

MTC Partnership Work Group Meeting Notes

June 27, 2022

I. Welcome & Introductions -

Laurie McElhatton, Chair (CA-FTB), convened the meeting.

II. Initial Public Comment

Bruce Ely: Noted he would have comments on the draft and the changes.

III. Review Notes from Prior Call –

Laurie stated the notes would be kept during work group deliberations and that the work group products, including the draft model on investment partnerships, would also reflect the discussions and comments received. She asked if there were any corrections to the notes to speak up or contact Helen Hecht, MTC Uniformity Counsel, at hhecht@mtc.gov.

IV. Review Comments and Edits on Draft Model - for June 27, 2022 Meeting

Helen Hecht, Uniformity Counsel, went over the draft model on investment partnerships with comments and edits as of June 27, 2022 (available on the project webpage). She noted that this draft attempted to capture comments received on the draft and also provide responses or edits. We will continue to track the changes closely until we reach consensus on an issue.

In reviewing the draft, Helen noted that this follows both the detailed issue outline and the investment partnership white paper, also available on the project web page. The decision was made to start on a draft statute with language that captures the general issues and principles identified, even if only a draft, to memorialize what we have discussed. This investment partnership issue might be affected by or could affect other partnership related issues that the work group may address.

Helen also noted that the draft is attempting to set out a clear safe harbor consistent with way states source and tax partnership income generally. The model can be distinguished from certain approaches by some states that have tied their investment partnership rules to the doing business standard or nonbusiness income. The model attempts to find a consistent approach to both the principles of Subchapter K, which says that while income or partnership items are characterized at entity level, the partners report that income as if they earned it directly. The model is also drafted with the goal of saying—if you meet the requirements—there's no need to look any further.

Helen noted that there have been questions about whether draft model is a regulation or statute. In some states, it may be that it can be adopted as a regulation. But we have drafted it as a statute.

Helen also went through the comments and edits in the 6/27/22 draft, which responded to discussion at the last call and other comments received. In particular, she noted the following:

- If the qualifications are not met, this doesn't necessarily mean the income will be sourced differently. It still might still be sourced to partner's state of residence, but not based on this safe harbor.
- Some states' rules say as long as the partnership qualifies, any income to any partner qualifies to be sourced to residence. This rule is narrower than that.
- There were concerns raised over including the purpose (Section 1) and the anti-abuse rules (Section 4). Those have been modified but left in.
- Noted that now neither the partnership nor the nonresident partner can be a "dealer" as defined.
- Noted that a question had been raised as to trusts or estates. The proposed edit would include a drafter's note that if trusts or estates are taxed the same as individuals (resident/non-resident) then the rule might apply to them as well.
- Noted that the model does not apply to corporate partners since most states have sufficient rules for sourcing the income of corporations from investments.

Bruce Ely commented that he had done research and found a minority of states limit this treatment to individuals. He wonders about retirement plans and hedge funds and how they would be treated, as well as family trusts, business trusts, others. Would ask that we consider why this needs to be limited.

Helen noted that, in part, this goes to whether this is a statute or regulation. Some states have set out their rule in statute and some in regulation. Pension plans, regulated investment companies, and other potential investors in partnerships will be taxed in their own way for federal and state purposes and so rather than make this rule broader, it simply addresses individuals.

Bruce Ely also noted that most states have a broader definition and often use the word "person."

Helen responded noting that it might be helpful to have a list of entities that are missing—with the idea that we are still looking to the ultimate taxpayer.

Helen noted that a qualifying investment partnership cannot hold an interest in a non-investment operating partnership. Also, this rule does not apply to operating partnerships that have investments. But a question has been raised as to whether the rule should narrow the qualifications so that the rule would apply only where there are a number of unrelated partners to avoid abuse. The draft tries to address potential abuse in other ways rather than distinguishing partnerships based on size or who the partners are.

Helen noted also that questions had be raised about the certification process. Is it necessary and does it work? Also, what if an entity fails to qualify for one year, then what happens? Are there penalties? Do taxpayers believe this provides some certainty?

Helen noted there were a few questions about qualified investments. Some states reference IRC § 851 which is the regulated investment company statute. The model doesn't take this approach because of the uncertainty of the definition of security under state law and the 1940 investment act. But there may be things this definition does not include that should be included.

Michael Fatale asked whether a qualifying debt security might include lending services done by the partnership. Helen answered that this is specifically excluded. Michael also asked Bruce Ely whether his clients would prefer to certify.

Bruce Ely responded that this was a feature that resulted from negotiations with the state of Alabama and his clients would be happy to get rid of it. He also noted that the question is what happens if the partnership fails to properly certify.

Karen Boucher noted that she has raised three specific issues: what goes into gross income to determine the 90% requirement, how is "active participation" defined, and how do the rules treat losses.

Helen also noted that the rule of the model provides that the qualifying nonresident partner sources the qualified investment income to residence. Income that doesn't meet the qualification and should be sourced differently will have to be reported and sourced differently. A question was raised whether the income that cannot be sourced under this rule because the partner was actively involved in the related investment, what happens to the other partners? The answer is the model is drafted to only affect the particular partner. So the situation might be, for example, that the investment partnership holds stock in a small C corp that the partner was involved in. So again, this income might be sourced differently and would not be covered by this rule.

Helen noted that Section 4, authority delegated to the agency, is more appropriate in a statute, not for a regulation. There are other aspects of partnership reporting that will be impacted by this rule including withholding, estimated payments, composite returns, etc. So it might be better for the agency to figure out the effect of this rule on those requirements. The alternative is to put in a drafter's note, but it might be better to put into the statute itself.

Helen noted that the issues summarized were not exhaustive so more items will likely come up.

Michael Fatale asked how this project might be brought to completion? Will the group take a vote on the language or on changes to the document?

Helen noted that it will be up to the work group and Uniformity Committee. She noted that the decision was made to do a white paper so as to give states a general road map on what the issues are. But, based on that work, and the fact that about half the states have at least some

rule for investment partnerships, and ones who don't probably should have, the decision was made to try to put model language on paper at least to memorialize the work. The staff advice to the Uniformity Committee was that it was probably too soon to formally adopt a model through our uniformity process, since there will be related issues as we go through the rest of the outline.

Bruce Ely noted that the AICPA and ABA tax section intend to file comments, and he will as well. Is there some deadline and should the comments address this draft?

Helen responded that the process is flexible at this point and that some of the comments made on the call could be addressed in a revised model for comment.

Bruce Ely commented that he would ultimately prefer to table any draft and revisit later.

Laurie noted that this is a working document and she agreed that it will not be proposed as a formal model at this point and that Helen should circulate a new copy after the edits from this call. She also noted that the work group could take up other issues in the meantime.

Helen noted that states should also provide comments if they wish. As for next issues that the work group might address, she noted that the work group was surveyed in November before this issue of investment partnerships was taken up and there wasn't consensus. There are other issues similar to investment partnerships that will address particular, common problems that may affect other areas. One is the credit issue, raised by practitioners as part of PTE process and in general. Will states give a credit for taxes paid? This is likely to be a sticking point for addressing other issues. The other issues we talked about before include PTE taxes, sale of PS interest, etc. Also, there are lots of general issues involving tiered partnership structures and how to source that income.

V. Discussion

There were no objections from the work group to proceeding with the draft model review but not having that draft formally approved. Also, staff will put together a list of next issue that the group may consider working on.

VI. Adjourn