similarity in the types of businesses and integration of executive forces lead almost inevitably to the conclusion that a mutually beneficial exchange of knowledge occurred between two entities, (Appeal of Anchor Hocking Glass Corporation, Cal. St. Bd. of Equal., Aug. 7, 1967.) We find totally unconvincing appellant's bare statement that such a conclusion in this case is unjustified. A partnership could be formed between any two investors who would then hire all the expertise needed to run a combination store, but when a grocery store operator and super drug store operator join to create a chain of combination stores, they clearly do so because each has valuable knowledge and expertise to contribute. That the partners in Skaggs-Albertson's recognized and took advantage of this situation is demonstrated by the fact that they joined and succeeded in this effort after each had previously made an unsuccessful attempt to integrate the other's type of operation into its own.

The partnership's ability to turn to appellant for necessary financial aid is also an indicator of unity. (Appeal of I-T-E Circuit Breaker Company, Cal. St. Bd. of Equal., Sept. 23, 1974.) Appellant supplied the partnership with a \$400,000 loan during the appeal years when it needed extra money for a purchase. In addition, appellant executed approximately one-half of the leases for the partnership and essentially acted as guarantor on them after they were assigned to the partnership. The partnership was thus able to make use, at least indirectly, of appellant's credit. Such indirect financial assistance has also been found to point toward unity. (Container Corp. of

America v. Franchise Tax Board, 117 Cal.App.3d 988 __ Cal.Rptr __] (1981), prob. juris. noted, May 3, 1982, __ U.S. __ (Dock. No. 81-523.)

Appellant also provided the partnership with economic research and computer time. Even though the partnership paid for these items, and could have obtained them elsewhere, the very fact that they were obtained from appellant indicates that the parties found a mutual benefit in this arrangement. (Cf. Chase Brass & Copper Co. v. Franchise Tax Board, supra, 10 Cal.App.3d at 503 (loans).) The partnership also used some of the same or similar advertising and public relations programs as appellant, and used appellant's accounting firm for every other audit. While perhaps not extremely significant individually, these factors in the aggregate fill in the already clear outline of unity which is present in this situation.

The foregoing factors, in the aggregate, show a degree of contribution and dependency between appellant and the partnership which fully satisfies us that respondent's finding of unity was appropriate. The elements of the partnership's independence and separateness emphasized by appellant are simply insufficient to convince us that the partnership was not engaged in a unitary business with appellant. Respondent's action, therefore, is sustained.

[Appeal of Saga Corp., No. 82-SBE-102 \(Cal. State Bd. of Equalization June 29, 1982\).](#)

Summary: This is an example of California finding the existence of a unitary relationship based upon substantial contribution and dependency for blended apportionment.

The Scope partnership owned and constructed the Westbridge dormitory complex which CHI leased and operated and for which Saga provided food services. Appellant contends that Scope's activities were not part of appellant's unitary business and none of the income from Scope should be included in apportionable business income.

Appellant first argues that our decisions in Appeal of Custom Component Switches, Inc., decided February 3, 1977 and Appeal of H. F. Ahmanson & Company, decided April 25, 1965 "stand for the proposition that no part of a partnership's property is combined with the property of any related entity in order to apportion the combined income of the partnership and such entity." However, as appellant admits, unitary treatment was not an issue in those appeals. They dealt solely with the source of a partnership's income, and thus do not support appellant's interpretation.

Unitary treatment of a partnership and a corporate partner, based upon either of the two general Pup 'N' Taco Drive Up. Order Denying Petition for Rehearing and Substituting Opinion, Cal. St. Bd. of Equal., Jan. 11, 1978. In the present appeal, we find that unitary treatment is warranted by the substantial contribution and dependency which existed between Scope and the unitary business.

Appellant mentions, without discussing, the issue of whether a corporation is required to own more than 50 percent of a partnership before the corporation's share of partnership income and apportionment factors may be included in a combined report. The same issue was raised, but not decided, in Appeal of Pup 'N' Taco Drive Up, supra. It arises here only with respect to the inclusion of CHI's share of Scope, since Saga clearly met any ownership requirement. In this appeal, as in Pup 'N' Taco, respondent argues that unity of ownership exists per se between a corporation and a partnership to the extent of the corporation's actual ownership interest in the partnership. In support of this position, respondent points out that a partnership is not a separate taxable entity and that the partnership income and apportionment factors are included in the combined report only to the extent of the corporate partner's actual ownership interest.

We find respondent's argument convincing. The same position is reflected in respondent's regulation 25137, subdivision (e), filed November 15, 1974. (Cal. Admin. Code, tit. 18, reg. 25137, subd. (e).) Although this regulation may not be controlling for earlier years (see Appeal of Pup 'N' Taco Drive Up; supra), the rationale is compelling, and for the sake of consistency and uniformity under the Uniform Division of Income for Tax Purposes Act (UDITPA), we believe that

respondent's theory should be used in apportioning and allocating partnership income for the years to which UDITPA is applicable. Therefore, Saga's and CHI's shares of the partnership items must be included in the combined report if Scope is otherwise found to be part of the unitary business.

Appellant states that the businesses of Scope and Saga were radically dissimilar and there was no actual, significant contribution to or dependence upon one another. It concludes that Scope was clearly not unitary with Saga. This assertion, however, does nothing to refute the contribution and dependency apparent in the functional integration of Scope with the unitary business. Saga made loans to Scope at various times. Scope owned the land and buildings which were leased and operated by CHI. A Saga subsidiary provided food service for the facilities. Through Scope, the unitary business not only had a guaranteed market for its services, but also was able to keep additional income within the group. This is unquestionably a relationship requiring unitary treatment and we find, therefore, that Saga's and CHI's distributive shares of Scope's income and apportionment factors should be included in the combined report.

[Appeal of Willamette Industries, Inc. No. 87-SBE-053 \(Cal. State Bd. of Equalization June 17, 1987\).](#)

Summary: This is an example of California finding the existence of a unitary relationship while disregarding ownership requirements, noting that interests in partnerships are treated somewhat differently. The Board also found that unitary combination does not require that a partner have control of the partnership that is combined.

Under the UDITPA regulations, interests in partnerships are treated somewhat differently. Regulation 25137-1 provides that if the partnership activities and the taxpayer's activities constitute a unitary business under established standards, disregarding ownership requirements, the taxpayer's share of partnership income and apportionment factors is included in the taxpayer's combined report. (Cal; Admin. Code, tit. 18, reg. 25137-1, subd. (f) (art. 2.5).) This, of course, is the regulation which respondent has applied in this case. Appellant contends, however, that this regulation is invalid as applied to partnerships where the taxpayer-partner does not have more than 50-percent control of the partnership. Appellant's position is based on its analysis of sections 25101-25105 and rests in large part upon the proposition that section 25102, rather than section 25101, provides the statutory authority for filing combined reports and that only corporations or other "persons" which satisfy the more-than-50-percent ownership requirement of section 25105 may be combined.

It is well settled, however, that section 25101, not section 25102, constitutes the statutory authority for combined reports in the context of formula apportionment of the income of a multi-corporate and multijurisdictional unitary business. (See, e.g., *Edison California Stores, Inc. v. McColgan*, supra; *Appeal of Revere Copper and Brass Incorporated*, supra; *Appeal of Douglas Furniture of California, Inc.*, supra.) Section 25102 and its companion sections, such as section 25105, are directed toward the problem of determining which one of a group of related entities is the proper source of particular items of income or deduction, while section 25101 is concerned with identifying the geographical source of the income of a unitary business. (See *Appeal of Revere Copper and Brass Incorporated*, supra.) Only the latter is at issue here. We conclude, therefore, that sections 25102 and 25105 are not applicable and that regulation 25137-1 does not conflict with them and is not invalid insofar as it provides for unitary combination of partnerships where the taxpayer owns less than a majority interest.

Disregarding the ownership question, then, the issue becomes whether the activities of the joint venture and appellant's activities constituted a unitary business under the established standards. On this issue, appellant has the burden of proving, by a preponderance of the evidence, that the unitary connections present were, in the aggregate, so trivial and insubstantial as to require a holding that a single unitary business did not exist. (*Appeal of Saga Corporation*, Cal. St. Bd. of Equal., June 29, 1982.) Appellant has not met its burden. The record shows that appellant's predecessor invested in the joint venture for the express purpose of securing a

dependable source of supply for certain veneers to be used in its Oregon plywood operations. During the appeal years, the operation of appellant's unitary business was aided by substantial purchases of veneers from the joint venture. In addition, appellant purchased significant amounts of waste materials from the venture for use in making particleboard and as fuel. A substantial flow of goods and raw materials in this fashion is one of the hallmarks of a vertically integrated unitary enterprise. (See, e.g., Appeal of Nippondenso of Los Angeles, Inc., Cal. St. Bd. of Equal., Sept. 12, 1984; Appeal of Monsanto Company, Cal. St. Bd. of Equal., Nov. 6, 1970.) When coupled with the accounting services and insurance coverage appellant provided to the joint venture, these sales are certainly sufficient to establish the "flow of value" that is the prerequisite to a constitutionally acceptable finding of a unitary business. (See *Container Corp. v. Franchise Tax Board*, 463 U.S. 159, 178 [77 L.Ed.2d 545] (1983).

Appellant emphasizes two points in arguing that the necessary unitary connections were absent. First, appellant contends that our cases require controlling ownership over all the parts of a business which are combined in a single combined report, and that "control" over the joint venture rested with the Freres interests rather than with appellant. The cases cited, however, all involve corporations rather than partnerships or joint ventures. (See Appeal of Douglas Furniture of California, Inc., supra; Appeal of Taylor Topper, Inc., Cal. St. Bd. of Equal., Jan. 31, 1984; Appeal of Revere Copper and Brass Incorporated, supra.) The proper rule for partnership-type arrangements was set out in the Appeal of Albertson's, Inc., decided by this board on September 21, 1982, where we held that unitary combination does not require that a partner have control of the partnership that is combined. This holding followed from the fact that, unlike a corporate shareholder, only the partner's ownership interest in the partnership's income and apportionment factors may be combined, and that combination is proper even though that ownership interest is less than a majority interest.

