

## State Income Taxation of Out-of-State Corporate Partners

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### INTRODUCTION

A recurring issue in state taxation is whether an out-of-state partner is subject to tax in a state where the partnership is doing business when the partner's sole connection with the state is membership in the partnership.<sup>1</sup> State taxing authorities will almost invariably seek to assert jurisdiction. It is one thing to treat partnerships as pass-through entities; it is quite another to allow them to serve as "pass-out" entities that permit income earned in the state to avoid tax altogether. From a tax policy perspective, allowing such income to escape taxation would skew the economic playing field in favor of partnerships comprised of (untaxed) out-of-state partners and against partnerships comprised of (fully taxed) in-state partners.

This tax policy concern might be mitigated in the case of out-of-state partners taxed as individuals, since state individual income taxes are generally imposed on the income of residents wherever earned. Thus, it might plausibly be expected that the out-of-state partner's state of residence will ensure full income tax accountability. For corporate taxpayers, however, the state of residence (or corporate domicile) cannot be relied upon to ensure full accountability. This is because all states that impose a corporate income tax have eschewed residence-based taxation, either as a matter of policy choice or federal constitutional constraints. Instead, these states have embraced a source-based, formula apportionment approach to the taxation of corporate business income.<sup>2</sup> Thus, unless corporate income is taxed at its

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<sup>1</sup> Partners whose sole connection with a state is membership in a partnership doing business in the state will hereinafter simply be referred to as "out-of-state partners" or "out-of-state limited partners."

<sup>2</sup> See 1 JEROME R. HELLERSTEIN, WALTER HELLERSTEIN & JOHN A. SWAIN, STATE TAXATION ¶¶ 8.01–.02, 8.07 (3d ed. 2012) (discussing the history and operation of the "unit rule" in the context of property taxation and the "unitary business" rule and the "right to apportion" in the context of corporate income taxation).

source, it will usually not be taxed at all.<sup>3</sup> For this reason, this Article focuses on the income taxation of out-of-state corporate partners, viewed from both a jurisprudential and tax policy perspective.

## I. THE AUTHORITIES

### A. Constitutional Principles

The assertion of jurisdiction to tax out-of-state corporate partners implicates both the Due Process and Commerce Clauses of the U.S. Constitution. In *Quill Corp. v. North Dakota*,<sup>4</sup> the U.S. Supreme Court held that due process was not offended by the state's imposition of a use tax collection obligation on a non-physically present out-of-state seller. All that due process required was "some definite link, some minimum connection, between a state and the person, property or transaction it seeks to tax."<sup>5</sup> The Court went on to say: "In this case, there is no question that . . . [the taxpayer] has purposefully directed its activities at North Dakota residents, [and] that the magnitude of those contacts is more than sufficient for due process purposes . . ."<sup>6</sup> The *Quill* Court, however, set a higher jurisdictional bar under the Commerce Clause, reasoning that while the "analytical touchstone" of due process analysis is "notice" or "fair warning," the "substantial nexus" requirement under the Commerce Clause is informed more by concerns about state taxes and regulations that may "unduly burden interstate commerce."<sup>7</sup> Thus, at least in the context of sales and use taxes, the Court established a "physical-presence" nexus test, requiring that a seller must be physically present in a state in order for the state to impose a use tax collection obligation on that seller.<sup>8</sup> The opinion also suggests, however, that the physical-presence test may be limited to sales and use taxes.<sup>9</sup> Indeed, in the wake of

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<sup>3</sup> See *infra* note 48 and accompanying text (discussing the ineffectiveness of various mechanisms adopted by "non-source" states to absorb "nowhere income" in the context of corporate partners). The risk of non-taxation is greatest where the partnership's factors are included in the calculation of the corporate partner's apportionment ratio in states where the partnership is not doing business. See generally Bobby L. Burgner, *Income Taxes: Special Problems in Formulary Apportionment*, 1180 TAX MGMT. MULTISTATE TAX PORTFOLIOS (BNA) at 1180:0003d (2014). This is because some of the corporation's income will in effect be apportioned to the partnership state, and unless the partnership state asserts jurisdiction over the corporate partner and imposes a tax, some portion of the corporate partner's income will escape taxation. *Id.*

<sup>4</sup> *Quill Corp. v. N.D.*, 504 U.S. 298 (1992).

