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January 17, 2023

Nancy L. Prosser
General Counsel
Multistate Tax Commission
444 North Capitol Street, NW Suite 425
Washington, DC 20001

Re: Comments on Proposed Draft Model Regarding the Treatment of Certain Income of Nonresident Qualifying Investment Partnership Partners

Dear Ms. Prosser:

Enclosed are comments with respect to the August 18, 2022 version of the proposed draft model regarding the treatment of certain income of nonresident qualifying investment partnership partners. These comments are submitted on behalf of the Section of Taxation and have not been reviewed or approved by the House of Delegates or the Board of Governors of the American Bar Association. Accordingly, they should not be construed as representing the position of the American Bar Association.

The Section of Taxation would be pleased to discuss these comments with you or your staff.

Sincerely,

C. Wells Hall, III
Chair, Section of Taxation

Enclosure

AMERICAN BAR ASSOCIATION
SECTION OF TAXATION

Comments on Proposed Draft Model Regarding the Treatment of Certain Income of Nonresident Qualifying Investment Partnership Partners (August 18, 2022 Version)

These comments ("**Comments**") are submitted on behalf of the American Bar Association Section of Taxation (the "**Section**") and have not been reviewed or approved by the House of Delegates or Board of Governors of the American Bar Association. These Comments should not be construed as representing the position of the American Bar Association.

Principal responsibility for preparing these Comments was exercised by Kelvin M. Lawrence. The following individuals provided substantial assistance in the drafting of these Comments: Alysse McLoughlin, William T. Thistle, II, Jaye Calhoun, Bruce Ely, and Debra Silverman Herman. These Comments were reviewed by Jaye Calhoun on behalf of the Committee on Government Submissions, and Lisa Zarlenga, the Section's Vice Chair for Government Relations.

Although members of the Section may have clients who might be affected by the tax principles addressed by these Comments, no member who has been engaged by a client (or who is a member of a firm or other organization that has been engaged by a client) to make a submission with respect to, or otherwise to influence the development or outcome of, one or more specific issues addressed by these Comments has participated in the preparation of the portion (or portions) of these Comments addressing those issues.

Additionally, while the Section's diverse membership includes government officials, no such official was involved in any part of the drafting or review of these Comments.

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Date: January 17, 2023

INTRODUCTION

The Section appreciates the opportunity to submit comments to the Multistate Tax Commission ("**MTC**") in connection with its Project on State Taxation of Partnerships. This round of Comments focuses specifically on the latest version of the draft model act on Treatment of Investment Partnership Income (the "**Draft Model**").[1] These Comments are offered in the spirit of collaboration and are intended to reflect substantive and administrative feedback of the taxpayer community with respect to the Draft Model, and the process that has led to its drafting. The Section intends to submit further comments as the Project on State Taxation of Partnerships continues its work with respect to the Draft Model and on other substantive areas of partnership taxation.

Prior to the Draft Model, MTC staff prepared an outline of issues that identified the key issues the MTC partnership tax project work group (the "**Work Group**") should address over the course of its work on the Project on State Taxation of Partnerships. The first issue from this outline the Work Group chose to address was "the treatment of partnerships engaged primarily in investment activity—and specifically, the sourcing of investment partnership income to the residence (and sometimes domicile) of limited partners."[2] In addressing these "investment partnerships," the MTC staff began by preparing a white paper providing background on the state taxation of investment partnerships, the system of state taxation of partnerships, the information and data surrounding such partnerships, existing state rules, and concluding with findings and recommendations (the "**White Paper**").

EXECUTIVE SUMMARY

We agree with the White Paper's premise that states should specifically address sourcing of investment partnership income to address uncertainty and the lack of uniformity. In that spirit, the Section offers the following recommendations with respect to the Draft Model:

1. We recommend that the asset test in Section 2(a)(7)(A) of the definition of a "Qualified Investment Partnership" ("**QIP**") be revised to include both tangible personal property and intangible personal property reasonably necessary to carry on the investment activities of the QIP, including, specifically, that accounts receivable with brokers, dealers, and trading partners should be: (1) treated as debt securities, or (2) considered assets necessary to carry on the investment activities of the QIP.

2. We recommend that the definition of "**Nonresident QIP Partner**" explicitly include any pass-through entities and trusts treated as disregarded entities for federal and state income tax purposes.

