November 19, 2025

Ms. Laurie McElhatton
Chair, MTC Work Group on State Taxation of Partnerships
c/o California Franchise Tax Board
Rancho Cordova, CA 95741-1720

Ms. Jennifer A. Stosberg
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Ms. Helen Hecht
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Re: Multistate Tax Commission Draft White Paper on State Tax Sourcing of Partnership Income Under the Pass-through Tax System & the Blended Apportionment Method, dated August 15, 2025

Dear Ms. McElhatton, Ms. Stosberg, and Ms. Hecht:

On June 16, 2025, the American Institute of CPAs (AICPA) submitted a comment letter in response to the Multistate Tax Commission's (MTC) draft white paper on State Tax Sourcing of Partnership Income and the Blended Apportionment Method, dated May 19, 2025, which is part of the MTC's State Taxation of Partnerships project. We appreciate the MTC and related work group on the State Taxation of Partnership's ("work group") July 15, 2025 thoughtful response to the letter, and the initiative in scheduling a meeting on July 16, 2025 to discuss the work group's feedback and questions.

This comment letter offers additional clarification and feedback on several points raised by the work group in the response to our letter and the updated MTC draft white paper on State Tax Sourcing of Partnership Income Under the Pass-Through Tax System and the Blended Apportionment Method ("white paper"), dated August 15, 2025.

We note that specific comments #4, #5, and #7 are updated and clarified in the white paper. Comment #7 is updated under Section I.C. in the white paper and a note is added under allocate or allocation – "The term 'allocate' is also used by some states to refer to how items of non-apportionable income are sourced however, this white paper will use the term 'assign' for that purpose." We welcome the update and thank the MTC for considering our recommendation.

We understand the complexity of partnership structures, special allocations, and related-party transactions and their effect on the ability of states to tax partnership income and the determination of how partnership income is sourced. Accordingly, we offer additional recommendations regarding the approach of the MTC white paper on these issues.

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I. General Recommendation: Define which rules partnerships should apply when computing entity-level taxes

II. Specific Recommendations:

1. Update footnote language regarding states not applying the same approach to sourcing multistate income of a business regardless of form of business

2. Add language to address where states have sourcing rules for income of businesses that are fundamentally different for nonresident or corporate partners

3. Clarify in example 3 why the sourcing rules are applied at the partner level rather than the partnership level

4. Add the DC Circuit Court's recent *Rawat v. Commissioner of Internal Revenue* decision regarding the appropriate law for determining the character of a partner's gain on disposition of their interest in the partnership

5. Apply the alternative approach only when there is evidence the original transfer was intended to evade tax regarding transactions between partners and partnerships or other related entities

6. Provide guidance regarding transactions involving partners or shareholders who act outside their capacity as partners or shareholders to clarify the reason for the difference in treatment for partnerships versus corporations

7. Add a step or consideration to the framework to first determine if the taxpayer is carrying on a trade or business before determining whether it is unitary

8. Add language noting that the state sourcing rule should not automatically assume the partnership is engaged in a business activity that gives rise to apportionable income

9. Allow taxpayers to have the flexibility to apply the item-based approach as an alternative approach in addition to allowing the distributive share-based approach for determining the share of a partner's apportionment factors

10. Remove the phrase "while not clearly required for blended apportionment" from the statement on the unitary business principle

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We appreciate your consideration of these comments and welcome the opportunity to discuss them further. If you have any questions, please contact Brian Myers, Chair of the AICPA SALT TRP at (317) 208-2478 or Brian.Myers@crowe.com; Ning Yim, AICPA Senior Manager, Tax Policy & Advocacy at (202) 434-9201 or Ning.Yim@aicpa-cima.com; or me at (610) 217-4495 or CheriFreeh@gmail.com.

Sincerely,

Cheri H. Freeh

Cheri Freeh, CPA, CGMA
Chair, AICPA Tax Executive Committee

# AICPA Comments on the MTC Draft White Paper on State Tax Sourcing of Partnership Income Under the Passthrough Tax System and the Blended Apportionment Method
November 19, 2025

## Background

At its meeting in April 2021, the Multistate Tax Commission (MTC) Uniformity Committee initiated a project on the state taxation of partnerships based on the recommendations of the MTC Standing Subcommittee that a work group be established to consider issues affecting:

- Sourcing of partnership operating income and partnership items for state tax purposes;
- Sourcing and taxation of gains and losses from the sale of partnership interests;
- Entity level taxation issues including transfer pricing or combined filing issues, and
- Other administrative and enforcement issues including information reporting and withholding.