Appellant's second contention is that the joint venture cannot be unitary unless it is shown to be directly connected with the portion of appellant's unitary business conducted in California. This position is contrary to a long line of cases beginning with the Appeal of Monsanto Company, supra, wherein we held that it is sufficient if the out-of-state operations in question are only indirectly connected with the specific portion of the unitary business carried on in California, and appellant requests that we reconsider these cases. We decline the invitation. In the first place, there is evidence of a direct connection in this case, since appellant's tax manager testified that appellant buys wood chips from the joint venture for use in appellant's paper-making operations, which are part of appellant's admitted unitary business and are carried on, in part, in California. In the second place, we do not agree that the Supreme Court's decisions in *ASARCO, Inc. v. Idaho State Tax Comm'n*, 458 U.S. 307 [73 L.Ed.2d 787] (1982), and *Container Corp. v. Franchise Tax Board*, supra, support appellant's theory. As the court said in *Container*, the relationship between the in-state and out-of-state activities of the purported unitary business must simply amount to "some sharing or exchange of value not capable of precise identification or measurement — beyond the mere flow of funds arising out of a passive investment or a distinct business operation — which renders formula apportionment a reasonable method of taxation." (*Container Corp. v. Franchise Tax Board*, supra, 463 U.S. at 166.) In the present case, we have found an operational relationship between the joint venture and the rest of appellant's unitary business activities. Clearly, the joint venture was not merely a passive investment or distinct business operation whose only function was to serve as a source of funds to appellant.

We likewise disagree with appellant's contention that *Chase Brass & Copper Co. v. Franchise Tax Board*, 10 Cal.App.3d 496 [87 Cal.Rptr. 2399], app. disp. and cert. den., 400 U.S. 961 [27 L.Ed.2d 381] (1970), requires that the Monsanto line of cases be overruled. Even if appellant is correct that the "other metals" were excluded from the unitary business only because they were not directly connected with Chase's copper-related activities in California, we do not believe that such a rationale would be consistent with the theory and holding of the California Supreme Court in *Bdison California Stores, Inc. v. McColgan*, supra. In that case, the court sustained the application of the unitary combined report method to an entire group of corporations which had only one member doing business in California. The court nevertheless combined this

California subsidiary with its out-of-state parent and all of the parent's other out-of-state subsidiaries, even though it was clear that the only unitary relationship between the California subsidiary and the parent's other subsidiaries was an indirect one through the parent. In our view, this decision continues to accurately reflect the law of this state and it suffices to dispose of appellant's argument.

[BIS LP v. Director, Div. of Taxation, 26 N.J. Tax 489 \(Super. Ct. App. Div. 2011\).](#)

Summary: This cases analyzes the unitary issue in the partnership context.

In determining that a business is unitary, the relevant statutory provisions and regulations do not set forth an exhaustive list of elements or prescribe the weight attributable to different elements. The right to inspect books, records, reports, and returns does not show that BIS controlled Solutions. However, N.J.A.C. 18:7-7.6(g)(3) lists factors that might suggest a unitary business: the partnership interest is the only or the most substantial asset of the corporation; the partnership interest produces all or most of the income of the corporation; the corporation and the partnership are in the same line of business; there is substantial overlapping of employees and offices; and there is sharing of operational facilities, technology, or know-how.

Here, the partnership interest was BIS' only or most substantial asset, and it produced BIS' income. However, BIS was not in the same line of business as Solutions. Nor, as we have stated, was there a "substantial" overlapping of officers, and there was no sharing of offices, operational facilities, technology, or know-how.

Based on these arguments, the Director claims that BIS was doing business and derived receipts from New Jersey consistent with N.J.S.A. 54:10A-2 and -15.7, and N.J.A.C. 18:7-1.6 and -1.9. Judge Bianco, however, was aware of these statutory and regulatory provisions and applied them to the underlying facts. Reviewing the matter de novo, we are satisfied that the sharing of some [*499] corporate officers does not satisfy the requirements of the CBT Act and its implementing regulations. In addition, BIS was not in the same line of business as Solutions, and BIS did not control Solutions.

Next, the Director asserts that decisions of the United States Supreme Court support the claim that New Jersey may impose the CBT based on the unitary business of BIS and Solutions. The Director relies on *Mead-Westvaco Corp. v. Illinois Department of Revenue*, 553 U.S. 16, 128 S.Ct. 1498, 170 L.Ed.2d 404 (2008). In that case, the Court applied the unitary business principle and determined that the State of Illinois unconstitutionally taxed an apportioned share of the capital gain realized by an out-of-state corporation on the sale of one of its business divisions. *Id.* at 19, 128 S.Ct. at 1502, 170 L.Ed.2d at 409. The case does not support the Director's argument, other than to set forth the parameters of the governing principles that affect taxation of a unitary business. The Court explained:

The "broad inquiry" subsumed in both constitutional requirements [from the Commerce Clause and the Due Process Clause] is "whether the taxing power exerted by the state bears fiscal relation to protection, opportunities and benefits given by the state" — that is, "whether the state has given anything for which it can ask return." *ASARCO Inc. v. Idaho Tax Comm'n*, 458 U.S. 307, 315, 102 S.Ct. 3103, 3108, 73 L.Ed.2d 787, 794 (1982) (quoting *Wisconsin v. J.C. Penney Co.*, 311 U.S. 435, 444, 61 S.Ct. 246, 250, 85 L.Ed. 267, 270-71 (1940)).

The Director argues that Judge Bianco's resort to a formalistic application of the unitary business principle gives short shrift to the United States Supreme Court's acknowledgement in *Allied-Signal, Inc. v. Director, Division of Taxation*, 504 U.S. 768, 112 S.Ct. 2251, 119 L.Ed.2d 533 (1992), of the evolution of this principle and overlooks the legal standards that apply to BIS. In *Allied-Signal*, the Court explained that although a parent company might have the potential to operate its subsidiaries as integrated divisions of a single unitary business, that potential was not significant if the subsidiaries in fact comprise discrete business operations. *Id.* at 781, 112 S.Ct. at 2260, 119 L.Ed.2d at 548. The Court noted that three objective factors must be considered in determining whether related entities are unitary, that is, whether there exist: [*500] (1)

functional integration; (2) centralization of management; and (3) economies of scale. *Ibid.*, (citing *F.W. Woolworth Co. v. Taxation & Revenue Dep't of N.M.*, 458 U.S. 354, 364, 102 S.Ct. 3128, 3135, 73 L.Ed.2d 819, 828 (1982)).

Here, there was no functional integration nor economies of scale because BIS and Solutions were engaged in different businesses: BIS was an investment company (as the Director now concedes), and Solutions' business was banking information data processing. Sharing a mailing address and certain corporate officers does not show that there was centralized management for Solutions and BIS.

The Director claims that equally important is the "flow of values" between Solutions and BIS that the Court set forth in *Allied-Signal*, *mpa*, 504 U.S. at 783, 112 S.Ct. at 2260-61, 119 L.Ed.2d at 549. The Court explained:

[U]nitary business may exist without a flow of goods between the parent and subsidiary, if instead there is a flow of value between the entities. [*Container Corp. of Am. v. Franchise Tax Bd.*, 463 U.S. 159, 178, 103 S.Ct. 2933, 2947, 77 L.Ed.2d 545, 561 (1983)]. The principal virtue of the unitary business principle of taxation is that it does a better job of accounting for "the many subtle and largely unquantifiable transfers of value that take place among the components of a single enterprise" than, for example, geographical or transactional accounting. *Id.* at 164-165, 103 S.Ct. at 2940, 77 L.Ed.2d at 553 (citing *Mobil Oil [v. Comm'r of Taxes of Vt.]* 445 U.S. [425], 438-439 [100 S.Ct. 1223, 1232, 63 L.Ed.2d 510, 521-22 (1980)]).

Because BIS and Solutions were not involved in a single enterprise or line of business, the Court's discussion of a flow of value is not relevant here.

The Director argues that BIS' limited partnership interest in Solutions was its sole asset, with a reported value of \$158,708,606. Solutions was the sole source of BIS' \$49 million partnership distribution (with \$24,688,054 earned from New Jersey sources). The Director asserts that partnership distributions are considered business receipts pursuant to N.J.A.C. 18:7-8.12. The Director thus argues that BIS existed only to own ninety-nine percent of Solutions, to derive receipts from Solutions, and to attempt to profit tax-free from Solutions by exporting those taxable receipts from New Jersey.

This argument is flawed because the record does not support the claim that BIS was created only to attempt to export taxable receipts from New Jersey. Further, N.J.A.C. 18:7-8.12 does not specifically address partnership distributions as a business receipt to be taxed. Under the principles set forth by the United States Supreme Court and the New Jersey courts, and the statutory and regulatory framework in New Jersey, the Director has not shown that Judge Bianco erred in finding no constitutional basis for imposing the CBT at issue.

[Blue Bell Creameries, LP v. Roberts, 333 S.W.3d 59 \(Tenn. 2011\).](#)

Summary: This is a sale of interest case but discusses the operational function test as part of its analysis.

