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# State Tax Sourcing of Partnership Income Under the Pass-Through Tax System & the Blended Apportionment Method

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Multistate Tax Commission  
DRAFT – JANUARY 29, 2026

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Prior versions of this white paper are on the MTC project page here:  
<https://www.mtc.gov/uniformity/project-on-state-taxation-of-partnerships/>.

Substantive changes from the September 15, 2025, version are highlighted in this version.

## FOR DISCUSSION PURPOSES ONLY

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*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.*

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## IMPORTANT NOTE ON SOURCING TERMINOLOGY

*Subsection I.C. below lists the critical terms and how they will be used in this white paper.  
This note is to alert readers as to how certain essential state sourcing terms will be used here.*

Terminology is critical for any possible discussion or understanding of this subject. And, as Section I.B. notes, there are three separate bodies of law that can affect definitions and usage of important partnership or tax terms—general state laws governing the formation of partnerships, federal Internal Revenue Code (IRC) and Subchapter K, and state tax laws and sourcing rules.

These different laws may use some important terms and concepts in somewhat different ways. Different states' tax laws may also use different terms to refer to the same or similar concepts.

### **Critical State Sourcing Terms – “Business Income” & “Nonbusiness Income”**

Two critical terms, in particular, should be noted here—“business income” and “nonbusiness income.” These terms were included in the Uniform Division of Income for Tax Purposes Act (UDITPA) when it was drafted by the Uniform Law Commission in 1957 to designate the income and items that may or may not be subject to formulary apportionment.<sup>1</sup> Over time, as these terms were used more widely, they also came to be associated with and interpreted in the context of U.S. Supreme Court precedent involving specific dormant commerce clause questions. These questions typically involved whether, in certain cases, items of income (e.g., dividends, gains, etc.) could be included in the net income of a taxable corporation apportioned using a given formula related to the corporation's business activities—that is, whether they were part of the “unitary business” along with the factors.

The concepts to which the terms “business” and “nonbusiness” income refer have also evolved over time and there are significant unanswered questions.<sup>2</sup> Nor has the Court ever addressed how these concepts, or the formulary apportionment approach generally, might apply to a partnership's distributive share income allocated to taxable partners under the pass-through tax system.

### **The Problem with the Terms “Business” and “Nonbusiness”**

As with many terms used in the tax area, “business” and “nonbusiness” may have both general as well as specific meanings, depending on the context. For example, “business income” might simply refer to the income of a business entity. As a result, these terms can be easily misunderstood. The MTC recognized this problem in 2014 when it adopted a revised version of UDITPA as part of the MTC's model Compact (Art. IV), which substituted the terms “apportionable” and “non-apportionable” for “business” and “nonbusiness.”<sup>3</sup> However, most states still use the terms “business” and “nonbusiness.” See Section III of this white paper.

### **Use of “Apportionable” and “Non-Apportionable”**

We recognize that “business” and “nonbusiness” are still used throughout state tax sourcing rules and are embedded in case law, so it is difficult for states to shift to using the terms “apportionable” and “non-apportionable.” But using the terms “business” and “nonbusiness” is especially problematic in the context of this white paper where the focus is on how sourcing rules are to be applied to *businesses* that are taxed under pass-through system and where, due to the complexity, it is important to be as clear as possible.

Therefore, this white paper will use the term “business” as a general term when referring to the entities or activities generating income (e.g. “income of a business conducted by a partnership”). But when referring to income or items that may or may not be included in the net income to be apportioned using a particular apportionment formula—the white paper will use the terms “apportionable” and “non-apportionable.”

<sup>1</sup> See the model on the Uniform Law Commission website – <https://www.uniformlaws.org/committees/community-home?CommunityKey=f2ef73d2-2e5b-488e-a525-51be29fbee47>.

<sup>2</sup> See, for example, *MeadWestvaco Corp. v. Illinois Dept. of Revenue*, 553 U.S. 16 (2008), FN 4.

<sup>3</sup> See the recommended version of UDITPA in Art. IV of the revised Multistate Tax Compact, here: <https://www.mtc.gov/the-commission/multistate-tax-compact/>, and the Hearing Officer's report describing the change in terminology and the reasons for it, here: <https://www.mtc.gov/wp-content/uploads/2023/02/Pomp-final-final3-2.pdf> (starting at page 44).

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## INTRODUCTION & BACKGROUND

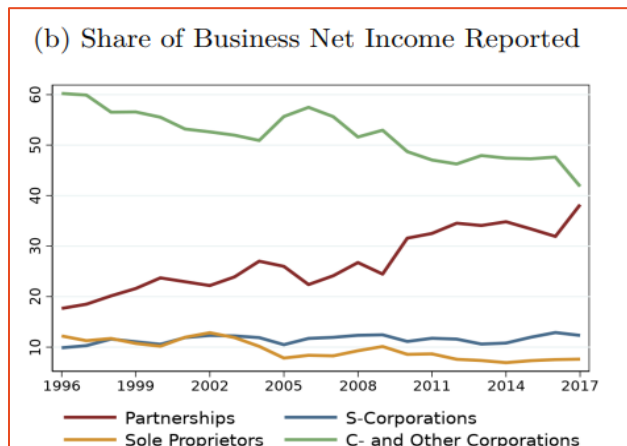
**NOTE:** Materials related to the MTC State Taxation of Partnerships project can be found on the MTC website, here: [MTC Partnership Project Webpage](#).

### The MTC Project on the Taxation of Partnerships

This project was proposed by an MTC compact member state, reviewed by the standing subcommittee, and approved by the MTC Uniformity Committee at its April, 2021 meeting. The committee created a work group of member states to oversee and provide input on the project. The work group developed a comprehensive issue outline which has been reviewed and periodically updated (available on the project webpage above).

The Uniformity Committee chose to focus on the taxation of partnerships for a number of reasons, including:

- The share of total business net income earned by partnerships has grown substantially. (See the graphic to the right—which shows the trend through 2017.<sup>4</sup>)
- Today, there are many more large, complex partnership structures than in prior years.<sup>5</sup>
- States conform to the federal pass-through tax system which adds a layer of complexity to state tax reporting and computation.



A significant portion of the issues identified by the work group involve the state “sourcing” of partnership income—that is, the determination of a state’s share of multistate income.

### Work Group Process

The work group for this project conducts its business publicly, reviewing the research and analysis of MTC staff and taking input from states, practitioners, and taxpayers. White papers are issued in draft form with changes highlighted as the drafting process goes on.

The project has focused on issues that may not be fully addressed under existing state rules. While states have adopted general rules for sourcing the income from various activities, the pass-through tax system raises some uncertainty about the application of those general rules to partnership income. This is especially true for complex partnership structures and the issues they raise. The lack of specific state rules may mean that some income is not sourced or taxed by any state. And differences between the states’ rules may subject partnership income to multiple taxation.

This project is, therefore, generally focused on two goals—preventing partnerships from being used merely to circumvent the general state tax rules, and developing workable, uniform sourcing rules to reduce the chance of multiple taxation. These rules can also help simplify the reporting of partnership income by practitioners, who must grapple with the difficulties of reporting the income from complex partnership structures created by taxpayers.

<sup>4</sup> 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>.

<sup>5</sup> 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>.

## **Separate Issues Addressed Prior to this White Paper**

Before undertaking this white paper, the work group studied two other related issues involving the sourcing of partnership income—drafting white papers and models to address those issues. To ensure consistency in the proposals, the work group is holding those draft models until the issues covered by this white paper are addressed. The treatment of issues covered in this white paper should be understood in the context of these other proposals—particularly the proposal with respect to investment partnership income.

- **Investment Partnerships** –

Over half of all partnership income is reported by the finance and insurance industry segment.<sup>6</sup> Much of this income flows through private equity funds or other investment partnerships. The majority of states have special rules for the treatment of investment partnership income, which differ from the treatment of operating partnership income. These special state rules do not look to the activities of the investment partnership (offices, employees, management of assets, etc.) when sourcing the partnership’s income. Instead, most simply source the income to the residence of the partners.

The problem is that this approach—sourcing investment partnership income to residence or domicile—may allow investment partnerships to be used to shift the income of certain assets, including investments in other operating partnerships, away from the state to which that income would otherwise be sourced.

The work group’s proposed approach, which addresses investment partnership income flowing to individual partners, would instead source the income as though the partner owned the underlying assets directly. Like the existing state rules, this proposed approach would not base sourcing on the activities of the investment partnership. But unlike the existing rules, it would not allow the use of investment partnerships to shift the sourcing of income from certain assets. This is more consistent with the attribution principle on which the pass-through tax system is based. And it also means the state sourcing of similar types of income would be more equitable.

The current version of the investment partnership model is on the MTC website on the project page, here: <https://www.mtc.gov/uniformity/project-on-state-taxation-of-partnerships/>.

- **Guaranteed Payments** –

The majority of states have rules addressing the treatment of guaranteed payments made to individual partners for services. The treatment varies. The majority of the states with specific rules source the payments in the same way as distributive share income. But a minority of states source certain guaranteed payments to the location where the partner performed the services or to the partner’s residence. The work group’s proposed approach would source guaranteed payments for services in the same way as distributive share but would also provide a credit to help avoid multiple taxation if state rules differ.

The current version of the guaranteed payment model is on the MTC website on the project page, here: <https://www.mtc.gov/uniformity/project-on-state-taxation-of-partnerships/>.

Note that because we have addressed the income of investment partnerships—proposing special rules—any references in this white paper to the treatment of partnership income generally should be understood in light of those special rules

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<sup>6</sup> See IRS Statistics of Income, available on the IRS website - <https://www.irs.gov/statistics/soi-tax-stats-partnership-statistics-by-sector-or-industry>.

## **General Approach to Sourcing Partnership Income**

States have long taken the position that they can tax the income flowing to non-resident partners by applying the state's general sourcing rules to the activities of the partnership giving rise to that income. This was the approach taken by the Multistate Tax Commission in 2003 in its model rule for withholding on partnership income for non-resident partners.<sup>7</sup> Indeed, during the adoption of this model, the debate centered not on whether the withholding approach would work, but on whether states could source partnership income of partners to the state where the partnership operates. Today, most states that tax partnership income impose similar withholding requirements for non-resident partners.

As this white paper explains in much more detail, this approach to sourcing partnership income is consistent with the pass-through tax system generally. (And the special investment partnership rules, discussed above, represent an exception that effectively "proves" this rule.)

### **Scope of this White paper**

This white paper addresses how this long-standing approach to sourcing partnership income applies where there are:

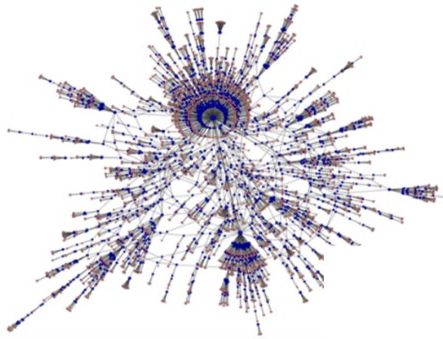
- Complex partnership structures,
- Special or mandatory allocations of partnership income to particular partners, and
- Related-party transactions.

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<sup>7</sup> See that model – <https://www.mtc.gov/wp-content/uploads/2023/02/ProposedStatLanguageReportingOptions.pdf>.

# EXECUTIVE SUMMARY- FINDINGS & RECOMMENDATIONS

*This section summarizes the findings of this white paper and the general recommendations for states to consider.*



The issues addressed in this white paper are complex—in part because of the federal pass-through tax system created by Subchapter K, to which the states generally conform. That system relies entirely on proper reporting of information by partnerships to their partners, but it also allows taxpayers to create extremely large and complex structures (like the one illustrated on the left).

## Approach to Drafting the White Paper & Important Criteria

The approach used by the work group and MTC staff in drafting this white paper can be summarized as follows:

1. Identify general issues with taxing partnership income and how the issues relate to each other.
2. Categorize and study related issues by –
  - a. Analyzing the critical context.
  - b. Researching existing state rules.
  - c. Looking for gaps and trends in the existing state rules.
3. Consider which approaches to addressing the issues are the best fit in terms of:
  - a. Conforming to applicable federal and state tax rules.
  - b. Treating the income of businesses consistently.
  - c. Being generally administrable by all business partnerships.
  - d. Curtailing the use of partnerships to avoid tax.
  - e. Complying with any constitutional restraints.

## General Points Necessary for Understanding the Issues

The following general points are critical to understanding the issues addressed by this white paper:

<b>States tax income of businesses on a source basis.</b>	Like the U.S. government and its trading partners, states generally tax income of businesses on a source basis. This is true regardless of whether the business is a proprietorship, corporation, or partnership. (The difference is that, for corporations, states rely entirely on formulary apportionment rather than taxing 100% of income based on domicile and giving credits for taxes paid.)
<b>States conform to the federal attribution principle.</b>	The federal pass-through system is based on the attribution principle—requiring partners to apply the tax rules as if they engaged directly in the underlying activity of the partnership. Without this, partnerships can be used to alter the tax results of those activities. States that conform to the federal pass-through system also conform to the attribution principle.
<b>Partnership structures are growing in complexity.</b>	Taxpayers and businesses are forming more and more complex partnership structures with multiple tiers and partners who may receive special allocations of partnership income. This requires states to adopt more specific state tax rules to address how income is sourced in these complex structures.

## Findings

The white paper’s most important finding is:

**State rules for sourcing multistate partnership income 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 reference the sections of the white paper that explore these topics in more detail.

### Findings Related to General Partnership Context (See Subsections I.A.-I.C.):

1	<b>State tax treatment of partnership income is affected by three important bodies of law:</b>	<ul style="list-style-type: none"> <li>• General state law governing partnership formation and operation,</li> <li>• Subchapter K and the federal pass-through tax system to which states conform, and</li> <li>• General state sourcing rules for business and related income.</li> </ul>
2	<b>Terminology is critical and imprecise or inconsistent use can create problems.</b>	Common partnership terms are often poorly defined and can vary in their exact use or meaning under the three separate bodies of law above. Moreover, states may use somewhat different terms when referring to the same general concepts. Consistent use of terms is critical to avoiding ambiguity and unintentional results.
3	<b>The aggregate theory of partnerships is not a reliable guide for most state tax questions.</b>	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. Nor is the aggregate theory necessary for imposing tax on a pass-through basis, as the U.S. Supreme Court recently noted in <i>Moore v. United States</i> . <sup>8</sup> 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	<b>Large, complex partnerships raise unique issues that state rules must address.</b>	Traditional partnerships were generally small, simple businesses in which partners participated and shared income according to their relative investment. In terms of numbers, most still are. But in recent years, there has been a rapid growth in huge, complex partnerships 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.
5	<b>Partners roles and relationships can vary substantially.</b>	State laws governing partnerships and partners allow for much more flexibility than for corporations and their shareholders. For example, in corporate structures, ownership equals control. But that is not true for partnerships. Partnerships allow partners’ to vary their roles and relationships, and to change those roles and relationships over time, regardless of ownership. So one characteristic of a partner (e.g., limited liability) does not dictate other characteristics (e.g., active participation in the business). 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.
6	<b>The partnership agreement is critical to understanding a particular entity.</b>	Because partnership structures and the relationships and roles of partners can vary substantially, each partnership is, in large part, a product of its partnership or operating agreement. The agreement may be the prime source for determining partners’ shares of income and their economic relationship.

<sup>8</sup> 602 U.S. 572 (2024).