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[1] The Comments are made with respect to the August 18, 2022, version of the Draft Model circulated in the weeks following the July 25, 2022, meeting of the MTC partnership tax work group (the "**Work Group**"), which is the latest version available. *See* Multistate Tax Commission, *Proposed Draft – Treatment of Investment Partnership Income (Edits and Comments)* (Aug. 18, 2022), available at: https://www.americanbar.org/content/dam/aba/administrative/taxation/committees/salt/investment-partnership-model-081822.pdf (hereinafter "**MTC August Draft**").

[2] Multistate Tax Commission, *White Paper: State Tax Treatment of Investment Partnerships* (Draft, May 20, 2022) at 2, available at: https://www.americanbar.org/content/dam/aba/administrative/taxation/committees/salt/white-paper-investment-partnerships-052022.pdf.

3. We recommend clarifying the types of debt securities included in the definition of "**Qualified Investments**"; specifically, we recommend the Draft Model follow the federal income tax criteria for determining whether an instrument will be treated as an equity investment or debt.

4. We recommend that state revenue agencies be directed to issue guidance on the applicability of nonresident partner withholding and composite return rules to investment partnerships with state taxable income.

5. We recommend adding language allowing for the waiver of estimated tax payments and penalties in certain instances where a previously qualifying QIP fails to qualify in a subsequent year. Those waivers should extend to both the partnership that failed to withhold or make composite payments on behalf of Nonresident QIP Partners, as well as the Nonresident QIP Partners themselves to the extent that failure to qualify creates a filing obligation on their part in the state.

6. We recommend the addition of clarifying language for QIPs that, for whatever reason, do not elect to certify to QIP status. Failure to certify should not create a presumption against sourcing an entity's income as QIP income, or otherwise create any legal obstacle to sourcing the income to an owner's state of residence or domicile under applicable law.

7. We recommend that QIP information returns not require extensive or burdensome disclosures, particularly disclosures relating to the identity of partners of QIPs reporting no taxable income.

8. We support removal of the language that would have given state revenue agencies authority to propose rules to create rebuttable presumptions as to when a QIP's certification could be revoked and its income or a portion thereof be subjected to that state's income tax.

DISCUSSION

The following summary provides a detailed rationale for each of the Section's proposals.

The Draft Model views itself as providing a safe harbor that is generally consistent with state sourcing rules but will not be subject to abuse.[3] The Draft Model is intended to "Designate certain investment income derived from a certain partnerships, which if characterized properly at the partnership level would, if earned directly by the partners, be treated by states as taxable in an individual partner's state of residency. Note that to accomplish this, the partnership and the income need to be properly defined and qualified."[4] This requires a three-prong approach: (1) defining the "Qualified Investment Partnership," or "QIP;" (2) defining the "Nonresident QIP Partner"; and (3) defining the QIP income or loss that may receive this treatment. "If the partnership, or the partner, or the income does not qualify, then the income is not sourced to residence" under the Draft Model, but "may still be sourced to residence under other rules or general state sourcing principles."[5] Accordingly, the Draft Model's definitions are of critical importance, and our

[3] MTC August Draft, at 3.

[4] Multistate Tax Commission, *Proposed Draft – Treatment of Investment Partnership Income (Edits and Comments)*, "General Notes" (for July 11, 2022 meeting), available at: https://www.americanbar.org/content/dam/aba/administrative/taxation/committees/salt/investment-partnership-model-071122.pdf (hereinafter "**MTC July Draft**").

[5] MTC July Draft, at "Design of the Rules."

recommendations regarding these definitions are offered first, followed by recommendations regarding administrative provisions.

1. **Recommendation 1 – The asset test in Section 2(a)(7)(A) of the definition of a "Qualified Investment Partnership" should be revised to include both tangible personal property and intangible personal property reasonably necessary to carry on the investment activities of the QIP, including, specifically, that accounts receivable with brokers, dealers, and trading partners should be: (1) treated as debt securities, or (2) considered assets necessary to carry on the investment activities of the QIP.**

   To be a QIP, no less than 90% of the cost of a partnership's total assets must consist of "Qualified Investments" and office facilities and tangible personal property reasonably necessary to carry on its investment activities. Many entities that would otherwise satisfy the requirements of being a QIP cannot satisfy this requirement because, through their trading activities, a substantial portion of their total assets are accounts receivable with brokers, dealers, and trading partners. These entities should not be disqualified from QIP status as a result of standard practices in the investment industry. Expanding the definition of "Qualified Investment Partnership" to include partnerships that have at least 90% of their asset costs from both tangible and intangible personal property reasonably necessary to carry on a QIP's investment activities – specifically, accounts receivable with brokers, dealers, and trading partners – would be consistent with the intent of the QIP definition and would not expand the definition beyond its intended scope.

