



State Taxation of Partnerships – Status Report

UNIFORMITY COMMITTEE
LONG BEACH, CALIFORNIA
APRIL 25, 2023

GENERAL APPROACH

1. Identify and generally describe a comprehensive list of potential issues.
2. Note the important relationships between those issues.
3. Select a particular issue and develop generally recommended practices or positions.
4. Repeat step 3 until all major issues have been addressed and reconcile any differences.
5. Agree on overall set of recommended practices/positions for all issues.
6. Begin creating draft models, etc., to carry out the recommended practices/positions.

PROJECT TIMELINE & STATUS

Comprehensive Issue Outline - Ongoing

- Nexus and Jurisdiction
- Tax Base
- Sourcing
- Gain on Sale of Interest
- Administrative and Enforcement

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Investment Partnerships

- White Paper
- Draft Model
- Reviewing Comments

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Investment Partnerships

- White Paper
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Other General Sourcing Issues

- Principles of Partnership Sourcing
- Guaranteed Payments
 - Draft White Paper



PRINCIPLES

- Based in the foundational rules of the law
- Provide a consistent framework
- Built upon by specific rules and application to facts and circumstances

01

Partnership
Income is Taxed
on a Pass-
Through Basis

02

Partnership Acts
as a Conduit for
Items

03

Tax Rules Allow
Partnership
Flexibility

04

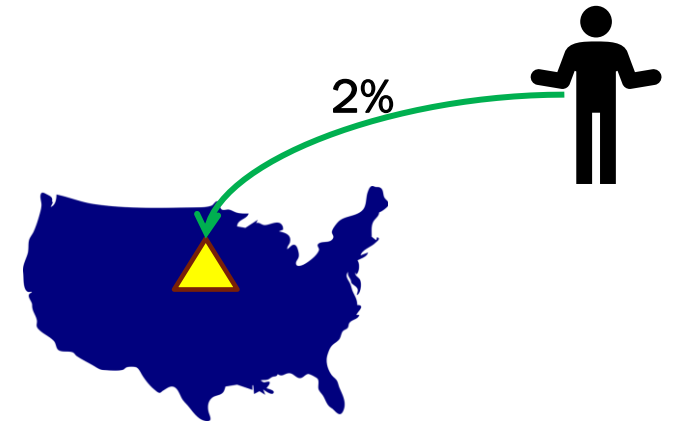
Different
Allocations and
Payments Must
be Distinguished

IMPORTANT FEDERAL TAX PRINCIPLES – SUBCHAPTER K

QUESTION

Assume a domestic partnership has a foreign limited partner with no rights of control that holds a 2% interest in the partnership with business operations in the U.S. In Year 1, the partner is allocated U.S. income but does not receive any distribution.

Does the partner owe U.S. tax?



PRINCIPLE:

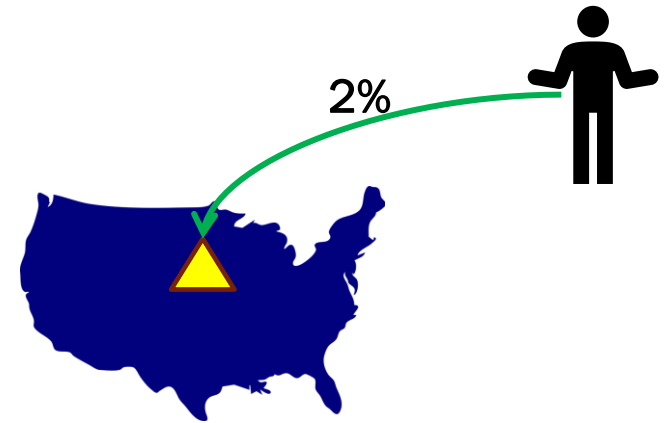
PARTNERSHIP INCOME IS TAXED ON A PASS-THROUGH BASIS

The partnership income is attributed to “persons carrying on business as partners.” IRC §701. There is no exception for limited, passive, or minority partners, although the partners role may affect whether allocations have substantial economic effect (e.g., allocations of certain losses to partners who have no liability for partnership debts).

ANSWER

The partnership will be required to withhold federal tax under IRC § 1446 regardless of the amount of foreign partner's ultimate U.S. tax liability and regardless of whether the partnership makes any distributions during its tax year.

See Revenue Procedure 92-66, and Treasury Regulation section 1.1446-3.