## **Findings Related to the Federal Pass-Through System (See Subsection I.D.):**

<b>1</b>	<b>Not all partnership structures are small or simple and federal tax rules allow complexity.</b>	Unlike S Corporations, partnerships may have an unlimited number of all types of partners, including tiered partnership partners, and this, in turn, can be used to create complex structures, including circular structures in which lower-tier partnerships own interests in upper-tier partnerships.
<b>2</b>	<b>Partnership contributions and distributions are generally non-recognition events.</b>	Contributions and distributions to and from a partnership generally do not give rise to income (expense) or gain (loss), with some limited 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.
<b>3</b>	<b>Distributions and distributive share are two different things.</b>	Partners pay tax on their distributive share of partnership income or loss when it is earned or incurred by the partnership, whether or not they receive any actual distributions (and they often don’t).
<b>4</b>	<b>A partner’s share of partnership income can vary by item and need not match their capital.</b>	Allocations of partnership income 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 items. These so-called “special allocations” must have substantial economic effect—a standard that is, in part, related to the federal tax effect of the 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.)
<b>5</b>	<b>Mandatory allocations may implicate state tax sourcing.</b>	In some circumstances, Subchapter K may require partnerships to make mandatory allocations to partners—the most common being allocating built-in gain or loss on contributed property to the contributing partner when that gain or loss is, ultimately, recognized by the partnership. This mandatory allocation recognizes that the built-in gain/loss was accrued in a prior period and this may also implicate state sourcing of that gain or loss.
<b>6</b>	<b>Partners and partnerships may engage in transactions that implicate state sourcing.</b>	Guaranteed payments or payments made under IRC § 707(a) (to partners not in their role as partners) raise apportionment questions states should address including: How should such payments be treated when computing the sales (receipts) factors of 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?
<b>7</b>	<b>Important federal anti-abuse rules may not apply where the issue is state-tax related.</b>	Federal anti-abuse rules are critical to making the pass-through system work as intended, but some of these rules reference the effect of structures or transactions on federal tax so that their application where the effect is on state taxes is less clear. States may therefore want to specifically adopt anti-abuse rules where the effect on state taxes is separate or indirect
<b>8</b>	<b>Federal rules related to the consistency requirement may not apply to state tax reporting.</b>	Federal tax administrative rules require partners to report partnership income consistently with the partnership’s treatment of that income. Any different treatment must be noted and there is an expedited process for adjusting inconsistent positions taken. States may need to adopt similar rules.
<b>9</b>	<b>States need to update partnership tax rules to address complexity.</b>	The inherent complexity of the pass-through system as well as the growing complexity of partnership structures necessitate a continuing process to adopt limits, presumptions, safe harbors, and other similar rules to make state taxation and sourcing of multistate income more administrable.

## Findings Related to State Sourcing Rules (See Subsection I.E. and Section III):

1	<b>Using consistent sourcing rules for all businesses and treating partners consistently contributes to equity and simplicity.</b>	Using the same general sourcing rules for different forms of businesses and partners contributes to a more equitable and simpler tax system. That said, it is important to recognize and address the differences between income taxed on a pass-through basis versus at the entity level, and the unique issues pass-through taxation may raise. Otherwise, the form of entity may significantly change the sourcing result for income from the same activities.
2	<b>State sourcing rules, developed in the context of taxable corporations may not sufficiently address partnership income.</b>	Both the state sourcing rules and the limits on state authority to tax multi-state 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.
3	<b>Embedding state partnership tax rules in context of corporate or individual taxes may make it more difficult to fully address issues.</b>	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 embedded in the corporate or individual tax sections. This may contribute to the difficulty in developing more detailed rules for sourcing partnership income.
4	<b>Application of the unitary business principle to partnerships and their income is uncertain.</b>	<p>The unitary business principle was created by the U.S. Supreme Court and has been applied to limit states' use of formulary apportionment to source multistate income of corporate businesses. The application of this principle to partnerships and the apportionment of distributive share income is uncertain. But two aspects of the principle should be noted:</p> <p style="margin-left: 40px;"><b>a. Apportionment can apply to less than the entire income of a unitary business.</b></p> <p style="margin-left: 40px;">Apportionment can be applied to only a portion of the income of a unitary business. So, for example, some states allow corporations that are part of a unitary group to file and apportion their income separately.</p> <p style="margin-left: 40px;"><b>b. A single business or taxpayer may have multiple unitary businesses subject to apportionment.</b></p> <p style="margin-left: 40px;">The drafters of UDITPA as well as most states have recognized that a single entity or group may be engaged in business activities that are not related to each other but are part of separate unitary businesses. In that case, the net income of each business can be apportioned using a separate formula with the related factors for that particular business.</p> <p>This is important for sourcing partnership income since states may apply separate apportionment to that income at the partnership level—without including the partner's share in its own apportionable income.</p>
5	<b>States may need to address the effect of partnership activities on sales (receipts) factor throw-back and throw-out rules.</b>	The question of how throw-back or throw-out rules apply where a partner has an interest in a partnership doing business in the destination state may be unclear, particularly where the state's jurisdiction may be limited by P.L. 86-272. The leading case on this question (discussed in subsection I.E.) would attribute the activities of the partnership in the state to the 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.

6	<b>In simple partnerships—state sourcing rules are applied at the partnership level.</b>	In the case of simple, traditional partnerships, states have applied their sourcing rules at the partnership level. Under this approach, if the partnership would source income to the state, applying that state’s rules to its own activities, then the out-of-state partners would be subject to the state’s tax on their share of that state-sourced income. States use withholding to enforce this tax.
7	<b>State rules of assignment for non-apportionable distributive share income will apply on an item-by-item basis.</b>	Under UDITPA, non-apportionable income is sourced using allocation rules, or “rules of assignment” as referred to in this white paper. None of those rules address partnership distributive share income specifically. But this is due to the fact that distributive share income is made up of partnership items which may have their own separate tax character, which is then attributed to the partners and which, in turn, would affect how the rules of assignment apply. So, for example, if the distributive share income allocated to a partner includes a non-apportionable capital loss from the sale of property, then that loss, and any partner’s share of that loss, would be sourced applying the rule of assignment for sales of the related property. In no case would distributive share income be subject to the rules for sourcing non-apportionable dividends.

### **Findings Related to the Attribution Principle (See Subsection I.F.)**

1	<b>The attribution principle is critical to the proper functioning of the pass-through tax system.</b>	The attribution principle is a fundamental part of the pass-through tax system as was recognized by the U.S. Supreme Court in its recent decision in <i>Moore v. United States</i> . The system would not work without this principle. But the interaction between the unitary business principle and the attribution principle is not clear.
2	<b>How the attribution principle will apply to state characteristics of partnership items is uncertain.</b>	To the extent a state conforms to Subchapter K, the attribution principle would determine the state tax treatment of partnership income where that treatment is based on the federal characteristics of the income. And this is true regardless of the partner’s role, relationship, or the partner’s own attributes. But there may be questions of an item’s character that only affect state tax. 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.
3	<b>Determining whether partnership income is apportionable or non-apportionable income at the partnership level is consistent with the attribution principle.</b>	The character of partnership items as either apportionable income or non-apportionable income can be determined at the partnership level and then attributed to the partners, along with sourcing-related information. Nor does this separate sourcing (or separate apportionment) create any conflicts with UDITPA, the general state apportionment rules, or any constitutional limits on state taxation.

## Recommendations

<b>1</b>	<b>Use terms consistently with partnership law and Subchapter K or clearly express or define any different use or terms.</b>	As noted throughout this white paper, the differences between partnerships and corporations as well as the special terminology used in partnership law and Subchapter K can often create confusion. This confusion can be exacerbated by the fact that state partnership tax rules are often inserted into the rules for individual or corporate taxpayers. One way to mitigate confusion is to be very careful with the use of important terms—using those terms consistently with general partnership law and Subchapter K, if at all possible. If terms are used differently (or if different terms are used), this should be expressly stated. (See subsection I.B., C. and D.)
<b>2</b>	<b>Recognize the attribution principle and its effect on the application of state tax rules to partnership income.</b>	This white paper emphasizes the importance of the attribution principle to the functioning of the pass-through tax system as intended. State tax rules should be applied consistently with this principle, which includes applying state sourcing rules at the partnership level to determine the essential characteristics of partnership items that, along with certain attributes of the partner, will determine how that income is sourced. (See subsection I.F.)
<b>3</b>	<b>Adopt the following general sourcing framework for partnership income:</b>	<ol style="list-style-type: none"> <li>a. The partnership will determine whether its items of income recognized directly from its own activities are apportionable or non-apportionable income, using information reasonably available and applying general state rules.</li> <li>b. The partnership will determine essential sourcing information for items determined to be non-apportionable, based on the item’s character, and will report this information to partners for their use.</li> <li>c. The partnership will determine its apportionment factors by state and provide information sufficient for partners to use those factors in sourcing their share of the partnership’s apportionable income.</li> <li>d. The partners will source their share of items determined by the partnership to be non-apportionable: <ol style="list-style-type: none"> <li>i. General Rule – Based on the partnership sourcing information.</li> <li>ii. Exception – Where the item is properly determined by the partner to be part of its apportionable income, it will be sourced by including the item in that apportionable income and using the partner’s related apportionment factors.</li> </ol> </li> <li>e. The partners will source their share of items determined by the partnership to be apportionable income: <ol style="list-style-type: none"> <li>i. General Rule – Separate Apportionment – Applying the partnership’s apportionment factors to those items.</li> <li>ii. Exception – Blended Apportionment – Combining the items with the partner’s own apportionable income and apportioning using a formula that also combines a share of the partnership factors.</li> </ol> </li> </ol> <p>NOTE: In no case will items determined to be apportionable by the partnership be treated as non-apportionable by the partner. (See subsection II.A.)</p>
<b>4</b>	<b>When applying blended apportionment, determine the share of the partnership factors to include in the partner’s apportionment formula using the absolute value approach.</b>	There are different methods that might be used for determining the share of partnership factors to include in the partner’s blended apportionment formula. Most states that use blending reference the use of distributive share to determine the share of factors but other states may not specify the method to use. The use of distributive share may create issues where there are special allocations, resulting in a partner with negative distributive share while the partnership has positive income or vice versa. The use of absolute value can address this issue. (See subsection II.B.)

5	<b>Apply blended apportionment when there is a sufficient unitary relationship between apportionable income of the partnership and the apportionable income of the partner.</b>	<p>The attributes of a unitary relationship between the apportionable income of the partnership and apportionable income of the partner may include:</p> <ul style="list-style-type: none"> <li>• control (without a minimum ownership requirement),</li> <li>• entity unity criteria including flows of value,</li> <li>• asset unity criteria including operational function of the partnership's assets in the business activity of the partner giving rise to its own apportionable income, or</li> <li>• other common criteria generally applied in the corporate context, including substantial intercompany transactions.</li> </ul> <p>(See subsection II.B.)</p>
7	<b>Expressly address how partner-partnership transactions will be treated in sourcing partnership income, including the effect on the receipts factor, and consider anti-abuse rules.</b>	<p>State rules should make clear that when applying blended apportionment, the effects of partner-partnership transactions will be eliminated to the extent of the partner's distributive share, and that this elimination also applies to amounts included in the blended receipts factor (including amounts treated as guaranteed payments). However, because it is not possible to require partnerships taxed on a pass-through basis to report income of related entities in a combined return, states should also look to the kinds of anti-abuse rules that may be imposed when taxing corporate income tax on a separate entity basis. The MTC model add-back statute is one resource. Adopting transfer-pricing authority, similar to that under IRC § 482, is another option. (See subsection II.D.)</p>
6	<b>Consider a special rule for sourcing mandatory allocations of built-in gains (losses) in some situations.</b>	<p>Because of the potential to use partnerships to shift the sourcing of built-in gains (losses) from contributed assets, states should consider adopting a special rule for sourcing these gains (losses) using partner information from the year of contribution. (See subsection II.C.)</p>
8	<b>To prevent abusive income shifting or other similar issues, states also need other anti-abuse rules and may look to those adopted by the federal government.</b>	<p>Subchapter K has numerous anti-abuse provisions which are essential to making the pass-through system work as intended. Some anti-abuse rules impose specific limitations, conditions, or exceptions to the general rules. Others may look to whether the federal tax results correspond with more generalized standards, including the economic effect of the activities or transactions. While states that conform to Subchapter K will also conform to the specific rules, it is not clear how the general rules apply when it is the state tax result, rather than the federal tax result, that is affected. Anti-abuse rules for states to consider adopting include:</p> <ul style="list-style-type: none"> <li>• IRC § 7701(o) - general economic substance rules,</li> <li>• IRC § 482 - transfer-pricing rules (see No. 7 above),</li> <li>• IRS Reg. § 1.701-2 - general partnership anti-abuse rules,</li> <li>• IRC § 704(b) - requirement for allocations of items to have substantial economic effect,</li> <li>• IRC § 6222 - requirement for partner/partnership reporting consistency, and</li> <li>• Rules for applying equitable apportionment when necessary.</li> </ul> <p>(See subsection II.E.)</p>
9	<b>Consider limitations or exceptions to simplify state sourcing requirements.</b>	<p>Where possible, offering simplified methods for reporting and sourcing partnership income may lower the burden on small, simple partnerships and businesses.</p>
10	<b>Consider updating partnership information reporting to ensure partners have necessary information.</b>	<p>States may need to update information returns from partnerships to ensure that partners have information necessary to properly treat and source income.</p>

## SECTION I. IMPORTANT CONTEXT FOR UNDERSTANDING THE ISSUES

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

<b>Section I - Important Context for Understanding the Issues includes the following subsections:</b>
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I.A. Examples of Issues and Common Questions
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I.B. Overview of Important Law
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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**

This subsection I.A. looks at some simple examples of how the pass-through system creates unique state sourcing issues and summarizes common sourcing questions that states are facing.

### **State Rules for Sourcing Multistate Income – Generally**

In all but a few states, the rules for sourcing income of multistate businesses are the same regardless of the form of the business (e.g., corporations, proprietorships, partnerships, etc.). See further discussion in subsection I.E. below.<sup>9</sup>

➤ **Non-Appportionable Income – Rules of Assignment**

States apply rules to identify items of income and related expense that are considered “non-apportionable” (“non-business”) and source those items using certain rules of assignment based on the items’ character (e.g. sales of property, interest, etc.).

➤ **Net Appportionable Income – Formulary Apportionment**

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

### **Treatment of Related Entities - Generally**

The constitutional basis for using formulary apportionment to source net income is the unitary business principle.<sup>10</sup> Rather than sourcing each item of income and expense, the net income from business activities is sourced using a formula based on related factors. And a single unitary business may be conducted by multiple related entities. So the net income from that business may be apportioned by a state using a common apportionment formula for that net amount—even if some portion of the income or expense is from an entity that, itself, has no activities in the state.

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 income from that unitary business or source, and not on a 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.<sup>11</sup> Still, most states exclude foreign corporations that have little U.S. based activity, even if they are part of the unitary group.

It may also be the case that a single entity conducts multiple unitary businesses. In that case, the net income of those businesses may be apportioned using different formulas.

### **Examples of Issues Created by the Pass-Through System**

Applying the general 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 possible results are “right” or “wrong”).

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

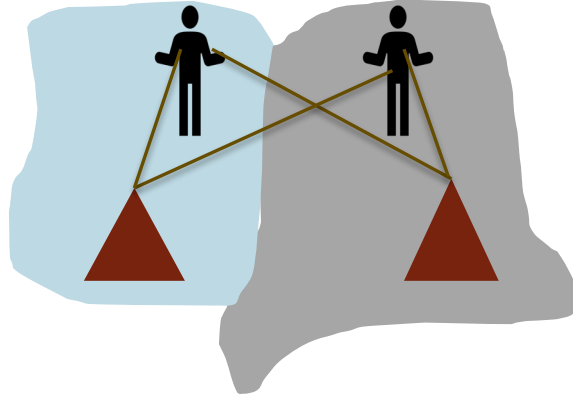
<sup>9</sup> For example, Bloomberg Law provides a multistate chart that categorizes how states source partnership income—whether at the “entity level” or the “owner level.” Only three states are listed as “owner level” and two of those states—Alaska and Florida—lack an individual income tax (so that the reference to owner would be to a corporate partner) and the third, Pennsylvania, only taxes particular items of income. As for the rules used, this resource also indicates states generally apply the same apportionment rules as used for corporations.

<sup>10</sup> See Hellerstein, Hellerstein & Appleby: State Taxation, ¶¶8.07-8.10 (WG&L). And note, the unitary business principle is discussed further throughout this white paper, including especially in section II.B.

<sup>11</sup> See Hellerstein supra fn. 9, ¶8.03.

### **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 – pay tax on 100% of their income to the state and receive a credit for taxes paid, generally using the resident state’s sourcing rules to determine the extent of that credit.
  - Nonresidents - partnership 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 (or taxed solely) to State A
  - P2 has \$100,000 of net loss apportioned entirely (or taxed solely) 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.