The United States Supreme Court has used the "operational-function" concept to determine whether income derived from assets such as stock is part of the Taxpayer's unitary business. *Allied-Signal, Inc.*, 504 U.S. at 787, 112 S.Ct. 2251; accord *MeadWestvaco Corp.*, 553 U.S. at 29, 128 S.Ct. 1498 ("The concept of operational function simply recognizes that an asset can be part of a taxpayer's unitary business even if what we may term a 'unitary relationship' does not exist between the 'payor and payee.'"); see Walter Hellerstein, *MeadWestvaco and the Scope of the Unitary Business Principle*, 108 J. Tax'n 261, 263 (May 2008) ("[T]he Court explicitly embraced the 'operational-function' concept as a basis for apportionability of income from assets." (emphasis in original)). The United States Supreme Court has held that income from a capital transaction such as the Stock Transaction and the reorganization is part of a taxpayer's unitary business if the capital transaction serves an operational function rather than an investment function. *Allied-Signal, Inc.*, 504 U.S. at 787, 112 S.Ct. 2251. An asset serves an operational function if the

asset helps the taxpayer make better use of the taxpayer's existing business-related resources. *Container Corp. of Am. v. Franchise Tax Bd*, 463 U.S. 159, 178, 103 S.Ct. 2933, 77 L.Ed.2d 545 (1983). The United States Supreme Court has stated that an investment function serves to diversify the entity and reduce the risks associated with "being tied to one industry's business cycle." *Id.* For the Department to be entitled to judgment as a matter of law as to this constitutional issue, therefore, the uncontested facts must show that the Stock Transaction and reorganization served an operational function.

Taxpayer contends, however, that the Stock Transaction and reorganization were BBC USA's activities. In support, it points to the uncontested fact that BBC USA implemented and controlled the reorganization, including the Stock Transaction. Although the reorganization resulted in Taxpayer's formation, Taxpayer states that it was a passive participant in the reorganization and Stock Transaction. Taxpayer further asserts that BBC USA is not unitary with Taxpayer's ice cream business in Tennessee.

The operational-function concept is limited to determining when earnings from assets are part of the taxpayer's unitary business. Assuming arguendo that the Stock Transaction and reorganization were exclusively BBC USA's activities, the United States Constitution would prohibit the Department from taxing Taxpayer for capital gains from the Stock Transaction unless it first determined that BBC USA was unitary with Taxpayer's ice cream business. See *MeadWestvaco Corp.*, 553 U.S. at 29-30, 128 S.Ct. 1498. We therefore consider whether BBC USA and Taxpayer are unitary pursuant to the unitary business principle.

It is uncontested that BBC USA is a separate business entity from Taxpayer. To determine whether two separate business entities form a unitary business, we must look beyond the superficial divisions between parent corporations and their subsidiaries to the "underlying activity" generating the income. See *Mobil Oil Corp. v. Comm'r of Taxes*, 445 U.S. 425, 440-41, 100 S.Ct. 1223, 63 L.Ed.2d 510 (1980). To be an unrelated business activity, the separate business entity must constitute a "discrete business enterprise" from the taxpayer. *Exxon Corp.*, 447 U.S. at 223-24, 100 S.Ct. 2109.

For Taxpayer and BBC USA, the only underlying activity generating income is the production, sale, and distribution of Blue Bell ice cream. BBC USA may be a separate business entity, but it is uncontested that BBC USA does not conduct any business operations of its own. Furthermore, BBC USA exists as a separate business entity to channel income from Taxpayer to BBC USA's stockholders without incurring a Texas franchise tax, according to William Rankin, the Chief Financial Officer of Taxpayer's general partner. Mr. Rankin also characterized BBC USA and BBC USA's subsidiaries as part of the singular ice cream business and characterized the stockholders of BBC USA as investors in the ice cream business. Because both entities derive their income from a single underlying activity, we hold that BBC USA is unitary with Taxpayer's Blue Bell ice cream business.

[Chiron Corp. v. Director, Div. of Taxation, 21 N.J. Tax 528 \(Tax Ct. 2004\).](#)

Summary: This case analyzes the unitary issue for purposes of blended apportionment.

Having determined that the joint business constitutes a partnership, and thus a separate entity for CBT purposes, I next must address plaintiff's argument that it was so integrated with the entity that plaintiff's income allocation factor under N.J.S.A. 54:10-6, and therefore the sales fraction component of the allocation factor, should be calculated using the flow through method (denominated "flow through accounting apportionment" in N.J.A.C. 18:7-7.6(g)).

If the flow through method is not applicable, the separate entity method (denominated "separate accounting apportionment" in N.J.A.C. 18:7-7.6(g)) would be used to calculate the allocation factor, and thus the sales fraction, for a corporation, such as plaintiff, owning a partnership interest. N.J.A.C. 18:7-7.6(g)(1) and Example I. See also New Jersey Division of Taxation, Technical Bulletin-3, issued June 21, 1991 and expiring June 30, 1992 (discussed below). Under the separate entity method, the corporation's allocation factor, and thus its sales fraction, is calculated

by determining a separate allocation factor (using a separate sales fraction) for the partnership and a separate allocation factor (using a separate sales fraction) for the corporation. The partnership's sales fraction has, as its numerator, the partnership's New Jersey receipts (as defined in N.J.S.A. 54:10A-6(B)) and, as its denominator, the partnership's total receipts. The corporation's sales fraction has, as its numerator, the corporation's New Jersey receipts and, as its denominator, the corporation's total receipts, with receipts attributable to the partnership excluded from both the numerator and denominator. Separate property and payroll fractions for the partnership and for the corporation also are calculated using a similar methodology. The allocation factor (representing, for the years under appeal, an average of the sales, property, [*544] and payroll fractions³) for the partnership then is multiplied times the corporation's distributive share of partnership income, and the allocation factor for the corporation is multiplied times the corporation's income exclusive of its distributive share of partnership income. The total of the two amounts so determined constitutes entire net income (defined in N.J.S.A. 54:10A-4) used to calculate CBT liability under N.J.S.A. 54:10A-5 (setting forth how the tax is to be computed).

Under the flow through method, a single allocation factor is calculated for the partnership and the corporation. The sales, property, and payroll fractions comprising the allocation factor have, as their respective numerators, the corporation's New Jersey receipts, New Jersey property, and New Jersey payroll (including the corporation's share of the partnership's New Jersey receipts, property, and payroll, respectively). The fractions have, as their respective denominators, the corporation's total receipts, property, and payroll (including the corporation's share of the partnership's total receipts, property and payroll, respectively). The single allocation factor is then multiplied times the corporation's entire net income, including its distributive share of partnership income, and the amount so determined constitutes entire net income used to calculate the corporation's CBT liability. N.J.A.C. 18:7-7.6(g)(2) and Example III. See also Technical Bulletin-3, *supra*.

Under the facts before me, I infer that, under the separate entity method, the allocation factor by which the Partnership's income would be multiplied to determine plaintiff's share of Partnership income taxable in New Jersey would be larger than the allocation factor by which plaintiff's income (including income from the Partnership) would be multiplied under the flow through method. That is, the denominator of the flow through method allocation factor would be larger in relation to the numerator than would be the case for the separate entity method allocation factor calculated for the Partnership alone. I further infer that this [*545] would occur because the sales fraction included in plaintiff's flow through method allocation factor would be reduced by plaintiff's substantial non-Partnership revenues derived from business outside New Jersey, and because plaintiff's property and payroll fractions would be significantly smaller than its sales fraction. Consequently, under the flow through method, the amount of plaintiff's distributive share of Partnership income allocated to New Jersey would be lower than the amount allocated under the separate entity method.

Plaintiff's contention that the flow through method should be used is based on Technical Bulletin No. 3, issued by the Division of Taxation on June 21, 1991, and published in State Tax News, N.J. Div. of Taxation, 20 State Tax News, May/June 1991 at 49-51. The Bulletin states that the Division generally treats a partnership as a separate entity from its partners and that, consistent with this theory, "the only item that a corporate partner may reflect in its New Jersey allocation factor is the partner's distributive share of partnership income." The Bulletin then sets forth circumstances under which the flow through method may apply:

In a particular instance a partnership may be so integrated with a corporate taxpayer's business and/or the entity theory may lead to such a distortion or elimination of the entire net income of the corporate partner that either the taxpayer or the Division may look through the entity to the partnership's nexus and/or apportionment factors under an aggregate approach.

In such a situation, nexus may exist by virtue of the partnership's activities in New Jersey, and the receipts, property and payroll of the partnership may be included in a corporate taxpayer's fractions of its allocation factor.

Facts that either singly or in combination may suggest that a flow-through approach may be appropriate include:

substantial intercompany-partnership transactions;

the partnership interest is the only or the most substantial asset of the corporation, or the partnership interest produces all or most of the income of the corporation;

the corporation and partnership are in the same line of business;

SUBSTANTIALOVERLAPPINGEMPLOYEESANDOFFICERS;

sharing of operational facilities, technology and/or know-how.

[New Jersey Division of Taxation, Technical Bulletin-3, Issued June 21, 1991 and expiring June 30, 1992.]

In 1997, after the last year under appeal in this matter, the Director incorporated the contents of the Technical Bulletin into [*546] his regulations under the CBT Act. N.J.A.C. 18:7-7.6(g). 29 N.J. Reg. 1686(a) and 4327(a) (1997).

Plaintiff contends that it and the Partnership are integrated, and, therefore, the requirements of the Technical Bulletin use of the flow through method are satisfied. Specifically, plaintiff contends that it satisfies the five factors set forth in the Bulletin as follows: 1) the sales by plaintiff to the Partnership of antigens and antibodies constitute substantial intercompany-partnership transactions; 2) the Partnership interest produces most of plaintiff's income, representing between 38% (for 1993 and 1994) and 50% (for 1992) of its gross income and between 180% and 608% of its net income (plaintiff having suffered losses on other aspects of its business); 3) plaintiff and the Partnership are in the same line of business, that is, developing tests to be used for detecting HCV and HIV; 4) there is substantial overlapping of employees and offices because three of plaintiff's senior executives serve as members of the six-member supervisory board, and employees of plaintiff performing their work for it are simultaneously performing work which benefits the Partnership; and 5) the Partnership and plaintiff share technology and/or know-how as evidenced by the licenses granted by plaintiff and ODS to each other under the 1989 Agreement and their continuing every day business relationship in developing and marketing Products.

