

## **SECTION X**

### **Sourcing of Partnership Income by Tiered & Corporate Partners**

#### **DRAFT – FOR DISCUSSION PURPOSES ONLY**

These draft sourcing rules were prepared by MTC staff for discussion by the uniformity work group established to study state taxation of partnership income.

Note: The terms or references to be included by the state are shown in [CAPS].

#### **Part I. Definitions of Terms:**

A. Certain terms used in this Section are defined as follows:

1. Allocate or allocation of distributive share income or items – These terms refer to a partnership’s determination of a partner’s share of partnership income or items under the partnership agreement as well as under any applicable state or federal tax rules. See IRC § 704.
2. Apportionable income or items – Income or items that are included in net taxable income sourced using a particular apportionment formula related to that net income. See [REFERENCE TO THE STATE’S RULES FOR DEFINING APPORTIONABLE OR “BUSINESS” INCOME].
3. Attribute (verb) or attribution of income or items – The way in which the pass-through system for partnerships assigns the tax character of partnership items, as determined by the partnership recognizing those items, to any direct or indirect partners who are allocated a share of those items. This includes character that may affect the sourcing of the items under [REFERENCE TO THE STATES RULES FOR SOURCING INCOME]. See IRC §§ 702(b), 875, 897(c)(4)(B), and 958(a)(2).
4. Built-in gain (loss) – The amount of an item’s fair market value as compared to its tax basis at a particular point in time—including the point at which the item is contributed to or distributed from a partnership. See IRC § 704(c).
5. Character of an item – The nature of items which may affect their tax treatment as determined by a partnership applying general substantive federal or state tax rules based on the activity giving rise to the item. See IRC §§ 702(b) and 703(a). The character of an item may include:
  - a. Type of receipts or expense – such as interest, royalties, dividends, gains (losses), etc.;

- b. The type of transaction giving rise to the income or expense – such as sales or purchases of property, leases of property, sales or purchases of services, depreciation of assets, borrowing of funds, etc.; and
  - c. The assets affected by the transaction – such as real property, tangible or intangible property, inventory, etc.
6. Contribution – Items including cash or property transferred by a partner to a partnership in exchange for a partnership interest. See IRC § 721.
  7. Direct partner – A partner that owns an interest in a partnership.
  8. Distribution – Items including cash or property transferred by a partnership to a partner that represent a return of the partner’s capital. See IRC § 731.
  9. Distributive share or distributive share of items or income – The percentage or amount of a partnership’s income (loss) or the percentage or amount of particular partnership items allocated to a partner in a given tax period. See IRC § 704.
  10. Indirect partner – A partner or owner of a partnership that, itself, owns an interest in another partnership.
  11. Lower-tier partnership – A partnership in which another partnership holds an interest. See IRC § 706(d)(3).
  12. Non-apportionable income or items – Income or items that are assigned (or allocated) to particular states. See [STATE RULES FOR SOURCING OR ALLOCATING NON-APPORTIONABLE OR “NON-BUSINESS” ITEMS OF INCOME.]
  13. Partner – A person, whether an individual, corporation, or other entity taxed as a partner under federal law, including direct and indirect partners. See IRC §§ 761(b) and 7701 and related regulations.
  14. Partnership – An entity taxed as a partnership under federal law including general partnerships, limited partnerships, limited liability companies, etc. See IRC §§ 761(a) and 7701 and related regulations.
  15. Partnership agreement – The agreement between the partners generally or on particular partnership matters, regardless of form, as the term is used for federal tax purposes and consistent with general state partnership law. See IRC §761(c).
  16. 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. Depending on the context, this term may also be applied to financial

results of the partnership that may or may not be the same as the taxable income (loss).