QUESTION

Partnership A has net income on the 1065 of \$100,000. Assume a partner's share of this net income amount would be \$20,000.

Is this the amount Partnership A must report on the K-1?

PRINCIPLE: PARTNERSHIP ACTS AS CONDUIT FOR ITEMS

Partnership items of income, expense, gain, and loss are valued and characterized based on partnership's activities and these attributes of the tax items then flow through to partners. IRC §§ 702 and 703.

This principle applies in tiered partnerships, as well so the character of items is maintained through the tiers.

The conduit principle also applies to federal sourcing of partnership income – see application under IRC § 875 and 26 CFR § 1.863-3.

ANSWER

Perhaps the best example of the conduit principle is Schedule K-1 which lists a number of different items that must be reported to the partners including:

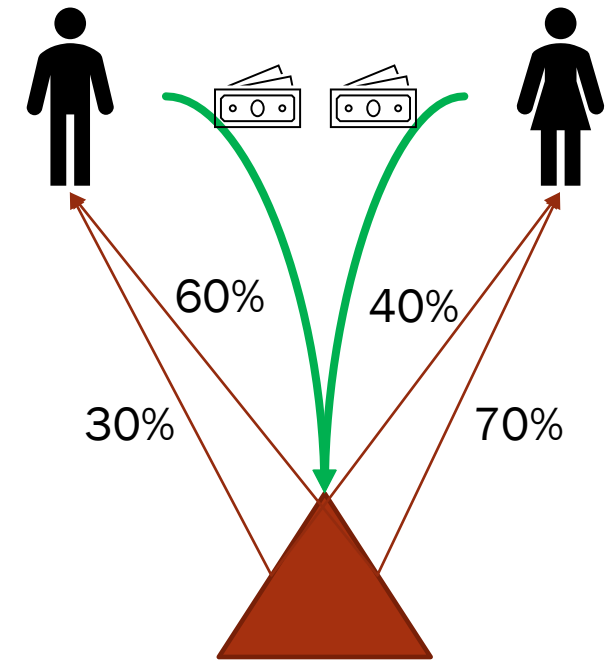
- Ordinary business income (loss)
- Net rental real estate income (loss)
- Other net rental income (loss)
- Total guaranteed payments
- Interest income
- Ordinary dividends
- Qualified dividends
- Dividend equivalents
- Royalties
- Net short-term capital gain (loss)
- Net long-term capital gain (loss)
- Collectibles (28%) gain (loss)
- Unrecaptured section 1250 gain
- Net section 1231 gain (loss)
- Other income (loss)
- Section 179 deduction
- Other deductions

QUESTION

Smith and Jones form a partnership and each contribute 50% of the capital and also participate in the business. They agree to share the ordinary income of the partnership, net of expense, 60/40, and the capital gains (losses) of the partnership, net of expense, 30/70.

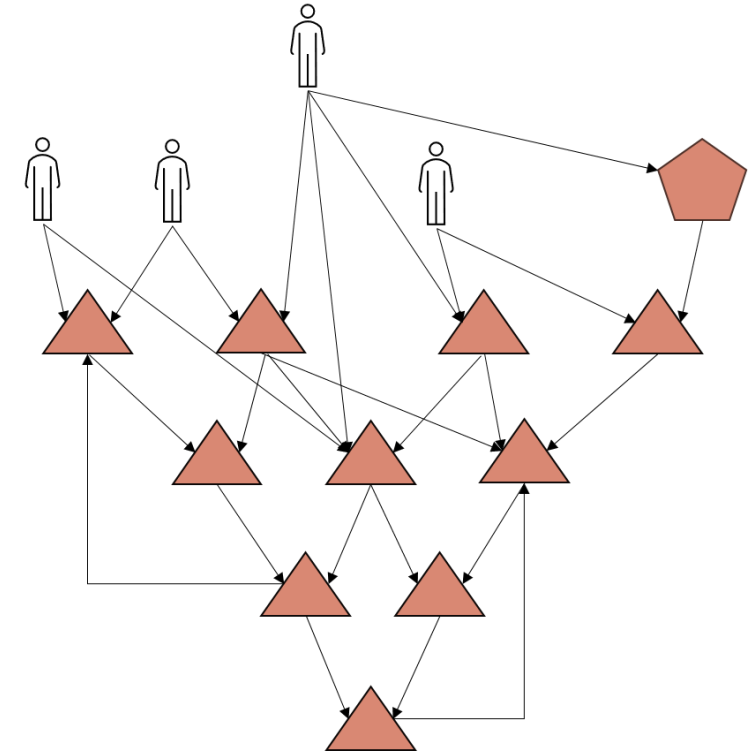
Will Subchapter K allow these allocations?

