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Chair, MTC Work Group on State Taxation
of Partnerships
c/o California Franchise Tax Board
Rancho Cordova, CA 95741-1720

Re: Preliminary Comments on June 27, 2022 Draft of MTC's Model Act on the State Tax Treatment of Investment Partnership Income

Dear Madame Chair:

These preliminary comments are submitted in my individual capacity and as one of the authors of the Alabama Investment Partnership Act, 2009 ("Alabama Act"), on which the June 27 version of the proposed MTC Model Act ("Model Act") is largely based. The Alabama Act was the product of lengthy negotiations between the private equity investment community (my clients), the Alabama Department of Revenue ("AL DOR"), the Alabama Society of CPAs, and the Alabama Education Association. These comments do not necessarily reflect the views of my law firm, clients (other than the one mentioned below), or professional associations with which I am affiliated.

These comments focus on three major disparities between the Model Act and the Alabama Act, as I mentioned during the June 13 Work Group conference call, and will hopefully explain why the provisions in the Alabama Act, or something similar, are more appropriate and workable than their counterparts in the Model Act. For your convenience of reference, enclosed is a copy of the Alabama Act.

(1) Overly narrow definition of qualifying partner.— Based on our research, 26 states provide some form of statutory framework for taxing investment partnerships or similar types of investment vehicles as well as their partners/members. Four states refer to these entities as "Qualified Investment Partnerships" or QIPs, while 10-11 others recognize the same or a similar entity as simply an "investment partnership" or "investment pass-through entity." For the sake of brevity, I will use "QIPs" and "partners" throughout this letter to mean and include both QIPs and other investment partnerships, LLCs, trusts, etc. by whatever name, and their partners, members, beneficiaries, shareholders, or the like, respectively.

The Alabama Act adopts the QIP concept and permits a relatively broad list of entities to qualify as "QIP members," including estates of decedents, trusts, statutory business trusts, C and S corporations, and Subchapter K entities — as well as individuals. That was a list negotiated by (then) senior officials of the AL DOR and the numerous other interested parties.

The majority of the 26 states, unlike the Model Act, include at least two of these legal entities in their list of qualifying partners, in addition to individuals. The most common examples are estates and trusts – and often QIPs themselves since most states allow a QIP to own an interest

in another QIP. That is consistent with the Model Act's definition of "Qualified Investment Partnership Income" as including the member's/partner's distributive share of income from a lower-tier QIP. See Section 2(a)(4) of the Model Act.

Many states offer eligibility as broad as or even broader than the Alabama Act. For example, Oregon's list of eligible partners includes corporations, partnerships or other business entities that are not commercially domiciled in that state as well as nonresident trusts and funeral trusts. Massachusetts includes nonresident estates and trusts, S corporations and certain Subchapter K entities. Oklahoma includes nonresident trusts and estates as well as nonresident corporations. Among others, Idaho's, Utah's, Rhode Island's and Arkansas' definitions are similar. Several other states simply use the term "person," and may or may not cross-reference to the typically broad definition of that term contained elsewhere in their tax code.

It's understandable if corporations were to be excluded from the Model Act's QIP partner definition since, as Helen Hecht points out, states already have a well-developed set of sourcing rules for these entities. But otherwise, there is no good reason to exclude other types of entities, particularly estates, trusts and other QIPs from the Model Act (vs. a drafters' note). For example, assume a nonresident individual is a partner in a QIP and dies during the year, with her QIP interest automatically becoming part of her estate. Should the QIP automatically lose its status as such or should the estate automatically be disqualified as a QIP partner? Also, many families invest in QIPs or similar entities through trusts. Likewise, the reference to "trusts" in many state acts includes qualified retirement plan trusts and IRAs – also common investors in these investment vehicles.

My suggestion is to follow the Alabama Act, and many others, in this regard, but if the Work Group insists, to delete corporations from the list. Limiting the scope of qualifying partners to only individuals potentially* denies the income tax exemption related to these investments to large investor groups across the U.S. Indeed, one of our largest asset management clients complains that doing so (if the Model Act were enacted in the present form) would cause at least two of their current investment partnerships to forfeit their QIP status or large groups of their investors to forfeit QIP partner status – for no good reason. The Work Group should reasonably expect opposition from the hedge fund industry and other investment and professional groups if this definition is not expanded.