### **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:

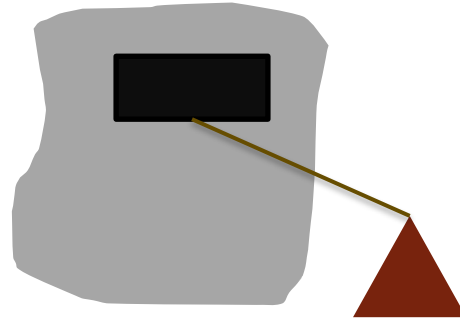
X net income -	\$2 million
X receipts factor -	\$10 million / \$10 million
LLC net income -	\$12 million
LLC receipts factor -	\$0 million / \$20 million

- 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:

$$\begin{aligned} \text{X's total income} &= \$2 \text{ M} + 50\% \text{ of } \$12 \text{ M} = \$8 \text{ M} \\ \text{Blended factor} &= \frac{\$10 \text{ M in State A}}{\$10 \text{ M} + 50\% \text{ of } \$20 \text{ M} = \$20 \text{ M}} \\ &= 50\% \end{aligned}$$

$$\text{Net income sourced to State A} = \$8 \text{ M} \times 50\% = \$4 \text{ million}$$



### **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 except 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 non-apportionable income under the circumstances.
- Two possible results:
  - None of the gain is taxable - State A’s rule for non-apportionable 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 non-apportionable 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

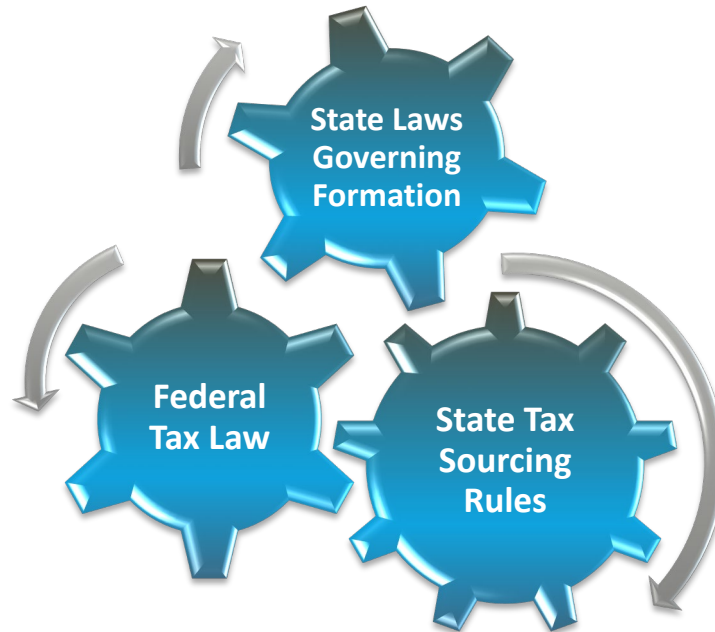
States today face common questions about sourcing of partnership income taxed under the pass-through system:

- 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 (combining the partner and partnership factors) 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. General 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 of Partnerships**

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 partnership laws also allow for the creation of different forms of partnerships (e.g., general partnerships, limited partnerships, LLCs, etc.).

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 the partners.

#### **Most States' Laws Generally Follow 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 the state governing laws. These theories sometimes also come up in the context of state tax 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 . . .

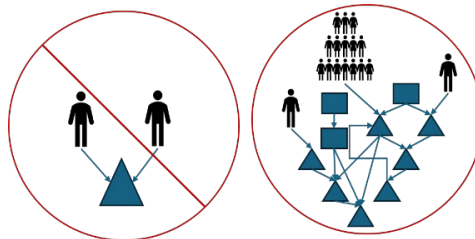
The [current] Act enhances the entity treatment of partnerships to achieve simplicity for state law purposes, particularly in matters concerning title to partnership property. RUPA does not, however, relentlessly apply the entity approach. The aggregate approach is retained for some purposes, such as 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 are less sound today. But see also the discussion of the attribution or “conduit” principle in subsection I.E. below.**

### **State Governing Laws Impose Few Limits on 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.<sup>12</sup>



**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.**

<sup>12</sup> See “Large Partnerships: Characteristics of Population and IRS Audits,” U.S. Governmental Accountability 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](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=5014267) .

## **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 Upon Formation**

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 formal articles of organization and other partnerships may have a similar requirement, those documents typically do not contain extensive information on owners, assets, or activities<sup>13</sup>.

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

## **CATEGORY 2: Federal Tax Law - Generally**

States are said to “conform” to the federal Internal Revenue Code (IRC) when taxing income—and most do to a degree. This includes the substantive tax rules that determine the timing, amount, and tax character of items of income, expense, gain, and loss. 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 of Subchapter K 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. Much of the focus of this white paper will be on the rules under Subchapter K, but the substantive tax rules may also come into play, especially when considering the treatment of the character of items of income or the tax attributes of partners that are determined under those rules.

The implications of conforming to the federal partnership tax system are 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.”<sup>14</sup>

**STATE TAX IMPLICATION: Understanding the basics of the federal pass-through system as well as how that system interacts with the substantive tax rules is essential to understanding how state sourcing rules may apply to partnership income.**

<sup>13</sup> 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.

<sup>14</sup> The Logic of Subchapter K: A Conceptual Guide to the Taxation of Partnerships, Laura E. Cunningham and Noël B. Cunningham, West Academic Pub., 6<sup>th</sup> ed., p. 1.

### **CATEGORY 3: State Tax Sourcing Rules - Generally**

Most states generally conform to the federal rules for determining domestic versus foreign income in that they limit the income to which state tax applies based on whether that income is subject to federal taxation. Otherwise, states have their own approaches for determining their share of multistate domestic business income that diverge from the international sourcing rules used for determining domestic income of foreign persons.

State tax sourcing rules have been developed over time in the context of taxes imposed on both 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 or issues may not be fully addressed.

Certain important aspects of these state sourcing rules are discussed in subsection I.F. below and further in Section II. 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 often not addressed, or that are addressed in ways that may not be consistent with the pass-through system.**

### **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 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 critical 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 subsection 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. Some common and important partnership terms and concepts may be defined and used somewhat differently in each context. Nor is it uncommon for 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 interest or partner's ownership interest.	A general description of a partner's ownership in a partnership or 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 or property transferred by a partner to a partnership in exchange for a partnership interest. See IRC § 721.
Distribution	Items including cash or 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 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).
Taxpayer Attribute (noun)	An aspect of a particular taxpayer that may affect the ultimate tax result for items recognized by or attributed to that taxpayer (e.g., whether the taxpayer is an individual or corporation, filing separately or jointly, has a low or high 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	The share of partnership items recognized by a particular partner as determined by the partnership agreement or by federal tax rules, including IRC § 704. NOTE: The term “allocate” is also used by some states to refer to how items of non-apportionable income are sourced—but this white paper will use the term “assign” for that purpose. (See below.)
Attribute (verb) or attribution	The way in which the pass-through system for partnerships assigns the character of partnership items, as determination by the partnership, to the partners. This includes character that may affect the source of the items for state tax purposes. 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 an item’s fair market value as compared to its 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)**

<b>Types of Partnerships</b>	
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.

<b>Types of Partners</b>	
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**

NOTE: The term “business” is used in multiple ways in state sourcing rules. For example, states may use this term to refer to income that can be apportioned as “business income.” This white paper uses the term “income of a business,” “income of business activities,” or similar terms when referring income generated by a person conducting a business, whether or not apportionable. But when discussing how state sourcing rules will apply, it will generally use the term “apportionable,” for example, as part of the term “apportionable income or items.” Similarly, the term “non-apportionable” will refer to the character of the income or item for purposes of state sourcing rules—as in the term “non-apportionable income.”

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 (verb)	Refers very generally to locating tax items in a state or states for tax purposes—including, depending on the context, determining the apportionment factor numerator for a particular state, or determining the state’s share of income or items.
Source (noun)	Refers very generally to the location (state or states) of items of income or a share of net income for tax purposes.
Apportion and apportionment	A method used to source multistate income that applies a single formula or ratio based on certain instate activities to determine the percentage of the related 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.
Specifically assign and rules of assignment	A sourcing method and the specific rules by which particular items of income or expense are sourced to a state rather than included in apportionable income. NOTE: Some states use the term “allocate” but this term is used for another purpose in the pass-through tax system. (See above.)
Apportionable income or items	Income or items that may be included in net income sourced using a particular apportionment formula under both state rules and applicable constitutional principles—sometimes referred to by states as “business income.”
Non-apportionable income or items	Income or items that may not be included in net income sourced using a particular apportionment formula under either state rules or applicable constitutional principles—sometimes referred to by states as “nonbusiness income.”

## **I.D. State 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 the pass-through system created by Subchapter K 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”).<sup>15</sup>

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 the application of federal regulations,<sup>16</sup> there have been questions about the extent to which federal courts will follow the 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 larger implication for states. To the extent states conform to the federal tax law but wish to use common terms in different ways, they may need to specifically define the terms 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.<sup>17</sup> 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 later in this subsection I.D.

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<sup>15</sup> See Hellerstein supra fn. 4, ¶7.02.

<sup>16</sup> *Loper Bright Enterprises v. Raimondo*, 603 U.S. 369, 144 S. Ct. 2244, 219 L. Ed. 2d 832 (2024).

<sup>17</sup> Cunningham & Cunningham, supra fn.7, p. 1.

## **Basic Elements of the Federal Pass-Through System and Critical 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.<sup>18</sup> Specific application of these requirements, even in the federal tax context, is sometimes unclear.<sup>19</sup> 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,<sup>20</sup> 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 taxing 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 § 702 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.**

<sup>18</sup> 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>.

<sup>19</sup> 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](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1479609).

<sup>20</sup> See IRC § 1361.

**4. 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.

**5. Federal sourcing is part of an item’s character 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. (See item 6.)

**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.

**6. A partner’s tax attributes also affect 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. Another partner attribute that may affect the federal taxation of partnership income in particular is whether the partner takes a passive or active role with respect to the partnership. If the partner’s role is passive, then it may limit the ways in which the partner’s own expenses or losses from other sources are treated and the extent to which they are allowed to be offset against the partnership items. This is more of an issue for individual partners.

Note also that when it comes to foreign individuals with U.S. income, that income may be treated somewhat differently depending on whether it is so-called effectively connected income (ECI) or whether it is fixed, determinable, annual or periodic (FDAP) income—which is typically investment-related income. In general, source-based tax is imposed on both types of income but the rules and methods may differ somewhat.

As noted in the introduction, the MTC work group has addressed the sourcing of multistate income from investment partnerships in a separate white paper which is available on the project page on the MTC website. The approach taken in that white paper would effectively look-through to the assets of the partnership and source the income from those assets as if the investment partnership’s partners held those assets directly. Apportionment would be used to source the business income of operating partnerships that are held by the investment partnership.

**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 the partner’s income or loss from other sources, may still have a substantial effect on the ultimate state tax paid on the partner’s partnership income. To the extent that a partner’s active or passive role in the partnership determines the treatment of items, this will also affect the state tax on those items.

## **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 partner's capital or ownership interests. Nor are different items required to be shared in the same proportions. Rather, partners' shares of 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 the items they recognize, 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 in item 7 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 of partnership agreements and allocations of income may not actually 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 of matching annual allocations with the long-term economic effects, 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.

But 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.<sup>21</sup>

**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.**

<sup>21</sup> Large Partnerships: With Growing Number of Partnerships, IRS Needs to Improve Audit Efficiency, U.S. Governmental Accountability Office, GAO-14-732, Sep. 18, 2014, available here: <https://www.gao.gov/products/gao-14-732>.

## 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.<sup>22</sup>

**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.**

## Federal Treatment of Transactions Between Partners and Partnerships

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 the income of businesses 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 to the partner or the partnership 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 later transfers the property.

To prevent partnerships, along with special allocations of partnership items, from being used to effectively sell or transfer property and shift that gain or loss to other taxpayers (partners), Subchapter K’s rules require that built-in gains or losses 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. See, for example, the scenario shown below:

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 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.

<sup>22</sup> 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.”

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 it 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 any 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 later 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, 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 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 (referenced in the Introduction). But payments made to corporate or tiered partners raise questions as to whether they should be included, in whole or in part, in the partner’s receipts factor (separately or on a blended basis) or eliminated (to the extent of the partner’s share).

**STATE TAX IMPLICATIONS:** Because states typically use formulary apportionment to source income of businesses and since the apportionment formula includes receipts from services in the receipts factor, this raises the question of how guaranteed payments for services 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.**

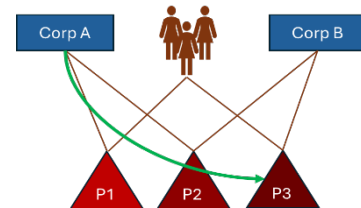
Under IRC §707(a), partners may also receive payments from transactions with partnerships where the partner is not acting in the capacity of a partner. For example, a partner might be engaged in a business that sells goods or services. That partner may provide those goods or services to the partnership 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). These payments also raise issues as to the treatment of related-party transactions in the computation of the partnership's and partner's income to which transfer-pricing rules may apply (see item 5 below).

**STATE TAX IMPLICATIONS:** As with guaranteed payments (above), since states typically use formulary apportionment to source income of businesses 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. These payments may also raise transfer-pricing issues.

#### **5. Partnerships can also engage in transactions with 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..

## **Federal Anti-Abuse Provisions and Uncertainty of State Conformity**

(Note: Anti-abuse rules are also discussed in subsection II.D below.)

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 related-party transactions solely to obtain tax benefits. This white paper will refer to these tax law provisions as “anti-abuse” provisions. These provisions are essential to making the pass-through system work as intended.<sup>23</sup> In addition, some anti-abuse rules found in the federal substantive tax law, particularly loss limitation rules, may also have a direct impact on state tax treatment of pass-through income.

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

- **Specific Anti-Abuse Rules**: Rules that impose specific limitations, conditions, or exceptions.
- **General Anti-Abuse 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 particular federal rule and whether the effect on state tax is direct, as with the general tax treatment of the item, or indirect, as with the state sourcing of the 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 of the rule also has a direct effect on the state tax result, the application of a general anti-abuse rule in a particular circumstance may be unclear. 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, its validity may be subject to challenge under *Loper Bright*.<sup>24</sup>

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 1: 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 detailed exceptions, or they may explicitly delegate to the IRS the authority to issue necessary regulations for limiting some tax effect. To the extent that states conform to the proper federal reporting and treatment of 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 the category of specific limits, 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.
- 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.

<sup>23</sup> See, Cunningham and Cunningham, *supra* fn. 7, pp. 65, and 161-163.

<sup>24</sup> *Loper Bright Enterprises v. Raimondo*, 603 U.S. 369 (2024) which overturned the *Chevron* deference standard for review of federal regulations by federal courts.

- Exceptions to Non-Recognition Treatment – As noted in subsection I.D. above, Subchapter K’s default rule is that contributions to and distributions from partnerships are non-recognition events so that no income, gain, or loss is recognized. But there are a number of exceptions to this default rule that have been adopted to avoid tax results not intended to be covered by this treatment, including:
  - §721(b) – which provides rules for certain contributions of appreciated property to an investment partnership;
  - §721(c) – which provides rules for contributions of certain property to a foreign partnership;
  - §731 – which requires that gain be recognized where a partner’s forgiveness of liability exceeds adjusted basis of contributed property;
  - §707(a)(2)(B) and (b) – which addresses certain types of disguised sales; and
  - Reg. §1.337(d)-3 – which addresses contributions by corporate partners where the partnership owns stock in the corporation and the contribution is determined to be made in order to avoid recognition of gain.

Again, to the extent states conform to Subchapter K and the proper treatment of items of partnership income, these rules would also apply to the determination of state income and presumably to the character of the income for purposes of sourcing that income. For example, to the extent a contribution/distribution is determined to be a disguised sale of property, it would also be sourced as a sale of property.

**Assumption 2: 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 specific guidance for application in a particular circumstance.

This white paper assumes 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 where the federal tax treatment is only one element contributing to that state effect, 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 have 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 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.<sup>25</sup> In addition, there may be instances in which § 482 is relevant to transactions between a partner, acting as a partner, and the partnership.<sup>26</sup> In general, however, there is far less federal guidance for applying § 482 in the partnership context.

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.<sup>27</sup> 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.<sup>28</sup>

*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.<sup>29</sup> 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.”<sup>30</sup> The regulation has been used sparingly over the years, but was recently raised in litigation involving a purported “disguised sale” involving the Chicago Cubs.<sup>31</sup>

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

<sup>25</sup> See IRS Reg. 1.482-1 (a)(1); *Dolese v. Commissioner*, 811 F.2d 543 (10th Cir. 1987); and *Aladdin Indus., Inc. v. Commissioner*, 41 T.C.M. (CCH) 1515, 1519 (1981).

<sup>26</sup> One example is found in IRS T.D. 9814, REG-127203-15, and Notice 2015-54 proposing to make an exception to the non-recognition 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.

<sup>27</sup> 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.

<sup>28</sup> See *Utah State Tax Comm’n v. See’s Candies, Inc.*, 2018 UT 57, 435 P.3d 147.

<sup>29</sup> 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.”).

<sup>30</sup> 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.

<sup>31</sup> *Tribune Media Co. v. Commissioner*, No. 23-1135 (7th Cir.) (pending on cross-appeals).

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.<sup>32</sup>

**States may also need additional anti-abuse rules to prevent income shifting.**

The nature of the pass-through system combined with the need to source the income from multi-state 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 business’s activity in the state. The MTC and states have also adopted special rules for implementing this authority in various circumstances.