The Director contends that plaintiff fails to satisfy any of the five factors for the following reasons: 1) the sales of antibodies and antigens by plaintiff to the Partnership do not constitute the type of intercompany-partnership transactions contemplated by the Technical Bulletin; 2) although, at least on a net income basis, plaintiff's interest in the Partnership produces most of its revenue, if plaintiff's other business ventures become profitable, then plaintiff will no longer have most of its revenues derived from the Partnership; 3) plaintiff and the Partnership are not in the same line of business, with plaintiff's business being research and [*547] development of antigens and antibodies and the Partnership's business being the use of those antigens and antibodies to develop, produce and market blood testing kits; 4) the service of three of plaintiff's senior executives on the Partnership's supervisory board does not constitute a substantial overlapping of employees or officers and plaintiff's employees do not work for the Partnership; 5) there is no use by plaintiff's employees or officers of any offices which are also used by the Partnership; and 6) the sharing of technology and know-how is limited to the specific purposes of the 1989 Agreement and there is no general agreement to share technology and know-how by plaintiff or by ODS.

The Technical Bulletin states that the factors articulated by the Director "either singly or in combination may suggest" that the flow-through approach "may be appropriate." Although I conclude that the relationship between plaintiff and the Partnership is such as to satisfy more than one of the factors in the Bulletin, I also conclude that, given the non-definitive language of the Bulletin ("may suggest" and "may be appropriate"), the factors are merely indicators that the Division will consider. The critical issue is whether the corporate partner and the partnership are "integrated" and parts of a "unitary business." See N.J.A.C. 18:7-7.6, Example III (applying the flow-through method when a corporation is "unitary with a partnership" and "there is a sufficient integration of assets and business activities"). Here, for the reasons discussed below, the relationship between plaintiff and the Partnership is not unitary or integrated. Therefore, plaintiff does not qualify for use of the flow through method.

The Technical Bulletin factor most obviously satisfied is the second, relating to the derivation of most of plaintiff's revenue from the Partnership. The Director is correct that plaintiff's receipts from other ventures may change and may diminish the significance of the revenues from the Partnership, but, during the years under appeal, those revenues were the most significant element of plaintiff's total revenue picture, both on a gross and net basis. The relationship between plaintiff and the Partnership also satisfies the fifth factor relating to sharing of technology. The sales of antigens and antibodies by plaintiff to the Partnership [*548] could satisfy the first factor relating to substantial intercompany-partnership transactions but I need not decide that issue.

Other factors set forth in the Bulletin are not satisfied and suggest a lack of integration between plaintiff and the Partnership. Plaintiff and the Partnership are not in the same line of business (the third factor). Viewed from the perspective of the Partnership, plaintiff's business simply is one aspect of the Partnership's business, namely, providing research and supplying antigens and antibodies. Plaintiff is not in the business of producing blood testing kits and marketing them throughout the world. Its inability to do so is precisely the reason for its entering into a relationship with ODS. The relationship between plaintiff and the Partnership does not satisfy the fourth factor relating to substantial overlapping of employees and offices (or officers). As indicated above, plaintiff's employees do not use offices of the Partnership. The Partnership's offices are the offices of ODS and are used by ODS personnel. The service by three executives of plaintiff on the supervisory board does not constitute a substantial overlapping of employees or officers. That work performed by plaintiff's employees and officers also benefits the Partnership does not mean that the employees or officers are working on behalf of the Partnership. Their employment is by plaintiff, and their work is directed by plaintiff.

The lack of integration between plaintiff and the Partnership is confirmed by the 1989 Agreement. As described above, the Agreement imposes on plaintiff significant obligations while imposing very few, if any, obligations on ODS. Plaintiff is obligated to provide to ODS the Partnership's requirements for antigens and antibodies, as determined solely by ODS. ODS has no obligation to have any such requirements, but does have a general obligation of good faith under the Agreement. Under the October 12, 1993 amendment, ODS no longer has any obligation to purchase any antigens or antibodies from plaintiff. ODS has no obligations under the Agreement to use its best efforts to produce and market blood testing kits using antigens and antibodies provided by plaintiff.[*549]

As to management of the Partnership, the Agreement provides, as described above, that, if the members of the supervisory board cannot agree on a budget or strategic plan for the following year, in most circumstances ODS alone has the right to make the budgetary decisions and develop the plan, including the right to change the allocation of responsibilities between the parties subject to plaintiff's retaining research responsibilities. See *Chiron Corp. v. Ortho Diagnostic Systems Inc.*, 207 F.3d 1126 (9th Cir.2000) (discussing an arbitrator's award enforcing a decision by ODS under the 1989 Agreement with which plaintiff disagreed). Under certain limited circumstances, a neutral third party may be required to make decisions in the event of a

deadlock, but, generally, if the business venture is successful, ODS retains total control of the budget and strategic plan, the two most critical elements of the business operation.

Not only does plaintiff have limited management rights under the 1989 Agreement and far greater responsibilities and obligations than ODS, but also plaintiff has the express right under the Agreement (as does ODS) to continue with other business ventures not involving the sale of antibodies and antigens as contemplated by the Agreement. As financial figures submitted by plaintiff indicate, the Partnership's operations represent no more than one-half of plaintiff's gross revenues.

The Partnership represents a successful business venture by plaintiff, but plaintiff has not relinquished its independence and does not have a position of parity with ODS in terms of obligations and rights under the 1989 Agreement. In no sense, therefore, can plaintiff be deemed or viewed as unitary or integrated with the Partnership. Consequently, even though several of the factors permitting use of the flow through method appear to be satisfied, I conclude that use of the method would be inappropriate and would result in a distortion of the sales fraction and thus plaintiff's allocation factor. See N.J.S.A. 54:10A-10 (authorizing the Director to adjust entire net income allocable to New Jersey, and other items, in order to make "a fair and reasonable determination of the amount of tax payable under [the CBT] act."). The separate entity approach, as generally applicable under the Director's [*550] Technical Bulletin and later regulation, does not result in a distortion of the sales fraction, and thus does not result in a distortion of the allocation factor to be used by plaintiff for purposes of calculating its CBT obligations to this State.

[Cook v. Oregon Dept. of Rev., No. TC 5298 \(Or. Tax Ct. Aug. 17, 2018\).](#)

Summary: This case addressed whether individual taxpayers can use blended apportionment for unitary flow-through businesses.

In this case, the department is not arguing that partnerships that have a unitary relationship must file combined reports including all entities and then apportion income to individual owners. That would be impossible to administer in cases where a nonresident partner, as taxpayer in this case, had different percentage ownerships in the several PTEs. This impossibility is not found in the case of shareholders in Subchapter C corporations that file unitary returns under ORS chapter 317. The reason for this is that such shareholders do not have potentially differing interests in the various members of the corporate group. The department's attempt to apply unitary rules developed in connection with Subchapter C corporations to partnerships fails to take into account this fundamental reality. Or, perhaps better stated, the department attempts to escape the reality by moving apportionment from the entity to the owner level. obligation for the PTE to withhold is triggered when the PTE has "distributive income from Oregon sources." That, of course, requires the entity to determine, at the entity level, whether it has income from Oregon sources. The entity cannot rely on some later recalculation by an owner or an auditor, done at the owner level, to determine if the owner has distributive income from Oregon sources in respect of which it has a withholding obligation . . .

Nothing in the rule addresses the critical step in the department's method that combines incomes and apportionment factors. In the case of corporate partners, the combination of income and factors from partnerships with other income and factors occurs, if at all, based on the combination requirements effectively included in ORS 317.705 to 317.715. However, as discussed, such combination requires statutory authority beyond UDITPA and no such statutory authority exists in respect of nonresident individuals . . .

The court has considered the text of the partnership tax statutes, the context of those statutes, especially the provisions of the PTE statutes and rules, the history of combined reporting in Oregon and the text and context of UDITPA. None of these is consistent with the department position in this case—a position requiring what is essentially combined reporting and apportionment at the owner level.

Summary: The Court agreed with the taxpayer that blended apportionment could not be used unless there was a unitary relationship and that the unitary determination could not be attributed. The Court looked at functional integration, centralized management, and economies of scale in its unitary analysis. The Court also noted there was no evidence in the record suggesting that the corporate partner used the income it earned from the partnership as part of its own working capital or for any other operational purpose. The Supreme Court of Virginia declined to review the state Department of Taxation's petition for appeal on May 30, 2025.

Second, the Department argues that, under *Allied-Signal, Inc. v. Director, Division of Taxation*, 504 U.S. 768, 112 S. Ct. 2251, 119 L. Ed. 2d 533 (1992), even if FJM and PTC did not share any of the three unitary-business factors of functional integration, centralized management, and economies of scale, the Department could still constitutionally treat FJM and PTC as a unitary business for tax-apportionment purposes because FJM's ownership interest in PTC was not passive, and FJM took on an operational role in PTC's management. The Department bases its argument on a statement of the United States Supreme Court in *Allied-Signal* that, in determining whether two entities should be treated as a unitary business for tax-apportionment purposes, "the payee and the payor need not be engaged in the same unitary business as a prerequisite to apportionment in all cases" and that "[w]hat is required instead is that [a] capital transaction serve an operational rather than an investment function." *Allied-Signal*, 504 U.S. at 787.