17. Partnership item or items of income – Any tax-significant result generated from a transaction or event including income, expense, gain, loss, etc. that is recognized and given particular treatment under the general state or federal substantive tax rules. See IRC §§ 702 & 704 (and IRS Form 1065, Schedule K-1).
18. Partnership interest or partner's ownership interest – Unless the context otherwise indicates, the general description of a partner's ownership in a partnership or value of the partner's partnership capital. See IRC §§ 704(e) and 864(c)(8).
19. Specifically assign and rules of assignment – The method used to source or allocate income to under [REFERENCE TO STATE RULES FOR SOURCING OR ALLOCATING NON-APPORTIONABLE OR "NON-BUSINESS" ITEMS OF INCOME.]
20. Sufficient unitary relationship – This term refers to the relationship between items of income, the business activities of entities generating those items, and the apportionment factors to be used in apportioning the items as further described in Part VI.
21. Taxpayer or partner attribute (noun) – An aspect of a particular taxpayer that may affect the ultimate tax result for items recognized by or attributed to that taxpayer, which may include:
  - a. Whether the taxpayer or partner is a resident or non-resident individual or a corporation or other type of entity;
  - b. Whether the taxpayer or partner files a separate, joint, or combined/consolidated return;
  - c. The taxpayer's marginal effective tax rate; and
  - d. The taxpayer's participation or role in certain activities.
22. Upper-tier partnership or tiered partner – A partnership that holds an interest in another partnership. See IRC § 706(d)(3).

B. Other terms not defined above are interpreted consistently with the context and with applicable state and federal tax rules.

## **Part II. Conformity to Federal Tax Rules, Including IRC Subchapter K**

- A. [STATE] conforms to the federal tax rules, including IRC Subchapter K, as provided in [REFERENCE TO STATE LAW THAT AFFECTS CONFORMITY FOR CORPORATE AND INDIVIDUAL TAXPAYERS]. In conforming to Subchapter K, [STATE] is also conforming

to the principle that partnerships determine certain tax character of items of income and then attribute the character of the items to partners who receive a distributive share of those items. This character as determined by the partnership may affect the state tax treatment of the items under the state tax rules, including the sourcing of those items under [REFERENCE TO STATE RULES FOR SOURCING INCOME].

- B. In addition, [STATE] conforms to certain anti-abuse rules under IRC Subchapter K as described further in Part V of this Section.

### **Part III. Obligations of Partnerships to File Information Returns and Report Information**

- A. A partnership shall provide to its direct partners the information necessary for its direct and indirect partners to properly compute and report their [STATE] tax. Necessary information includes any information as described or provided for in regulations, forms, and instructions issued by the [STATE TAX AGENCY]. This requirement to provide information applies to:
1. Any partnership doing business in [STATE];
  2. Any partnership that has a direct or indirect partner doing business in or resident in [STATE].
  3. Any partnership that has a direct or indirect interest in a partnership doing business in [STATE].
- B. A partnership shall provide to the [STATE TAX AGENCY] certain information as directed by the [STATE TAX AGENCY] necessary to verify the information required to be reported to partners under Subpart A, above and as provided in regulations, forms, and instructions issued by the [STATE TAX AGENCY].
- C. The type of information that may be required to be reported to partners or to [STATE TAX AGENCY] under this Part II includes:
1. Federal tax-related information, including the character of partnership income and items recognized by the partnership or allocated to the partnership from lower-tier partnerships;
  2. State tax-related information, including the character of partnership income and items recognized by the partnership or allocated to the partnership from lower-tier partnerships, as relevant to compliance with [REFERENCE TO STATE INCOME TAX RULES FOR CORPORATIONS AND INDIVIDUALS];
  3. Information necessary for direct or indirect partners to properly determine the source of partnership income and items, as described further in this Section;

4. Information from lower-tier partnerships or business entities in which the partnership holds an interest that is necessary for that partnership's direct or indirect partners to properly determine the source of partnership income and items as described further in this Section; and
5. Any other information the partnership may have or obtain that is necessary for direct or indirect partners to properly report their state tax on partnership income and items.

#### **Part IV. Sourcing of Partnership Income and Items**

A. A partnership required to report information as described in Part III, must apply the applicable [STATE] and federal tax rules as required by Part II in determining that information.

