General partnerships -- such as joint ventures -- and limited liability flow-through entities -- such as limited partnerships, limited liability companies electing partnership treatment and publicly traded partnerships, also known as master limited partnerships -- are common structures in today’s business world. There are several business, financial and tax reasons for this. Partnerships allow businesses and individuals to mitigate risks while increasing investment abilities and opportunities, buying power, marketability and market share. Partnerships also allow for the sharing of beneficial tax attributes such as deductions and (in some cases) credits. But although partnerships provide many benefits, they also often create state income tax issues for the unwary.

In general, most states provide two methodologies for attributing a taxpayer’s income to various states: allocation and apportionment. When income is allocated because it is non–business income or otherwise required by statute, it is attributed to a particular state or states that are considered to be the source of the income. When income is apportioned, it is divided among the various states in which the taxpayer derives apportionable income based upon its business activity and the various state apportionment formulas. Both mechanisms often come into play when calculating the distributive share of income from partnerships to corporate partners. When and where the differing mechanisms come into play — that is, distinguishing between business and non–business income and clarifying other state statutory pronouncements — requires an analysis by tax practitioners.

**Partnership Income: Business or Non–business Income?**

Corporate partners often assume that partnership tax attributes such as apportionment factors flow through to be combined with the corporation’s own factors. This assumption is not always correct. For example, a handful of states, including Arkansas, Louisiana, Mississippi and Oklahoma, presume that a corporate partner’s distributive share of income or loss is non–business income. They therefore require separate allocation with regard to such income. Other states, such as New Hampshire, Tennessee and Texas, generally subject partnerships to direct taxation. In Mobil Oil Corp. v. Commissioner of Taxes of Vermont, the Supreme Court stated that determination of a unitary relationship is the lynchpin of state apportionment. Several states, including California, Illinois and New Jersey among others, explicitly require a unitary relationship before allowing corporate taxpayers to flow through and combine partnership apportionment factors with their own.

The Multistate Tax Commission (MTC) regulations construe the Uniform Division of Income for Tax Purposes Act (UDITPA) as establishing a presumption in favor of apportionment in stating, “the income of the taxpayer is business income unless clearly classifiable as non–business income.” New Jersey, however, has taken the position in Chiron Corp. v. Director, Division of Taxation that there is a presumption against finding a unitary relationship between a corporate partner and partnership in the context of partnership factor flow—through. Absent a unitary finding, partnership income is treated as non–business income and separately allocated to a state based on the appropriate sourcing rules for that state. A unitary analysis is important in all cases to ascertain whether the partnership income should be characterized as business or non–business.

The unitary analysis generally requires that one analyze three factors:

1. Unity of ownership;

2. Unity of operation as evidenced by central purchasing, advertising, accounting and management divisions; and
3. Unity of use of its centralized executive force and general system of operation.5

Additionally, the out-of-state activities of the purported unitary business must be related in some concrete way to the in-state activities.6 The functional meaning of this requirement is that there must be some sharing or exchange of value beyond the mere flow of funds arising out of a passive investment in order for a unitary relationship to exist.7 When no unitary relationship exists between the corporate partner and the partnership, an evaluation of the partnership’s activities must be examined to determine whether it has sufficient contact with the state to subject its corporate partners to state taxation. If a corporate partner in a non-unitary partnership finds that it has nexus with a state in which the partnership does business, then the corporate partner should allocate, or separately account for the partnership income, rather than apportion it.

Alvarez & Marsal Taxand Says:

Tax practitioners should not overlook the fact that partnership income is not always treated as business income and automatically flow the partnership apportionment factors through to the corporate partner and apportion the entire income. A careful analysis should be performed to determine whether the partnership income is unitary with the corporate partner. Each state’s statutory characterization of partnership income as business or non-business should also be reviewed. The difference between allocating and apportioning partnership income could have a material impact on a corporation’s state blended rates utilized for provision purposes and could go as far as turning an otherwise non-cash paying taxpayer into one that pays cash taxes.

2 18 Cal Code Regs §§25137–1(a), (f) and (g); 86 Ill Admin Code § 100.3380(d)(1); NJ Admin Code § 18:7–7.6(g).
3 MTC Reg. IV.1.(a).
5 Butler Bros. v. McColgan, 315 US 501 (1942).
7 463 US at 166.

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