The Department's position reflects a fundamental misunderstanding of *Allied-Signal's* "operational function" test. In *MeadWestvaco Corp. v. Illinois Department of Revenue*, 553 U.S. 16, 128 S. Ct. 1498, 170 L. Ed. 2d 404 (2008), the United States Supreme Court clarified that "[its] references to 'operational function' in *Container Corp.* and *Allied-Signal* were not intended to modify the unitary business principle by adding a new ground for apportionment" and that "[its] decisions in *Container Corp.* and *Allied-Signal* did not announce a new ground for the constitutional apportionment of extrastate values in the absence of a unitary business." *Id.* at 29-30. Rather, "[t]he concept of operational function [*516] simply recognizes that an asset can be a part of a taxpayer's unitary business even if what we may term a 'unitary relationship' does not exist between the 'payor and payee.'" *Id.* at 29 (quoting *Allied-Signal*, 504 U.S. at 791-92). Thus, "[i]n the example given in *Allied-Signal*, the taxpayer was not unitary with its banker, but the taxpayer's deposits (which represented working capital and thus operational assets) were clearly unitary with the taxpayer's business." *Id.* Put differently, "the 'payor' was not a unitary part of the taxpayer's business, but the relevant asset was." *Id.*

Under *Allied-Signal*, the question here is not whether FJM took on any non-passive, operational role in PTC's management. Rather, the proper question is whether the income that FJM earned from its minority ownership interest in PTC served an operational function in FJM's own independent business activities. Here, there is no evidence in the record before this Court on appeal suggesting that FJM used the income it earned from PTC as part of FJM's own working capital or for any other operational purpose related to FJM's independent business activities. Accordingly, reversal of the trial court's judgment under *Allied-Signal* is not warranted in this case.

C. Code § 58.1-391(B)

Finally, the Department asserts that Code § 58.1-391(B) supports the Department's position that FJM's income earned from PTC should be subject to the Virginia statutory apportionment method. Since PTC is a limited liability company that is treated as a partnership for income tax purposes, PTC is a "pass-through entity" and FJM is an "owner" of PTC,⁷ subject to the requirements of Code § 58.1-391(B), which provides:

Each item of pass-through entity income, gain, loss or deduction shall have the same character for an owner under this chapter as for federal income tax purposes. Where an item is not characterized for federal income tax purposes, it shall have the same character for an owner as if

realized directly from the source from which realized by the pass-through entity or incurred in the same manner by the pass-through entity.

The Department has interpreted Code § 58.1-391(B) to entail that

[f]or Virginia income tax purposes, income retains its character as income from the operations of a partnership in computing Virginia taxable income and is properly included in the apportionable income of the partner. This means that partners are considered to be operating in the business conducted by the partnership. As such, the Department generally presumes that the income passed through from a partnership to be operational.

P.D. 07-197 (Nov. 30, 2007). In upholding the Department's initial determination that FJM's income from PTC was properly subject to apportionment, the Tax Commissioner relied on the Department's interpretation of Code § 58.1-391(B) and summarily concluded that

[i]n this case, [PTC] operates a retail business. Therefore, the characteristics of the operator of the retail business would flow through to [FJM]. Because [FJM] is considered to be operating a retail business for income tax purposes, [PTC] is considered to be a unitary part of [FJM's] business.

"[I]nterpretation of a tax statute is a question of law reviewed de novo on appeal." *Commonwealth v. 1887 Holdings, Inc.*, 77 Va. App. 653, 658, 887 S.E.2d 176 (2023). Although "the Department 'administer[s] and enforce[s] the Commonwealth's tax laws,'" "it is the province of the courts to review an agency's interpretation of a statute de novo." *Id.* at 663-64 (alterations in original) (quoting *Nielsen Co. (US), LLC v. Cnty. Bd. of Arlington Cnty.*, 289 Va. 79, 88, 767 S.E.2d 1 (2015)). "[A] regulatory interpretation of a statute 'does not bind a court in deciding [a] statutory issue,'" and "'Virginia courts do not delegate' the responsibility of statutory construction 'to executive agencies.'" *Id.* at 664 (first quoting *Va. Dep't of Tax'n v. R.J. Reynolds Tobacco Co.*, 300 Va. 446, 455, 868 S.E.2d 429 (2022) (alterations in original); and then quoting *Berglund Chevrolet, Inc. v. Va. Dep't of Motor Vehicles*, 71 Va. App. 747, 752, 840 S.E.2d 19 (2020)). "[A]bsent ambiguity' in the statute, 'the plain language controls[,] and the agency's interpretation is afforded no weight beyond that of a typical litigant.'" *Id.* (alterations in original) (quoting *Nielsen*, 289 Va. at 88).

By its plain language, Code § 58.1-391(B) is concerned solely with the characterization of a pass-through entity's "income, gain, loss or deduction" for the pass-through entity's owners, requiring the character of such income, gain, loss, or deduction to be imputed to the owners for tax purposes. However, the statute's language does not extend so far as to require the business characteristics of the pass-through entity itself to be imputed to its owners, nor does the statute require the owners of the pass-through entity to be treated as conducting the business operations of the pass-through entity as part of a unitary business. In the context of constitutional tax apportionment, these are different analytical matters beyond the mere characterization of income, gain, loss, or deduction that are not directly addressed by Code § 58.1-391(B) and are ultimately beyond the scope of the statute.

By interpreting Code § 58.1-391(B) to treat every owner of a pass-through entity as conducting the pass-through entity's business operations, the Department has essentially created a presumption that every owner of a pass-through entity forms a unitary business with the pass-through entity, even when the actual economic reality is that no such unitary-business relationship exists. Such an approach could circumvent the United States Supreme Court's unitary-business test for constitutional tax apportionment—as demonstrated by the Tax Commissioner's cursory conclusion that "[b]ecause [FJM] is considered to be operating a retail business for income tax purposes, [PTC] is considered to be a unitary part of [FJM's] business." To the contrary, FJM presented sufficient evidence demonstrating that it did not share functional integration, centralized management, or economies of scale with PTC and thus did not form a unitary business with PTC. And it is this evidence—not the Department and Tax Commissioner's artificial presumptions—that carries the day in this case.

Florida TAA # 11C1-001(February 2, 2011)

Summary: This TAA discusses attribution in the context of blended apportionment.

Whether the taxpayer's sales, payroll, and property factors of the apportionment formula should include the taxpayer's interest in various partnerships . . .

The Florida statutes and rules are clear that the activities of a partnership flow through the partnership to its partners. In its letter dated XXX, the taxpayer states that the partnerships it invests in contain multiple layers of ownership, and the lower tiered and middle tiered partnerships do not report apportionment information to the top tiered partnership because they are not required to do so in the states where they are located. Therefore, the upper tiered partnerships do not have any way to report the apportionment information from the middle and lower tiered partnerships to the corporate partner (in this case the taxpayer).

For federal income tax purposes, partnerships generally have no formal federal filing requirement other than information returns, and because a partnership is a conduit, items of partnership income, expense, gain, or loss pass through to the partners and are given tax effect at the partner level. For state income tax apportionment purposes, a particular state's approach in this area dictates the flow-through of partnership tax attributes up to the corporate partner.

Florida's approach conforms to the federal concept of the flow-through of partnership tax attributes up to the corporate partner. The apportionment rule, Rule 12C-1.015(10), F.A.C., governs the corporate income tax treatment of corporations that invest in partnerships. This rule provides that a corporation that is a partner in a partnership must add its share of the partnership's property, payroll, and sales to its own apportionment factor. Based on the foregoing, the partnerships' property, payroll, and sales should be combined with the taxpayer's property, payroll, and sales, for purposes of determining the taxpayer's apportionment factor as provided by Rule 12C-1.0153(9), F.A.C., Rule 12C-1.0154(6), F.A.C., and Rule 12C-1.0155(4), F.A.C.

The taxpayer asserts that the tiered partnerships do not provide the taxpayer with their respective apportionment factors. Therefore, the taxpayer does not have the required apportionment information to correctly apportion its income in accordance with Rule 12C-1.015(10), F.A.C. However, the Florida statutes and rules are clear that the activities of a partnership flow through the partnership to its partners. Therefore, the activities of the partnership are attributable to the partners and, contrary to the statement in the taxpayer's letter, are unitary to the partners.

Hugo Neu-Proler Intl. Sales Corp. v. Franchise Tax Bd., 195 Cal.App.3d 326, 240 Cal.Rptr. 635 (App. 2d Dist. 1987).

Summary: This case considered attribution of ownership in the unitary analysis.

Whether or not a business is unitary is determined by the "three unities" test. (Ibid.) These are the three unities of ownership, operation and use set forth in *Butler Bros. v. McColgan* (1941) 17 Cal.2d 664, 678 [111 P.2d 334]. The parties agree that the business was unitary when Hugo Neu-Proler Company processed and sold the scrap metal. However, the Franchise Tax Board contends that unity of ownership was destroyed when Hugo Neu-Proler International Sales Corporation was incorporated.

Revenue and Taxation Code section 25105 defines "ownership," stating: "Direct or indirect ownership or control of more than 50 percent of the [*332] voting stock of the taxpayer shall constitute ownership or control for the purposes of this article." The Board asserts that since Hugo Neu and Sons, Inc., and Proler International Corporation each own 50 percent of Hugo Neu-Proler Company, which in turn owns 100 percent of Hugo Neu-Proler ISC's stock, neither Hugo Neu and Sons nor Proler International Corp. has "ownership or control of more than 50 percent of the voting stock of the taxpayer [Hugo Neu-Proler ISC]."

Plainly, neither partner directly controls more than 50 percent of Hugo Neu-Proler ISC's stock. However, section 25105 also contemplates "indirect ownership or control of more than 50 percent of the voting stock." (*Italics added.*) "Indirect ownership" is not defined in the code, nor have we found any prior cases which resolve the question.

The trial court ruled that indirect ownership was present, on two grounds: first, that the partnership owned 100 percent of the corporation's stock and exercised total control over it; and second, that ownership and control could be attributed to the business partners. We agree.

The case of *B. Forman Co. Inc. v. C.I.R.* (2d Cir. 1972) 453 F.2d 1144, is instructive. The court in *B. Forman* had to interpret section 482 of the United States Internal Revenue Code of 1954, concerning the allocation of income among taxpayers "owned or controlled directly or indirectly by the same interests," which is thus analogous to Revenue and Taxation Code section 25105. In that case, two unrelated corporations, McCurdy and Forman, each owned 50 percent of a third corporation, Midtown, the purpose of which was to build and operate a shopping center.

