**Proposed Draft – Treatment of Investment Partnership Income (CLEAN)**

For July 11, 2022 Meeting

NOTE: This proposed draft is based on a detailed white paper prepared by MTC staff. That white paper may provide information useful for the review of this proposed draft and is available on the project webpage here: <https://www.mtc.gov/Uniformity/Project-Teams/Partnership-Tax>.

This draft was prepared by MTC staff for discussion purposes only.

The following notes may assist in reviewing the draft model:

* It applies only to income tax on individuals – not corporations.
* It makes an exception for income of individuals that actively participate in the management of the investment partnership or its investments.
* It excludes partnerships that own interests in non-investment partnerships.
* It provides exclusion for certain investment income.

GENERAL NOTES: This annotated draft is intended to:

* Be generally consistent with state sourcing and other pass-through tax principles.
* Create a safe harbor that is not susceptible to abuse.
* 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.

This draft does NOT create a rule that any other income not specifically addressed would necessarily not be sourced to an individual partner’s residence under general state sourcing rules. This means that income which falls outside the rule will be sourced using those general state rules and principles. Also, note that this draft differs from some state’s rules which seem to be couched in the idea that limited partners who are passive investors are not “doing business” in a state or that their income is always “non-business” income.

Because the general state rules and principles for sourcing the income of corporate partners are considered sufficient, this draft does not apply to corporate partners.

There were questions about whether this is a draft statute or regulation. We have generally drafted it as a model statute, but since we believe it is generally consistent with established state sourcing statutes and rules in most states, states may also want to adopt it as a regulation. The critical issue may be whether the state believes the anti-abuse provisions in Section 4 should be adopted by statute.

DESIGN OF THE RULES: This draft model is designed to impose three independent qualifications for the safe-harbor sourcing. First, the partnership must be a Qualified Investment Partnership. Second, the partner must be a Qualified Investment Partner. Third, the income or loss subject to the sourcing rules must be a Qualified Investment Partnership Income (Loss). Each of these terms is defined and imposes distinct requirements. If the partnership, or the partner, or the income does not qualify, then the income is not sourced to residence under this safe-harbor rule. Again, it may still be sourced to residence under other rules or general state sourcing principles. But to determine if the income would be sourced to residence it has to come from a Qualified Investment Partnership, must flow to a Qualified Investment Partner, and must be Qualified Investment Partnership Income.

**Title. Treatment of Certain Income of Nonresident Qualifying Investment Partnership Partners.**

**Section 1. Purpose: [Drafter’s note: This section is included to give guidance to the use of anti-abuse authority in Section 4 below.]**

The purpose of this [Act] is to create a safe harbor for sourcing and taxation which is consistent with applicable state sourcing requirements of certain investment income, and to clarify that whether income is derived from the holding of those investments directly or from an interest in a qualified investment partnership that holds those investments, the sourcing will be the same.

**Section 2. Definitions:**

(a) In this [Act]:

(1) “Amount of Gross Income or Proceeds” refers to the total of all items of gross income or proceeds from activities or sales of any kind.

(2) “Dealer in Qualifying Investments” is any person who meets the definition of a "dealer” in 26 U.S.C. § 475(c) with respect to Qualifying Investments or who regularly purchases Qualifying Investments for sale to customers in the ordinary course of a trade or business or regularly offers to enter into, assume, offset, assign or otherwise terminate positions in Qualifying Investments with customers in the ordinary course of a trade or business;

(3) “QIP Manager” means any individual that holds an ownership interest in a Qualified Investment Partnership and who participates in the management of the partnership including recruiting investors, overseeing investments, performing administrative functions, etc.

(4) “Nonresident QIP Partner” means an individual who is a nonresident as determined under [reference to applicable state law], holds an ownership interest in a Qualified Investment Partnership, and is not a Dealer in Qualifying Investments or a QIP Manager at any time during the tax period. [Drafter’s Note: States may also consider including taxable estates and trusts to the extent they believe this treatment is consistent with their taxation of those entities.]

(5) “Partnership,” as the term is used, alone or in conjunction with other terms, means an entity properly subject to treatment as a partnership under Subchapter K of the Internal Revenue Code.