2. **Recommendation 2 – The definition of "Nonresident QIP Partner" should explicitly include pass-through entities and trusts treated as disregarded entities for federal and state income tax purposes.**

   Under the laws of most states, an entity, such as a single member LLC or grantor trust, that is disregarded as separate from its owner for federal income tax purposes, is also disregarded as separate from its owner for state income tax purposes. However, the Draft Model permits only three classes of Nonresident QIP Partners: nonresident individuals, nonresident estates taxable under state law, and nonresident trusts taxable under state law. This creates potential ambiguity as to whether disregarded entities for whom the sole owner is a nonresident individual can be Nonresident QIP Partners. Other commentators have pointed out this deficiency. We recommend the definition be clarified to state explicitly that pass-through entities and grantor trusts are Nonresident QIP Partners when the sole owner or grantor is a nonresident individual and the entity is disregarded for federal and the adopting state's income tax purposes.

3. **Recommendation 3 – The types of debt securities included in the definition of "Qualified Investments" should be clarified; specifically, we recommend the Draft Model follow the federal income tax criteria for determining whether an instrument will be treated as an equity investment or debt.**

   Section 2(a)(9)(A) of the Draft Model provides that "Qualified Investments" includes "Common stock of corporations, including preferred or debt securities convertible into common stock; and preferred stock, including debt securities convertible into preferred stock,

provided that the corporation is taxed under the Internal Revenue Code Subchapter C." The Section believes this definition runs the risk of being unduly narrow. For example, certain loans that lack a conversion feature into common or preferred stock may be treated as equity investments for federal income tax purposes. We recommend this provision of the definition of "Qualified Investments" be amended to specifically treat as equity investments any debt instrument that would be considered an equity investment for federal income tax purposes.[6] This would provide greater consistency from state to state, and as between state and federal income tax treatment for these investments.

4. **Recommendation 4 – State revenue agencies should be directed to issue guidance on the applicability of nonresident partner withholding and composite return rules to investment partnerships with state taxable income.**

Section 4(a)(4) of the Draft Model grants state revenue agencies the authority to issue regulations and other guidance to carry out the purposes of the Draft Model, including "[f]iling of withholding or estimated payments [and/or composite returns]" by QIPs when income is taxed by the state. Section 3 provides an exclusion from a Nonresident QIP Partner's state income tax for such partner's distributive share of Qualifying Investment Partnership Income (Loss). However, many QIPs will have nonresident partners other than Nonresident QIP Partners, and will have distributive share income allocated to their partners other than items of income, expense, gain or loss derived from Qualifying Investments. Accordingly, in most states, a QIP will still be required to withhold estimated income tax, or to pay that state's income tax in connection with a composite return. QIPs and their advisors tasked with administering these withholding/composite return requirements will need additional guidance on how to report this income. Therefore, we believe the state revenue agencies should be affirmatively directed to provide this guidance rather than simply being granted authority to provide it.

5. **Recommendation 5 – Language should be added allowing for the waiver of estimated tax payments and penalties in certain instances where a previously qualifying QIP fails to qualify in a subsequent year. Those waivers should extend to both the partnership that failed to withhold or make composite payments on behalf of Nonresident QIP Partners, as well as the Nonresident QIP Partners themselves to the extent that failure to qualify creates a filing obligation on their part in the state.**

Status as a QIP under Section 2(a)(7) of the Draft Model is determined for each "applicable tax period," rather than being determined based on the entity's characteristics in a preceding tax year, or over a span of several tax years. Thus, it is possible for a partnership to qualify for QIP status in one taxable year, and to enter the next taxable year operating with a good faith belief that it would qualify, only to learn later that it failed to qualify based on circumstances not directly or completely under its control or some technical foot-fault. In such instances, the former QIP could be delinquent in its estimated or withholding tax payments, and subject to penalties for the failure to have collected and remitted required tax. While partnerships typically would know if they were considered Dealers in Qualifying Investments or "financial