B. Items Recognized Directly by a Partnership:

Application of the rules for sourcing income under [REFERENCE TO STATE'S SOURCING RULES] to partnership income requires that a partnership determine the following with respect to the items of income, expense, gain, loss or other tax items that it recognizes directly from its activities:

1. Information as to the general tax character of those partnership items as it may be relevant to state tax treatment of the items, including:
  - a. The character of the items for purposes of determining their federal tax treatment to which the state conforms;
  - b. The character of the items for purposes of determining their state tax treatment, including any treatment that varies from the federal tax treatment; and
  - c. The character of the items for purposes of applying the sourcing rules in [REFERENCE TO STATE'S SOURCING RULES].
2. Information as to whether any partnerships items would be non-apportionable as that term is defined by this Section and the rules provided in [REFERENCE TO STATE'S SOURCING RULES—TREATMENT OF NON-APPORTIONABLE OR NON-BUSINESS ITEMS] if those rules were applied based on:
  - a. The item's particular character as determined by the partnership; and
  - b. The relationship of the item to the business activity conducted by the partnership, alone or in conjunction with any entity in which the partnership holds an interest.

In determining this information, the partnership must determine whether its items of income have a sufficient unitary relationship to any business in which

the partnership participates that generates apportionable income, with the understanding that a partnership may engage in more than one unitary business.

3. Information necessary for sourcing all non-apportionable items determined under Paragraph 2 under [REFERENCE TO STATE'S SOURCING RULES—TREATMENT OF NON-APPORTIONABLE OR NON-BUSINESS ITEMS].
4. Information on the net apportionable income of the partnership as determined under [REFERENCE TO STATE'S SOURCING RULES—TREATMENT OF APPORTIONABLE OR BUSINESS ITEMS] based on the particular business activities to which the items making up that net income have a sufficient unitary relationship, including business activity conducted by the partnership alone or in conjunction with any entity in which the partnership holds an interest, with the understanding that a partnership may engage in more than one unitary business.
5. Information on the partnership's apportionment factors related to the items determined to be part of net apportionable income under Paragraph 4, applying [REFERENCE TO STATE'S SOURCING RULES—APPORTIONMENT FACTORS] to determine those apportionment factors.

C. Upper-Tier Partnership Treatment of Items Allocated from Lower-Tier Partnerships:

Items of income, expense, gain, loss or other tax items that are allocated to an upper-tier partnership by a lower-tier partnership generally retain their tax character as determined in Subpart B. But the upper-tier partnership will also determine the following with respect to these items:

1. Whether items determined by the lower-tier partnership to be non-apportionable under Subpart B.2, or apportionable under Subpart B.4, have a sufficient unitary relationship to any business activity generating apportionable income in which the upper-tier partnership is engaged directly or in conjunction with any entity in which the partnership holds an interest.
2. If items determined to be non-apportionable by the lower-tier partnership are properly determined by the upper-tier partnership to have a sufficient unitary relationship to that partnership's own business activity generating apportionable income, then the upper-tier partnership would include these items in the net apportionable income from that upper-tier partnership's related business activities to be apportioned using the upper-tier partnership's related factors when reporting information to that upper-tier partnership's own partners.
1. If items determined to be apportionable by the lower-tier partnership are also determined to have sufficient unitary relationship to the upper-tier

partnership's business activity generating apportionable income, the upper-tier partnership would include these items in the net apportionable income from that partnership's related business activity and would also include a share of the lower-tier partnership's in the upper-tier partnership's apportionment factors to create a "blended apportionment" approach when reporting information on those items and related factors to the upper-tier partnership's own partners.

3. The share of the lower-tier partnership factors to be included under Paragraph 3 is determined using the upper-tier partnership's total distributive share income from the lower-tier partnership as a percentage of that lower-tier partnership's total income using the absolute value of the items making up that distributive share.
4. In determining the blended apportionment factors, any factors included representing transactions between the partner and partnership would be eliminated to the extent of the partner's share determined in Paragraph 4.