(6) “Qualified Investment Partnership” means a partnership that meets all the following requirements for the applicable tax period:

(A) No less than 90 percent of the cost of the partnership’s total assets consists of Qualified Investments and the office facilities and tangible personal property reasonably necessary to carry on its activities as an investment partnership; and

(B) No less than 90 percent of the partnership’s Amount of Gross Income or Proceeds is derived from items that would be Qualified Investment Partnership Income (Loss), as determined at the level of the partnership which first recognizes the items;

(C) The partnership is not a Dealer in Qualifying Investments at any time during the tax period;

(D) The partnership is not a financial institution as defined in [reference to state law]; and

(E) The partnership has certified to the [state revenue agency] that it meets the criteria above with respect to the tax period covered by the certification, in a form and at the time prescribed by the [state revenue agency].

(7) “Qualified Investment Partnership Income (Loss)” means interest, dividends, distributions, or gains and losses from Qualified Investments, including distributive share from lower-tier Qualified Investment Partnerships. For purposes of this definition, distributive share of items from lower-tier Qualified Investment Partnerships retain their characterization as either items as Qualified Investment Partnership Income (Loss), or not, as the items pass through any upper tier partnerships.

(8) “Qualified Investments” means:

(A) Common stock of corporations, including preferred or debt securities convertible into common stock; and preferred stock, including debt securities convertible into preferred stock;

(B) Bonds, debentures, and other debt securities such as certificates of deposit and collateralized securities;

(C) Deposits and any other obligations of banks and other financial institutions regulated by the United States government, a state, or by any political subdivision or governmental agency thereof, and cash and cash equivalents, including foreign currencies;

(D) Corporate stock and bond index securities, future contracts, derivative securities, warrants or options on securities, and other similar financial securities and instruments;

(E) Interest in a partnership but only if that partnership, itself, is a Qualified Investment Partnership under Section 2(a)(3) above;

(F) Other similar or related financial or investments contracts, instruments, or securities.

The term does not include:

(G) Any investment in a captive REIT, as defined by [reference to federal or state law]; or

(H) Loans that are not debt securities.

(b) All other terms used in this Section are given their general meaning as used under the [reference to personal income tax act].

**Section 3. Certain Qualified Investment Partnership Income of Nonresident QIP Partners Excluded from Personal Income Tax.**

(a) Except as provided in Section 3(b), a Nonresident QIP Partner may exclude from tax under [reference to state income tax] the partner’s distributive share of Qualified Investment Partnership Income (Loss).

(b) The exclusion in Section 3(a) does not apply to the distributive share of Qualified Investment Partnership income to the extent derived directly or indirectly from an investment in an entity if the Nonresident QIP Partner holds or has held within the last five years a direct ownership interest in that entity, unless the entity is a publicly traded entity or the Nonresident QIP Partner does not or did not actively participate in the entity’s activities. For this purpose, active participation means being an officer or director, or holding an ownership interest greater than 20%.

**Section 4. Authority Delegated to the [State Revenue Agency].**

(a) The [state revenue agency] has authority to issue regulations and other guidance to carry out this [Act] including, [but not limited to]:

(1) Requirements for the certification of Qualified Investment Partnerships;

(2) Requirements for information returns to be filed by Qualified Investment Partnerships including requirements 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.

(3) Rules for the calculation of asset and income values for purposes of implementing the requirements of this [Act];

(4) Filing of withholding [and/or composite returns] by Qualified Investment Partnerships when any income of such partnerships is subject to tax in this state and as provided by this Section and [reference to state law] waiver of estimated payments and related penalties in cases where a previously qualifying partnership fails to qualify.

(b) Consistent with the purpose of this Act, the [state revenue agency] has authority to issue regulations to effectuate that purpose and to prevent abuse including rules creating rebuttable presumptions as to when a Qualified Investment Partnership’s certification may be revoked and its income or a portion thereof subjected to tax. Further, if the [state revenue agency] determines that this Act has been used to avoid [state] income tax liability, the [state revenue agency] shall have the authority to revoke the certification of the Qualified Investment Partnership and distribute, apportion, or allocate the partnership’s income in accordance with [State law].