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State Tax Developments For Pass-Through Entities: Apportionment Of Income For Corporate Partners

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State taxation of corporate partners in multistate partnerships raises interesting issues. In many circumstances, the corporate partner is subject to multistate taxation and is therefore engaged in the process of allocating and apportioning its income on a multistate basis. 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.

Two questions often arise with respect to corporate partners: (1) whether the business/nonbusiness income determination is made at the partner or partnership level; and (2) whether, for purposes of computation of the corporate income tax base, the corporation’s income from the Partnership will be determined on an “aggregate” basis or “entity” basis.

With respect to the first question, most states have failed to address the issue of whether the business/nonbusiness income determination is made at the partner or partnership level. There are a few exceptions. Specifically, Alabama, California and Illinois require that the determination be made at the partnership level, while Arizona and Pennsylvania require that it be done at the partner level, which may yield a different result in those states because the corporate investment in the partnership is typically treated as an intangible asset.

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. Those states therefore require separate allocation with regard to such income.

Despite the position of these few states, one may almost always assume that most states consider income to be “business income” unless the taxpayer can prove otherwise. This theory is reinforced by the Multistate Tax Commission (MTC) regulations which construe the Uniform Division of Income for Tax Purposes Act (UDITPA) as establishing a presumption in favor of apportionment.

As for the second question, for apportioning business income of corporate partners, most states follow the “aggregate” or “flow-through” approach. Under this approach, partnership income is aggregated with the corporate partner’s business income. The total business income is then apportioned using an apportionment formula that combines the corporate partner’s distributive share of the partnership's apportionment factors with the corporation's own apportionment factors.

On the other hand, under the "entity" approach, a partnership is treated as a separate entity distinct from its partners and the corporation is taxed on its distributive share of the partnership income determined separately. If the corporate partner has operations of its own in the state, it computes its own state apportioned income and adds to the result the income from the partnership's K-1.

A few states, including California, Illinois, Michigan and New Jersey, require the flow-through of apportionment factors ***only if*** the corporate partner and the partnership are unitary. The analysis in these particular states that take a unitary approach becomes more complicated considering states' differing unitary standards. For example, in California, a unitary relationship was generally considered to exist if any of three unity tests is satisfied. These unity tests include the *Mobil* three-factor test comprised of centralized management, functional integration and economies of scale, the three unities test comprised of unity of ownership, unity of use and unity of operation, and the contribution and dependency test. However, in a recent case, *ComCon Production Services I, Inc. v. California Franchise Tax Board*, Los Angeles Superior Court, No. BC489779, the court relied on the *Mobil* indicia of a unitary business, which it said subsumed the contribution and dependency test. Relatedly, a few California courts have noted that, while using slightly different terminology, the *Mobil*indicia and the three unities test look to the same basic factors. In the aggregate, these findings could be interpreted as meaning that the *Mobil* indicia are the sole factors used to determine whether a unitary relationship exists and that the contribution and dependency test is a subset of the *Mobil* test. As *ComCon* illustrates, a unitary relationship analysis can be complex and confusing.

While states apply no hard and fast rule, limited partners are generally not considered to be unitary with the partnership due to the passive nature of the relationship. The converse is not necessarily true however, i.e. whether a general partner is unitary with the partnership is a factual determination made in accordance with the particular state's rules.

In conclusion, because state apportionment and allocation of a corporate partner's income in a multistate situation is nearly without any legislative guidance, it is critical for the owners of pass-through entities and their advisors to vigilantly monitor changes in the dynamic world of state and local taxation, particularly relating to apportionment in order to avoid unknown tax liabilities and unnecessary penalties.

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