**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 federal 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 states 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.**

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<sup>32</sup> See, for example, Oregon Administrative Code, 2020, OAR Section 150-314-0475, Consistent Treatment of Partnership Items.

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

(Some information previously included in this section has been moved to Section II.A.)

NOTE: This subsection provides some general context for addressing sourcing issues in the pass-through tax system. Application of these state sourcing rules to partnership income, including blended apportionment, is further addressed in Section II.

### **Background – State Sourcing Rules for Income of Businesses**

When sourcing multinational business income, the federal tax system and the tax systems of most other countries use detailed rules of assignment of individual items of income, expense, gain, and loss based on the nature of those items and the activities giving rise to them. Indirect expenses and overhead costs may then be apportioned based on the income assigned to different jurisdictions. See IRC Subchapter N.

State tax systems also used this approach to source multistate income at one time. But, as interstate commerce expanded in the mid-Twentieth Century, and the U.S. Supreme Court found states tax jurisdiction applied to out-of-state businesses targeting in-state markets, the states concluded that a simpler approach to sourcing multistate income was needed. They developed an approach using formulary apportionment.

Under the formulary apportionment approach, an apportionment formula comprised of the ratio of certain factors of the business in the state is applied to the net income of the business to determine the amount of that income derived from the state. Rules of assignment may also be used to source certain items. Formulary apportionment has been repeatedly upheld as constitutionally appropriate.<sup>33</sup> (The unitary business principle is discussed further in subsection II.B.)

States primarily draw their sourcing rules from the Uniform Division of Income for Tax Purposes Act (UDITPA), a uniform statute drafted in the 1950's.<sup>34</sup> That statute was incorporated into the Multistate Tax Compact (the Compact), Art. IV, and in that form it was updated by the MTC in 2014 to reflect the use of market-based sourcing to determine location of receipts from services and intangibles for purposes of the receipts (sales) factor.<sup>35</sup>

### **Application of State Sourcing Methods to Different Forms of Businesses**

While UDITPA does not define the term “taxpayer,” as used throughout the model, the Compact defines “taxpayer” to include partnerships and other non-corporate entities. See Compact, Art. II.3. Still, critical litigation in the U.S. Supreme Court and most lower courts addressing formulary apportionment has been in the context of taxable corporations. The U.S. Supreme Court has never addressed the application of the unitary business principle to sourcing the distributive share income of partnerships.

While states tax resident individuals and corporations differently in one important respect, summarized below, they apply the same general sourcing rules to income from multistate businesses, whether the business is conducted in the form of a corporation or a proprietorship. As the research in Section III below shows, states also apply these same general sourcing and apportionment rules when the business is conducted by a partnership. Nor are there any apparent reasons to treat the sourcing of income differently based on the form in which the business is conducted.

The summary below highlights some of the different issues presented when applying these general state sourcing methods to different forms of businesses.

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<sup>33</sup> 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)

<sup>34</sup> See supra fn.1.

<sup>35</sup> Supra fn. 3.

## **Sourcing of Corporate Income**

Because tax is imposed on corporations at the entity level, the income of related entities can simply be combined for tax purposes—even though the common ownership may be less than 100%—since here will be no need for minority owners to file or pay tax separately on their shares. The benefit of combining the net incomes of related entities is that it eliminates intercompany transactions which may be hard to impute or value and which can be used to shift income to low or no-tax jurisdictions.

Today, the following methods may be used by states in apportioning corporate income:

- **Separate Entity Filing**: Each entity files and apportions their direct income using their own apportionment factors, even when engaged in a unitary business with related entities.
- **The “Joyce” Combination Method**: Under the Joyce method, corporations engaged in a unitary business combine their incomes and each apportions that income using its state apportionment numerator divided by the group denominator.
- **The “Finnigan” Method**: Under the Finnigan method, the group of corporations engaged in a unitary business are treated as the “taxpayer” and combine both their income and factors.
- **Federal Consolidated**: States may also allow corporate groups to file a return for entities in the federal consolidated group. Under this method, the net income apportioned may include income that is not part of the unitary business conducted by members of the group.

Much of the focus concerning sourcing of corporate income has been on how unitary business principle limits the use of combined filing.<sup>36</sup> However, as will be discussed further below and in Section II, a taxpayer (or group) may also have more than one unitary business to which separate apportionment formulas may be applied.

## **Sourcing of Income of Proprietorships**

The primary difference between state taxation of income from businesses conducted by corporations versus those conducted by individuals (through proprietorships) is that states generally apply a hybrid method when taxing the income of individuals:

### **Nonresident Individuals**

States will generally source the income of a nonresident individual from that individual’s business activities conducted in a state by applying the kind of state sourcing rules discussed above to the activities of that business. So a nonresident individual conducting a business in the state (e.g., selling items, performing services, holding property, etc.) through a proprietorship will not escape tax solely because the business is conducted in that form.

### **Resident Individuals**

States will generally include the entire income of resident individuals in income subject to the state’s tax, but residents are also given a credit for the tax paid to other states on the same income. That credit is generally limited to the tax that would have been owed by the individual had the other state(s) applied the same sourcing rules as the residency state. In addition, the credit will generally be limited to the rate of tax charged by the other state(s) or the residency state’s rate, whichever is less.

Also, unlike corporations, there may not be clear rules for how individuals should report (or combine) income generated by different business activities. This may also be true for partnerships. See Example No. 1 in subsection I.A. above where, if the income and loss from different partnerships were sourced separately to different states, rather than combined, the partner would be unable to offset the income and loss for state tax purposes.<sup>37</sup>

<sup>36</sup> See Hellerstein, *supra* fn. 4, ¶8.09.

<sup>37</sup> The case of *Cook v. Oregon Dept. of Rev.*, No. TC 5298 (Or. Tax Ct. Aug. 17, 2018), summarized in Section III below, also illustrates this issue. There, the court noted that the state had no mechanism to combine the income and factors of different partnerships, given their income was taxed to the individual partner on a pass-through basis.

## **Sourcing of Income of Partnership Businesses**

The pass-through system raises questions about the application of state sourcing rules that are not raised when applying those rules to taxable persons. This is because the substantive tax rules, including state sourcing rules, may take into account both the character of items of income as well as the attributes of the taxpayer when determining the tax treatment of those items. And states typically do not have a separate section of rules for partnerships similar to federal Subchapter K. Rather, partnership-specific provisions are often embedded in the rules for individuals or corporations. This reflects a partner-focused approach which can limit the ability of states to fully respond to the sourcing issues raised by the pass-through tax system.

For example, when rules for partnerships are embedded into the state tax sections for individuals and corporations, this can raise questions about whether the rules are applied at the partnership level or only at the partner level. The extent of these questions may depend on exactly how a state's reference to or application of the sourcing rules is worded—whether the rules apply to the *partnership*, the *income of the partnership*, or to the *partner's share of partnership income*, for example. Some states make clear that the sourcing rules are applied at the partnership level.

Also, because partnerships are not taxable entities, they cannot simply be combined in the way states may tax corporations. Rather, in the partnership context, blended apportionment is typically used to combine a share of the partnership's apportionable income and factors with the apportionable income and factors of the partner.

### **IMPLICATIONS:**

**State tax rules and judicial precedent often cite very general principles or rules, or describe the application of those rules in very specific contexts. Because the pass-through system has been, in some ways, overlooked, care must be taken when applying these general principles or specific rules in that context.**

**For example, because income of partnerships cannot simply be combined, a different approach—blending—may be necessary to more fairly represent the apportionable income and apportionment formula when partnership income is connected to a partner's unitary business. This may also necessitate applying the unitary business principle to the income and activities, rather than to the entities themselves.**

## **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., however, it is not possible to say one of these theories is necessarily controlling. Even the rules governing traditional partnerships have evolved so that they are based much more in the entity theory than was true originally. Similarly, the federal pass-through tax system sometimes treats partnerships as aggregates and sometimes as entities. This white paper proposes that it is more useful to consider the fundamental principle underpinning the pass-through system, that is—the attribution or “conduit” principle.

### **Why the Attribution or “Conduit” Principle is Critical**

To understand the importance of the attribution principle, it is necessary to consider the goals of the pass-through system.

#### **The basic goals of the pass-through system are widely acknowledged.**

The goals of the partnership pass-through system have been explained by experts as:

1. Achieving a single level of tax on the income,
2. Avoiding 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.<sup>38</sup>

#### **Achievement of these goals benefits taxpayers.**

The partnership form of business and the pass-through system under which partnerships are taxed provide substantial benefits for partners. First, there is a single level of tax. 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.

#### **The pass-through 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. Under the attribution principle, the activities of the partnership and the tax effect of those activities on the tax character of items of income are attributed to the partners as part of their distributive share of those items. This is what prevents partnerships from being used to, effectively, change the basic tax treatment of those items.

#### **Substantive tax rules look to both the character of items and attributes of the partner.**

The importance of the attribution principle does not mean that the substantive treatment of items depends solely on their character. As discussed in subsection I.D above, substantive tax rules may also take into account the partner’s own attributes including whether the partner is a corporation or individual, files as part of a consolidated group or joint return, has other items of income and loss from other sources, takes an active or passive role (with respect to the treatment of losses in particular), has a higher or lower marginal effective tax rate, etc. Nevertheless, most substantive tax rules look to the character of items

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<sup>38</sup> See Cunningham, *supra* fn. 7, generally and pp. 19-21.

## **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 applying the substantive tax rules. IRC § 703.
- The character of the items is attributed along with the share of the items to the direct and indirect<sup>39</sup> 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.<sup>40</sup>
- Partners' attributes may also affect the application of substantive tax rules to partnership items attributed to those partners.

## **Federal Recognition of the Attribution Principle**

In 2024, the U.S. Supreme Court handed down its decision in *Moore v. United States*,<sup>41</sup> which discussed the attribution principle at length. The Moores argued that they could not be taxed on the 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. The Moores' tried to distinguish the pass-through taxation of partnerships on the basis that partnerships, unlike corporations, are aggregates. But the Court rejected this argument, 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 to tax their income at the entity level or at the level of the owners.<sup>42</sup> (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.<sup>43</sup>

*Moore* also touched on due process, with the Court saying: "To be clear, as we indicated earlier, the Due Process Clause proscribes arbitrary attribution," then citing footnote 4 where it also 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."<sup>44</sup>

Finally, 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 also be argued that 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).<sup>45</sup>

## **Attribution Principle in the State Tax Context**

There have only been a few state tax cases raising the application of the attribution principle and, as with litigation generally, the results may be dependent on the specific questions at issue and the arguments raised. Below is a summary of three cases where the attribution principle was discussed at any length.

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<sup>39</sup> See, for example, IRS Reg. § 1.704-3(a)(10).

<sup>40</sup> See IRC § 702(b), IRS Form 1065 - Schedule K-1, and rules for taking an inconsistent position under IRC § 6222 and related regulations as well as IRS Form 8082.

<sup>41</sup> 602 U.S. 572 (2024).

<sup>42</sup> *Moore*, at 585.

<sup>43</sup> *Id.*, at 594.

<sup>44</sup> *Id.*, at 599.

<sup>45</sup> *Id.*, at 580.

## **“Conduit” Treatment of Partnership Income is Limited to Federal Attributes**

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 themselves will qualify for certain state tax treatment will also depend on the specific treatment in question.

## **Interaction of Attribution with the Unitary Business Principle**

As noted in subsection I.E above, states have long looked to the unitary business principle as setting limits on when income of a corporation or related group of corporations can be included in the apportionable income tax base. 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. . . . 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 unitary 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.*, No. 0701-23-2 (Va. Ct. App., Nov. 12, 2024), the court reached a different conclusion. This case involved a partnership engaged in the business of selling goods in the state. The question was how the corporate partner's distributive share income should be sourced. The state apparently argued that blended apportionment should be used. The partner argued that its distributive share income was non-apportionable and it should be sourced to the partner's domicile.

There was apparently no argument made by the state that the income could be separately apportioned at the partnership level, attributing the source of the income to the partner. Nor was there, apparently, any argument that if the distributive share was non-apportionable, it should be sourced based on the character of that income (sales of goods), rather than simply sourcing it to the partner's domicile.

In deciding if the distributive share was non-apportionable, the court looked at the traditional elements of a unitary business as applied to corporate entities: functional integration, centralized management, and economies of scale. The court also noted there was no evidence in the record suggesting the corporate partner used income it earned from the partnership as part of its own working capital or for any other operational purpose. The court also 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.

Finally, 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 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 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. Nor did it address whether the character of the income, which it agreed could be attributed to the partner, should determine the sourcing of the distributive share

The possible application of the unitary business principle to the sourcing of partnership income and the use of blended apportionment is discussed further in Section II below.

## **Attribution Principle and the Sourcing of Partnership 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 tax items and the activities giving rise to them matter under both sets of rules.

### **Attribution in Determining the Domestic or Foreign Source of Partnership Income**

Federal sourcing rules depend on the characterization of items of income. When the items are earned or incurred by a partnership, their character is determined at the partnership level under IRC § 703. Partners are deemed to recognize both their share of the item and its character when computing their tax under IRC § 702(b). The federal sourcing regime applies rules of assignment

to source different types of items. See IRC Subchapter N.<sup>46</sup> The taxpayer's own characteristics, especially whether the taxpayer is a U.S. or foreign person, may also be taken into account.

This application of the attribution principle is 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.

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. See IRS 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.

States generally conform to the determination of whether income, including partnership income, is domestic or foreign-sourced. Consequently, for a foreign person that has partnership income that 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 U.S. income and subject it to state taxation.

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.

### **Attribution in Determining the State Source of Partnership Income**

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, in turn, affect the state tax treatment. (See further discussion of state conformity in subsection I.D. above.) However, as with anti-abuse rules, also discussed above, it can be difficult to determine how the attribution principle applies when the question turns on the state tax character of items not tied to federal substantive rules.

When sourcing the income in a simple partnership structure with direct, individual partners, states generally apply the sourcing rules at the partnership level and attribute this sourcing information to the partners (to nonresident partners to determine their taxable income and to resident partners to determine any limits on their credit for taxes paid). The questions that arise in this context generally have to do with the state's jurisdiction to tax out-of-state partners, rather than the way in which the income would be sourced.<sup>47</sup> This is because it is generally accepted that the attributes of the individual partners do not change the sourcing of the partnership income in most cases.

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<sup>46</sup> 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).

<sup>47</sup> When it comes to individual non-resident partners, some state courts have recognized limits on state taxing authority under the state's imposition or "doing business" statutes. A few have found that there may be constitutional limits. It appears 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, states may have avoided this constitutional

But when the partner is not an individual but another business entity—a corporation or tiered partner—then the sourcing rules may be applied either at the partnership level or at the partner level with potentially different results. For example, an item of income earned by a partnership may be determined to be apportionable income under state rules applied at the partnership level, but the distributive share of the partnership income might be determined to be non-apportionable income applying the rules solely at the partner level.

If, in that case, the income is apportioned at the partnership level and the sourcing is then attributed to the partner, this would be consistent with the sourcing of income in the simple partnership structure with individual partners. In contrast, to re-characterize the income itself as non-apportionable income at the partner level would override the attribution of the character of the income determined based on the partnership’s business activities in the state and would require the rules of assignment for non-apportionable income to be applied to the items instead.

It is also possible that, under state rules as applied at both the partnership and partner level, the distributive share would be characterized as apportionable. In that case, the question is whether the partnership’s own apportionment factors or the partner’s factors should be applied. But there is also a third approach—blended apportionment—that is discussed in Section II.

In short—like most substantive tax rules, the state rules for sourcing partnership income may take into account both the character of the items of income in the context of the partnership activities giving rise to those items as well as certain attributes of the partner—such as the partner’s own business activities and any relationship of those activities to the activities of the partnership.