<sup>5</sup> *Id.* at 306 (quoting *Miller Bros. Co. v. Md.*, 347 U.S. 340, 344–45 (1954)).

<sup>6</sup> *Id.* at 308.

<sup>7</sup> *Id.* at 312.

<sup>8</sup> *Id.* at 317–18.

<sup>9</sup> *Id.* at 317.

*Quill*, the overwhelming majority of state courts have held that the *Quill* physical-presence test does not extend to state income taxes, although the Court has yet to squarely address the issue.<sup>10</sup>

## B. Authorities Imposing Tax on Out-of-State Corporate Partners

In most states, a corporate partner in a partnership doing business in the state is subject to the state's corporate income or franchise tax on its distributive share of the partnership income, even if the corporate partner has no other ties to the state.<sup>11</sup> The tax is based on the aggregate—as distinguished from the entity—theory of partnerships, under which each general partner is deemed to be conducting the partnership business directly and as owning a share of its assets; or on the alternative theory that the partners who actually conduct the business act as agents for the out-of-state partners.<sup>12</sup> The states generally apply this rule to limited corporate partners as well as to general partners. Thus tribunals in Illinois,<sup>13</sup> Kentucky,<sup>14</sup> Massachusetts,<sup>15</sup> New York

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<sup>10</sup> 1 HELLERSTEIN, HELLERSTEIN & SWAIN, *supra* note 2, ¶ 4.14.

<sup>11</sup> This discussion draws freely from 1 HELLERSTEIN, HELLERSTEIN & SWAIN, *supra* note 2, ¶ 6.12. Portions of the next three sections (B., C., and D.) are reprinted with permission with some updated material, from Jerome R. Hellerstein, Walter Hellerstein, and John Swain, STATE TAXATION ¶ 6.12 (3d ed. 2011). See also Michael W. McLoughlin & Walter Hellerstein, *State Tax Treatment of Foreign Corporate Partners and LLC Members After Check-The-Box*, ST. & LOC. TAX LAW., 2003, at 1; Prentiss Willson, Jr. & Mark Windfeld-Hansen, *State Taxation of Pass-Through Entities: General Principles*, 1500 TAX MGMT. MULTISTATE TAX PORTFOLIOS (BNA) at 1500:0002d (2014); People *ex rel.* Badische Fabrik v. Roberts, 42 N.Y.S. 502, 505 (N.Y. App. Div. 1896), *aff'd*, 46 N.E. 161 (N.Y. 1897); *In re* Chapman v. Browne, 48 N.Y.S.2d 598, 598 (N.Y. App. Div. 1944).

<sup>12</sup> See *supra* note 11. As a Tennessee trial court declared, “[A] general partner of a general partnership doing business in Tennessee is present in Tennessee, is doing business in Tennessee, and meets all requirements for taxable nexus with Tennessee through the partnership in Tennessee.” *Vodafone Ams. Holdings, Inc. v. Farr*, No. 07-1860-IV, Tenn. Chancery Ct., 20th Jud. Dist., Davidson Cnty. (Nov. 2, 2012) (Ex. 1 to *Vodafone Ams. Holdings, Inc. v. Roberts*, No. 07-1860-IV, Tenn. Chancery Ct., 20th Jud. Dist., Davidson Cnty. (Mar. 19, 2013)); *In re* Shell Gas Gathering Corp. # 2 & Shell Gas Pipeline Corp. # 2, 2009 WL 1745811 (N.Y. Div. Tax App. 2009), *aff'd* DTA Nos. 821569 & 821570 (Sept. 23, 2010) (where an administrative law judge (ALJ) sustained the state's power to tax foreign holding companies whose only connections with the state were their interests in a general partnership that, in turn, held a general partnership interest in a firm that did business in New York).