The court stated: "If Midtown was the creature of only one of the taxpayers, and all of its stock were owned by that single parent, i.e., if Midtown were a strange creature having a father, but no mother, the most rigid, literal wooden interpretation of section 482 would bring Midtown within the ambit of that section. It is the contention of the taxpayers, however, that section 482 is not applicable because Midtown is the normal child of a father and a mother, the product of an earthy relationship between McCurdy and Forman, twentieth century parents exercising no control over their progeny. [] Midtown is the creation of a union of McCurdy and Forman--not in holy matrimony but in a legitimate business enterprise. Their interests in the existence and career of Midtown and the interests of Midtown are identical. [] To contend that these parents do not control their child is to fly in the face of reality. They have had complete control of Midtown from the day of conception (its incorporation) throughout the years relevant to this case. Every act of Midtown has been dictated by papa and mamma [*333] who, directly or indirectly, have financed its career and controlled its every move." (*B. Forman Co., Inc. v. C.I.R.*, supra, 453 F.2d at p. 1153.)

We believe that the Board similarly flies from reality, and flees from common sense. While neither corporate partner alone had a controlling interest in Hugo Neu-Proler ISC, together they had absolute sovereignty over it. The Board's narrow and fastidious view prevents it from seeing that the interposition of Hugo Neu-Proler ISC did not work any substantive change in the overall scrap metal operation. The enterprise retained its unitary character. Thus, the trial court properly concluded that Hugo Neu-Proler ISC could not be considered a separate taxable entity.

[Hunt Corp. v. Dept. of State Revenue, 709 N.E.2d 766 \(Ind. Tax Ct. 1999\).](#)

Summary: Indiana rules require a unitary business to use blended apportionment. The Court found a unitary relationship existed based on active management by the corporate partner and a lack of evidence presented by the taxpayer.

Section 6-3-2-2 does not specifically address the question of whether a partnership's property, payroll, and sales factors may be considered in apportioning a corporation's business income derived from a corporate partnership. The regulation addresses this technical problem and provides a comprehensive description of the treatment of income derived from corporate partnerships. Mirroring the analysis required by section 6-3-2-2, the regulation makes the crucial distinction between the situation where the corporate partner's activities and the partnership's activities constitute a unitary business and when they do not.

The regulation provides that where the corporate partner's activities and the partnership's activities constitute a unitary business, "the business income of the unitary business attributable to Indiana shall be determined by a three (3) factor formula consisting of property, payroll, and sales of the corporate partner and its share of the partnership's factors...." IND. ADMIN. CODE tit. 45, r. 3.1-1-153(b). Where the corporate partner's activities and those of the partnership do

not constitute a unitary business, then the amount of the corporate partner's share of the income from the partnership that is attributed to Indiana is determined as follows:

(1) If the partnership derives business income from sources within and without Indiana, the business income derived from sources within Indiana, the business income derived from sources within Indiana shall be determined by a three (3) factor formula consisting of property, payroll, and sales of the partnership.

(2) If the partnership derives business income from sources entirely within Indiana, or entirely without Indiana, such income shall not be subject to formula apportionment.

Id. r. 3.1-1-153(c).

Whether the issue is analyzed with reference to section 6-3-2-2 alone or section 6-3-2-2 in conjunction with the regulation (assuming *arguendo* that the regulation is applicable to the tax years at issue), the Court must determine whether the members of the affiliated group and the partnerships were engaged in a unitary business or not. Hunt fails to mention this issue in its brief, despite the fact that the regulation (which is quoted in full in Hunt's brief) clearly requires its resolution before determining how the income from the corporate partnerships is to be attributed. Hunt simply quotes subsection (c)(1) of the regulation and asks the Court to blindly follow it. However, subsection (c)(1) only would apply if the corporate partners and the partnership are not engaged in a unitary business.

In its letter of findings, the Department found that the income from the corporate partnerships constituted business income, which means that the Department found that the corporate partners and the partnerships were engaged in a unitary business. (Schuster Aff'd Ex. 38, at 5). Hunt does not dispute this finding, and the Court will not presume that a dispute exists in the absence of the affirmative representations of the parties. Because Hunt has not designated any evidence that would call this finding into question, the Court will assume that the Department's conclusion is correct. Moreover, the evidence designated by Hunt actually supports the Department's conclusion. Mr. Schuster's affidavit demonstrates that Hunt played an active role in managing the corporate partnerships. (Schuster Aff'd ¶ 33). This supports the Department's conclusion that the corporate partnership income constituted business income. See *Lee v. Department of Revenue*, No. 3909, 1998 WL 283143, at *2 (Or. Tax Ct. May 14, 1998). The finding that the income from the corporate partnerships constituted business income for the affiliated group means that it was subject to factor apportionment.

[Indiana Letter of Findings 02-20191221 \(June 3, 2020\).](#)

Summary: Indiana rules require a unitary business to use blended apportionment. A unitary relationship was not found in this case. The analysis was conducted by looking at functional integration; centralized management; and economics of scale. The findings also noted that there was little or nothing in the record to show that the taxpayer had exercised operational control.

The issue is whether Taxpayer has established it shares a unitary business relationship with Gas Station LLC and that the Department's contrary decision - and the consequent assessment of additional corporate income tax - was wrong.

Both Indiana's Tax Court and the Supreme Court have laid out a blueprint for making such a determination. That blueprint calls for the parties to meet the "three unities" standard: functional integration; centralized management; and economics of scale. In other words, does the Taxpayer exercise "day-to-day operational control in the partnership" and is there a "flow of value between the entities"? *Hunt Corp.*, 709 N.E.2d at 769; *Allied Signal*, 504 U.S. at 788.

The Department acknowledges Taxpayer's reliance on the governing document entered into between itself and Gas Station LLC. That document clearly calls for Taxpayer's two members of the Board of Managers to participate in decisions relating to the day-to-day operation of Gas Station LLC's travel centers. However, when pressed to provide concrete examples of when and

how that authority was exercised, Taxpayer declined to provide the specifics requested. Did the Board of Managers - including Taxpayer's two members - decide when and how to expand or contract its gas station operations? Did they make decisions on hiring or firing Gas Station LLC's managers or employees? Did they make decisions on the pricing of fuel sold at the Gas Station LLC's locations? Did they make decisions on the impact or cost of increased or changed state, federal, or state environmental regulations? Although the governing agreement clearly states that the Board of Managers *could* make such operational decisions, the evidence that they actually did so is absent. There is little or nothing to indicate that Taxpayer met its requirement of "showing of day-to-day operational control in the partnership . . . indicat[ing] the existence of a unitary business relationship." *Allied Signal*, 504 U.S. at 788.

As the Supreme Court has explained, the virtue of the "unitary business concept" is that it does a better job of accounting for the many subtle and largely unquantifiable transfers of value that take place among the components of a single enterprise." *Id.* at 783 (internal punctuation omitted). There is no such subtlety here. Other than the apparently unrealized formalities contained in the governing agreement between Taxpayer and Gas Station LLC, the evidence indicates that Taxpayer is an employee-less, officer-less, property-less holding company that owns a minority interest in Gas Station LLC and earns money by virtue of that interest.

Although not entirely dispositive of the issue, Taxpayer itself seems to realize that it did not intend nor does it now share a unitary relationship with Gas Station LLC. At the time Gas Station LLC was acquired in 2008, Venture Capital, Taxpayer's parent, announced in a press release that Gas Station LLC's "current management . . . will continue to manage the business on a day-to-day basis." In addition during the course of the audit, Taxpayer was asked to allow an extension of time - a seemingly routine matter - in which to conclude the audit of Taxpayer, Gas Station LLC, and Holding Company LLC. Taxpayer's representative replied in writing.

One thing I wanted to make sure you were aware of, we can only sign the waiver for [Taxpayer]. [Taxpayer] does not have the authority to sign the waivers for [Gas Station LLC] or [Holding Company LLC], the two underlying partnerships. Since we do not have authority to sign the waivers, we also do not have the authority to extend the statute for the partnerships.

Taxpayer's own view of its relationship with Gas Station LLC does little to reinforce the premise that it exercises "operational control" over that business.

[Louis Dreyfus Petroleum Products Corp. v. Dep't of Revenue, No. 03-I-132 \(Wis. Tax Appeals Commission Jan. 2, 2008\).](#)

Summary: This case analyzed unitary issues in the partnership context focusing on operational function and functional integration, centralized management, and economies of scale.

B. Constitutional Limits: Unitary Business Test

Although the Capital Gain appears to be apportionable under Wisconsin law, such apportionment must still pass constitutional muster under the unitary business and operational function tests. The unitary business test centers on three factors: functional integration, centralization of management and economies of scale.

1. Functional Integration

According to *Allied-Signal*, the first factor used to determine whether a business is unitary is whether there is functional integration between the entities in question. Among the factors that demonstrate such functional integration is a history of transactions not undertaken at arm's-length. *Allied-Signal*, 504 U.S. at 789.

The record shows that Petitioner and PTV engaged in transactions that were not undertaken at arm's-length. At the inception of the partnership, Petitioner's parent company, LDEC, agreed to perform hedging transactions for PTV to increase the profitability of the partnership. According

to the hedging contract, LDEC was to perform hedging transactions and only charge PTV for out-of-pocket expenses. These hedging transactions were performed in the name of LDEC and all profits or losses that resulted from the hedging transactions for PTV were the profits or losses of PTV as computed by LDEC.