#### STATE TAX IMPLICATIONS –

- **Sourcing partnership income based on the character of the items determined at the partnership level is consistent with the attribution principle and the way in which federal sourcing rules are applied to partnership income. (And to the extent that a state conforms to the federal sourcing of domestic income, it would presumably also tax foreign partners determined to have U.S. income, to the extent that income would also be sourced to the state.)**
- **While it may be presumed that conforming states would therefore determine certain important state sourcing-related information at the partnership level and attribute that information to the partners, states should consider making this approach clear in their own sourcing rules.**

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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. 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 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 should:

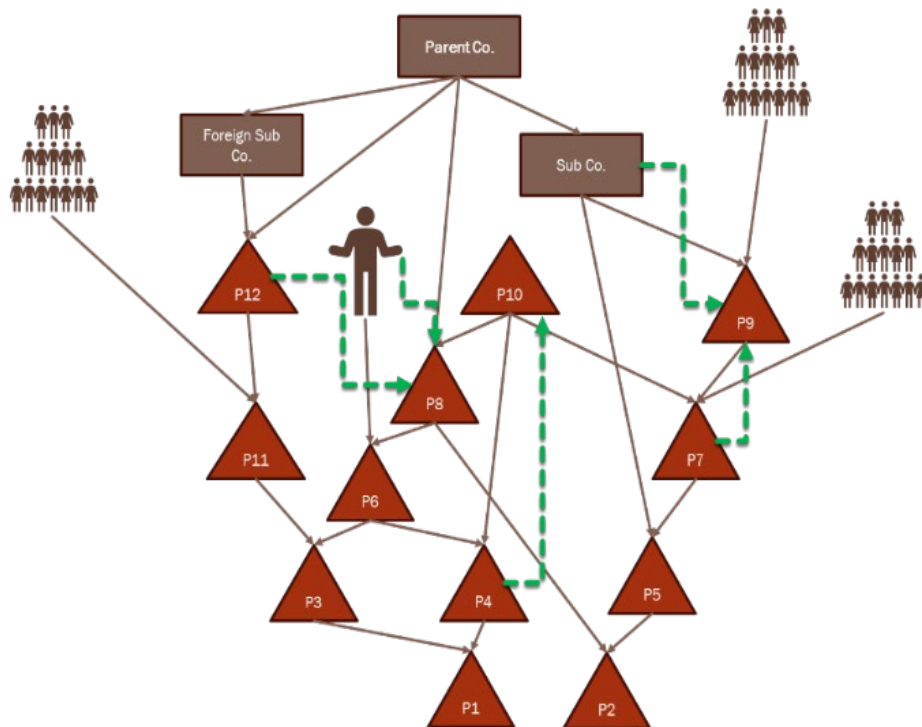
- Use certain general partnership terminology and concepts consistent with state governing laws or federal tax laws to which the state tax rules conform (unless state rules separately define those terms).
- NOT assume that:
  - Partnerships are primarily treated as aggregates under the law or the federal 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 this 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 – PROPOSED APPROACHES FOR ADDRESSING COMPLEX PARTNERSHIPS

This Section II draws on the “lessons” from Section I above and the detailed research into existing state sourcing rules for complex partnerships summarized in Section III below. First, it sets out a general framework for sourcing partnership income, which the MTC work group has considered and appears to reflect the consensus as to how the general state sourcing rules apply 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.

### Use of Simple Examples to Illustrate the Approaches

In order to illustrate the approaches for sourcing partnership income, this section includes a number of simplified examples which may focus on particular aspects of the approach and its application. But when considering these approaches, 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.



- A partnership’s partners may include other domestic or foreign partnerships or pass-through entities, corporations, individuals, non-profits, or governmental organizations.
- A partnership’s distributive share income may be allocated through a number of upper-tier partnerships before the shares of that income (along with the income of the upper-tiers) is allocated to the ultimate taxing partners.
- Partnerships may engage in transactions with partners or other related entities (as shown by the dotted green lines above), and these transactions will affect the partners’ and partnerships’ taxable income and expense as though they were not related.

## **Critical Assumptions About State Authority**

For the approaches discussed in this section to be viable, the following assumptions are critical:

### **States have authority to impose information-reporting on tiered partnerships.**

The federal government imposes detailed and sometimes complex information-tracking and reporting requirements on partnerships. These requirements are essential for partners to give them the information necessary to properly compute their tax.

States conforming to the federal pass-through system must also impose information-reporting requirements in order to track the sourcing of partnership income so that partners can properly compute their state tax. (And this would be true whether states sourced income using formulary apportionment or rules of assignment.) The use of blended apportionment in complex structures will require additional information-reporting.

This, in turn, raises questions concerning state jurisdiction which have not been fully answered by the courts. It is clear, however, that partnerships and their partners are on notice that the tax benefits supplied by this pass-through system also require compliance with that system. And this, in turn, provides an additional basis for imposing state reporting requirements. Moreover, it would not be in the interest of an out-of-state partnership to simply deny to any resident partners the information they need to properly report their state taxes.

### **States have authority to tax all partners on state-sourced partnership income.**

The U.S. Supreme Court has never addressed the question of whether a state can impose tax on an out-of-state partner whose only connection to the state is an interest (direct or indirect) in a partnership doing business in the state. But a few state tax cases have held that nonresident partners cannot be subjected to tax on their share of state-sourced partnership income, whether due to a lack of constitutional nexus or because the state's statutory imposition or "doing business" standard was not met, at least in certain circumstances. Most of these decisions appear to have been based on the partner's passive role in the partnership.<sup>48</sup>

The basis for these cases is now questionable. Not only has the U.S. Supreme Court never ruled on the issue, but it has also expanded its view of state jurisdiction to tax in recent decades. Today, most states assert nexus to tax direct or indirect partners with income from a partnership doing business in the state, regardless of the nature or role of the partner.<sup>49</sup> And this is consistent with the recent *Moore v. United States* case (discussed in Section I.F. above), which recognized the attribution principle as a legitimate way to impose tax on business owners for income earned by the business.

If a complex partnership structure is all it takes to avoid liability for income derived from a state, then states should reconsider conforming to the pass-through system and, instead, impose tax at the entity level. Therefore, this Section II assumes that states have nexus to impose tax on direct or indirect taxpaying-partners for income properly sourced to that state.

### **States may ensure compliance by requiring partnerships to withhold tax.**

State concerned about the possible challenges to their jurisdiction may expand their withholding requirements to address complex partnership structures. These requirements may also ease administrative burdens in addition to ensuring that tax is paid.

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<sup>48</sup> 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/>.

<sup>49</sup> See Hellerstein *supra* fn. 4, ¶20.08.

## **II. A. General Framework for Sourcing Partnership Income**

*This entire subsection II.A. was revised to combine information that, in prior versions, was included in subsection II.E and to clarify the sourcing framework described below.*

This subsection lays out a framework for applying state sourcing rules to the distributive share income of partnerships.

(As a reminder to readers, special rules would apply for certain investment partnerships, which are covered by a separate white paper and draft model. But note that the approach used under that draft model is also consistent with the principles on which the framework below is based.)

### **Introductory Notes**

The following notes may be helpful in understanding the framework below:

- **Use of the Term “Business” or “Income from a Business”:**

As noted on page 2 of this white paper, “business income” and “nonbusiness income” are terms of art that have traditionally been used to categorize income for purpose of state sourcing. This white paper uses the terms apportionable and non-apportionable, instead, and uses the phrase “income of businesses” or “the business” to refer to the general category of partnerships or entities not strictly engaged in investment activities.

- **Use of the Term “Person”:**

As noted above, while UDITPA uses the term “taxpayer” but never defines 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.” (Compact, Art. II.3.) Similarly, most non-compact-member states use formulary apportionment based on UDITPA and apply the sourcing rules to the income of businesses taxed on a pass-through basis. (See Section III.) But statutes and regulations may specify that the rules are applied to “income” or “the business” rather than to “taxpayers.” So, this section may use the term “person” to indicate that the rules do not necessarily apply only to taxpaying entities.

- **Partnership-Level versus Partner-Level Application:**

Throughout the following subsection the framework specifies whether the state sourcing rules are applied at the partnership or partner level. This information is sometimes missing from state rules that address the sourcing of partnership income and can significantly affect the results.

- **The Apportionment Formula and the Receipts Factor:**

The original version of UDITPA used an equally weighted three-factor formula—property, payroll, and receipts (sales) in the state—and also located receipts from intangibles and services based on cost of performance. Today, most states use a single receipts factor formula and source all receipts to the market. So this section focuses primarily on the use of the receipts factor and assumes market sourcing is used to locate receipts.

- **Role of the Partnership Generally:**

Under the pass-through system, the role of the partnership is to report to the partners essential information for those partners to properly report and compute tax on their partnership income. Therefore, when reviewing the framework set out below, the steps are generally couched in terms of the information that the partnership will need to provide partners so that they can then determine the source of their partnership income.

### **Step One: Partnership Identifies Non-Appportionable Items**

Under the general state sourcing system, income earned by businesses may be sourced in one of two ways—formulary apportionment or rules of assignment. Rules of assignment are typically used for income (expense) that cannot be apportioned. Non-apportionable income is often passive investment income lacking a unitary relationship with business operations. For example, UDITPA's rules of assignment (“allocation”) cover non-apportionable “rents and royalties from real or tangible personal property, capital gains, interest, dividends or patent or copyright royalties.” (UDITPA Sec.s 4-8.)<sup>50</sup>

So the first step in sourcing multistate income from businesses conducted by partnerships is for the partnership to identify any non-apportionable income or items applying state rules to its own activities. For example, a partnership which is engaged in a retail sales business in the state would analyze its items of income to determine if they are sufficiently connected to apportionable income and factors from that retail business.

This partnership-level approach is consistent with the attribution principle that is the foundation of the pass-through system as discussed in subsection I.F. It is also consistent with long-standing state tax treatment of the business income of individuals, which generally sources that income based on where the related activities are conducted. And this is also why most states that tax income of partnerships doing business in the state also impose withholding requirements on partnerships for any tax on the partnership's state-sourced income allocated to non-resident partners.

The partnership would apply the same state rules for determining non-apportionable item that are used for sourcing corporate income.

#### **UDITPA's approach for distinguishing apportionable and non-apportionable items.**

The original UDITPA Sec. 1.(a) refers to apportionable income as “business income” and defines that term as:

“income arising from transactions and activity in the regular course of the taxpayer'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 regular trade or business operations.”

So nonbusiness (non-apportionable) income is all other income.

State courts were divided over whether this original definition included two separate tests. The revised version of UDITPA recommended by the MTC clarifies this issue and changes the term “business” 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 [person'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 [person'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.”

(See links for both versions of UDITPA in footnotes 1 and 3 above.)

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<sup>50</sup> Supra, fn 3.

As both definitions show, the critical issue is the relationship between the specific activity generating the item of income in question and any larger trade or business. This, in turn, raises the constitutional concept of a “unitary business,” which, although not referenced by UDITPA, has become a critical standard.

Further discussion of the unitary business principle and its application to partnership income is included in subsection II.B. Here, the focus is on distinguishing non-apportionable items from apportionable items. For that purpose, two additional points should be noted.

***NOTE: A person may have more than one unitary business.***

A person may have income or items that are related to multiple unitary businesses. In that case, states generally use separate apportionment—determining the net apportionable income and apportionment factors related to each unitary business.<sup>51</sup> Indeed, the comments incorporated into the original version of UDITPA, under the definition of “business income,” make this very clear:

“This definition [of business income] refers to the taxpayer’s trade or business as if he had one business. It is not intended by this language to require a taxpayer having several “businesses” to use the same allocation and apportionment methods for the businesses. The language permits separate treatment of different businesses of a single taxpayer. Section 18 clearly permits separate treatment.”<sup>52</sup>

**IMPLICATION:**

**It is generally incorrect to assume that a person can have only one unitary business. Therefore, it is also incorrect to assume that income which cannot be included in the net income to be apportioned using a particular apportionment formula must therefore be non-apportionable income and sourced using rules of assignment. Rather, that income may be part of a separate unitary business and subject to apportionment using a separate apportionment formula.**

***NOTE: States may apportion less than 100% of income from a unitary business.***

States are not required to apply a single apportionment formula to the entire net income of a unitary business. Nor is this generally the approach that states take. For example, a minority of states provide for reporting corporate income on a separate entity basis. Each related corporation files its own return and apportions its income separately, even if that income is part of the group’s unitary business. And most states that require combined filing will exclude certain foreign entities even when they are part of the unitary business.

In addition, states that could apportion certain income may instead use rules of assignment to source that income. And any non-apportionable income that a state would, constitutionally, be entitled to source entirely to the state using rules of assignment may be sourced by that state using apportionment instead. (See the revised UDITPA definition above.)

<sup>51</sup> 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.”

<sup>52</sup> See supra, FN 1, page 4.

**IMPLICATION:**

**It is incorrect to assume that states must source 100% of income from a unitary business by applying a single apportionment formula or that apportioning only part of that income means that the remainder is necessarily non-apportionable income as that category is defined under UDITPA or constitutional principles. Further, the fact that a state may provide for the application of rules of assignment for certain income does not necessarily mean that this income is non-apportionable under constitutional principles.**

These implications are especially important when reviewing application of state sourcing rules in Section III and for the discussion of “blended” apportionment in below.

**Step Two: Partnership Identifies Source Information for Non-Apportionable Items**

Once the partnership identifies its non-apportionable income, the partnership would then look to the state rules of assignment to determine the necessary information for sourcing that income. Because those rules of assignment generally depend on the specific type of income (i.e., interest, dividends, royalties, gains from sales of real property, etc.), the non-apportionable income must be identified by its character so that it can be sourced using the appropriate rule.

Here, it is important to emphasize—UDITPA does not list “partnership distributive share” or anything similar as an item to which a specific rule of assignment would apply. No doubt this is because distributive share income is not some generic type of income. Rather, partners are attributed specific partnership items as if the partner had recognized the items directly from the source. See IRC § 702. This is a fundamental part of the federal pass-through system to which states conform and often benefits the partners. (The attribution principle is discussed in Subsection I.F.)

Nevertheless, some have theorized that UDITPA’s rule for assigning non-apportionable dividends to the person’s domicile (Sec. 7) should apply to distributive share as well. But this ignores the clear, fundamental differences between dividends and distributive share (discussed briefly in subsection I.D). To the extent a state conforms to the federal tax rules for characterizing income, partnership distributive share is simply not a dividend or distribution.

**IMPLICATION:**

**Where all or part of a partner’s distributive share is determined to be non-apportionable income or items, rules of assignment must be applied to the items making up that distributive share based on the character of the items determined at the partnership level. This also means that the partnership must provide the partners with the information necessary to determine the source of the non-apportionable items. Nor is it the case that any distributive share income determined to be non-apportionable would simply be sourced to domicile as a dividend.**

**Step Three: Partnership Determines the Apportionable Income Base(s)**

After the partnership determines whether it has generated any items of non-apportionable income, providing partners with the necessary information to properly characterize and source those items, the partnership would next determine whether the remaining items of income are part of a single net apportionable income base or, perhaps, multiple apportionable bases. Under the pass-through system, where the character of income and items is attributed to the partners as though they engaged in the activities directly, income determined to be apportionable at the partnership level will not change as it flows to direct and indirect partners.

Note that it appears that in certain specific state contexts, some have argued that the determination of whether income is apportionable can only be made at the partner level, and not at the partnership level. Further, some would argue that this determination depends on whether the partner’s distributive share is sufficiently connected to the partner’s own unitary business.

However, as discussed 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 use of a single formula. This flexibility is limited primarily by the general requirement that the income and factors used be part of the same unitary business.<sup>53</sup>

Therefore, the default assumption would be that income determined at the partnership level to be apportionable using the related partnership factors would then be sourced using those factors, unless the state provides for the use of blended apportionment (discussed further below). That source of the apportionable income would be attributed to direct and indirect partners (again, unless blended apportionment is used).

**IMPLICATION:**

**There is nothing that prevents states from apportioning a partnership's apportionable income at the partnership level using the related partnership factors (what this white paper refers to as separate apportionment) and then attributing this sourcing information to the partners who receive a share of that income, whether or not the income of the partnership is also part of a unitary business engaged in by the partner. And there is no requirement that the partnership income also be part of the unitary business of the partner in order for the income to be apportioned at the partnership level. If the partnership income is part of the partner's unitary business, then blended apportionment may be used instead.**

**Step Four: Partnership Determines its Apportionment Factors**

The state apportionment formula is the ratio of certain factors related to the net apportionable income (e.g., receipts, property, and/or payroll) which are 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 receipts (sales) factor formula.<sup>54</sup> 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.

**Application of throw-back or throw-out rules.**

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

- 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.

<sup>53</sup> 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."

<sup>54</sup> 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 & Greton, 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. So an apportionment formula which includes a property factor will treat those businesses dependent on physical property very differently from those more dependent 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, the payroll expense incurred in a particular tax year may not be directly related to income generated in that same year.

- 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.

**Application of P.L. 86-272 in the context of throw-back or throw-out rules.**

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 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, referred to as the “Finnigan” method. Under that method, the state will 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, partnerships would not fit the concept of a “person” on which tax is imposed under P.L. 86-272. 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, it is the partner that would be “taxable” in the state.