(2) Restrictions on investments and investment activities of the QIP and its partners are unworkable.— Section 3(b) of the Model Act states that the exclusion of the distributive share of QIP income in Section 3(a) does not apply

> to the extent [the income is] derived *directly or indirectly* from an investment in an entity if the Nonresident QIP Partner *holds or has held* a direct ownership interest in that entity, unless the entity is a publicly traded entity and the Nonresident QIP Partner does not or did not *actively participate* in the entity's activities [emphasis mine].

This language appears to be based loosely on the Alabama Act but is modified in several key respects; most importantly, it conflates two separate restrictions in the Alabama Act (see *Alabama Code* Section 40-18-24.3(a)). First, the Alabama Act denies the exemption only to a partner who "actively participate[s] in the *day-to-day* management" of the QIP. (As an aside, several drafters of the Alabama Act contemplated this phrase would be interpreted similarly to the passive activity loss rules of IRC Section 469 and the "material participation" test.)

Second, in contrast to the Alabama Act, the Model Act requires an unlimited look-back at entities owned "directly or indirectly" by each QIP partner, at any time in their lifetime ("holds or has held"), and further, contains no minimum ownership threshold of any such entity – even a 1% limited partnership interest held 20 years ago by one of the QIP partners. In contrast, the Alabama Act requires the targeted entity not only to be currently owned but to be "majority-owned" (defined term) by the QIP partner at issue.

Only a handful of the 26 states impose similar restrictions, including California, Arkansas and Illinois. I recommend using the Alabama Act language instead, or something similar, and de-coupling and providing the two separate exceptions to the exemption of QIP income, with workable boundaries.

(3) Model Act's anti-abuse language is overbroad and ambiguous. Section 4(b) of the Model Act allows the state DOR to revoke the QIP's certification if it "determines that *this Act has been used* to *avoid [state] income tax liability*... If so, the state tax commissioner has the "authority to .... distribute, apportion or allocate the partnership income in accordance with [state law]" [emphasis mine]. The Model Act should instead refer not to the *Act* being abused by the *QIP,* but to the *QIP* abusing the *Act.*

Moreover, although not a model of clarity, the counterpart provisions of the Alabama Act at least impose certain boundaries on the Alabama DOR's powers. Like New York's, Ohio's and Connecticut's laws, the alleged abuse must be "principally" or have a "principal purpose" to avoid that state's income tax liability through the use of a QIP. Notably, many of the 26 state acts do not contain *any* sort of broad anti-abuse language.

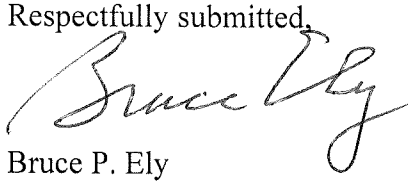
Alternatively, a few states limit the state tax commissioner's scope of review to provisions in the partnership/LLC agreement, which is more in line with the IRS Commissioner's powers under IRC Subchapter K, particularly Section 704(b). That may be a better and more administrable route to take.

Further, the Alabama Act clearly limits the Commissioner of Revenue's powers to those analogous to IRC Section 482, i.e., "to clearly reflect the income of [the entity] engaged in such tax avoidance." That statutory guidance would be helpful to both the states and taxpayers.

Again, I recommend reverting to the Alabama Act as the starting point for this language although clear and administrable language can also be found in the New York and Ohio laws. Or even better, the Model Act should focus on the particular language in the partnership/LLC agreement or its mis-application, as found in, e.g., Virginia, Colorado and Connecticut law.

By limiting these preliminary comments to just three key issues, I don't mean to imply that other provisions of the Model Act are not important or won't need review and discussion. That will be left to other commentators and members of the Work Group. I applaud the drafters of the Model Act for the tremendous amount of thought and work they have devoted to this project and would be glad to discuss any of these comments with them or with members of the Work Group.