<sup>13</sup> See *Borden Chems. & Plastics, L.P. v. Zehnder*, 726 N.E.2d 73, 84 (Ill. App. Ct. 2000) (holding that a nonresident limited partner was subject to tax on distributive share of partnership income based on partnership's in-state activities).

<sup>14</sup> *Revenue Cabinet v. Asworth Corp.*, Nos. 2007-CA-002549-MR & 2008-CA-000023-MR, 2009 WL 3877518, (Ky. Ct. App. Nov. 20, 2009), available at [http://scholar.google.com/scholar\\_case?case=14564833589495378568&hl=en&as\\_sdt=6&as\\_vis=1&oi=scholarr](http://scholar.google.com/scholar_case?case=14564833589495378568&hl=en&as_sdt=6&as_vis=1&oi=scholarr) (corporation whose only connection with Kentucky was ownership of limited partnership interest in partnership doing business in Kentucky was taxable as a partner doing business in Kentucky) (unpublished opinions may be cited in Kentucky only if there is no published opinion that would adequately address the issues before the court. Ky. St. RCP Rule 76.28(4)).

City,<sup>16</sup> Alabama,<sup>17</sup> North Carolina,<sup>18</sup> and Oregon<sup>19</sup> have so ruled. The Georgia Court of Appeals likewise ruled that a nonresident limited partner in a partnership engaged in securities investment in the state is subject to tax.<sup>20</sup>

On the federal level, it can be noted that the United States has adopted a similar approach, treating foreign corporate limited partners of partnerships engaged in a U.S. trade or business as personally engaged in that trade or business.<sup>21</sup>

### C. Authorities Holding, on Statutory Grounds, that Out-of-State Corporate Partners Are Not Subject to Tax

Tribunals in some jurisdictions, however, have reached a different conclusion, although typically on the ground that the limited partners were not “doing business” in the state under the state statute rather than on the ground that they were not constitutionally subject to tax, an issue these decisions do not

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<sup>15</sup> See *Utelcom, Inc. v. Comm’r*, No. C262339, 2005 WL 244820, at \*2 (Mass. App. Tax. Bd. Jan. 31, 2005) (nonresident corporate limited partner was “doing business” in the state based on activities of partnership within the state and was taxable on its distributive share of partnership income earned in the state); see also *SAHI USA, Inc. v. Comm’r*, No. C262668, 2006 WL 3068116 (Mass. App. Tax Bd. Oct. 27, 2006), available at [www.mass.gov/anf/docs/atb/2006/06p794.doc](http://www.mass.gov/anf/docs/atb/2006/06p794.doc) (same).

<sup>16</sup> *In re Mazie Corp.*, TAT(H) No. 92-353 (GC), 2000 WL 1162056 (N.Y.C. Tax App. Tribunal July 21, 2000) (foreign corporation whose only contact with New York City was ownership of limited partnership that owned real property in the city had nexus with the city).

<sup>17</sup> The Alabama Department of Revenue ruled that holding a limited partnership interest in an Alabama real estate business does not constitute “doing business” in the state for Alabama franchise tax purposes. Ala. Rev. Rul. 98-002 (Ala. Dep’t Rev. 1998).