This is generally consistent with one of the few cases to address this question—*Arizona Dept. of Revenue v. Central Newspapers, Inc.*, 222 Ariz. 626, 218 P.3d 1083 (App. Div. 1 2009). There, the Arizona appeals court considered corporations which filed a consolidated return and were partners in a partnership making sales into the state. The taxpayer argued that the partnership’s Arizona sales could not be included in the group’s apportionment factor (so as to source some portion of the partnership’s income to Arizona) 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 is responsible for paying tax on the partnership's distributive share income and is 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 also be properly included in the state apportionment formula.<sup>55</sup>

#### **IMPLICATIONS:**

**A partnership that has apportionable income should be able to determine the location of related factors, including the receipts giving rise to that income, and to source those factors based on state rules. This information on the partnership's apportionment factors can then be provided to partners for their use in sourcing their distributive share of the partnership income.**

**When determining if a person is taxable in another state for the purpose of applying a state throw-back or throw-out rule, if the person is a partner in a partnership which has activities in the state, those activities may generally be attributed to the partner. Similarly, the fact that a partnership's own activities may not exceed the protection of P.L. 86-272 does not prevent the partnership's income from being taxed to partners whose own activities exceed the protection.**

#### **Step Five: Partner Determines its State-Sourced Distributive Share Income**

Finally, partners use the information supplied by the partnership to determine the source of their distributive share income:

- Partnership income or items determined to be non-apportionable by the partnership:
  - General Rule – These items be sourced using the state(s)' rules of assignment based on the information provided by the partnership as to the source or relevant activities giving rise to those items.
  - Exception – In the rare case where the item determined to be non-apportionable by the partnership, based on information available to the partnership, is also connected to the partner's own business such that it might be included in the partner's net apportionable base under applicable state rules—then that item will be included in the partner's apportionable income and apportioned using related apportionment factors of the partner.
- Partnership income or items determined to be apportionable by the partnership:
  - General Rule – Separate Apportionment – The items would be sourced using separate apportionment – where the related factors of the partnership are used to apportion that income.
  - Exception – Blended Apportionment – Where the income or items are also related to the partner's own net apportionable income the partner would include the income or items in its net apportionable income and a share of the partnership factors in its apportionment formula. (See the discussion of blended apportionment in Section II. B below.)

<sup>55</sup> 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>.

As this step demonstrates—both the character of the partnership income and items, determined at the partnership level, and the partner’s own attributes—including its own unitary business activity—may affect the sourcing of the income or items. But in no case where the partnership determines that income is apportionable after properly applying the state sourcing criteria at the partnership level would that income be converted to non-apportionable income by any of the partner’s own attributes.

#### **Implication**

**A partnership must provide sufficient information to partners in order for them to properly source their distributive share of the partnership income. While the partner’s attributes may affect the sourcing of the income, it would generally not be the case that some attribute of the partner would convert income or items determined to be apportionable by the partnership into non-apportionable income sourced using rules of assignment.**

## **Application of State Sourcing Framework – Simple Examples**

### **Example 1:**

- Partnership has \$10 million of ordinary income and \$1 million of capital loss.
- Partnership determines the ordinary income is apportionable as part of a single unitary business and the \$1 million of capital loss is non-apportionable.
- Partnership apportions 40% of the ordinary income to State A and assigns the loss to State B.
- Partner Smith is allocated 20% of the partnership’s ordinary income and 50% of the capital loss.
- Smith’s State A income would include \$2 million of partnership ordinary income.
- Smith’s State B income would include \$500,000 of capital loss.

### **Example 2:**

Assume:

- Corp X operates entirely in State 1
- Corp X is a partner in Partnership Y.
- Corp X is allocated 10% of Y’s \$1 million ordinary income.
- Partnership Y properly apportions 50% of its \$1 million income to State 2
- Corp X considers its distributive share of Y’s income to be non-apportionable “investment” income

Corp X would source 50% of its 10% share of the \$1 million to State 2. It does not matter that Corp X would consider its distributive share to be investment income without any unitary relationship to its own business(es)—and so not “blendable.”

### **Example 3:**

Assume the same facts as Example 1 except that Corp X would consider its distributive share of Y’s income to have a unitary relationship to the business conducted by X—that is, “blendable.” In that case, X would use blended apportionment, provided that State 2 allows blended apportionment in this circumstance.

### **Example 4:**

Assume:

- Corp is a partner in Partnership
- Corp is domiciled in State A and Partnership is domiciled in State B
- Partnership sells real estate in State C for a net capital gain
- Partnership considers the gain to be non-apportionable income
- Corp considers its distributive share of the gain to be non-apportionable income

In this case, Corp would NOT source its distributive share to State A or State B. Rather, because the character of the gain (capital gain from the sale of real property) is attributed to the partners, Corp would use rules for sourcing non-apportionable gains from the sale of real property and would source the gain to State C.

**Example 5:**

Assume the same facts as Example 4 except Corp is not a direct partner in Partnership. Rather, Corp holds an interest in Upper Tier, a partnership which holds an interest in Partnership. Upper Tier receives a distributive share of the gain from Partnership and allocates a portion of that gain to Corp. The result is the same as in Example 4.

## **Partnership versus Partner-Level Approach**

Under the federal pass-through tax system to which states conform:

- A partner's substantive federal and state tax treatment of any item of income, expense, gain, or loss included in its distributive share depends, first, on that item's relevant character.
- The relevant character must be determined by the partnership, applying the applicable substantive tax rules, which also determine whether the income is domestic or foreign-sourced. (See subsections I.D., E, and F above.)
- Partners must then treat their share of these items consistently with their individual character. See IRC §§ 702(b) and 6222(a).

This attribution principle is essential to prevent partnerships from being used to effectively alter the tax treatment of items. Moreover, partners regularly rely on this "conduit" system to claim tax benefits—such as the beneficial rates imposed on capital gains or the ability to delay recognition of income as allowed under the substantive rules.

While the state sourcing treatment of partnership income is determined under separate state rules, those rules also rely on the items' character. In particular, it would be impossible to determine if an item of income, expense, gain, or loss is non-apportionable or how it should be sourced without information on the item's character when that item is recognized.

### **Partnership-Level Approach**

For these reasons, this white paper concludes that the proper approach to sourcing partnership income, as described in the framework above, is a partnership-level approach where:

1. The partnership identifies its non-apportionable items.
2. The partnership identifies source information for its non-apportionable items.
3. The partnership determines its apportionable income base(s).
4. The partnership determines its apportionment factors.
5. The partner then determines its state-sourced distributive share income.

### **Alternative Partner-Level Approach**

The alternative to the partnership-level approach is to apply state sourcing rules at the partner level. While this is generally inconsistent with the pass-through system, perhaps the biggest problem with this alternative partner-level approach is that it would prevent the proper application of the sourcing rules.

Under the partner-level approach, income that would otherwise be apportionable based on the business activities conducted by the partnership and the nature of the income generated might not be sourced using apportionment if the partner determines that its distributive share of that income is non-apportionable. Moreover, in that case, it is not clear how the state rules of assignment (allocation) would apply since these rules generally do not have a separate category for "distributive share" income—but rather—assume that items of distributive share would be sourced based on their character.

Nevertheless, some appear to argue that using the partnership-level approach to determine the character of items for state sourcing purposes is inconsistent with applicable state rules or principles, or that the character of items making up a partner's distributive share do not affect how that income is sourced. Rather, the argument appears to be that it is solely the partner's own attributes and relationship to the partnership that determine whether its distributive share is apportionable or non-apportionable, and if non-apportionable is then sourced to domicile or residence. Whether this argument has any support under the laws of a particular state is unclear. But not only is it inconsistent with the pass-through system, to which states conform and on which taxpayers rely, it also appears based on a false assumption.

## **False Assumptions That Appear to Underlie the Partner-Level Approach**

Often, those arguing for a partner-level approach appear to assume that if distributive share is deemed to be non-apportionable to the partner, it must be sourced entirely to the partner's residence or domicile. There is no support for this assumption.

### **Distributive share is not a dividend.**

The false assumption that distributive share deemed to be non-apportionable will be sourced to residence or domicile may be based on the theory that distributive share income is a dividend. But it is not. First, distributive share is not a distribution. Second, as discussed above, distributive share is made up of items which maintain their own separate character. So rules for sourcing dividends, including the sourcing of non-apportionable dividends under UDITPA, would not apply.

Nor does UDITPA provide any separate rules for sourcing non-apportionable "distributive share" as such—which is consistent with the idea that distributive share has no character of its own. So even if partners could make a separate determination that their distributive share is non-apportionable, it would still be the character of the items making up that distributive share would then control how state rules of assignment apply.

### **States are not restricted in taxing partners to whom state-sourced income is allocated.**

The assumption that distributive share which is deemed to be non-apportionable to the partner would be sourced to domicile or residence may also be based on the theory that, in such cases, states would lack jurisdiction over out-of-state partners. As discussed in the "Critical Assumptions" at the beginning of this Section, there appears little, if any, support for this theory. And even if it were true, it can be addressed through withholding at the partnership level.

### **Separate apportionment at the partnership level does not create substantial burdens.**

Finally, some may argue that despite the requirement imposed by federal law that partnerships track the tax character of income and then attribute that character to the ultimate (direct or indirect) taxpaying partners—the attribution of the character as apportionable or non-apportionable is too burdensome, especially in the case of complex partnership structures. However, states cannot be held responsible for the complexity of business arrangements they did not create or require. Nor is separate apportionment more burdensome than the true alternative—which would be to apply rules of assignment to the items of income making up the distributive share.

That said, states may be able to simplify the rules that would be applied in some cases. And states may need to be clear about the information partnerships will need to report in order to provide partners with necessary information to properly source their distributive share.

#### **Implication**

**States should clarify any uncertainty about the approach used to source partnership income so that the income is sourced consistently with the income of other businesses and so that partnerships are not effectively used to shift the source of income earned from business activities conducted in the state to the domicile or residence of partners.**

## **II.B. Use of Blended Apportionment**

*This section has been edited for clarity.*

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 blendable 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 when blended apportionment will be used.

### **Effect of Blended Apportionment – Simple Example**

For example, assume Corporation is a partner in Partnership and is allocated 20% of the Partnership’s income which also has a unitary relationship with Corporation’s own business. For State X, the separate income and apportionment factors of Corporation and Partnership 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 own income using their own factors, the result would be:

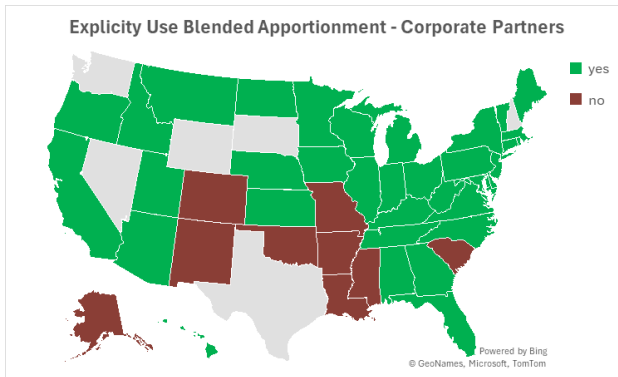
	Result
Corporation’s own income apportioned to State X (10% of \$10 million)	\$ 1,000,000
Corporation’s 20% share of Partnership’s income apportioned to State X (50% of 20% of \$2 million)	\$200,000
<b>Corporation’s Total State X income</b>	<b>\$1,200,000</b>

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 its 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% of \$2 million)	\$400,000	
<b>Corporation’s Total Apportionable Income</b>		<b>\$10,400,000</b>
Corporation’s Own Receipts in State X	\$10,000,000	
Corporation’s Share of Partnership Receipts in State X (20% of \$50 million)	\$10,000,000	
<b>Corporation’s Total Receipts in State X</b>		<b>\$20,000,000</b>
Corporation’s Own Everywhere Receipts	\$100,000,000	
Corporation’s Share of Partnership Everywhere Receipts (20% of \$100 million)	\$20,000,000	
<b>Corporation’s Total Everywhere Receipts</b>		<b>\$120,000,000</b>
State X Blended Receipts Factor (\$20 million ÷ \$120 million)		<b>16.666%</b>
<b>Corporation’s Income Sourced to State X</b>		<b>\$1,733,333</b>

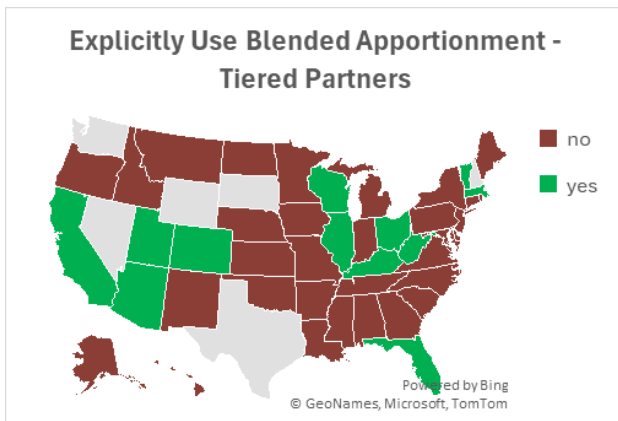
So, in this case, the income sourced to State X using blended apportionment would be 44% greater than using separate apportionment. In different scenarios, the amount sourced to State might be less than with separate apportionment. While the relative amounts of any differences may vary, the extent of 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 also to that partner's other income as well.

## **Current State Use of Blended Apportionment**



### **Corporate Partners**

The map at the left here shows the states (in green) that have explicitly adopted some form of blended apportionment for use in sourcing income where the partner is a corporation. (This is based on research contained in Section III below.)



### **Tiered Partners**

This map at the left here shows the states (in green) that have explicitly adopted some form of blended apportionment for use in sourcing income where the partner is a tiered (partnership) partner. (This is based on research contained in Section III below.)

The use of blended apportionment involves both “how” and “when” questions—that is—how should the method be applied and when should it be applied? These questions are considered here, starting with the how questions

## **How Does Blended Apportionment Work – Generally?**

The steps for using blended apportionment in its simplest form are as follows:

1. Determine the partner's share of partnership apportionable income or items that will be included in the related apportionable income of the partner.
2. Combine the partner's share of partnership apportionable income with the partner's own related apportionable income.
3. Determine the partner's share of partnership factors that will be included in the apportionment factor of the partner to be applied to the blended apportionable income.
4. Combine the partner's share of partnership factors with the partner's own apportionment factors related to the blended apportionable income and compute the blended factor—eliminating from the receipts factor the effects of partnership-partner transactions (and guaranteed payments if applicable).
5. Use the blended factor to apportion the total apportionable income.

Use of blended apportionment may vary somewhat in complex structures and may have effects on the state-sourced income of multiple entities.

### **Application of blended apportionment in various scenarios.**

The following examples demonstrate how blended apportionment would generally apply:

#### **Example 1 – Combined Corporate Filing - Joyce:**

- Corp X (X) files in State 1 as part of a combined corporate group along with Corp Y (Y).
- The group files on the so-called “Joyce” basis—with each entity apportioning the combined income of the group using its own in-state factors divided by the group’s everywhere factors.
- X is a partner in Partnership P (P).
- P’s income is apportionable applying UDITPA at the partnership level and is related to a business conducted by the corporate group.

The combined group’s apportionable income would include X’s distributive share of P’s apportionable income. The combined group income would include X’s share of P’s income. Both X and Y’s apportionment factors would include X’s share of P’s everywhere factors. X would also include its share of P’s State 1 factors in its own State 1 factors.<sup>56</sup>

#### **Example 2 – Combined Filing - Finnigan:**

- Corp X (X) files in State 1 as part of a combined corporate group along with Corp Y (Y).
- The group files on the so-called “Finnigan” basis—using a single combined apportionment formula to apportion combined income.
- X is a partner in Partnership P.
- P’s income is apportionable applying UDITPA at the entity level and is related to a business conducted by the corporate group.

The combined group’s apportionable income would include X’s distributive share of P’s apportionable income. The group’s apportionment factor would also include X’s share of P’s factors.<sup>57</sup>

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

- Corp X (X) files in State 1 as part of a combined corporate group along with Corp Y (Y).
- Both X and Y are partners in Partnership P.
- P’s income is apportionable applying UDITPA at the entity level and is related to a business conducted by the corporate group.

Using the Joyce or Finnigan approach (above), the combined group’s apportionable income would include both X’s and Y’s distributive share of P’s apportionable income and the apportionment formula would include X’s and Y’s share of P’s everywhere factors (with a share of P’s State 1 factors included in the entities’ or group’s formula depending on the approach).

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

- Corp X (X) files in State 1 as part of a combined corporate group along with Corp Y (Y).
- X is a partner in Partnership P.
- X charges P a fee which is treated as an IRC § 707(a) transaction between unrelated parties.
- P’s income is apportionable applying UDITPA at the entity level and is related to a business conducted by the corporate group.

Same as Example 3 except P’s expense from charges by X would be offset in the blended apportionable income to the extent of X’s distributive share of that expense and the same share of the charges by X would be eliminated from X’s receipts when computing the blended apportionment factor for X (Joyce) or the group (Finnigan). See additional discussion of this issue below.

