Workbook 2 - Guide

Purpose

This workbook provides a platform showing the effects of partnership structures on state sourcing rules and illustrates how UDITPA applies to partnership structures.

This workbook is organized in five tabs: a “Factor Baseline Method” tab, a “Chart” tab, the “All Blended” data tab, the “Bld-Sep Comparison” tab and the “Separate Sourcing” tab.

Factor Baseline Method

The formulary apportionment system created by UDITPA recognizes an essential connection between the receipts factor and the net income to be apportioned. Net income is the taxpayer’s gross receipts less related business expenses.

In a partnership, the entity computes the income and identifies the gross receipts from apportionable income to be included in the receipts factor. These apportionment items are used to compute source income and are then assigned to the partners in the same proportion to their profit and loss (P&L) percentage used for the determination of their distributive share of partnership items under IRC 704(b). Assigning apportionment items matters when the distributive share of partnership income must be blended with the direct or indirect partner’s apportionable income.

However, the rule under IRC 704(b) also allows for the assignment of deductions to specific partners. This type of special allocation creates a mix of gains (positive numbers) and losses (negative numbers) in the allocation of distributive shares for one or more types of income. Under UDITPA, the receipts factor is a measure of the economic presence in a state whether that presence generates an overall gain or a loss. Without a rule incorporating the special allocation of deductions in factor representation, the assignment of apportionment items to net income would lead to the creation of nowhere losses. As shown in the example below, these nowhere losses may alter the sourcing of apportionable income in a way that is not consistent with UDITPA’s formula when blending occurs on the partner’s return.

For example, partnership P1 realizes a net ordinary income of $400, which is the net of $900 of gross receipts and ($500) of business deductions, and a rental of $100. All items of income are apportionable and derived from a unitary business. The total of receipts equal

$1,000. A quarter of these receipts are allocated to State A and three quarters to State B. State A's apportionment ratio at the partnership level is 1/4. If partner Corp is assigned 10% of profit and loss, Corp will receive 10% of the numerical value of receipts from the numerator and from the denominator of the partnership's apportionment factor[1]. Its assigned apportionment ratio related to its distributive share would still be 1/4.

Assume P1 specially allocates business expenses of ($500) with $100 of rental income to Corp. for a net of ($400). P1 therefore allocates all the gross receipts to the other partners as ordinary business income for a total of $900, which is 225% of net income. Corp's overall P&L percentage of P1 distributive share is -100% of the partnership's net income. There are just not enough gross receipts to assign a numerical value of gross receipts to P3 that would equal 225% of $900, and assigning a negative number of gross receipts is not possible.

A seemingly simple solution would be to assign all the ordinary business gross receipts as apportionment items to the partners that are assigned the ordinary business gross receipts as net income. However, that solution would result in the creation of nowhere deduction assigned to Corp. If Corp must blend its operating income with its distributive share of partnership item, the nowhere deduction would reduce net income while lacking factor representation in Corp's apportionment factor. Assume Corp derives $800 of net income from gross receipts in states A and B of $1,000 each.

				Receipts		
Corp.		P&L	Income/Loss	State A	State B	Total
P1's Share	OBI	-125%	$ (500)	$ -	$ -	
	Rental	100%	$ 100	$ 100	$ -	
Corp. Operating	OBI		$ 800	$ 1,000	$ 1,000	
	Total		$ 400	$ 1,100	$ 1,000	$ 2,100
Factor				0.52380952	0.47619048	

Income sourced to state B, attracting 75% of P1's economic activity and 50% of Corp's economic activity, now only equals 47.62% of the blended income. That is the result of ignoring the special allocation of deductions as net loss.

[1] If Corp. must blend the factors, the ratio expressed in terms of percentage without the numerical values of the fraction is useless because the same ratio can reflect numerical values of different scales. For example, 250/1,000 generates a result vastly different than 25,000/100,000 when blended with 45,000/60,000. Therefore, Corp. must use the numerical value of its distributive shares of receipts from the numerator and the denominator, in this case 250/1000. This simple math principle must be observed to guarantee the consistency of factor representation.

The Factor Baseline Method (FBM) addresses the lack of factor representation of net losses when a special allocation of deductions occurs. It assigns the $900 of ordinary business gross receipts from P1's activities in proportion to each partner's absolute value of their distributive shares of partnership items over the sum of all the absolute values of distributive shares of partnership items. In our example, Corp's absolute value of ordinary business loss is $500, and its absolute value of rental is $100 for a total of $600. Because the other partners are receiving $900 of ordinary business income the factor baseline is $1,500 [$900 + $600]. Corp's share of factor baseline is $600 over $1,500, which is 40%. Once applied to the original gross receipts from P1, $1,000, Corp must be assigned $400 of gross receipts as apportionment items, with $100 allocated to State A and $300 allocated to state B. Corp's factor for State B is now between 50% and 75% as anyone would have expected:

				Receipts		
Corp.		P&L	Income/loss	State A	State B	Total
P1's Share	OBI	-125%	$ (500)	$ 100	$ 300	
	Rental	100%	$ 100			
Corp. Operating	OBI		$ 800	$ 1,000	$ 1,000	
	Total		$ 400	$ 1,100	$ 1,300	$ 2,400
Factor				0.45833333	0.54166667	

The corollary of assigning receipts to represent the economic presence of losses means that partners that are assigned $900 of net income will receive a total of $600 of gross receipts as apportionment items from P1. That may look counterintuitive. However, as we said at the beginning, UDITPA recognizes a connection between gross receipts and the net income to be apportioned. That connection exists in terms of proportion not in terms of separate accounting on an items per item basis. The FBM keeps that proportion as consistent as possible among partners.