<sup>18</sup> N.C. Tax Review Bd., Admin. Dec. No. 351 (Jan. 28, 1999) (corporation with no connection to state other than interest in limited partnership that owned and operated restaurants in the state is doing business in North Carolina); N.C. Dep’t of Revenue, Secretary of Revenue, Dec. No. 97-548 (Apr. 24, 1998) (corporate limited partner in partnership doing business in North Carolina, but with no other connection to the state, is “doing business” in North Carolina and is subject to tax on an apportioned share of its distributive share of partnership income); cf. N.C. Dep’t of Revenue, Secretary of Revenue Dec. No. 2007-28 (Sept. 14, 2007) (corporation with no connection to state other than investment in limited liability company (LLC), which elected to be treated as a partnership for federal tax purposes, is taxable on pro rata share of LLC’s apportionable business income from its North Carolina activities).

<sup>19</sup> *CRIV Inv., Inc. v. Dep’t of Revenue*, 14 Or. Tax 181, 184 (Or. T.C. 1997) (“When the income is distributable partnership income, it is immaterial that taxpayer is a limited rather than a general partner.”).

<sup>20</sup> *Dep’t of Revenue v. Sledge*, 528 S.E.2d 260, 262 (Ga. Ct. App. 2000). Georgia law now provides, however, that a nonresident limited partner in a partnership engaged exclusively in selling, buying, and holding securities does not have Georgia taxable income. See GA. CODE ANN. § 48-7-24(c) (West 2006). This provision does not, however, change the jurisdictional principle announced in the case; it simply provides an exclusion for a particular category of income. *Id.*

<sup>21</sup> See I.R.C. § 875(1) (2012); 2 JOEL D. KUNTZ & ROBERT J. PERONI, U.S. INTERNATIONAL TAXATION C1-90 (2013).

address. Decisions from Alabama, California,<sup>22</sup> Louisiana,<sup>23</sup> and Tennessee<sup>24</sup> fall within this description. In a similar vein, New York generally does not treat a limited partner as doing business in New York, unless “it is engaged, directly or indirectly, in the participation or in the domination or control of all or any portion of the business activities or affairs of the partnership.”<sup>25</sup>

#### D. Authorities Holding, on Constitutional Grounds, that Out-of-State Corporate Partners Are Not Subject to Tax

The decisions of two New Jersey courts, however, may be read as suggesting that a taxpayer, whose only connection to New Jersey was its investment in a limited partnership doing business there, could not *constitutionally* be taxed by the state.<sup>26</sup> There, the taxpayer was a limited partner owning a ninety-nine percent interest in a partnership that provided outsourcing

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<sup>22</sup> See, e.g., *In re Appeals of Amman & Schmid Finanz AG*, No. 96-SBE-008, 1996 WL 281551 (Cal. State Bd. of Equalization Apr. 11, 1996) (holding that foreign corporations with interests in limited partnerships that acquired, managed, rented, and sold California real property were not subject to California franchise tax, because the corporations were inactive participants in the partnerships). Unlike general partners, the corporations were not entitled to possess specific partnership property or to participate in partnership management. *Id.* Their only contact with the state was the receipt of their distributive share of the partnerships' California-source income. *Id.* Accordingly, the corporations were not doing business in California. *But see* Appeal of Int'l Health Inst., LLC, No. 305199, 2006 WL 680482 (Cal. St. Bd. of Equalization Mar. 7, 2006) (explaining that a single-member LLC that purchased interests in California LLCs and partnerships was “doing business” in California).

<sup>23</sup> See, e.g., *Utelcom, Inc. v. Bridges*, 77 So. 3d 39 (La. Ct. App. 2011) (franchise tax measured by capital stock).

<sup>24</sup> The Tennessee Department of Revenue ruled that a foreign corporation owning a limited partnership interest in a partnership engaged in the real estate construction business in Tennessee is not “doing business” in that state under Tennessee’s franchise and excise taxes as long as this activity constitutes the limited partner’s only business endeavor in Tennessee and the limited partner exercises no power, management, or control over the partnership. Tenn. Rev. Ltr. Rul. 97-49 (Dec. 2, 1997).