<sup>56</sup> See the MTC Model Statute for Combined Reporting – Joyce Method, here: [MTC Joyce Model](#).

<sup>57</sup> See the MTC Model Statute for Combined Reporting – Finnigan Method, here: [MTC Finnigan Model](#).

#### **Example 5 – Combined Corporate Filing – Multiple Partnerships:**

- Corp X (X) files in State 1 as part of a combined corporate group along with Corp Y (Y).
- X is a partner in two partnerships – P1 and P2.
- The income of P1 and P2 is apportionable applying UDITPA at the entity level and is related to a business conducted by the corporate group.

The Joyce or Finnigan approach (above) would be used and the combined group's 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 (X) files in State 1 as part of a combined corporate group along with Corp Y (Y).
- X is a partner in two partnerships – P1 and P2.
- P1 sells services to P2.
- The income of P1 and P2 is apportionable applying UDITPA at the entity level and is related to a business conducted by the corporate group.

The income of P1 and P2 would include income and expense from the charges by P1 to P2. In including X's distributive share of P1 and P2 income and items in the group's apportionable income will offset the income and expense to the extent of X's share of each (which may differ). In determining the apportionment formula, the receipts of P1 from charges to P2 would be excluded from the apportionment factor to the extent of Corp. X's distributive share of those charges. See more on this issue below.

#### **Example 7 – Tiered Partners:**

- Corp X (X) is a partner in Partnership 1 (P1) which is a partner in Partnership 2 (P2).
- X, P1, and P2 each have their own ordinary income.
- P2 allocates a 20% distributive share of its income to P1.
- P1 allocates a 50% distributive share of its income (including P2 income) to X.
- Assuming all income is apportionable applying UDITPA at the entity level and that the apportionable income is related to the same business for which a single apportionment formula may be applied, X's apportionable income would be:

X's own apportionable income + 50% of P1's income including P1's 20% of P2's income

- X's apportionable factor would include:  
X's own apportionment factors + 50% of P1's factors and 50% of P1's 20% of P2's factors

#### **Example 8 – Special Allocations:**

- Corp X (X) is a partner in Partnership (P)
- P has ordinary income and a capital loss
- P allocates 20% of the ordinary income and 50% of the capital loss to X
- X's share of P's items (ordinary income and capital loss) on an absolute value basis is 30%
- Assuming all income is apportionable applying UDITPA at the entity level and that the apportionable income is related to the same business for which a single apportionment formula maybe applied, X's apportionable income would be:

X's own apportionable income + 20% of P's ordinary income + 50% of P's capital loss

- X's apportionable factor would include:  
X's own apportionment factors + 30% of P's apportionment factors

Note that in its receipts factor, X would include 30% of the receipts giving rise to both the ordinary income and the capital loss (assuming this is consistent with the state's rules for determining the receipts factor). Special allocations are addressed further in the subsection II. C below.

## **Is blended apportionment necessary?**

Use of blended apportionment requires additional information reporting by partnerships and may raise certain difficulties in calculating a partner's state-sourced income. So is blended apportionment necessary?

As noted at the beginning of this subsection, separate apportionment of partnership income, versus blending, will generally result in a different amount of state-sourced income for corporate or tiered partner structures. But, as with combined corporate reporting, blended apportionment may also mitigate the effects that intercompany transactions can have on sourcing.

### **Example 1 – Intercompany Charges:**

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

If P1's income were apportioned separately, it would be sourced entirely to State Y—and so would Corp's and Sub's distributive shares of that income. At the same time, Corp and Sub would have expense from the charges by P1, reducing their income sourced to State X.

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 before sourcing (apportioning) the net amount. Assuming that State X also provides 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.

### **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:

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

State 1:	Blended factor \$1 million / \$10 million = 10% X \$40,000 =	\$4,000
State 2:	Blended factor \$1 million / \$10 million = 10% X \$40,000 =	\$4,000
State 3:	Blended factor \$8 million / \$10 million = 80% X \$40,000 =	\$32,000
Total =	\$40,000	

Note that this example raises issues that are beyond the scope of this white paper and may potentially involve how resident state credits for taxes paid would work.

## **How is the share of partnership factors to include determined when using blending?**

The main “how” 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 specified how this share is determined. The share of partnership factors could be determined 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***

This method attributes the receipts to particular partners based on the partnership items making up their distributive share. So, for example, if a partner is allocated a share of ordinary income, the receipts giving rise to that income would be included in the partner’s apportionment factor. 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 that should be associated with these special allocations will be difficult if not impossible to determine.

### ***2. Interest-Based Approach***

This approach uses a ratio of the partner’s “interest in the partnership” (based on 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. Also, this approach will not necessarily reflect the share of income the partner is allocated.

### ***3. Capital Share-Based Approach***

This approach uses a ratio of the partner’s share of capital. The problem with using the partner’s share of capital is that, like the use of a partner’s “interest in the partnership,” this may not reflect the share of income the partner is allocated in the particular tax year. For example, partners may have no capital interest but are allocated substantial income—as in the case of carried interest. And a partner’s capital interest will typically not reflect a partner’s special allocations of partnership items.

### ***4. Distributive Share-Based Approach***

This approach uses a ratio of the partner’s share of partnership net distributive share income. While this approach reflects the partner’s share of income, the problem with this approach is that special allocations may cause the partner to be allocated net expense or loss while the partnership has net income or vice versa. This problem can be solved by converting all items allocated 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) in more detail, converting items to absolute value. (There are Excel spreadsheets on the project page on the MTC website that also demonstrate this approach.)<sup>58</sup>

The result is that it appears this distributive share approach (using absolute value when there are special allocations) is the best method—since it reflects the share of partnership income (loss) that a partner receives 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.)

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<sup>58</sup> See here: <https://www.mtc.gov/uniformity/project-on-state-taxation-of-partnerships/>.

## **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 the receipts factor 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 have no 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 the receipts factor 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 apportionable net income and receipts factors.

Categories 2-3 above are the primary concern here.<sup>59</sup> 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 and allow “dilution” of the receipts factor in particular states. About a dozen states which have explicitly addressed blended apportionment have also addressed the need to eliminate a share of any related-party receipts from the blended apportionment factor.

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.

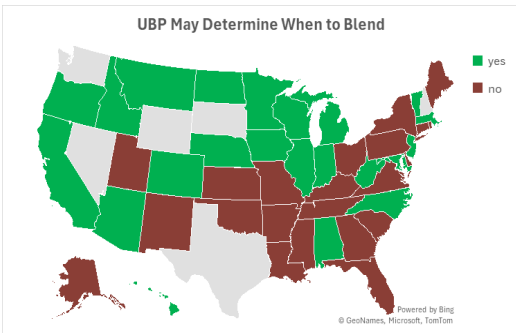
Note that blended apportionment with the rules discussed above may not be sufficient to address every possible state tax sourcing issue raised by the pass-through system. Other issues are covered in the following subsections and may need to be combined with rules for blended apportionment in order to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

### **IMPLICATION:**

**States should consider addressing the use of blended apportionment including the method for determining the partner's share of partnership factors and how the receipts factor would treat receipts from partner-partnership transactions, including guaranteed payments.**

<sup>59</sup> 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](#).

## **When to Use Blended Apportionment Versus Separate Apportionment**



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

The question of when states can or should use blended apportionment to source the distributive share income of a partnership allocated to a particular partner is complicated and has no clear answers currently. So it is important to be clear about the choice involved.

### **Default – Separate Apportionment**

We assume states will follow the general framework summarized in subsection II.A above. The partnership will apply the general state sourcing rules to its items of income to determine if they are apportionable or non-apportionable in relation to the partnership’s own business activities. If any items are non-apportionable, they will be sourced using rules of assignment applied based on the character of the item and the activity giving rise to it. If the items are apportionable income, they will be netted and sourced applying the appropriate apportionment formula using the partnership’s own factors—referred to here as separate apportionment. This sourcing information will then be attributed to the partners receiving a share of the items. The only exception is if blended apportionment is applied.

### **Option – Blended Apportionment**

The character of the items and their related source will not change when allocated to the partners, with one exception—where states provide for the use of blended apportionment. In that case, the partner’s share of the apportionable items will be included in the partner’s related apportionable income and a share of the partnership’s factors will be included in the partner’s apportionment formula for that income, eliminating the effects of partner-partnership transactions on both the blended income and the receipts (sales) factor.

### **Reasons for and Limits on the Use of Blended Apportionment**

Just as combined corporate filing for a unitary group of corporations is not constitutionally required, neither is blended apportionment. States may use separate apportionment—unless this clearly results in distortion. And the reasons for using blended apportionment are similar to those for using combined filing. It can create a better match between the income and the apportionment formula and help prevent income-shifting through related-entity transactions. The effect can be substantial, as has been demonstrated by examples in this white paper and discussed by the work group.

There are also times when blended apportionment is clearly inappropriate. For example, a partner’s own apportionable income and related apportionment factors may have no connection to the partnership’s apportionable income and factors. But, in general, limits fall into two categories—constitutional and practical.

#### **Constitutional Limits**

The constitutional limits on the use of blended apportionment are not entirely clear. So the general principles are summarized here to allow states to consider the kinds of criteria they may wish to include in their rules.

##### ***Entity unity – as developed in the context of taxable corporations.***

The unitary business principle was created by the U.S. Supreme Court to help set two types of limits on state taxing authority: (1) the requirement that there be sufficient nexus between the state and the income to be taxed, and (2) the requirement of “fair apportionment.” In the last

100 years, only about two-dozen Supreme Court cases have turned on the application of the unitary business principle.

The first case to use the term “unitary business,” decided in 1924, involved a foreign manufacturer that argued its taxable income from selling products in a state could not be determined based on apportionment of its total worldwide income. The Court disagreed.<sup>60</sup> Then, 18 years later, the Court again addressed the application of the unitary business principle, noting the necessary relationship between the income and the apportionment formula, and finding that the taxpayer had failed to show that any disconnect between the income of the unitary business and the apportionment formula used to source it.<sup>61</sup>

Another 18 years passed before the Court decided one of the more important cases, *Mobil Oil*. That case involved the question of whether a state could include foreign dividends in the parent company’s income to be apportioned by the parent’s own factors.<sup>62</sup> The Court agreed this was allowable since the parent and subsidiary were part of a unitary business.

Later cases also involved income derived from related corporations.<sup>63</sup> All in all, these cases continued to demonstrate that the unitary business question not only involves the relationship between items of income to be apportioned but also the relationship of that apportionable income to the apportionment formula to be applied.

But because the context of these cases typically involved income derived from separate taxable corporations, the criteria applied by the Court often looked to the relationship between those corporations, including whether they had centralized management, functional integration, and economies of scale. The court also noted that a unitary relationship could be established by a flow of “value” between the entities.<sup>64</sup> So it is this issue of the necessary relationship between separate taxable entities that was both the early focus and the primary concern of the Supreme Court cases.<sup>65</sup>

Still, there are lingering questions. A common question has to do with the effect of “holding companies” or other structures that provide legal separation of the ultimate parent from a subsidiary or that divide ownership in such a way that creates uncertainty as to how the centralized management or related ownership criteria would apply.

#### **“Asset unity” or operational function and lingering questions.**

The unitary business principle also involves another test that can be applied separately from the criteria above—where a taxpayer’s income from a particular asset is at issue. This test looks to the “operational function” of the asset in the unitary business.<sup>66</sup> Some have theorized that this operational function test—sometimes called “asset unity”—may be better suited to determining when blended apportionment would be appropriate, but the principle is less developed so that there is little governing precedent.<sup>67</sup>

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<sup>60</sup> *Bass, Ratcliff & Gretton, Ltd. v. State Tax Comm’n*, 266 U.S. 271 (1924).

<sup>61</sup> *Butler Bros. v. McColgan*, 315 U.S. 501, 509 (1942).

<sup>62</sup> 445 U.S. 425 (1980). It appears the Court concluded that the taxpayer had not offered an alternative formula but only took issue with the inclusion of the dividend income in the unitary apportionable base. See *id.* at 432.

<sup>63</sup> See *Exxon Corp. v. Dept. of Revenue of Wisconsin*, 447 U.S. 207, (1980), *F. W. Woolworth Co. v. Taxation & Revenue Dep’t of N.M.*, 458 U.S. 354, 102 S. Ct. 3128, 73 L. Ed. 2d 819 (1982), and *Allied-Signal, Inc. v. Director, Div. of Taxation*, 504 U.S. 768 (1992).

<sup>64</sup> See *Container Corp. of America v. Franchise Tax Bd.*, 463 U.S. 159, 164 (1983).

<sup>65</sup> See Charles E. McLure, Jr, *Defining a Unitary Business: An Economist’s View* Nat’l Bureau of Economic Research, Working Paper 1125, DOI 10.3386/w1125, Issue Date May 1983, available here: <https://www.nber.org/papers/w1125>. McLure, the preeminent economist in this field, focuses on why determining the profit of separate legal entities may not be possible.

<sup>66</sup> Hellerstein, *supra* fn. 4, ¶8.07.

<sup>67</sup> 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.

Critics of this asset-unity approach to income from separate businesses often cite *MeadWestvaco Corp. v. Ill. Dep't of Revenue*,<sup>68</sup> involving the sale of a division of the taxpayer's business, which was determined by the trial court not to be unitary with the taxpayer's other business. The appellate court nevertheless concluded that the division sold had an "operational purpose" in the taxpayer's business so that the gain could be included in the taxpayer's apportionable income subject to apportionment using only *the taxpayer's* own factors.

The Court disagreed with the appellate court and ultimately remanded. Acknowledging that "the unitary business principle is not so inflexible that as new methods of finance and new forms of business evolve it cannot be modified or supplemented where appropriate," it nevertheless concluded that because the sale here involved "another business," it was the traditional tests for entity unity that should apply.<sup>69</sup>

But *Mead* did not involve partnership distributive share income that is attributed to a partner under the pass-through tax system. So it is not clear how the asset-unity or operational function test would apply to the question of when distributive share can be sourced using blended apportionment. There may be circumstances in which a partnership or partnership structure serves primarily to divide up ownership interest in the assets held. In that case, the income allocated to partners would not be significantly different in nature than if the partners held a joint interest in the assets directly.

### **The Court has never applied the unitary business principle to partnerships.**

The U.S. Supreme Court has never addressed state sourcing of partnership distributive share income or the application of the unitary business principle in the pass-through tax context.<sup>70</sup> Indeed, there have only been a handful of reported cases that have been brought in state courts challenging the method by which the state sourced distributive share income of a partner. See subsection III.C. below. Some of these cases appear to turn on interpretation of state law and sourcing rules. And conclusions in these cases vary considerably.

The lack of specific Supreme Court guidance is critical. First, the unitary business principle as a constitutional limit on state taxation is a creation of the Court, so only the Court can determine the contours of that principle. Second, as the court did in *Mead*, it has sometimes noted that the test for a unitary business can be flexible—depending on the nature of income, the structure of the business, the apportionment factor used, etc.<sup>71</sup> Third, as this white paper has noted in subsections I.B. and I.D., there are important differences in the legal nature and tax treatment of partnerships, including the requirement that the tax character of partnership income be attributed to the partner as though the partner recognized that income directly from the source. IRC §§ 702 and 703.

### **Applying the unitary business principle to partnerships raises unique issues.**

The criteria for a unitary business which have been applied in the context of taxable corporations are 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 the ultimate authority to control. This is not true in the case of partnerships—where control can be vested in minority owners (or in LLCs, non-owners). So an ownership test for a unitary relationship is misplaced in the partnership context.

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<sup>68</sup> 553 U.S. 16 (2008).

<sup>69</sup> The Court also acknowledged the argument that, rather than using the taxpayer's own apportionment formula and factors, the state might have applied the factors of the business sold—as it noted some states did—but found that because this was not what the state had done, nor had the state raised the issue below, that approach could not be addressed. See *id.* at 30-31.

<sup>70</sup> The Court did address state taxation of an individual's pass-through income from an S corporation in *Comptroller of Maryland v. Wynne*, 575 U.S. 542 (2015). But it focused on the internal consistency test and its application to the credits granted to residents for taxes paid, rather than on the use of apportionment to source the income of nonresidents.

<sup>71</sup> This idea of the relationship of the apportionment formula to the income is sometimes referred to as "external consistency." See *Trinova Corp. v. Michigan Dept. of Treasury*, 498 U.S. 358, 380 (1991)(citing *Container*).

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 circumstances, a partner might make substantial use of its interest in the partnership and the partnership's assets without the kind of "functional integration" or "economies of scale" that might have been typical in more traditional manufacturing businesses and their shared use of physical assets (the subject of early Supreme Court cases).