D. Corporate Partner Treatment of Items from Partnerships:

Items of income, expense, gain, loss or other tax items that are allocated to a corporate partner generally retain their tax character as determined in Subparts B and C. But the corporate partner will also determine the following with respect to these items:

1. Whether items determined by the partnership to be non-apportionable under Subparts B.2 or C.2 or apportionable under Subparts B.4 or C.3 of this Part VI have a sufficient unitary relationship to any business activity generating apportionable income in which the corporate partner is engaged directly or through related entities.
2. If items determined to be non-apportionable by the partnership are determined to have a sufficient unitary relationship with business activity of the corporate partner generating apportionable income, the corporate partner would include these items in the net apportionable income from that corporate partner's related business activity to be apportioned using the corporate partner's related factors.
3. If items determined to be apportionable by the partnership are determined to have a sufficient unitary relationship with the business activity generating apportionable income of the corporate partner, the corporate partner would include these items in the net apportionable income from that corporate partner's related business activity and would also include a share of the partnership's factors in the corporate partner's apportionment factors to create a "blended apportionment" approach.

4. The share of the partnership factors included under Paragraph 3 is determined using the corporate partner's total distributive share income from the partnership as a percentage of that partnership's total income using the absolute value of the items making up that distributive share.
5. In determining the blended apportionment factors, any factors included representing transactions between the partner and partnership would be eliminated to the extent of the partner's share determined in Paragraph 4.

**Part V. Application of Federal Tax Requirements, Limitations, and Anti-Abuse Rules**

- A. A number of federal tax rules are applied to determine the proper tax treatment of partnership income under the Internal Revenue Code generally, Subchapter K, and related federal regulations. To the extent these rules set requirements for or limits on certain treatment of partnership items for federal tax purposes, those requirements or limits would also apply to any directly related state tax effects.
- B. Other federal tax rules provide that the results of the federal tax treatment claimed must be consistent with the economic effect or substance of the activities or transactions purported to be undertaken. Where the tax results are not consistent with the economic substance, these rules may require modification of the tax treatment. Again, to the extent these rules limit certain treatment of partnership items for federal tax purposes, they would also limit any directly related state tax effects.

But these rules may also be applied in determining the proper treatment of partnership income where the effect is solely on the state tax result, including the application of sourcing rules under [REFERENCE TO STATE SOURCING RULES]. In applying these federal requirements to the state tax treatment of partnership income, the inquiry will not be limited to the effect on federal taxes but will also consider whether the state tax results fairly represent the economic effect or substance of the activities or transactions.

In particular, the following federal requirements will be applied when determining the proper state tax treatment, including the sourcing of partnership income.:

1. The general federal tax economic substance rule set out in IRC § 7701(o)
2. The general partnership anti-abuse rule set out in IRS Reg. § 1.701-2.
3. The substantial economic effect requirements under IRC § 704(b) and related regulations.
4. The rule for determining the effects of related-party transactions under IRC § 482.
5. The consistency requirement of IRC § 6222.

- C. In the case of mandatory allocations of built-in gains (losses) to the contributing partner as required under Subchapter K, the source of those gains (losses) will be determined under the rules of Part V of this Section unless there is evidence that the property was contributed by the partner to the partnership in order to shift the sourcing of that gain (loss).

#### **Part VI. Sufficient Unitary Relationship**

The term “sufficient unitary relationship” as used in this section refers to the necessary relationship between items of income and the apportionment factors used to source that income, especially in the pass-through tax system used to impose tax on partners for their shares of partnership income. The term takes into account all the facts and circumstances relevant to the sourcing treatment of particular items of income including:

- A. The relationship between the partnership that recognizes the income or items and the partners, including tiered partners, or other entities that are engaged in the related business activities generating other income or items, including:
  - 1. The extent of actual control held or exercised or the existence of common control held, regardless of the share of partnership capital held;
  - 2. The extent to which related activities are integrated or coordinated;
  - 3. The extent to which resources and costs are shared; and
  - 4. The extent of transactions or flows of value between the entities.
- B. The extent of common use by the partnership and partners, including tiered partners, of assets held by the partnership or partners.
- C. The nature of common use by the partnership and partners, including tiered partners, of assets held by the partnership or partners.

[NOTE: Here states may also want to consider other limitations on the use of blended apportionment, such as limits related to the amount of a partner’s distributive share.]