<sup>25</sup> N.Y. COMP. CODES R. & REGS. tit. 20, § 1-3.2(a)(6)(i) (2013). The regulations spell out in detail factual situations that will subject a foreign corporate limited partner to the New York tax. *Id.* This regulation may have taken its cue from the Uniform Limited Partnership Act, which provides that a limited partner is not liable for the debts (including the tax debts) of the partnership, as is a general partner, unless “he takes part in the control of the business.” UNIF. LTD. P'SHIP ACT § 303 cmt. (amended 2001), 6 U.L.A. (2008) (citing UNIF. LTD. P'SHIP ACT § 7 (1916)).

<sup>26</sup> *BIS LP, Inc. v. Dir., Div. of Taxation*, 25 N.J. Tax 88, 102–05 (N.J. Tax Ct. 2009), *aff'd and remanded*, 2011 WL 3667622 (N.J. Super. Ct. App. Div. 2011) (unpublished, not citable or precedential in New Jersey). In a separate portion of the New Jersey Tax Court's decision, the court held that the taxpayer was a qualified investment company under New Jersey Law, subject to a reduced tax for the periods at issue, because the investment in the limited partnership should be treated as an investment in a security. N.J. STAT. ANN. § 54:10A-4(f) (West 2014); *BIS*, 25 N.J. Tax at 94–95. It refused to follow a regulation, issued after the tax year in question, purportedly “clarifying” the taxing authority's position, which excluded direct investments in pass-through entities from the definition of a qualified investment asset if the entity would not have satisfied the definition of an investment company if it had been organized as a corporation. *Id.* at 99.

technology services for its clients. The taxpayer's sole connection to New Jersey was its limited partnership interest. The New Jersey statutes assert jurisdiction over every corporation "exercising its corporate franchise in this State,"<sup>27</sup> and further provide that: "[a] taxpayer's exercise of its franchise in this State is subject to taxation in this State if the taxpayer's business activity in this State is sufficient to give this State jurisdiction to impose the tax under the Constitution and statutes of the United States."<sup>28</sup>

The New Jersey Tax Court approached the jurisdictional question as if it turned entirely on one of the bases set forth in the regulations for asserting jurisdiction over a foreign corporate limited partner—namely, whether "the business of the partnership is integrally related to the business of the foreign corporation."<sup>29</sup> Using this criterion, and relying heavily on the U.S. Supreme Court's unitary business decisions, the court concluded there was no jurisdiction because the taxpayer and the partnership "were not integrally related."<sup>30</sup> Specifically, the court noted that the taxpayer was a "passive investor," that it had "no control or potential for control in the limited partnership," and that it "was . . . not in the same line of business."<sup>31</sup> It further observed that the corporate partner's interest was "more akin to an example in the regulations, which illustrates that a foreign corporation that simply holds a limited partnership interest in a foreign New Jersey partnership and is not part of the unitary business of the partnership is not subject to the [corporation business tax]."<sup>32</sup>

In affirming the New Jersey Tax Court's decision "substantially for the reasons stated by Judge Bianco [the Tax Court Judge],"<sup>33</sup> the Appellate Division added little to Judge Bianco's analysis, but it strongly reinforced the impression that

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<sup>27</sup> N.J. STAT. ANN. § 54:10A-2 (West 2014).

<sup>28</sup> *Id.* The implementing regulations reiterate the constitutional nexus standard for exercising a franchise. N.J. ADMIN. CODE §§ 18:7-1.6(b), -7.6(b) (2014).

<sup>29</sup> *Id.* § 18:7-7.6(c).

<sup>30</sup> *BIS*, 25 N.J. Tax at 105 (2009).

<sup>31</sup> *Id.*

<sup>32</sup> *Id.* The example in the regulation provides:

Corporation LMN holds a limited partnership interest in the same limited partnership. The corporation and the partnership are not part of a unitary business, and the limited partnership does not have liabilities to third parties. LMN is not subject to corporation business tax in New Jersey since it is a true limited partner . . . .

