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| **Proposed Draft – Treatment of Investment Partnership Income (Edits and Comments)**  **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 annotated version below contains edits to the original draft (in Blue) and notes (in Red) from commentary and discussion of certain issues that have been raised. Proposed drafters notes may also be shown in the edits on the left in brackets. In addition – edits or notes that were added after the June 27, 2022 work group call are highlighted in yellow. This draft is still being actively reviewed and the edits and notes here are not exhaustive. To help in the review, the draft as first circulated noted the following:   * 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.** | **COMMENTS:**  Change in the title is in response to a comment that the title may be somewhat misleading. |
| **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. | There were comments asking about this section and why it is included. It is primarily included because of the anti-abuse authority granted to the state revenue agency in Section 4 below. In other words, this purpose section provides guidance for the use of that authority. See further comments in that Section 4 below. The edits made here (at left) are meant to further clarify |
| **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.] | There was a question asked about how to treat losses in the calculation that defines Qualified investment Partnership below. This definition clarifies that the gross income used in that test is true gross receipts—without offsetting deductions for basis or expense.  The original draft excluded from the definition of qualified investment partnership a “dealer.” There was a comment asking whether the partner might be a dealer. As proposed clarification, we added a definition of Dealer in Qualifying Investments here and used it to limit both the definition of a Nonresident QIP Partner and a Qualified Investment Partnership (see below).  A comment was received that we did not clearly exclude investment partnership managers from the safe harbor sourcing rule (even though the notes indicate this was intended).  There was also a comment about whether taxable trusts/estates receive the same treatment. We would propose to add the drafter’s note shown left.  See note above regarding the comment about excluding investment partnerhip managers. |
| (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; | Note: One comment asked whether there should be a requirement for a certain number of unrelated partners or a certain percentage of interests held by unrelated partners. But it would not be consistent with the goals above to limit this treatment only to large partnerships with unrelated partners.  This change represents a response to two comments. The first has to do with how losses would be treated in computing the 90% income limitation. (See definition of Amount of Gross Income or Proceeds above.) The second had to do with clarifying that the character of the gross income or proceeds is determined by the QIP that first recognizes it and is maintained as that income or loss flows through to any upper-tiered partnerships. |
| (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]. | We received comments about what happens if the partnership does not certify. The partnership would not get the benefit of this safe-harbor. That does not necessarily mean that the income would not be sourced to the partner’s residence.  QUESTION: Should there be some presumption that attaches to those partnerships that do NOT certify such that those partnerships can be presumed not to qualify unless they subsequently prove to the state that they do? |
| (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. | Note: We received a comment asking whether it was clear that income does not change its character as qualified or non-qualified income as it flows up through tiered 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. | Note: We received a comment about including cash and cash equivalents including foreign currencies.  Note: We also received a comment about the term “debt security,” which we’ve attempted to clarify here.  Note: Some states reference the federal tax definition of a regulated investment company (RIC) in IRC § 851—which is a classification of entity subject to specific tax rules under the IRC and not taxed as a pass-through entity. States that take this approach generally provide that the definition of a RIC, with or without modifications, applies to the definition of a qualified investment partnership for state purposes. Reviewers may want to look at that definition. The potential problem with simply referencing IRC § 851, which is fairly detailed, is that doing so might also incorporate regulations and other guidance issued by the IRS. Also care will have to be take to ensure that investments in other non-investment partnerships are not deemed “securities” under the section. |
| 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%. | In reviewing this subsection (b) please keep in mind that a Qualified Investment Partnership CANNOT hold an interest in another partnership unless it is also a Qualified Investment Partnership. Therefore, ANY investment in a non-qualifying partnership will negate the effect of this sourcing rule. Also, because of the limitations imposed on S corporation ownership, these entities automatically excluded. So, the only entities that this rule will possibly affect are those that are not taxed as a partnership or S corporation for federal purposes – typically C corporations.  There was a comment that there may need to be a time limit on this rule. There was also a comment that we may need to define more precisely what “active participation” involves.  NOTE: We received the following question: “So if a partner has or has had a direct holding in an investment it seems like that partner cannot exclude the income from that particular holding. But what of the other partners? It seems like they would be permitted to exclude income from that holding even though they are all partners.” There was also a comment suggesting that we split this requirement into separate parts.  The answer to the question is yes, that is the intention of this provision. It is the relationship of the partner that was active in the business that is being altered, not the other partners. As to the suggestion, if we are in agreement with the principle, then we can further discuss how to clarify. |

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| **Section 4. Authority Delegated to the [State Revenue Agency].** | There was a comment that this section should be subject to further review and discussion. |
| (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. | This is in response to a comment that agencies do not need to be given authority to issue instructions.  Note: There was a comment as to whether this provision (4) should be addressed as it is here or whether further provisions should be developed for this purpose. Because the specific treatment of withholding or composite returns is beyond the scope of this particular model—we might, instead, suggest the following drafter’s note be added to the model:  [Proposed Drafter’s Note: The state may also want to address how this affects the obligation of a Qualified Investment Partnership to comply with withholding and/or composite return requirements.] |
| (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]. | Note: There were comments on whether it is necessary to connect the remedial provision here to the purpose of the model above.  There was also a comment about whether revoking the certification would affect a nonresident partner’s treatment in other states. The answer is no. It may be that the change here clarifies that revoking the certification will simply address the adopting state’s law. |