Respectfully submitted,



Bruce P. Ely

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**I use the word "potentially" to restate my concern that there should be a caveat contained in the final version of the Model Act confirming there is no negative implication as to state taxability of the nonresident partners or their distributive shares of the entity's income if the QIP fails to strictly qualify as such or loses its qualification at some point after the first year. Perhaps a drafter's note would suffice.*

Enclosure (1)

cc: Helen Hecht, Esq.
Debra S. Herman, Esq.
Eileen Sherr, CPA

APPENDIX

ALA. CODE § 40-18-24.2.

Taxation of pass-through entities.

(a)(1) MEMBER. An individual, estate, trust or business trust as defined in Section 40-18-1, a corporation as defined in Section 40-18-1, or Subchapter K entity as defined in Section 40-18-1, that is a partner in a general, limited, limited liability, or limited liability limited partnership, or a member of a limited liability company.

(2) NONRESIDENT.

(a) An individual who is not a resident of or domiciled in this state during the applicable tax year.

(b) A nonresident trust as defined in Section 40-18-1.

(c) A nonresident estate as defined in Section 40-18-1.

(d) A foreign corporation as defined in Section 40-18-1, not commercially domiciled in this state during the applicable tax year.

(e) A Subchapter K entity or business trust that is created or organized under the laws of a jurisdiction other than this state and that is not commercially domiciled in this state.

(3) PASS-THROUGH ENTITY. A partnership or other entity classified as a Subchapter K entity under Section 40-18-1. Neither estates nor trusts, including business trusts, are included in this definition or subject to this section except in their capacity as a nonresident member, as herein defined, of a pass-through entity or lower-tier pass-through entity.

(4) QUALIFIED INVESTMENT PARTNERSHIP. A partnership or other entity classified as a Subchapter K entity, or a business trust as defined in Section 40-18-1, that meets all of the following requirements for the applicable tax period:

(a) No less than 90 percent of the cost of the entity's total assets consist of qualifying investment securities and office facilities and tangible personal property reasonably necessary to carry on its activities in this state as an investment partnership.

(b) No less than 90 percent of its gross income consists of interest, dividends, distributions, and gains and losses from the sale or exchange of qualifying investment securities, and management fees paid by its members.

(c) An authorized officer, partner, member, or manager of the entity files on behalf of the entity a certification that it meets the above two criteria with respect to the tax period covered by the certification, in a form and at the time prescribed by the Department of Revenue.

ALA. CODE § 40-18-24.3.

Taxation on distributive share of interest, dividends, etc., of nonresident member of qualified investment partnership.

(a) Notwithstanding any other provision of this chapter to the contrary, including Sections 40-18-2 and 40-18-24.2, no income tax shall be due [to] the State of Alabama from a nonresident member of a qualified investment partnership, or from the qualified investment partnership itself, with respect to the nonresident member's distributive share of interest, dividends, distributions, or gains and losses from qualifying investment securities owned by the entity, as long as the nonresident member does not actively participate in the day-to-day management of the entity. Provided, however, that in the event a qualified investment partnership invests in the qualifying investment securities of an entity that is majority owned by a nonresident member of the qualified investment partnership, income tax shall be due by such nonresident member with respect to the member's distributive share of any interest, dividends, distributions, gains and losses from the qualifying investment securities of the other entity. For purposes of this section and Section 40-18-24.2, "majority owned" means ownership of more than 50 percent of the issued and outstanding voting stock of the other entity, applying the attribution rules of 26 U.S.C. § 318.

(b) The terms "nonresident," "member," "qualified investment partnership," and "qualifying investment securities" shall have the same meanings ascribed to them in Section 40-18-24.2.

(c) The Department of Revenue shall promulgate reasonable rules to effectuate the intent of this section, including rules permitting certain corporate members of qualifies investment partnerships to be eligible for the provisions of this section. Further, if the Commissioner of Revenue determines that this section is being used in an abusive fashion principally to avoid Alabama income tax liability, the commissioner shall have the authority to promulgate rules to distribute, apportion, or allocate gross income in order to clearly reflect the income of any such entity engaged in such tax avoidance.