For these allocations to be allowed, must there be corresponding distributions?



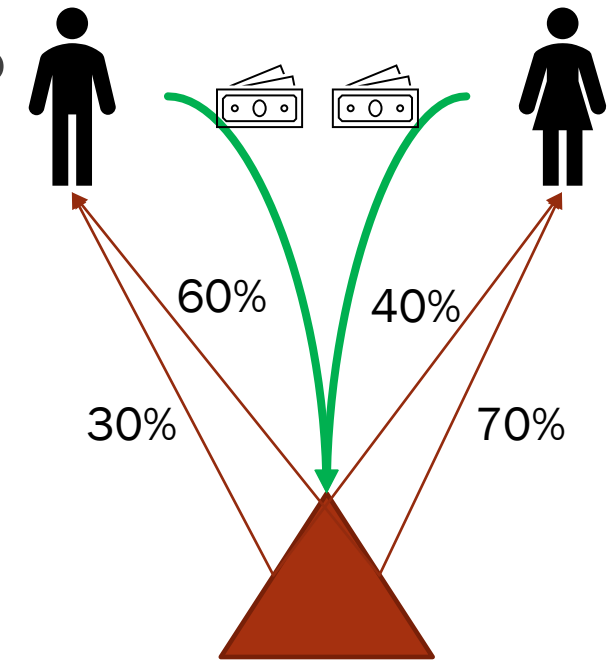
PRINCIPLE: TAX RULES ALLOW PARTNERSHIP FLEXIBILITY

- State law provides for flexibility in both the structure of partnerships and the economic arrangements between the partners.
- Tax rules allow this flexibility as well.
- There are no limits on the numbers or types of partners and tiered entities are becoming much more common.
- Partners also have flexibility in allocating items, within limits, and can change their agreements over time.
- Partners can share some items of income, gain, expense, and loss differently from other items and partners' shares of items or income need not match their interests in the partnership. See IRC §704.



ANSWER

Subchapter K allows these “special allocations” provided that they have substantial economic effect (a binding partnership agreement and proper accounting for the partners’ shares effect on capital) and do not violate any anti-abuse provisions. There do not need to be corresponding distributions in the tax year in order for the allocations to be respected.



PRINCIPLE:

DIFFERENT ALLOCATIONS AND PAYMENTS MAY BE DISTINGUISHED

- Distributive Share – allocations of items when earned or incurred – taxed based on their character in that year. IRC §704.
- Distributions – payments to partners from income or capital and typically nonrecognition events to extent of outside basis. IRC § 731.
- Guaranteed payments for services or the use of capital – taxed as ordinary income when made. IRC §707(c).
- Payments to partners not as partners and treated as transactions between unrelated parties. IRC §707(a).

QUESTION

A partnership provides its managing partner will generally receive payment equal to a 10% share of total net income/gain (loss), but no less than:

- a 1% share of gross operating income, or
- \$50,000.

Year 1 – Partnership has:

- Gross operating income of \$10 million
- Ordinary net income of \$50,000
(after expenses and a \$2 million capital loss)

Result:

What will the MP's payment be? _____

Will any of this payment be a guaranteed payment?

Will the MP have any allocation of capital loss?



ANSWER

Good question!!!

Tune into our regular partnership project work group meetings where we will be discussing guaranteed payments and whether they can be distinguished . . .

WHAT ABOUT STATE TAX SOURCING PRINCIPLES?

Are there any state tax sourcing principles that apply to partnerships?

OR

Does conformity to the federal pass-through system confound the ability to apply those principles?

STATE TAX PRINCIPLES – APPARENT MAJORITY VIEW

General Sourcing Rules Apply to
Activities of a Single Partnership –

- UDITPA or similar sourcing rules apply to partnership income.
- Exception to the general sourcing rules may be made for income of nonresidents from partnerships that are solely or primarily engaged in investing.*

* More below.