As a result of the project, the MTC created the MTC Uniformity Committee's State Taxation of Partnerships Project in 2021. The MTC and related work group on the State Taxation of Partnership's ("work group") recently developed a draft white paper on state tax sourcing of partnership income under the pass-through tax system and the blended apportionment method. The work group requested feedback on the white paper.

The AICPA offers recommendations below regarding white paper on state tax sourcing of partnership income under the pass-through tax system and the blended apportionment method.

## I. General Recommendation: Define which rules partnerships should apply when computing entity level taxes

We appreciate that the work group clarified that the white paper is intended to address both corporate partners and partners of tiered partnerships. The work group agrees that when calculating the withholding on nonresident partners or elective entity-level taxes (passthrough entity taxes PTETs and composite returns), the state sourcing rules should be applied as consistently as possible in accordance with the way those rules are generally applied to distributive share income under the pass-through system. The work group also agrees that states adopting changes to their sourcing approach may need to make changes to forms, instructions, and systems. However, further clarification is needed for partnerships for computing entity level taxes.

The AICPA recommends that the states define which rules partnerships should apply when computing entity level taxes.

The individual and corporate sourcing rules are different for some states. For example: 1) NYS – Corporations are required to utilize single sales factor market-based sourcing (SSF MBS) for corporations however, partnerships are required to utilize three-factor cost of performance (COP); 2) PA – Partnerships use the personal income tax (PIT) rules to the extent the partnership has individual, estate, partnership partners. If a partnership has corporate partner, the partnership files Form PA-65 CORP*, Directory of Corporate Partners* and includes Schedule H-CORP*, Corporate Partner Apportioned Business Income (Loss)* for computing the apportionment factors under corporate income tax (CIT) rules. If a partnership only has corporate partners, the partnership only files the Form PA-65 CORP and not Form PA-65, *Partnership Information Return*.

## II. Specific Recommendations

### 1. Update footnote language regarding states not applying the same approach to sourcing multistate income of a business regardless of form of business

We understand that the white paper is not intended to provide a comprehensive summary of every state's rules for sourcing multistate income. However, further clarification would help readers better understand the variability in state treatment to avoid potential misinterpretation.

The AICPA recommends updating the footnote language regarding states not applying the same approach to sourcing multistate income of a business regardless of form of business under Section I - Important Context for Understanding the Issues to state, "Some states do not apply the same approach to sourcing the multistate income of a business, regardless of the form of the business."

Most states apply the corporate apportionment rules to partnerships, however, PA, NY, CT, and CO apply the individual income tax rules for sourcing partnership income. In CO, there is an election to use the corporate sourcing rule, however, the default is to look to the individual income tax rules to directly assign income to the state. Furthermore, some states apply different sourcing methodologies for nonresident individuals versus corporations.

### 2. Add language to address where states have sourcing rules for income of businesses that are fundamentally different for nonresident or corporate partners

We appreciate that the white paper is updated to clarify in the example under Subsection I.A. Examples of Issues and Common Questions that resident partners would be taxed on 100% of their income and would receive credit for taxes paid to other states. However, additional clarification would be helpful to acknowledge that state sourcing rules for business income for states can vary significantly, particularly for nonresident or corporate partners.

The AICPA recommends adding language to address instances where states have sourcing rules for income of businesses that are fundamentally different for nonresident or corporate partners.

These differences can lead to inconsistent tax treatment across states and create compliance challenges for multistate partnerships. The update will help readers to understand that while the example provides a general rule for resident partners, it may not reflect the complexities of state sourcing rules for other types of partners, such as nonresidents or corporate partners.

### 3. Clarify in example 3 why the sourcing rules are applied at the partner level rather than the partnership level

We understand that the examples in the white paper are intended to address some common questions raised by applying general state sourcing rules under the pass-through tax system. However, more clarity is needed as to why the sourcing rules are applied at the partner level rather than the partnership level to avoid confusion.