Petitioner argues that these transactions are irrelevant because LDEC stopped performing these transactions for PTV prior to the period under review. According to Petitioner, the hedging transactions did not perform as well as the partners had hoped and LDEC stopped performing the transactions 1.5 to 2 years after the partnership began. However, the agreement that allowed the hedging contracts to take place remained in effect up until the time of the termination of the partnership. PTV could take advantage of LDEC's expertise in negotiating these hedging contracts without paying a fee for the services at any time until then, including during the year at issue in the assessment. This contract to use LDEC's expertise to improve the profitability of PTV bears none of the hallmarks of an arm's-length contract.

There are essentially no facts on the record showing a history or pattern of arm's-length transactions between Petitioner and PTV. Indeed, because its ownership in PTV was Petitioner's only business activity, and PTV was a general partnership, there is little support for drawing any distinction between these two entities. Overall, the record shows that they were functionally integrated.

2. Centralization of Management

Centralization of management exists where there is a management role by the parent grounded in its own operational expertise and operational strategy. *Allied Signal*, 504 U.S. at 789. Control over the enterprise is a basis for that management role:

In any event, although potential control is, as we said in *F.W. Woolworth*, not “dispositive” of the unitary business issue, . . . it is relevant, both to whether or not the components of the purported unitary business share that degree of common ownership which is a prerequisite to a finding of unitariness, and also to whether there might exist a degree of implicit control sufficient to render the parent and the subsidiary an integrated enterprise.

Container Corp., 463 U.S. at 177 n. 16, citing *F.W. Woolworth Co. v. Taxation and Revenue Dep't of N.M.*, 458 U.S. 354, 362 (1982) (citations omitted).

Petitioner had a management role in PTV. Petitioner was a wholly owned subsidiary of LDEC and its only business was its 50% interest in PTV as a general partner. Petitioner and Pilot each contributed an equal amount of capital to start up the business of PTV, and Petitioner shared the profits and losses of PTV as an equal partner with Pilot. While day-to-day management of PTV was handled by Pilot under the Management Agreement, ultimate control of the partnership was held by PTV's Executive Committee, which was composed of two representatives from Petitioner and two representatives from Pilot. Only the Executive Committee could determine whether additional funds were needed for the partnership and arrange for financing, as well as decide questions involving the ultimate disposition of the partnership's assets. Finally, the Executive Committee entered into the LDEC Agreement (regarding hedging transactions) and the Management Agreement to operate the business of the partnership.

Petitioner's investment in PTV was Petitioner's only business activity. Petitioner's 50% ownership of and concomitant right to control PTV via its 50% representation on the PTV Executive Committee reflect an active, not passive, investment. These facts indicate that PTV and Petitioner had centralized management.

3. Economies of Scale

Where the corporations in question are engaged in the same line of business, then there may be economies of scale created, indicating a unitary business. *Allied Signal*, 504 U.S. at 789. Providing start-up and operating capital for a joint venture can create economies of scale. See

Chilstrom Erecting Corp. v. Wis. Dep't of Revenue, 174 Wis. 2d 517, 529 (Ct. App. 1993) (taxpayer and partner provided all start-up capitalization and only source of operating capital in joint ventures, which showed economies of scale).

PTV was Petitioner's only business activity, so Petitioner and PTV were in the same line of business. Petitioner provided half of the capital investment to start up PTV, and, through PTV's Executive Committee, had joint control with Pilot over management of PTV's capital requirements. These facts show that there were economies of scale between Petitioner and PTV.

C. Constitutional Limits: Operational Function Test

According to the operational function test under *Allied Signal*, income from a capital transaction that serves an operational rather than investment function can be subject to apportionment by a state even where the payor and payee are not engaged in the same unitary business. Here, the record shows that Petitioner's investment in PTV served an operational rather than investment function.

LDEC, one of the largest wholesale distributors of petroleum products in the U.S., entered into a partnership with its customer, Pilot, to sell petroleum products at retail through Travel Centers. LDEC formed Petitioner as a wholly owned subsidiary and loaned to Petitioner its share of the start-up capital of PTV. Petitioner and Pilot entered into a 50/50 general partnership in PTV for the purpose of selling petroleum products at the Travel Centers. Pilot agreed to manage the Travel Centers owned by PTV and LDEC agreed to provide its hedging transaction expertise to the partnership.

This ongoing business with PTV continued until the partnership terminated in 1997. When Petitioner sold its interest in PTV to Pilot, it paid back the loan of start-up capital to LD Capital, another member of the Louis Dreyfus Group that had loaned funds to Petitioner to pay off the initial loan from LDEC. Petitioner loaned the remaining sale proceeds to LDEC, which LDEC used as working capital in its business.

From inception to disposition, Petitioner's investment in PTV served an operational purpose tied to LDEC's ongoing operations. LDEC was in the business of selling petroleum products to Pilot. To bolster this relationship with Pilot and to profitably use its hedging transaction expertise, LDEC formed Petitioner and entered into the PTV partnership with Pilot. When the partnership terminated, the proceeds from the sale of PTV were returned LDEC to use as working capital in its ongoing business.

[Luhr Bros. v. Director of Revenue, 780 S.W.2d 55 \(Mo. 1989\).](#)

Summary: The Court found a unitary business in the partnership context focusing on flows of values. The Court also noted that there was "substantial evidence of a degree of implicit control sufficient to render Luhr Bros. and the partnership an integrated enterprise."

Relevant Excerpts:

Relying upon the broadened definition of unitary business set forth in *Container Corp.*, the Administrative Hearing Commission found evidence of exchange of value both in the types of jobs in which the two business entities engaged and in the leadership they shared. The Commission found that the partnership and the taxpayer had an "exchange of value not capable of precise identification or measurement--beyond the mere flow of funds arising out of a passive investment," the fundamental characteristic of a unitary business relationship as defined in *Container Corp.* [Id. at 166, 103 S.Ct. at 2940.](#)

There is substantial and competent evidence in the record to support the Commission's findings. The facts, recited above in detail, first reflect that Luhr Bros. and the partnership engaged in similar business activities involving excavation and rock work for highway and marine construction. The facts further evidence an exchange of value, more than a passive investment,

between Luhr Bros. and the partnership through Luhr Bros. assisting in obtaining and guaranteeing bonds and executing contracts. Moreover, Arthur A. Baltz, secretary-treasurer of Luhr Bros., testified that he could not measure the dollar value of these activities to the partnership, nor, in turn, to Luhr Bros., in terms of the additional financial commitment the partnership was able to maintain as a result of Luhr Bros.' involvement.

The record reflects that Luhr Bros. also played a management role in the partnership's affairs. The process by which Mr. Luhr was involved in the partnership's business decisions and in providing assistance to the partnership is grounded in Luhr's own operational expertise gained through his engagement in similar business activities. There is no evidence in the record of Luhr's being compensated for his assistance. Upon being asked to measure the dollar value of Mr. Luhr's advice to the partnership and, hence, to Luhr Bros., Mr. Baltz replied that he did not know whether one could measure a dollar value, concluding that Mr. Knisely paid "quite a bit of attention" to Mr. Luhr's opinion. Considering all the evidence, there is, thus, substantial evidence of a degree of implicit control sufficient to render Luhr Bros. and the partnership an integrated enterprise.

The Commission correctly concluded that Luhr Bros.' distributive share of income from the partnership constitutes taxable business income.

[Malpass v. Dep't of Treasury, 833 N.W.2d 272 \(Mich. 2013\).](#)

Summary: This case addressed whether individual taxpayers can use blended apportionment for unitary flow-through businesses.

Relevant Excerpts:

The Michigan Supreme Court held "that the ITA does not prohibit individual taxpayers from combining the profits and losses from unitary flow-through businesses and then apportioning that income on the basis of the businesses' combined apportionment factors. Moreover, we hold that the ITA did not limit apportionment of income to domestic businesses during the 1994 and 1995 tax years, and that the apportionment could properly be applied to a foreign entity to the extent that the foreign entity and the individual taxpayer's in-state business were unitary." This case allows individuals the freedom to choose combined or separate apportionment on a year-by-year basis.

[Matter of Alvaco Trading Co., Inc., Dkt. No. 220410259 \(Cal. Office of Tax Appeals, January 23, 2024\).](#)

Summary: The OTA analyzed unitary and business income issues in the partnership context.

Third, Appellants' argument is misplaced. For purposes of the functional test, the property for which control must be shown is the membership interest in ABB (which was Alvaco's only asset), not ABB. (See Hoechst, at 527; Appeal of Centennial Equities Corp. (84-SBE-086) 1984 WL 16165.) Moreover, in applying the functional test, the critical inquiry is the relationship between the property and the taxpayer's business operations. (Hoechst, at p. 527.)

The record leaves no doubt that Alvaco managed and controlled its interest in ABB. Alvaco was the sole owner of its ABB interest. The interest was a proxy for the business assets Alvaco formerly owned before their contribution to ABB; these same assets generated business income. Indeed, the ABB interest produced most, if not all, of Alvaco's income. Alvaco, through its CEO and COO, exercised powers associated with the interest, such as the appointment of managers and, ultimately, the power to dispose of most of the interest. (See Hoechst, at p. 536.)

In summary, Alvaco and ABB were engaged in the same unitary business of contact lens distribution. Alvaco held and managed that business through ABB, and Alvaco's control and use of its ABB interest contributed materially to its production of business income so that the interest

was "interwoven into and inseparable" from its unitary contact lens business. (See Hoechst, at p. 529.)

[Matter of the Appeal of J. Blau, Dkt. No. 21088383 \(Cal. Office of Tax Appeals, July 7, 2023\).](#)

Summary: In a case involving multiple levels of entities, the taxpayer failed to produce evidence establishing a unitary relationship for purposes of blended apportionment. This case shows some of the complexities with blended apportionment when there are multiple levels of entities.