The Factor Baseline Tab shows a second example illustrating two types of special allocations, one allocating net income in a different proportion than capital interest in the partnership, and another one allocating deductions.

Chart

The partnership structure on the chart on the second tab is intended to encompass most situations relevant to the sourcing of distributive shares in a multistate environment.

It shows a partnership structure with economic presence in four states. The geographical delimitations on the chart represent the contours of the market for each state. When a state delimitation crosses an entity, this entity is present in both markets.

For example, P1 can generate receipts from states A and D. P2 may receive only receipts from state C. This last limitation is intended to reduce the number of calculations to the minimum required to illustrate possible outcomes where the partnership structure matters.

By default, John Doe and Jane Doe are not related unless the example says otherwise, and they are both residents of State B. That will allow us to compare the effect of sourcing on the tax paid in State B when the two individuals are in different situations regarding partnership income.

In the Separate Sourcing Tab, the presence may also be physical through the use of a payroll and property factor.

Could a larger chart yield a different result?

It is unlikely. Although the chart does not include all the possible situations a partnership or a taxpayer can find themselves in, especially with indirect ownership, it covers the most relevant issues with the sourcing of distributive shares. Increasing the size of the structure with the addition of partners or tiers only compounds the problems without changing their nature.

Workbook Data Tabs

The workbook is designed to require little input from users. All fields that can be changed are framed in bold. They require numerical input except for the separate apportionment determination which is a yes/no choice.

Description	Color	Sign
Gross receipts	Yellow	Positive
Payroll/Property	Yellow	Positive
Deductions	Blue	Negative
P&L	Yellow or Green	As required
Separate apportionment	Green	N/A

Each column reflects the layers of the partnership structure on the chart. The first column of lower tier partnerships includes two operating partnerships P1 and P2. The second column is the middle tier layer of the partnership structure that includes partnership P3

and the taxpayer Jane Doe. Partnership structures can have multiple middle tier layers with taxpayers receiving distributive shares. The last column, the upper tier, only includes taxpaying entities.

Distributive shares are set to 50% by default, but they can be changed at will to create special allocations. When the percentage is changed for one partner, it automatically changes the percentage for the other partner.

Users can change the effective tax rates to get a feel of the overall outcome that would be closer to their own state. The tabs also calculate credits for taxes paid to another state at the individual level. That calculation remains basic and does not include all the subtilties that may occur in actual credit calculation in each state.

All Blended

The “All Blended” tab illustrates what happens to distributive shares of partnership income when they are all blended at each tier. It also shows how the Factor Baseline Method works. It uses only a single sales factor.

Bld-Sep Comparison

This tab is a tool allowing for the comparison between blending and separate apportionment based on the data from the “All Blended” tab. The purpose of this tab is to highlight the differences in source income for each state when one or the other method is used across the entire structure.

It also compares the distribution in each state for both methods with the distribution of gross receipts. In general, the closest the distribution of income is to the distribution of receipts, the more it fits UDITPA’s principle posing an essential connection between gross receipts and net income.

This tab also shows a simple withholding calculation for distributive shares received by P3 and assigned to P3 owners for states A and C.

Separate Sourcing

The “Separate Sourcing” tab also uses the chart partnership structure and adds a couple of important features to the “All Blended” tab.

Up to Three factor formula

Some states use a three factors formula either as a default or as a special industry rule. This tab simulates a two or three factors formula by adding factors at the operating partnership level.

Separate sourcing choice

The user may choose to keep the sourcing determined at the partnership level on the partner's return. To keep the partnership sourcing, select "yes", otherwise select "No".

If the user selects "no" then blending occurs. Not that blending only one stream of apportionable income does not change the sourcing.

Simulations

The workbook is constructed to exemplify partnership issues through simulations. Simulations will be provided with data entry tables and some comments. Here is an example:

Plain Vanilla

The plain vanilla situation only includes income generated at P1 and P2 level. The distributive shares are allocated on a 50%/50% basis at each level.

Enter the following data in the "All Blended" Tab:

Fields	Amount	State A	State B	State C	State D
D5/G5		$6,000			$3,000
D6		$3,000			
C12	($4,500)				
C13	($1750)				
F38				$3,000	
C45	($1,500)				

You can compare the result of separate apportionment vs blending on the Bld-Sep Comparison tab. The distribution of source income for blending should be slightly closer to the distribution of gross receipts than the distribution of source income from separate apportionments.