The AICPA recommends clarifying why the sourcing rules are applied at the partner level rather than the partnership level for example 3 under Subsection I.A. Examples of Issues and Common Questions.

The work group states that the corporate partner's share of partnership income is properly treated as business (apportionable income), but that may not be the case. Several states provide guidance on the treatment of income from a partnership that is dependent on the relationship between the corporate partner and the partnership. Those states provide that when a partner and partnership are engaged in a unitary business, the partner includes its share of partnership income and apportionment factors, and all income is apportioned to the state by means of the combined method. In contrast, partners who are not engaged in a unitary business with a partnership are required to use the allocation method. It should be considered that there could be a circumstance where the character of the gain recognized by a partnership as nonbusiness income could retain its character at the corporate partner level regardless of whether there is a unitary relationship, based on the corporate partner's relationship to the income-generating activity.

The work group notes that if a corporate partner would generally treat its distributive share of that partnership's income as nonbusiness income, then it would source that income using the state's rules of assignment, instead. This method agrees with our point above that two different relationships exist as follows:

- The relationship between the corporate partner and the partnership, and
- The relationship between the taxpayer and the income generating activity.

The work group also notes that the state sourcing rules are first applied to the business conducted by the partnership. As a result, its income is characterized as business (apportionable) or non-business (non-apportionable) and sourced appropriately. The source of the income is then attributed to the partners, along with the partners' shares of the income, and does not change except in situations where blended apportionment is used. In a state that has blended apportionment, if the income is nonbusiness (non-apportionable), it could be separately assigned outside of a blended formula. Only apportionable (business) income would be combined and apportioned.

### 4. Add the DC Circuit Court's recent *Rawat v. Commissioner of Internal Revenue* decision regarding the appropriate law for determining the character of a partner's gain on disposition of their interest in the partnership

The white paper refers to federal sourcing rules under Internal Revenue Code (IRC) section[1] 875 and Treas. Reg. § 1.702-1(a)(8)(ii) several times. The recent DC Circuit Court decision in *Rawat v. Commissioner of Internal Revenue ("Rawat v. Comm'r")* [2] includes a useful discussion of these concepts that are relevant to the sale of a partnership interest and gain recognized under section 751.

The AICPA reiterates our recommendation to include the DC Circuit Court's recent *Rawat v. Comm'r* decision regarding the appropriate law for determining the character of a partner's gain on disposition of their interest in the partnership.

It would be beneficial to note in the white paper that the decision in *Rawat v. Comm'r*, which states that section 751 does not serve to distinguish business versus non-business income also applies for state tax purposes. The white paper refers to federal sourcing rules in the

[1] All references to "section" (unless referencing the House reconciliation legislation) are to the Internal Revenue Code of 1986, as amended, and all references to "Reg. §," "Prop. Reg. §," and "regulations" are to U.S. Treasury regulations promulgated thereunder, unless otherwise specified.
[2] *Rawat v. Commissioner of Internal Revenue*, No. 23-1142 (D.C. Cir., July 23, 2024).

international sections of the IRC and discusses the interaction of federal income tax treatment of partnerships and their partners ("Subchapter K") and foreign sourcing rules. It may be beneficial to cite the DC Circuit Court's decision in *Rawat v. Comm'r* as it provides a well-written and clear discussion of these concepts. The decision mentions aggregate versus entity theory analysis as well. However, to the work group's point, the sale of partnership interest may be a separate project where this discussion would be better served.

In addition, California issued Legal Ruling 2022-02, stating that section 751 ordinary income means that income is business income for California franchise tax purposes and has different sourcing rules than treating the entire gain on disposition of a partnership interest as a capital gain sourced to the partner's state. These conflicts with the purpose served by section 751 (to cause some of the partner's gain to be treated as ordinary income rather than as capital gain) and the DC Circuit's conclusion in *Rawat v. Comm'r*. It would be helpful for the work group to take a position in line with the *Rawat v. Comm'r* case, stating that section 751 is not applicable to identify when a partner's gain on sale of an interest in a partnership is business income for state income tax purposes.