Relevant Excerpts:

Third, appellant can only use TRC LP's apportionment percentage instead of Yukon's apportionment percentage to apportion the 1231 net gain if Yukon and TRC LP are not unitary. Regulation section 17951-4 contains income sourcing provisions applicable to a nonresident's business, trade, or profession and generally incorporates the apportionment rules of the Uniform Division of Income Tax Purposes Act contained in R&TC sections 25120 to 25139, including Regulation section 25137-1. (See e.g., R&TC, § 17951-4(c), (d), (e); see also *Appeal of Smith*, 2023-OTA-069P.) A taxpayer's distributive share of partnership business income is generally apportioned by the formula set forth in Regulation section 25137-1(f) or (g), whichever is applicable. (Cal. Code Regs., tit. 18, § 25137-1(a).) Generally, if a partner's or member's activities are unitary (disregarding ownership requirements) with the partnership's or LLC's activities, the partner or member shall combine its share of the partnership's or LLC's apportionment factors with the partner or member's own apportionment factors to apportion the combined income. (See Cal. Code Regs., tit. 18, § 25137-1(f); *Appeal of Smith*, supra.) By contrast, if a partner's or member's activities are not unitary (disregarding ownership requirements) with the partnership's or LLC's activities, the partnership or LLC apportions its business income separately and its factors are not combined with the partner or member's own apportionment factors. (See Cal. Code Regs., tit. 18, § 25137-1(g); *Appeal of Smith*, supra.)

Appellant contends that the "TRC LP apportionment factor should flow[-]through to [appellant];" therefore, FTB should use the California apportionment percentage of 9.2511 from TRC LP, as modified by appellant, to source the 1231 net gain business income. However, appellant has not provided any details as to the composition of the apportionment factors for Yukon and TRC LP. Also, appellant did not explain the discrepancy between the California apportionment percentages originally reported by Yukon, 10.0640 percent, and TRC LP, 12.1215 percent. In sum, appellant fails to show potentially relevant facts of how income and apportionment factors should flow-through from the various underlying pass-through entities to TRC LP and from TRC LP to Yukon. For example, appellant did not establish whether some or all of the underlying pass-through entities (where the various 1231 net gain transactions originated) were unitary with TRC LP and whether Yukon was unitary with TRC LP. As such, appellant has not shown the 1231 net gain (generated by the various underlying pass-through entities) is properly apportioned using TRC LP's apportionment factors (modified to include the 1231 net gain transactions generated by the various underlying pass-through entities) without regard to Yukon's apportionment factors. (See Cal. Code Regs., tit. 18, § 25137-1(f) and (g).) Therefore, appellant has not established any basis to rebut FTB's determination which used the reported California apportionment percentage from Yukon to source the 1231 net gain business income to California.

As noted above, appellant's unsupported assertions are insufficient to satisfy his burden of proof. (Amarr, supra.) Here, appellant has not demonstrated by a preponderance of the evidence that FTB's apportionment of business income to appellant for the 2011 tax year is erroneous . . .

While not discussed in either party's briefing it appears that FTB's proposed assessment uses Yukon's apportionment percentage of 10.064 percent to apportion the 1231 net gain generated by the underlying passthrough entities on the basis that Yukon is unitary with TRC LP, and Yukon's apportionment factors incorporate its share of TRC LP's apportionment factors. (See Cal.

Code Regs., tit. 18, § 25137-1(f); see also Cal. Code Regs., tit. 18, § 17951-4(d)(2).) It is unclear whether FTB determined these entities were unitary based on the entities' California returns, appellant's statements or representations during audit, an audit of the issue, or if FTB assumed that these entities were unitary. It appears that both parties are treating the underlying pass-through entities where the 1231 net gain transactions originated as unitary with TRC LP. Otherwise, the California source income determination would have been made at each of the underlying pass-through entities' level using that pass-through entities' California apportionment factors. (See Cal. Code Regs., tit. 18, § 25137-1(g); see also Cal. Code Regs., tit. 18, § 17951-4(d)(1).)

[Matter of the Appeal of: L. Smith, Dkt. No. 20036033 \(Cal. Office of Tax Appeals, December 7, 2022\).](#)

Summary: The OTA noted that lack of control over the partnership business does not preclude unitary treatment of a partner and its share of the partnership business.

Relevant Excerpts:

Similar to the three unities test, the contribution or dependency test implicitly contains an ownership requirement. (*Appeal of Willamette Industries, Inc.* (87-SBE-053) 1987 WL 50176.) In the affiliated corporation context, unity of ownership requires more than 50 percent of the voting power of a corporation's stock be owned, directly or indirectly, by another corporation. (R&TC, § 25105.) But in the partnership context, the unitary determination is applied "disregarding ownership requirements." (Cal. Code Regs., tit. 18, § 25137-1(a), (f), (g).) "[U]nlike a corporate shareholder, only the partner's ownership interest in the partnership's income and apportionment factors may be combined, and that combination is proper even though that ownership interest is less than a majority interest." (*Appeal of Willamette Industries, Inc., supra.*)

Critically, Regulation section 25137-1 's instruction that unity is to be determined without regard to ownership requirements also means "unitary combination does not require that a partner have control of the partnership that is combined." (*Appeal of Willamette Industries, Inc., supra*; see also *Appeal of Albertson's, Inc.* (82-SBE-211) 1982 WL 11960 ["lack of control over the partnership business, by itself, does not preclude unitary treatment of a partner and its share of the partnership business"].) This disposes of appellant's contention that Holdco and Shell were nonunitary because York, through its majority representation on Shell's Board, had a controlling membership interest in Shell.

[North Carolina Secretary of Revenue Decision No. 2007-28.](#)

Summary: This is an example of a state that uses blended apportionment when the income from the partnership is apportionable.

Relevant Excerpts:

Where the business of the partnership is directly or integrally related to the business of the corporate partner, the corporate partner's share of the partnership net income is classified as business or apportionable income. NCAC T17: 5C .1702.

When classified as business or apportionable income, the corporate partner's apportionment factors shall include its proportionate share of the partnership's property, payroll and sales. NCAC T17: 5C .1702.

As a holding company with no other business activities apart from its ownership interest in its investments, the businesses of Taxpayer and LLC are directly or integrally related; the income from LLC is apportionable business income under G.S. 105-130.4; and the proportionate share of the partnership's property, payroll and sales are includible in Taxpayer's apportionment factors.

Summary: Apportioned distributive share based on the operational function test.

Relevant Excerpts:

These cases suggest that the “operational function” test of *Allied-Signal*, adopted at 830 CMR 63.38.1(4)(a)1.b., would look to 1) the character of the funds used to purchase an intangible asset as “working capital”, and 2) whether the investment resulted in an operational benefit to the ongoing business of the corporation, beyond a passive monetary return to the corporate treasury. These criteria, applied in the instant appeal, supported a finding that Sasol's investment in ASMC-II LP served an operational function in the conduct of the taxpayer's business. First, Sasol drew on its working capital to acquire its stake in ASMC-II LP, and returned the distributive share income it received to working capital. Sasol, a highly leveraged business, used a revolving credit facility with the Chase Manhattan Bank as a source of working capital. Sasol authorized the funds it needed to purchase the ASMC-II LP limited partnership interest out of the budget of its Manufacturing Division, a key operational arm of its business. \$5,000,000 was borrowed to buy the ASMC-II LP holding. Income received from ASMC-II LP was applied to the Chase Manhattan debt and thus returned to working capital. If shares of stocks were included in the distributions received, Sasol immediately liquidated the stock so it could apply the cash value to the revolving debt which comprised its working capital.

Second, there was a clear interrelationship between the ASMC-II LP holding and the business operations of Sasol. Sasol was attracted to the investment opportunity because it saw potential synergies in partnering with a private equity fund which had access to 300-500 business proposals from specialty chemical start-ups each year. Dissatisfied with the work of its Planning Division, an operational arm of its business, Sasol was looking for other ways to further its goal of greater vertical integration, by making acquisitions of specialty chemicals firms. The taxpayer sought to reap the added profits available downstream from its commodities chemicals business, in the specialty chemicals area where profit margins were higher. While established specialty chemicals firms could be acquired only at a premium, promising start-ups were potentially available at more economical prices.

ASMC-II LP offered a window on new developments in the specialty chemicals field, so that through its purchase of the limited partnership interest, Sasol could more effectively survey the landscape of the industry and identify promising opportunities for acquisitions. Furthermore, the strategic partnership with Ampersand Ventures enabled by the limited partnership holding could serve as a means of identifying new customers, and strengthening existing customer accounts, for its sales of commodities chemicals. Investing in ASMC-II LP opened doors through which Sasol could optimally pursue its own strategic business objectives, given the private equity firm's practice of sharing information with its “strategic investors.” Cf. *Container Corp.*, 463 U.S. at 180, n.19.

In contrast to the Bendix investment in ASARCO in *Allied-Signal*, ASMC-II LP operated exclusively in the same business niche in which Sasol sought to expand its own presence. ASMC-II LP and Sasol were both tightly focused on uncovering profit-making opportunities in the specialty chemicals industry. This overlap in the respective lines of business of Sasol and ASMC-II LP reinforced the conclusion that Sasol's investment in the partnership was operational in character.

It is inconsequential for purposes of the operational function test that Sasol did not consummate any major acquisitions it learned about through its relationship with Ampersand Ventures. Not all business undertakings pan out as originally intended. It is sufficient that Sasol had a good-faith business operational justification for embarking on its collaboration with Ampersand Ventures during the years at issue. Sasol was dissatisfied with the results of the activities of its own Planning Division, but there can be no question that strategic business planning is an operational function.

In sum, Sasol invested in ASMC-II LP because it saw an opportunity for a strategic partnership which had the potential to advance its own business operational objectives. The evidence indicated that Sasol made few, if any, passive investments solely for the purpose of securing a financial return. Accordingly, the Board concluded that Sasol met its burden of proof to show that its purchase of the limited partnership interest served an operational function.

The finding of an operational function for the ASMC-II LP investment is dispositive of the question of apportionability.