N.J. ADMIN. CODE § 18:7-7.6, ex. IV (2014).

<sup>33</sup> *BIS LP, Inc. v. Dir., Div. of Taxation*, No. 7847-2007, 2011 WL 3667622, at \*2 (N.J. Super. Ct. App. Div. Aug. 23, 2011) (unpublished, not citable or precedential in New Jersey).

both courts' decisions rested on constitutional grounds. Thus, in response to the state's assertion that an amendment to the New Jersey statute reflected an intent to apply the tax broadly "to all circumstances permitted by the federal and state constitutions,"<sup>34</sup> the Appellate Division responded that "such an intent, like the statutory provisions themselves, cannot override *constitutional limitations* on a state's taxing power."<sup>35</sup> In characterizing Judge Bianco's opinion, the Appellate Division declared that "[h]e found that [the taxpayer] . . . did not have sufficient business activity to give New Jersey jurisdiction to impose tax *under the Constitution*."<sup>36</sup> Finally, in concluding, the Appellate Division observed that "the Director has not shown that Judge Bianco erred in finding no *constitutional basis* for imposing the [tax] at issue."<sup>37</sup>

The New Jersey courts' decisions would have been unexceptional if the question had been simply whether a state can constitutionally assert jurisdiction over a holding company with no contact with a state other than its investment in a non-unitary corporation. Indeed, even the existence of a unitary relationship between an in-state and an out-of-state corporation may not, by itself, establish nexus over an out-of-state corporate affiliate.<sup>38</sup> The problem, however, is that we are dealing with partnerships, not corporations. In this context, the New Jersey decisions cannot be reconciled, at least as a matter of constitutional law, with the overwhelming weight of authority (described above) that even a limited partner is deemed to be doing business (and is subject to tax) wherever the partnership is doing business. Those decisions that have held limited partners nontaxable in the states in which the partnerships have carried on business have relied on state statutory, rather than federal constitutional, grounds.

One might try to reconcile the New Jersey decisions with these cases on the theory that they were construing the state statute rather than the federal Constitution. Moreover, the courts can hardly be taken to task for following the example in the state taxing authority's own regulations, which supports the view that the limited partner was not taxable under the facts presented in the example. However, because the state statute explicitly asserts jurisdiction as far the federal Constitution

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<sup>34</sup> *Id.* at \*5.

<sup>35</sup> *Id.* (emphasis added).

<sup>36</sup> *Id.* (emphasis added).

<sup>37</sup> *Id.* at \*7 (emphasis added).

<sup>38</sup> See 1 HELLERSTEIN, HELLERSTEIN & SWAIN, *supra* note 2, ¶¶ 6.13[2], 8.07[1]; see also Barclays Bank PLC v. Franchise Tax Bd., 512 U.S. 298, 311–12 & n.10 (1994).

would permit, the decisions seem inconsistent with the plain language of the statute.

Perhaps the distinction between a limited partner and a corporate shareholder is a meaningless one, and the strong policy for resolving tax cases on the basis of substance rather than form justifies the New Jersey courts' analyses.<sup>39</sup> Although such a position is plausible, it does not accurately reflect the contemporary understanding of constitutional restraints on state taxation, which generally treats limited partners the same as general partners for jurisdictional purposes.

## II. TAX POLICY PERSPECTIVE

Persons engaged in cross-border activities should compete on a level tax playing field with similarly situated persons who engage in intrastate commerce.<sup>40</sup> To subject cross-border economic actors to multiple taxation, for example, would put them at an unfair competitive disadvantage compared to persons engaging in economic activities solely in state. Indeed, a prohibition against multiple taxation of multistate businesses is firmly embedded in Dormant Commerce Clause jurisprudence, which is designed to maintain our national common market.<sup>41</sup>