QUESTION

- Partnership A operates a business primarily in State 1.
- Partnership B is a partner in Partnership A.
- Partnership B operates a separate (non-unitary) business primarily in State 2.
- Partner Smith owns an interest in Partnership B.

Question: Should the portion of Smith's allocation of income from Partnership B, which represents B's allocation of income from Partnership A, be sourced based on A's activities or B's activities?

STATE TAX PRINCIPLES – GROWING CONSENSUS

- Items are not simply “re-sourced” when they pass through tiered partners.
- Only if the partner is also separately engaging in another trade or business, *may* the activities of that partner be considered in the sourcing of partnership income or items.

QUESTION:

- Smith is a partner in Partnership A
- Partnership A has:
 - A store in that generates income in State 1, and
 - Property in State 2 that generates a capital loss, and
 - The store and the property are part of a unitary business.

Assume Smith agrees to receive a special allocation only of ordinary income so that no part of the capital loss is allocated to him. How would Smith's income be sourced – by apportionment at the partnership level, or specific sourcing, based on the store's activities, to State 1?

STATE TAX PRINCIPLES – APPARENT MAJORITY VIEW

Business/Nonbusiness Rules and Unitary Business Principle Apply to Activities of a Single Partnership –

- Items that are part of the partnership’s “business income” are sourced together using apportionment, and
- Items that are “nonbusiness income” are sourced applying allocation or specific attribution rules.

QUESTION:

- ❑ Partnership A
 - ❑ Operates a store in State 1 and generates ordinary income.
 - ❑ Has three partners – A, B, and C.
 - ❑ Each hold 1/3 interests and share control over operations.
- ❑ Partnership B
 - ❑ Owns property in State 2 and generates a capital loss.
 - ❑ Has three partners – B, C, and D.
 - ❑ Partners each hold 1/3 interests, but D has sole control over operations.
- ❑ The property in State 2 is used directly in the business of the store in State 1.

Question: Should Partnership A's income and factors be combined with Partnership B's loss and its factors in determining the source of the income/loss? Should this be done for A and D as well as B and C?


STATE TAX PRINCIPLES –





INVESTMENT PARTNERSHIPS

ISSUE – SHOULD THERE BE A SPECIAL RULE FOR THE SOURCING OF INCOME FROM INVESTMENT PARTNERSHIPS, TREATING IT AS SOURCED TO A PARTNER'S RESIDENCE, RATHER THAN THE LOCATION OF PARTNERSHIP ACTIVITIES?



INVESTMENT PARTNERSHIPS

- Drafted white paper and discussed findings.
- Drafted model and discussed and circulated for comment.
- Received and are in the process of reviewing comments.
- Decision was to eventually table a draft, in some form, and proceed to address other issues before finalizing.
- Circling back to check for significant issues.





IRS SOI DATA FOR 2020

- Portfolio income for the Investment and Finance Industry was \$1 trillion.
- The largest component of this was long-term net capital gains of \$646 billion.
- <https://www.irs.gov/statistics/soi-tax-stats-partnership-statistics-by-sector-or-industry>

INVESTMENT PARTNERSHIPS – WHITE PAPER FINDINGS

- States have developed a system for sourcing and taxing partnership income that generally sources the income based on the activities and operations of the entity, while it imposes the tax on the partners.
- This is consistent with both the federal tax system and the long-established state tax principles for dividing multistate income.

INVESTMENT PARTNERSHIPS – WHITE PAPER FINDINGS

- The treatment of investment partnership income—sourcing that income to the residence or domicile of the partners—does not appear to be dictated by constitutional principles or limitations, at least not to the extent that this treatment has generally been applied.
- Nevertheless, there are principled and policy reasons for the special treatment including establishing bright-line rules where limits may otherwise be difficult to discern, equitable treatment of investment income, and ease of administration and compliance.

INVESTMENT PARTNERSHIPS – WHITE PAPER FINDINGS

- Unless the special sourcing treatment is properly designed and implemented, however, it could undermine the general system for taxing partnership income or lead to unintended results.
- Regardless of how a state applies sourcing rules to investment partnership income, the state should explicitly address this issue to avoid uncertainty.
- States should consider basing the special sourcing rule for investment partnership income on the federal principle that income under the pass-through system should be treated as if it was earned directly.

