

- ADMIRALTY & MARITIME
- ANTITRUST & TRADE REGULATION
- APPELLATE LITIGATION
- AVIATION
- BANKING
- BANKRUPTCY, RESTRUCTURING & CREDITORS-DEBTORS RIGHTS
- BUSINESS & COMMERCIAL LITIGATION
- CLASS ACTION DEFENSE
- COMMERCIAL LENDING & FINANCE
- CONSTRUCTION
- CORPORATE & SECURITIES
- EMPLOYEE BENEFITS, ERISA, & EXECUTIVE COMPENSATION
- ENERGY
- ENVIRONMENTAL & TOXIC TORTS
- GAMING
- GOVERNMENT RELATIONS
- HEALTH CARE
- INSURANCE & FINANCIAL SERVICES
- INTELLECTUAL PROPERTY
- INTERNATIONAL
- LABOR RELATIONS & EMPLOYMENT
- MERGERS & ACQUISITIONS
- PRODUCTS LIABILITY
- PROFESSIONAL LIABILITY
- PROJECT DEVELOPMENT & FINANCE
- PUBLIC FINANCE
- REAL ESTATE: LAND USE, DEVELOPMENT & FINANCE
- TAX (INTERNATIONAL, FEDERAL AND STATE)
- TELECOMMUNICATIONS & UTILITIES
- TRUSTS, ESTATES & PERSONAL PLANNING
- VENTURE CAPITAL & EMERGING COMPANIES
- WHITE COLLAR CRIME

LOUISIANA COURT HOLDS THAT ELECTING OUT OF PARTNERSHIP TREATMENT DID NOT AFFECT DETERMINATION OF ALLOCABLE INCOME

By

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A Louisiana court of appeal has held that an unincorporated association must be treated as a partnership for purposes of determining the treatment of income generated by the unincorporated association even though it opted out of partnership treatment for purposes of Subchapter K of the Internal Revenue Code (“IRC”) and similar Louisiana law. (*Unocal Pipeline Co. v. Kennedy*, 2003-1946 (La. App. Ct. 1st Cir. 12/30/04)). The court determined that even though the unincorporated association had opted out of the provisions Subchapter K and the equivalent state provisions, it still was a partnership for all other purposes and the income it distributed had to be treated as partnership income for Louisiana income tax allocation and apportionment purposes. As such, the income from the unincorporated association was allocated to the location where the income was earned, which was outside of Louisiana.

The taxpayer, Unocal Pipeline Company (“Unocal”), owned an interest in Trans Atlantic Pipeline Systems (“TAPS”), which was an unincorporated association that operated a pipeline in Alaska. As an unincorporated association, TAPS generally would be treated as a partnership for federal and Louisiana income tax purposes under IRC Section 761(a) and La. R.S. 47:220.3(A), respectively. However, the owners of TAPS elected out of the federal and state partnership provisions by making elections under IRC Section 761 (a) and La. R.S. 47:220.3(A). Despite the elections to opt out of the partnership provisions, Unocal argued that TAPS should be treated as a partnership for purposes of determining its allocable income under La. R.S. 47:287.92.

Unlike most states, Louisiana does not distinguish between apportionable and allocable income based on whether the income qualifies as business or non-business income. Instead, Louisiana treats certain designated types of income as allocable, with all non-allocable income being designated as apportionable income. La. R.S. 47:287.92. Income from partnerships is specifically designated as allocable income and is allocated based on where the income is earned by the partnership. La. R.S. 47:287.93(A)(7). Essentially, the income is allocated and apportioned at the partnership level instead of being allocated and apportioned at the partner level. Unocal argued that the income from TAPS should be treated as allocable partnership income, none of which was allocated to Louisiana because TAPS had no operations in Louisiana. If it were apportionable income, as asserted by the Louisiana Department of Revenue (“Department”), Unocal would have to apportion its TAPS income within and without Louisiana along with its other income, which would have resulted in an increase in its Louisiana taxable income.