Therefore, when it comes to the question of constitutional limits on the use of blended apportionment, it is necessary to go back to fundamentals and ask—is there a sufficient relationship between the apportionable income of the partnership and apportionable income of the partner such that the use of blended apportionment would fairly represent the source of that income.

### **Practical limitations may be critical to administrability of blended apportionment.**

In addition to the potential constitutional limits on blended apportionment, there are practical limits states may want to consider. The most important is the information reporting requirements that will be necessary to make blending work.

Presumably, with separate apportionment, there would be no need for partnerships to provide apportionment factor information. Partners would only need to know the state-source of items of income in their distributive share which would be determined by the partnership applying apportionment to its apportionable items or rules of assignment to non-apportionable items. This method would therefore require less information-reporting than blending, which would necessitate that the partnership provide more detailed state factor information so that partners can determine the amount and share of those factors.

There may be ways to limit the additional information-reporting to those partners who indicate that they would be required to use blended apportionment. In that case, the number of partners for whom this information would have to be prepared and provided would be greatly reduced. In many cases, it might only be a single partner.

Still, in complex partnership structures, transmitting this kind of detailed information related to particular items allocated to the ultimate taxpaying partners may be difficult. However, the problems would be mitigated to the extent that certain tiered partnerships are simply "holding companies" and would, therefore, simply transmit information from lower tiers.

## **Conclusion**

State guidance is needed to address:

- ***How blended apportionment will be applied—including the determination of the share of partnership factors to include in the partner's apportionment formula.***

Of the states that apply blended apportionment, the majority that have addressed the issue would use the partner's share of the partnership income to determine their share of the partnership factors to include. This also appears to best represent the purpose of the apportionment formula. However, use of this approach requires that states also address the effects of special allocations—where a partner's distributive share may be negative even though the partnership's total distributive share income allocated to partners is positive, or vice versa.

- ***When blended apportionment will be applied—including constitutional and practical limits.***

The majority of states that require blended apportionment reference the unitary business principle as the test for when blending will be applied. Some also provide that in applying the entity unity test for control, the partner's percentage of partnership capital is not determinative. (This tracks with the reality that a partner's capital ownership does not determine control of a partnership.) At least one state lists certain criteria that may be taken into account in determining when a partnership and partner are unitary and includes substantial partner-partnership transactions as one of those criteria. Otherwise, state guidance is limited.

## II.C. Sourcing Special or Mandatory Allocations

As discussed in subsection I.D., 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 use partnerships to effectively change the sourcing of income or loss. This is particularly true where states apply blended apportionment.

### Special Allocations

Partners may receive a greater share of income (loss) from some partnership activities or assets and a lesser share from others. Nor do these so-called special allocations have to match the partner's capital ownership.

#### 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.
- Partnership tracks 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 of Income	\$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 Corp's share of receipts using its distributive share of the total income:
  - Corp would calculate the share of Partnership factors to include using the average ratio of its *total* distributive share income divided by Partnership's total income  
 $\$12 \text{ million} \div \$40 \text{ million} = 30\%$ .
  - Corp's apportionment factor would include 30% of *total* Partnership factors from both activities  
 $\$18 \text{ million in-state (30\% of } \$60 \text{ million)} \div \$60 \text{ million everywhere (30\% of } \$200 \text{ million)} = 30\%$
  - Corp's State X income would be 30% of \$12 million = \$3.6 million.

- Method 2: Determine Corp's share of 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, the blended apportionment factor would still be applied to Corp's total distributive share income from both the consulting and product development activities (which are assumed to be part of one unitary business). The only difference is how the share of receipts for inclusion in the receipts factor is determined.

As this example demonstrates, in cases where there are special allocations of different items of income, the way in which a partner's share of receipts is determined will change the apportionment result. While the second approach here may seem more "accurate" in some sense, it may be impractical for use in complex partnership structures and would require significant additional information reporting by the partnership.

In addition, this use of separate items to determine the share of related factors might be viewed as contrary to the unitary business principle—which relates the receipts or apportionment factors of the entire 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 and presumably share overhead and contribute to each other's profits.

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, including the rule requiring that special allocations have substantial economic effect including those special allocations that affect state tax sourcing of partnership income.

### **Mandatory Allocations – Built-in Gains (Losses)**

**(This example was corrected.)**

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 by the contributing partner 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—apart from whether separate or blended apportionment is applied. A simple example below illustrates the differences and seeks to isolate those differences to the treatment of the built-in gain, looking at both separate apportionment and blended apportionment results.

NOTE: This example uses data that allows the separate and blended apportionment results to be the same.

#### Assume:

- State A has an income tax and State B does not.
- State A uses a receipts factor to apportion income including net gains from sales of business assets.
- Corp owns real property in State A.
- Partnership manages real property in State B.

#### In YEAR 1:

- Corp contributes its real property to Partnership
- The real property has a built-in gain of \$100 million (none of which is recognized).
- Partnership manages the real property as part of its properties.
- In Year 1, Corp, itself, has \$100 million in total receipts and \$50 million in State A.
- Corp's own net apportionable income in Year 1 = \$0.

#### In YEAR 3:

- Partnership sells the real property in State A recognizing a \$120 million gain – which are the only receipts that would be included in State A's receipts factor
- Partnership's total rents and gains = \$1.2 billion
- Partnership's total net distributive share income including the gain = \$200 million.
- Corp is allocated the built-in gain of \$100 million as required under IRC § 704(c) and its total distributive share income from Partnership is \$150 million.
- Corp, itself, has receipts of \$100 million with \$10 million in State A.
- Corp's own net income = \$0.

Assuming the gain is generally considered apportionable income, possible sourcing outcomes for Corp in State A for Year 3 include:

- Separate apportionment at the partnership level – Year 3:
  - \$120 million Partnership receipts in State A ÷ \$1.2 billion total receipts = 10% Factor
  - 10% x \$200 million Partnership income = \$20 million income apportioned to State A
  - Corp's share of total Partnership income = \$150 million ÷ \$200 million = 75%
  - **Corp's income sourced to State A using separate apportionment = 75% x \$20 million = \$15 million**
- Blended apportionment – Year 3:
  - Corp's share of Partnership receipts is determined by its distributive share of \$150 million to the total Partnership income of \$200 million = 75%
  - Corp's 75% share Partnership receipts = \$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 including its distributive share sourced to State A using blending = 10% x \$150 (all distributive share) = \$15 million**

While the results here are the same for separate and blended apportionment, the example can now be used to show how an alternative approach to sourcing the allocation of built-in gain where that gain is, instead, sourced using Corp's own apportionment factors from Year 1 when the property was contributed to the partnership.

- Sourcing the built-in gain in Year 3 using Year 1 Corp factors (with built-in gain) and separate apportionment for the remaining partnership income allocated to Corp:

Total Partnership gain on sale of the real property in State A	\$120 million
Less built-in gain	(\$100 million)
Non-built-in gain also included in State A factor	\$20 million
Total Partnership receipts everywhere	\$1.2 billion
Less built-in gain of \$100 million	(\$100 million)
Non-built-in gain receipts everywhere	\$1.1 billion
Partnership receipts factor in State A without built-in gain	1.8%
Corp distributive share less built-in gain (\$150 M minus \$100 M)	\$50 million
Non built-in gain separately apportioned to State A	\$900,000
Corp's State A factor for sourcing the built-in gain:	
Corp's State A receipts (as recognized) in Year 1	\$50 million
Plus Corp's net built-in gain (as receipts) attributed to State A	\$100 million
Total Corp State A receipts (including the built-in gain) in Year 1	\$150 million
Corp's total receipts (as recognized) in Year 1	\$100 million
Plus Corp's net built-in gain (as receipts) in Year 1	\$100 million
Total Corp receipts (including the built-in gain) in Year 1	\$200 million
Corp's State A receipts factor for Year 1 including the built-in gain	75%
Built-in gain from Year 3 sourced to State A using Corp's Year 1 factors	\$75 million
<b>Total Corp State A Income</b>	<b>\$75.9 million</b>

The result from sourcing income to State A using separate apportionment of partnership distributive share, including the built-in gain, using Partnership's Year 3 factors (\$15 million) is significantly less than the result here using Corp's factors from Year 1 to source the built-in gain, and using separate apportionment for the remaining partnership distributive share (\$75.9 million).

- Sourcing the built-in gain in Year 3 using Year 1 Corp factors (with built-in gain) and blended apportionment:

Total Partnership gain on sale of the real property in State A	\$120 million
Less built-in gain	(\$100 million)
Non-built-in gain receipts in Partnership's State A factor	\$20 million
Total Partnership receipts everywhere	\$1.2 billion
Less built-in gain of \$100 million	(\$100 million)
Non-built-in gain Partnership receipts everywhere	\$1.1 billion
Corp's share of Partnership non-built-in gain receipts:	
Distributive share - \$150 million less \$100 million built-in gain	\$50 million
Total Partnership income - \$200 million less \$100 million built-in gain	\$100 million
Corp's share of factors (without built in gain)	50%
Corp's blended State A apportionment factor:	
50% of Partnership's \$20 million non-built-in gain State A receipts	\$10 million
Plus Corp's own State A receipts - Year 3 - recognized	\$10 million
Plus Corp's built-in gain receipts - Year 1 - attributed to State A	\$100 million
Total blended State A receipts	\$120 million
50% of Partnership's total \$1.1 billion non-built-in gain receipts	\$55 million
Plus Corp's total receipts - Year 3 - recognized	\$100 million
Plus Corp's built-in gain receipts - Year 1	\$100 million
Total blended receipts	\$255 million
Blended apportionment factor	47%
Corp's distributive share income in Year 3	\$150 million
<b>Corp's distributive share sourced to State A using blended factor</b>	<b>\$70.5 million</b>

What this example illustrates is that, whether or not separate or blended apportionment is used, there will be a difference (in this case a significant difference) in the result if built-in gains are sourced using the contributing partner's own apportionment factors in the year of contribution versus the factors of the partnership (or the blended factors of the partnership and the partner) in the year the contributed property is sold. The difference may favor the state in which the property is located, but it may also result in less income apportioned to that state, depending on the facts and circumstances. But most importantly, it demonstrates that partnership structures could be used intentionally to shift the source of partnership income.

Also, while this example does not raise the issue—built-in gains (losses) can also alter the depreciation expenses that are attributed to the contributing partner because of the difference in that partner's (tax basis) versus the non-contributing partners (book basis) over time, effectively decreasing the contributing partner's distributive share income. This may serve as a practical limit on when states need to use a partner's factors to source any built-in gain or loss.

**Implication:**

**Sourcing special allocations using different shares of the related partnership receipts raises a number of issues, including the complexity of that approach. But using the partner's own factors in the year of contribution to source mandatory allocations of built-in gains (losses) would rely on information that the partner has (including the value of the gain the state would include in the receipts factor in that year). Moreover, there appears to be significant potential to use partnerships to shift the sourcing of certain gains, unless there is a special rule for the treatment of those gains.**

## II.D. Other Related-Entity Transactions

While partner-partnership transactions may be eliminated from income and the receipts factor to the extent blending is used, 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 common owners of tiered or other related entities. Therefore, states should look to the kinds of anti-abuse rules that may be imposed when taxing corporate income tax on a separate entity basis.

### Add-Back Statutes

States have long used so-called add-back statutes to disallow the effects of certain inter-company or related-entity transactions involving interest or 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.<sup>72</sup> 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 also 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.

#### **Implication:**

**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 IRS transfer-pricing regulations helpful for this purpose.**

<sup>72</sup> Available here: <https://www.mtc.gov/wp-content/uploads/2023/02/Add-Back-FINAL-version.pdf>.

## **II.E. More on Anti-Abuse Rules**

As noted in subsection I.D. above, Subchapter K depends on anti-abuse rules that states may or may not be able to invoke when the related effect is on the state tax rather than the federal tax owed. As with the sourcing of mandatory allocations of built-in gains (losses), discussed in subsection II.C. above, states may want to provide special rules to avoid the shifting of income.

In addition, states might also provide for simplified reporting of partnership income under certain circumstances where certain criteria are met. Such “relief” or safe-harbor exceptions from the general rules, where there is no evidence of abuse, may help to simplify partnership reporting, especially for smaller, less complex partnerships.

States should especially give consideration to the following federal anti-abuse provisions:

### **IRC § 7701(o) - General Economic Substance Rule**

The general federal tax economic substance rule is set out in IRC § 7701(o). It requires that transactions recognized for tax purposes 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 general economic substance 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. Presumably, this would include state sourcing of income which may or may not be sufficiently related to the federal tax treatment of items of income. 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**

The IRS has issued a specific anti-abuse rule for partnerships, see Reg. § 1.701-2 (also discussed in subsection I.D. above). This regulation refers to “tax consequences” which may be interpreted to include only federal tax consequences.

Therefore, while states may rely on this regulation in determining the proper federal tax result to which they conform, it is unclear whether they could rely if the state tax effect is only indirect related to the federal treatment, as with sourcing. States may wish to provide explicitly that this same general anti-abuse rule will apply in those circumstances where the state effect is indirect or related to state sourcing rules.

### **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). 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 limit allocations that have an effect on the partners’ *state* tax results but not their federal tax results. So, for example, the sourcing of special allocations or built-in gains discussed in subsection II.C above could be subject to the substantial economic effect treatment only if it is clear that the state would apply that standard in the case of state sourcing results which have no economic effect on the partners. In fact, some states have explicitly provided that this substantial economic effect requirement would also apply to the state tax effects of partnership allocations.<sup>73</sup>

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<sup>73</sup> As the summary in Section III notes, those states include Connecticut, Kansas, Louisiana, Maine, Missouri, New York, Rhode Island, Virginia, West Virginia, and Wisconsin.

## **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.<sup>74</sup> This is especially important given the recommended approach in this white paper—which is to source partnership income based on partnership-level information reported to the partners.

## **Specific Equitable Apportionment and Related Rules**

Partnerships may be created by partners for various reasons—including taking advantage of general tax rules to shift the sourcing of income without changing the underlying activities or assets that generate that income. To address these so-called “special purpose entities” created solely for tax purposes, states may need to adopt rules for equitable apportionment applicable in the partnership context. Such rules are, in some ways, a last safeguard against the use of partnerships to alter state tax sourcing of income.

### **Implications:**

**The federal pass-through system depends on anti-abuse rules. And to the extent that states provide for more specific sourcing rules for partnership income, they may also have to consider how the pass-through system may be used to artificially shift income in unintended ways or in ways that do not have any corresponding economic effect.**

**As noted in subsection I.D, the federal anti-abuse rules may serve as models for how states can limit the use of partnerships to alter sourcing of income—but states also have the option of looking to equitable apportionment authority and using that authority to prevent income shifting.**

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<sup>74</sup> 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

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*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 (conduit) principles involved in state tax sourcing rules 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 business 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 state 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 state 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 of partnership factors 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.

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#### **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.

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#### **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.

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## **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.

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## **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.

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## **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. . . .

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## **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.

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## **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.

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## **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.

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## **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).

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## **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 apportionments 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.

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## **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 per cent × \$800,000). Corporation A is taxable in this State upon 35 per cent of the income from its toy manufacturing business (\$350,000 = 35 per cent × \$1,000,000) plus its full distributive share of the partnership income attributed to this State (\$16,000 = 20 per cent × \$80,000), or \$366,000.

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## **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.

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## **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.

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## **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, longterm 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.

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## **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.

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## **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.

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## **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.

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## **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 prove 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.

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## **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.

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.

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## **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.

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## 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.

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## 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.

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## 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.

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## 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).

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## **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.

Mont. Admin. R. 42.26.229

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.

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## **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.

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## **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.

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## 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 non-operational 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.

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## **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.

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## **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 nonresident 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.

(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.

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## **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] to 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.

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## **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.

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## 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.

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## **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.

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## 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.

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## 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.

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## **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).

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## 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.

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## 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).

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## **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.

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## 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 . . .

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## **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.

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## **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](http://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 nonbusiness 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 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.

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## **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 “multistate partnership”. To determine the portion of income attributable to Wisconsin, a multistate 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. 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. In fact, this is the practice followed in most states and, at least historically, was "consistent with the [Multistate Tax Commission] practice."

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, 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. 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.

#### 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.3d 496, 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 multicorporate 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 Nippon-denso 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 Bdisson 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*, *supra*, 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 fractions<sup>3</sup>) 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;

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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.

**Virginia Dep’t of Taxation v. FJ Management Inc., No. 0701-23-2 (Va. Ct. App., Nov. 12, 2024).**

**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,<sup>7</sup> 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.

**Sasol North America Inc. v. Massachusetts Comr. of Rev., No. C273084 (Mass. App. Tax Bd. Sept. 5, 2007).**

**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.