INVESTMENT PARTNERSHIPS – WHITE PAPER FINDINGS

- States should be explicit that, if they appear to base their special sourcing rule on nexus or apportionment principles generally, the rule is a bright-line standard meant to increase certainty.
- The special sourcing rule should not apply to corporate partners since the rules for sourcing investment income are much more developed in the corporate tax context.

INVESTMENT PARTNERSHIPS – WHITE PAPER FINDINGS

- States should consider excluding from special sourcing treatment any partners that take an active role in the investment activities.
- The special sourcing rule for investment partnership income should not apply to partnerships that are invested in other non-investment partnerships or to the income which is derived from those non-investment partnerships. Without this limitation, investment partnerships might be used to simply shift the sourcing of other partnership income.

INVESTMENT PARTNERSHIPS – WHITE PAPER FINDINGS

- Because of the general complexity in this area, states should consider including certain details in their rules to address common situations, including:
 - Defining and measuring of any assets for the application of an asset test,
 - Defining and measuring any income for the application of an income test,
 - Defining which partners are subject to the special treatment and that the treatment, if applied only to limited nonresident partners, is applied only to the extent those partners:
 - Are passive and have no role in the investment partnership's activities or the activities of any of the entities in which it might invest,
 - Have no past or current ownership or other relationship to the underlying portfolio companies or investments.

DRAFT MODEL – TREATMENT OF INVESTMENT PARTNERSHIPS

- Excludes
 - “Qualified Investment Income” allocated by a “Qualified Investment Partnership,” if allocated to a “Nonresident QIP Partner,” with certain exceptions. Each of the operative terms is defined, as is the term “Qualified Investments,” used in the definitions of some of the terms.
 - Essentially works as a sourcing rule—so that the residence of the qualifying partner is used, rather than the location of investment activities or the underlying investment assets.

Is the partnership a
"Qualified Investment
Partnership"?



Are 90% of the investment
assets "Qualified
Investments"?



Yes

Which assets are
"Qualified Investments"?

Which income is
"Qualified Investment
Partnership Income
(Loss)"?