5. Apply the alternative approach only when there is evidence the original transfer was intended to evade tax regarding transactions between partners and partnerships or other related entities

The work group noted in their response that the rules for built-in gains and losses under Subchapter K, including the mandatory allocation rules of section 704(c) and the disguised sale rules, were enacted by Congress in response to concerns that the general non-recognition treatment could be used to effectively shift, defer, or avoid tax on accrued gains and losses. Also, since Subchapter K imposes these anti-abuse rules, partnerships and partners must already comply with certain specific record-keeping and tracking rules.

There is an alternative approach requiring that built-in gains and losses be sourced to where they would have been sourced at the time of contribution or distribution. States might, instead, apply this look-back approach only when there is evidence that the partnership was used primarily to change the sourcing of accrued gains or losses.

The AICPA recommends that the work group's alternative approach should apply only when there is evidence the original transfer was intended to evade tax regarding transactions between partners & partnership or other related entities.

We appreciate the concern that the general non-recognition treatment could be used to effectively shift, defer, or avoid tax on accrued gains and losses. However, the situation is not dissimilar from that under section 351. A contributing shareholder could have a different filing footprint and apportionment than the recipient corporation. Applying the alternative approach a decade after the partnership received the property at issue and used it in an active trade or business seems inappropriate. The alternative approach, potentially impractical and burdensome, is not the default and should be reserved for cases involving clear state tax avoidance, sourcing manipulation, or income shifting. It may be helpful to establish rebuttable presumptions so that taxpayers and states are fully aware of when the alternative approach will be applied.

6. Provide guidance regarding transactions involving partners or shareholders who act outside their capacity as partners or shareholders to clarify the reason for the difference in treatment of partnerships versus corporations

The work group acknowledged in their response that transactions between partners and partnerships are common within partnerships, and these transactions can affect sourcing of income, sometimes in unintended ways. These transactions, even when conducted at arm's-length, may still raise sourcing complexities due to the unique nature of the partnership structure.

The AICPA recommends including guidance in the white paper regarding transactions involving partners or shareholders who act outside of their capacity as partners or shareholders to clarify why there is a different treatment of partnerships versus corporations.

Most states do not provide guidance on inter-company eliminations in the partnership context, unlike the treatment available for corporate combined or consolidated returns. This lack of clarity can create challenges for taxpayers navigating arm's-length transactions involving partners or shareholders who act outside of their capacity as owners. Providing guidance in this area would help ensure more consistent treatment and assist taxpayers in applying state sourcing rules appropriately.

7. Add a step or consideration to the framework to first determine if the taxpayer is carrying on a trade or business before determining whether it is unitary

The work group noted in their response that the determination of whether the taxpayer is carrying on a trade or business before determining whether it is unitary are issues to be reviewed when the more general sourcing rules addressed by this white paper are finalized. The AICPA welcomes the idea that these questions have been taken into consideration by the work group.

The AICPA recommends adding a step or consideration to the framework to first determine if the taxpayer is carrying on a trade or business before determining whether it is unitary under Subsection I.E. General State Sourcing Rules for Income of Businesses.

The application of sourcing rules for corporations and tiered partnerships is essential. For example, consider a partnership with non-resident individual partners. If the partnership is not engaged in a trade or business, and it is merely investing in stock or other partnership interests as investments, that should be a crucial step in determining whether the income is unitary apportionable income. The partnership may not qualify as an investment partnership, particularly if the partnership invests in other partnerships that are not investment partnerships.

8. Add language noting that the state sourcing rule should not automatically assume the partnership is engaged in a business activity that gives rise to apportionable income

The Subsection I.G. Summary – Issues & Important Context – Lessons of the white paper does not have a step to determine whether a partnership is engaged in a trade or business to determine the proper characterization of income at the partnership level as business or nonbusiness income.

The AICPA recommends adding language noting that the state sourcing rule should not automatically assume the partnership is engaged in a business activity that gives rise to apportionable income.

Per *Mobil Oil Corporation v. Commissioner of Taxes of Vermont*, "The linchpin of apportionability in the field of state income taxation is the unitary-business principle."[3] This concept applies both in the corporate and partnership context. There should be a threshold question in the sourcing rule to determine whether a partnership is engaged in a trade or business to determine the proper characterization of income at the partnership level as business or nonbusiness income. In other words, the question is whether the income is generated from activities of the taxpayer's trade or business. The partner would then determine whether the partner's share of income from the partnership is business (apportionable) or non-business (allocable) based on the partner's relationship to the partnership (i.e., whether the partner and partnership are unitary) and/or the partner's relationship to the income-generating activity. For many states, if a unitary relationship exists, then combined apportionment is required. Otherwise, partnership income is separately allocated.