[6] *See, e.g.*, *Dixie Dairies Corp. v. Commissioner*, 74 T.C. 476 (1980) (identifying factors for determining whether an advance should be treated as debt or equity); 26 C.F.R. § 1.385-3 (treating the distribution of certain debt instruments as stock).

institutions" under state law, it is altogether possible that they could fail the 90% of asset cost requirement in Section 2(a)(7)(A), or the 90% gross income or proceeds test in Section 2(a)(7)(B). Accordingly, the state revenue agency should be granted explicit statutory authority to waive the requirement for former QIPs to make estimated tax payments and to not assess or to abate penalties against former QIPs, as well as the Nonresident QIP Partners themselves to the extent the failure to qualify creates a filing obligation in the state when the former QIP fails to qualify for a taxable year but qualified in the immediately preceding tax year.

6. **Recommendation 6 – The Section also recommends the addition of clarifying language for QIPs that, for whatever reason, do not elect to certify to QIP status. Failure to certify should not create a presumption against sourcing an entity's income as QIP income, or otherwise create any legal obstacle to sourcing the income to an owner's state of residence or domicile under applicable law.**

The Section acknowledges and appreciates the Work Group's previous change to the Draft Model making it elective for a partnership to certify to the state revenue agency that the partnership meets the criteria for QIP status for the tax period covered by the certification. However, the Section recommends adding clarifying language for QIPs that do not elect to certify. The Draft Model should include language in the new Section 4(c) that an entity's failure to certify its status as a QIP does not preclude the classification and sourcing of its income as QIP income, or otherwise preclude sourcing the income to a nonresident partner's state of residence or domicile. There should be no presumption that the income of an entity that fails to certify itself as a QIP is treated as apportionable income, or is otherwise sourced to the taxing state solely on account of the partnership's failure to certify.

The Section commends the Work Group for including language in the new Section 4(c) to allow the state revenue agency to waive certain requirements of the certification to establish QIP status for entities that otherwise qualify for QIP status, but which fail to satisfy one or more of the requirements for a tax period, when the sourcing of the QIP income in question is not affected.

7. **Recommendation 7 – QIP information returns should not require extensive or burdensome disclosures, particularly disclosures relating to the identity of partners of QIPs reporting no taxable income.**

Section 4(a)(2) of the Draft Model grants the state revenue agency the authority to issue regulations and other guidance pertaining to tax and information returns, including requirements mandating QIPs to provide "lists of partner names and addresses, lists of investments or other investment information, lists of other assets and their values, and similar records, as well as exceptions to the application of these requirements." Annual disclosure of such detailed information would constitute a significant administrative burden for most investment businesses, particularly for partnerships with high turnover in either their investments or their partnership composition. Indeed, reviewing this information could be equally burdensome for the state revenue agency. The current proposed language suggests that extensive disclosures regarding this information would be the norm, and less burdensome

disclosures the less frequent approach. Extensive and, in some circumstances, unnecessary disclosure requirements would impose an undue burden on most QIPs, and the Section recommends more modest disclosure requirements for tax and information returns, with the state revenue agency retaining authority to request information in the context of an audit consistent with other applicable state law. We agree with the helpful comments offered by the AICPA in this regard.

8. **Recommendation 8 – The Section supports removal of the language that would have given state revenue agencies authority to propose rules to create rebuttable presumptions as to when a QIP's certification could be revoked and its income or a portion thereof subjected to that state's income tax.**

The Section acknowledges and commends the Work Group's previous removal of language that would have allowed state revenue agencies to propose rules to create rebuttable presumptions as to when a QIP's certification could be revoked and its income subjected to that state's income tax. The stated purpose of the Draft Model is to create a safe harbor consistent with other applicable state law. While a state revenue agency should have authority to challenge whether a taxpayer qualifies for the safe harbor, the rules surrounding such a challenge should be based on the statute itself, and not on administrative rules. Administrative rules that create presumptions against partnerships claiming the safe harbor run counter to the purpose of having such a safe harbor in the first instance. Accordingly, we commend the MTC staff and the Work Group for removing this provision from the previous draft.

CONCLUSION

The Section recognizes that the Draft Model is not yet complete and would like to offer further comments to the Draft Model as necessary. We welcome the opportunity to continue to work with MTC staff and the Work Group to refine the Draft Model and to make it something that tax administrators, taxpayers, and their representatives can understand and apply as easily and effectively as possible.