No

No

Safe
Harbor
does NOT
apply

**Is the partnership a
“Qualified Investment
Partnership”?**



**Are 90% of the investment
assets “Qualified
Investments”?**



Yes

**Is 90% of the gross income
Qualified Investment
Partnership Income (Loss)?**

**Which assets are
“Qualified Investments”?**

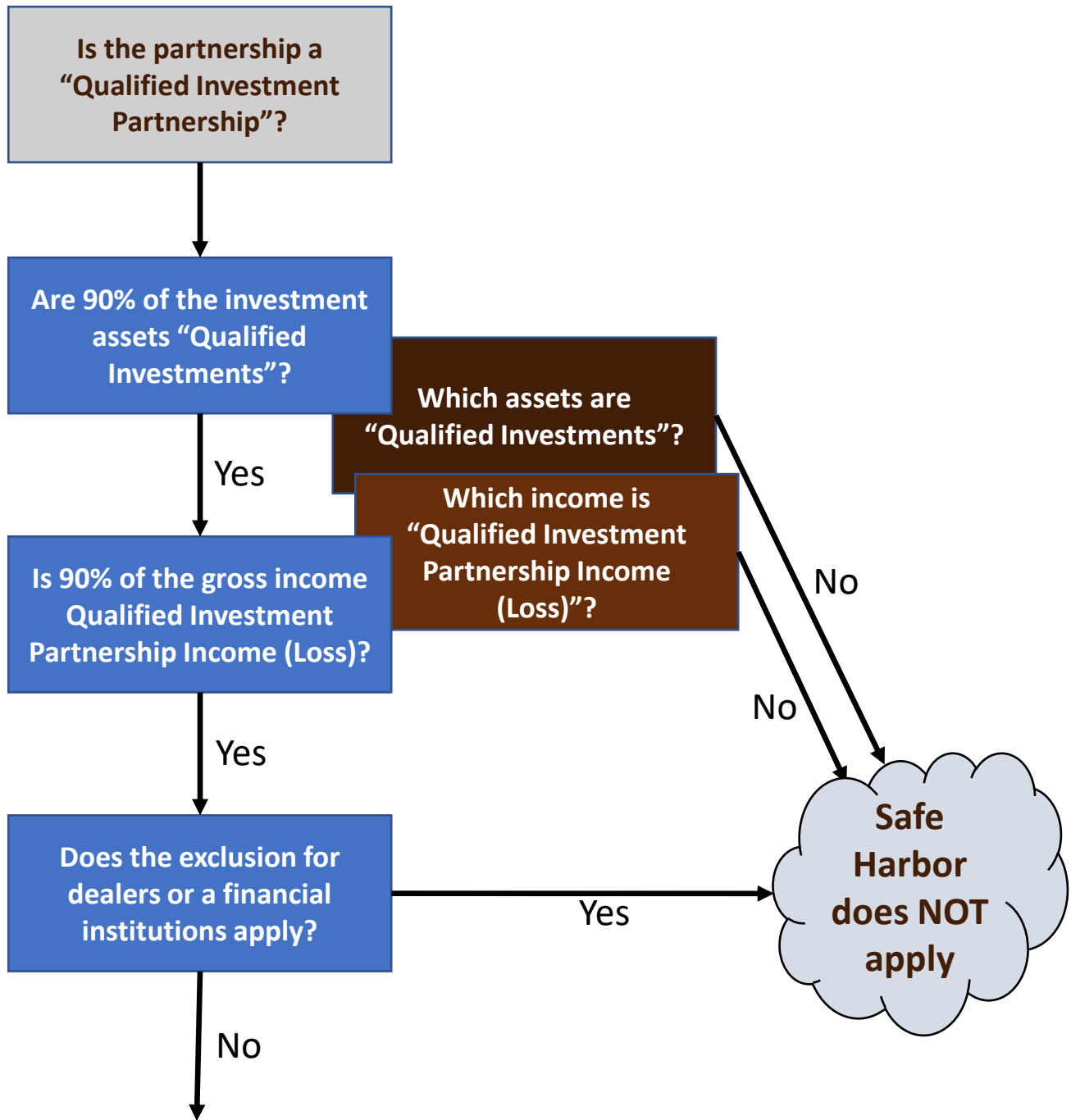
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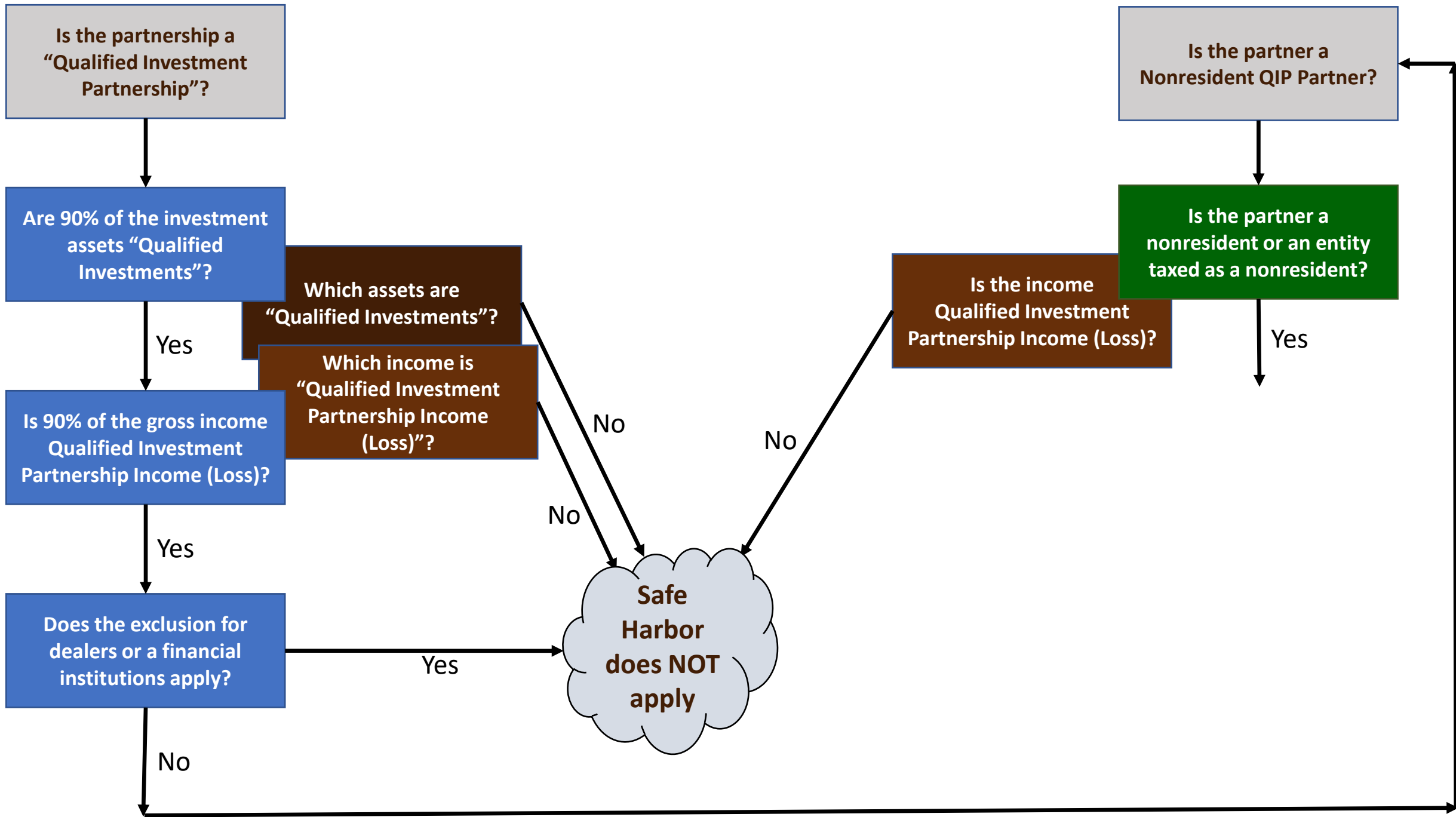