### 9. Allow taxpayers to have the flexibility to apply the item-based approach as an alternative approach in addition to allowing the distributive share-based approach for determining the share of a partner's apportionment factors

The white paper proposes converting items to absolute values to solve the blended apportionment issue by using a ratio of the partner's share of partnership distributive share income when certain partners are allocated net losses while the partnership has positive net income or vice versa under Subsection II.B. Use of Blended Apportionment. While the distributive shared-based approach aims to resolve disparities, it may introduce potential distortions. For example, significant depreciation allocations to one partner and significant gross income allocations to another, while generally permissible under IRC section 704, could in some instances result in outcomes that do not reflect economic reality.

The AICPA recommends allowing taxpayers to have the flexibility to apply the item-based approach as an alternative approach in addition to allowing the distributive share-based approach for determining the share of a partner's apportionment factors.

The item-based approach is described in the white paper under Subsection II.B. Use of Blended Apportionment. This approach directly attributes the receipts to particular partners based on the partnership items making up the partners' distributive share. The white paper notes that the problem with 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 associated with these special allocations will be difficult if not impossible to determine. We acknowledge that in some cases, the item-based approach may create more leg work for the partnership calculation. The data required for the calculation would be onerous, and currently there is no way to present it on a state return in a manner that would make it auditable. The inclusion of states with property and payroll factors would add some further complexity.

The item-based approach would give each partner a more accurate share of the combined apportionment factor by aligning their share of each type of receipt included in the factor with the partners' allocation of that income for federal purposes. For example, the special allocation of interest income would be used to allocate the amount of interest included in the apportionment factor across the partners since the special allocation for federal purposes would

[3] *Mobil Oil Corporation v. Commissioner of Taxes of Vermont,* 445 U.S. 425 (U.S. Supreme Court, 1980).

be readily available. Further, we do not agree with the work group's concern regarding expenses and losses. For both the apportionment factor and the special allocations of income, expenses would be ignored while each separate line item of receipts would be considered. Overall, the item-based approach may be the least distortive option.

Taxpayers should have the flexibility to apply the item-based approach as an alternative, in addition to the distributive share-based approach, when determining a partner's share of apportionment factors.

### 10. Remove the phrase "while not clearly required for blended apportionment" from the statement on the unitary business principle

Per the white paper, "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." The white paper also combines apportionment factors even when the partnership is not unitary with the partner, if the partnership interest serves as an operational function in the partner's business. That method disregards the U.S. Supreme Court's clarifying language in *MeadWestvaco Corp. v. Illinois Dept. of Revenue*[4] that "the operational function references in *Container* and *Allied-Signal* were not intended to modify the unitary business principle by adding a new apportionment ground." In addition, the recent Virginia Court of Appeals decision in *Virginia Dept. of Taxation v. FJ Management Inc.,*[5] which rejected the Department of Taxation's argument that a second, distinct ground for apportionment exists. The phrase in the white paper, "while not clearly required for blended apportionment," creates confusion and could be burdensome for both taxpayers and tax agencies due to the lack of certainty and the potential for lengthy litigation if the state's tax assessments are challenged on constitutional grounds.

The AICPA recommends removing the phrase, "while not clearly required for blended apportionment," from the statement, "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."

*MeadWestvaco Corp. v. Illinois Dept. of Revenue* is relevant to the extent it held the income at issue, in that case, gain on the sale of a division must be part of a unitary business. States may treat partnerships as separately apportionable businesses in the same way that states treat corporations as separate businesses – even when the partnerships are part of a unitary business group. The states may not, however, treat partnerships as combinable in a single apportionment, absent evidence of a unitary relationship, more than the states can do so for a corporation.

[4] *MeadWestvaco Corp. v. Illinois Dept. of Revenue*, 553 U.S. 16, 24–25 (2008).

[5] *Virginia Dept. of Taxation v. FJ Management Inc.*, Record No. 0701-23-2 (Va. Ct. App., November 12, 2024), cert. denied Virginia Supreme Court (June 3, 2025).