Though not a constitutional imperative, a closely related principle is that cross-border actors should not be given an unfair competitive *advantage* over local economic actors through "double non-taxation."<sup>42</sup> As one of the early architects of the international income tax regime put it: "[T]he state which with a fine regard for the rights of the taxpayer takes pains to relieve double taxation, may fairly take measures to ensure that the person or property pays at least one tax."<sup>43</sup> Together, the tenets of avoiding multiple taxation of cross-border activities, on the one hand, and

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<sup>39</sup> See *Int'l Harvester Co. v. Wis. Dep't of Taxation*, 322 U.S. 435, 445 (1944) (upholding a withholding tax on dividends received by out-of-state shareholders measured by dividends attributable to the corporation's in-state earnings); 2 JEROME R. HELLERSTEIN, WALTER HELLERSTEIN & JOHN A. SWAIN, *STATE TAXATION* ¶ 20.05[1][a][i] (3d ed. 2012) (discussing jurisdiction to tax out-of-state shareholders).

<sup>40</sup> This is a specific instance of the generally recognized tax policy value of horizontal equity. See generally JOHN L. MIKESELL, *FISCAL ADMINISTRATION: ANALYSIS AND APPLICATIONS FOR THE PUBLIC SECTOR* 282–84 (4th ed. 1995).

<sup>41</sup> 1 HELLERSTEIN, HELLERSTEIN & SWAIN, *supra* note 2, ¶ 4.14.

<sup>42</sup> Reuven S. Avi-Yonah, *All of a Piece Throughout: The Four Ages of U.S. International Taxation*, 25 VA. TAX REV. 313, 316 (2005).

<sup>43</sup> Michael J. Graetz & Michael M. O'Hear, *The "Original Intent" of U.S. International Taxation*, 46 DUKE L.J. 1021, 1039 n.72 (1997) (quoting Thomas S. Adams, *Interstate and International Double Taxation*, in *LECTURES ON TAXATION* 101, 112–13 (Roswell Magill ed., 1932)).



ensuring full accountability on the other, have been called the “single tax principle.”<sup>44</sup>

In global (residence-based) tax systems, full accountability is easily achieved, at least in theory. The state of residence taxes all of its residents’ activity wherever that activity occurs, and so the issue of “double non-taxation” (under-taxation) does not arise, and double taxation (over taxation) is prevented by the allowance of a credit for foreign taxes paid.<sup>45</sup> The American states, however, either as a matter of policy choice or federal constitutional constraints, generally have eschewed residence-based taxation of business income. Instead, they have embraced a territorial (source-based) approach to the taxation of these items.<sup>46</sup>

Traditional, geographically based sourcing rules, however, are not well suited to capturing the income of a resident corporate limited partner earned in a state that chooses not to tax out-of-state limited partners. While states are well aware of the problem of under-taxation generally<sup>47</sup> and have proposed (and sometimes adopted) a variety of mechanisms for achieving full accountability—such as “throwback,” “throwaround,” and “throwout”<sup>48</sup>—these rules only apply to income over which the source state has no power to tax under federal law, either statutory or constitutional.<sup>49</sup> The application of throwback and

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<sup>44</sup> Reuven S. Avi-Yonah, *International Taxation of Electronic Commerce*, 52 TAX L. REV. 507, 517–20 (1997).

<sup>45</sup> Determining the source of such activity may be, and often is, still important in connection with efforts to avoid double taxation. For example, if a jurisdiction that taxes income on a residence basis treats nowhere income as having its source in the state of residence, then it typically will deny a credit for taxes paid to another jurisdiction that claims to be the source of the nowhere income and taxes it on the basis of such claim. See REUVEN S. AVI-YONAH, DIANE M. RING & YARIV BRAUNER, U.S. INTERNATIONAL TAXATION chs. 2, 8 (3d ed. 2011).