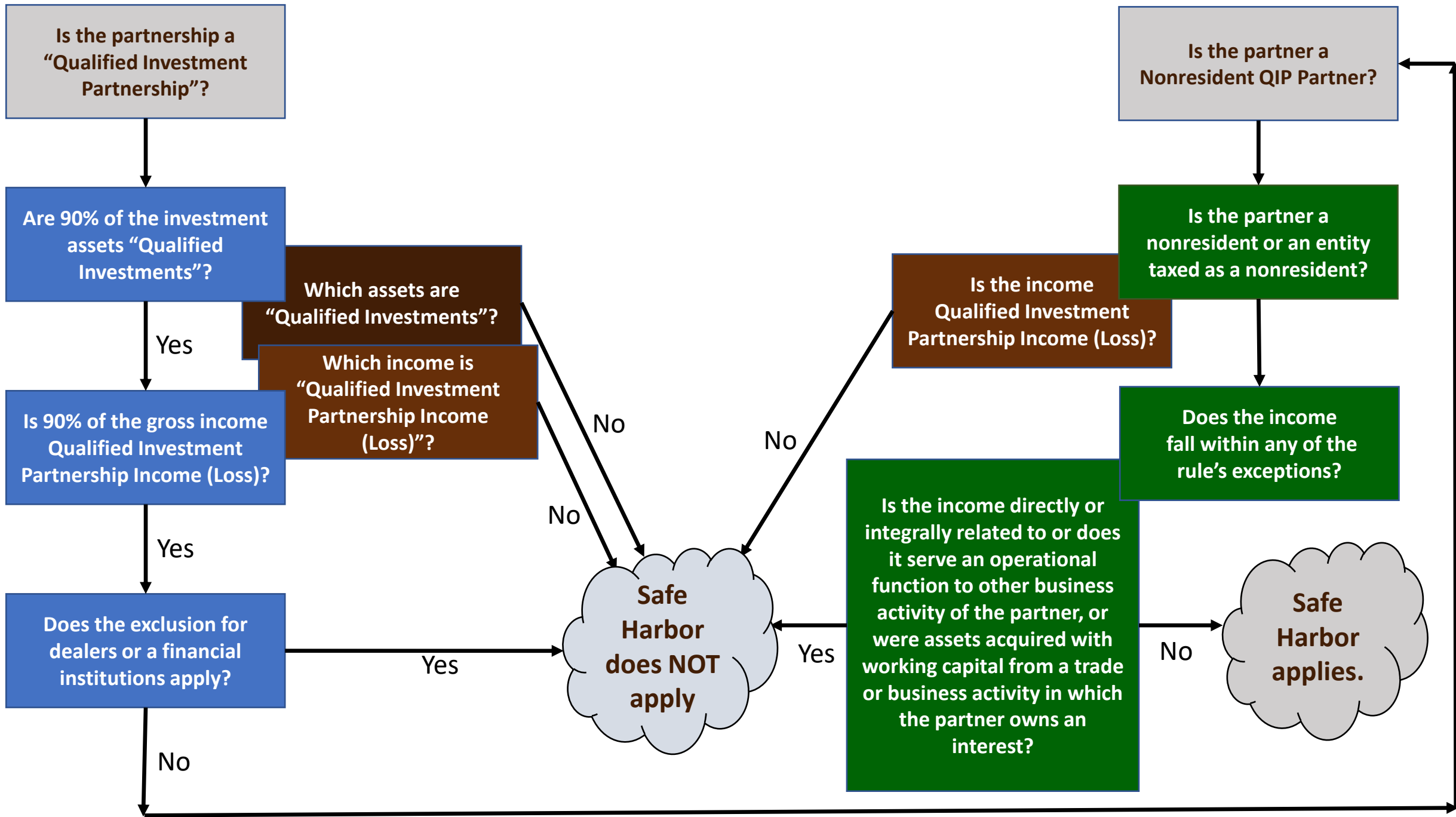
No

No

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Harbor
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apply**







DRAFT MODEL – PURPOSE SECTION

- The model contains a “Purpose” section,
- The purpose section was revised somewhat to reflect recent discussions and clarify the basis for the special treatment provided by the model.
- As this section has stated in the past, the model’s purpose is to:
 - Create a safe harbor.
 - Not provide an exclusive or exhaustive list of sourcing rules for investment-related income.

SIGNIFICANT DRAFTING QUESTIONS

How to ensure that the model cannot be used to simply restructure a business that has operational investments and, by doing so, change the sourcing?

How to make sure the “interlocking parts” don’t contradict or overlap in a way that causes ambiguity.

How to structure the definition of “Qualified Investments” – whether a comprehensive list, a description, or something in between.

How to address administrative issues – certification, filing, withholding, PTE filing, etc.

**STRUCTURING
DEFINITION OF
“QUALIFIED
INVESTMENTS”**

Detailed listing

General description – with examples

Tie it to state treatment of investment
income generally

Tie it to federal treatment – IRC § 864 –
with any exceptions

RELATED DEVELOPMENT

Illinois SB 1880 and HB 2237

- Adds “the distributive share of partnership income from lower-tier partnership interests meeting the definition of qualifying investment security” to the list of income satisfying the 90% of gross income test for investment partnerships.
- Adds to the list of qualifying investment securities “a partnership interest which, in the hands of the partnership, qualifies as a security” under 77b(a)(1) of Chapter 2A of Title 15 of the U.S. code.

HOW TO ADDRESS ADMINISTRATIVE ISSUES

Delegation to agency with
specific instructions


Divide issues and provide
delegation only on some

Provide detailed instructions
for all administrative issues



GUARANTEED PAYMENTS

ISSUE – SHOULD THERE BE A SPECIAL RULE FOR THE SOURCING OF GUARANTEED PAYMENTS FOR SERVICES, TREATING THEM AS TAXABLE WHERE THE SERVICES ARE PERFORMED RATHER THAN WHERE THE PARTNERSHIP ACTIVITIES ARE CONDUCTED (AS DISTRIBUTIVE SHARE WOULD NORMALLY BE SOURCED)?



GUARANTEED PAYMENTS

- Had discussions of the issue.
- Drafting a white paper.





IRS SOI DATA FOR 2020

- Total guaranteed payments reported in 2020 were approximately \$74 Billion.
- As a percentage of total net partnership income that year, this is roughly 10%.
- <https://www.irs.gov/statistics/soi-tax-stats-partnership-statistics-by-sector-or-industry>

GUARANTEED PAYMENTS – PRELIMINARY THOUGHTS

- Federal distinctions are not always clear or consistent.
- Federal rules do not necessarily control sourcing.
- If state sourcing rules differ then, unless there are generous credits for state taxes paid, there could be double taxation (or no-where income).
- About half of the states have specific rules.
- The majority of those source guaranteed payments for services as distributive share.
- States also have to think about addressing the treatment of guaranteed payments under PTE taxes.



POSSIBLE FUTURE ISSUES

WHERE MIGHT WE BE IN A YEAR
... OR FIVE ... OR TEN ...



ISSUES

- Treatment of tiered structures generally and sourcing.
- Anti-abuse rules.
- Sourcing of gains/losses from sales of partnership interests.
- Withholding, composite returns, PTE taxes.