In the litigation, the Department took the position that because the owners of TAPS had opted out of the partnership provisions of Subchapter K and the similar Louisiana provisions, TAPS could not be treated as a partnership for purposes of determining allocable income under La. R.S. 47:287.92. Interestingly, Unocal had treated the TAPS income as apportionable on its original Louisiana income tax returns for the tax

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- BANKING
- BANKRUPTCY, RESTRUCTURING & CREDITORS-DEBTORS RIGHTS
- BUSINESS & COMMERCIAL LITIGATION
- CLASS ACTION DEFENSE
- COMMERCIAL LENDING & FINANCE
- CONSTRUCTION
- CORPORATE & SECURITIES
- EMPLOYEE BENEFITS, ERISA, & EXECUTIVE COMPENSATION
- ENERGY
- ENVIRONMENTAL & TOXIC TORTS
- GAMING
- GOVERNMENT RELATIONS
- HEALTH CARE
- INSURANCE & FINANCIAL SERVICES
- INTELLECTUAL PROPERTY
- INTERNATIONAL
- LABOR RELATIONS & EMPLOYMENT
- MERGERS & ACQUISITIONS
- PRODUCTS LIABILITY
- PROFESSIONAL LIABILITY
- PROJECT DEVELOPMENT & FINANCE
- PUBLIC FINANCE
- REAL ESTATE: LAND USE, DEVELOPMENT & FINANCE
- TAX (INTERNATIONAL, FEDERAL AND STATE)
- TELECOMMUNICATIONS & UTILITIES
- TRUSTS, ESTATES & PERSONAL PLANNING
- VENTURE CAPITAL & EMERGING COMPANIES
- WHITE COLLAR CRIME

years 1986 through 1988. On audit, the Department determined that the income qualified as allocable income. Unocal subsequently filed a claim for refund based on the Department's position that the TAPS income should be treated as allocable income. Facing a substantial refund payment, the Department quickly reversed its position and decided that the TAPS income was apportionable after all. For years after 1998, Unocal treated the income as allocable, but the Department assessed additional Louisiana income tax based on its belief that the income was apportionable.

The issue on appeal was whether the TAPS income should be treated as allocable partnership income regardless of whether TAPS had opted out of the partnership provisions of Subchapter K and the equivalent Louisiana law. Both Louisiana and federal law define a partnership similarly to include "a syndicate, group, pool joint venture or other unincorporated organization through or by means of which any business, financial operation, or venture is carried on, and which is not, within the meaning of this title, a corporation trust or estate." IRC Section 761 and La. R.S. 47:220. Both laws also include a provision allowing the members of an unincorporated organization to opt out of the partnership provisions. The Department had traditionally treated unincorporated organizations as partnerships for Louisiana corporation income and franchise tax purposes regardless of whether they were treated as such for other federal or state law purposes.

In determining whether the decision to elect out of partnership treatment for TAPS under La. R.S. 47:220.3(A) applied for all Louisiana income tax purposes, the court focused on the fact that the statute, like its federal counterpart, specifically stated that it applied only to "this subchapter." The court determined that for purposes of the federal statute, "this subchapter" referred *only* to Subchapter K and that "the partnership remains a partnership" when applying other sections of the Internal Revenue Code. Similarly, the court held that for Louisiana purposes the election under La. R.S. 47:220.3(A) only prevented the application of La. R.S. 47:201 through 220.3, but did not affect the application of La. R.S. 47:287 *et esq.* to TAPS' income. The court held in favor of Unocal.

Louisiana taxpayers with interests in unincorporated organizations need to carefully examine whether these entities qualify for partnership treatment, regardless of how they have treated them for federal tax purposes. Taxpayers should also be aware that treating the income from the entity as allocable income for Louisiana income tax purposes may not provide a tax benefit if the unincorporated organization has activity within Louisiana. It is uncertain whether the Department will seek a writ of certiorari to the Louisiana Supreme Court in this case.

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Remember that these legal principles may change and vary widely in their application to specific factual circumstances. You should consult with counsel about your individual circumstances. For further information regarding these issues, contact:

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