<sup>46</sup> See generally 1 HELLERSTEIN, HELLERSTEIN & SWAIN, *supra* note 2, ¶¶ 8.01, 8.02, 8.07 (discussing the history and operation of the “unit rule” in the context of property taxation and the “unitary business” rule and the “right to apportion” in the context of corporate income taxation). States do, however, tax on the basis of residence (with a credit for taxes imposed by the state of source) in other contexts, e.g., personal income taxation. See 2 HELLERSTEIN, HELLERSTEIN & SWAIN, *supra* note 39, ¶¶ 20.04, 20.10.

<sup>47</sup> Of course, that “problem” may lie in the eye of the beholder, and non-taxation of activity that occurs in locations where it is not taxable would not amount to a “problem” in the eyes of many observers. In a real sense, this Article is an exploration of the conceptual and legal tension between these conflicting views of the non-taxation of economic activity.

<sup>48</sup> See 1 HELLERSTEIN, HELLERSTEIN & SWAIN, *supra* note 2, ¶¶ 9.18[1][b], 9.18[1][c]; see also Walter Hellerstein, *Construing the Uniform Division of Income for Tax Purposes Act: Reflections on the Illinois Supreme Court’s Reading of the “Throwback” Rule*, 45 U. CHI. L. REV. 768, 775 (1978) (discussing throwback and throwout rules).

<sup>49</sup> See *Whirlpool Props., Inc. v. Dir.*, Div. of Taxation, 26 A.3d 446, 452 (N.J. 2011) (finding that a “throwout” rule was constitutional only insofar as sales in states which did not have the constitutional (or federal statutory) power to tax were thrown out). See generally John A. Swain & Walter Hellerstein, *State Jurisdiction to Tax “Nowhere” Activity*, 33 VA. TAX REV. 209 (2013).

similar rules in situations where a state simply has chosen not to impose a tax on income<sup>50</sup> that is fully within the state's power to tax is undoubtedly unconstitutional. Thus, even where throwback and similar rules have been adopted, they would not effectively enforce full accountability in the case of out-of-state corporate partners.<sup>51</sup>

Accordingly, if full accountability of partnership income is to be achieved as a practical matter, source states will need to enforce a tax on corporate partners' distributive share of partnership income. As already noted, many states have straightforwardly done so by asserting jurisdiction over out-of-state corporate partners and their distributive share of partnership income. States that have failed to do so on statutory grounds could extend their jurisdictional reach with the stroke of a legislative pen. As for New Jersey, where two courts have held that the state cannot reach out-of-state limited partners as a matter of federal constitutional law, it can only be urged that the judiciary reconsider this view, which seems predicated on a false analogy between limited partners and corporate shareholders.

Even if a state were to remain uncomfortable with asserting jurisdiction over out-of-state corporate limited partners, the state could, as is often done, impose a withholding tax on the in-state partnership—an entity over which the state clearly has jurisdiction as a constitutional matter and against which the state can often more effectively collect the tax as a practical matter.<sup>52</sup> Finally, a state might consider imposing an entity-level tax on partnership income as a way to effectively collect tax against income earned within the state. A full exploration of entity-level taxation of partnerships (and limited liability companies) is outside the scope of this paper. For purposes of achieving full accountability, however, an entity-level taxation regime would need to ensure that the aggregate taxation of the entity's in-state income—taking into account both the entity level tax and the tax on partners' (or members') distributive shares—would be equal regardless of whether the entities have in-state or out-of-state partners (or members).

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<sup>50</sup> Or on the taxpayer earning such income.

<sup>51</sup> The states that fail to tax out-of-state partners have generally done so on state statutory grounds. *See supra* Part I.C.

<sup>52</sup> *See* 2 HELLERSTEIN, HELLERSTEIN & SWAIN, *supra* note 39, ¶ 20.06[5] (withholding regimes limited to nonresident partners); KUNTZ & PERONI, *supra* note 21, ¶ C2.02[2][e] (2014) (discussing foreign partner distributive share withholding requirements under the Internal Revenue Code).