MULTISTATE TAX COMMISSION

Notes on Comments Received on Draft Model for Treatment of Investment Partnership Income and Proposed Revisions to August 18, 2022 Draft

For Discussion Purposes Only – April 16, 2023

This document contains comments received from the AICPA, ABA, and the accounting firm PwC, organized by sections of the model to which the generally relate. It also contains proposed revisions to the latest version of the model, circulated on August 18, 2022, and notes for consideration by the MTC work group. The copy of the circulated model, copies of comments received, and a related white paper are on the MTC website, project page, here: https://www.mtc.gov/uniformity/project-on-state-taxation-of-partnerships/.

Note – Purpose of the Model

The model contains a "Purpose" section, Section 1 (see page 4 below). While none of the comments recently received were specifically addressed to this section, we have previously received comments about this section. And since the August, 2022 draft was circulated, the work group has also engaged in discussions of the general principles for sourcing partnership income. The purpose section was retained but revised somewhat to reflect those discussions and the basis for the special treatment provided by the model.

As this purpose section has stated in the past, the model creates a safe harbor. It does not provide an exclusive or exhaustive list of sourcing rules for investment-related income. It does, however, provide the basis for the special rule provided for the Qualified Investment Partnership Income (Loss) of certain QIP Partners.

Note – Comments Concerning "Qualified Investments"

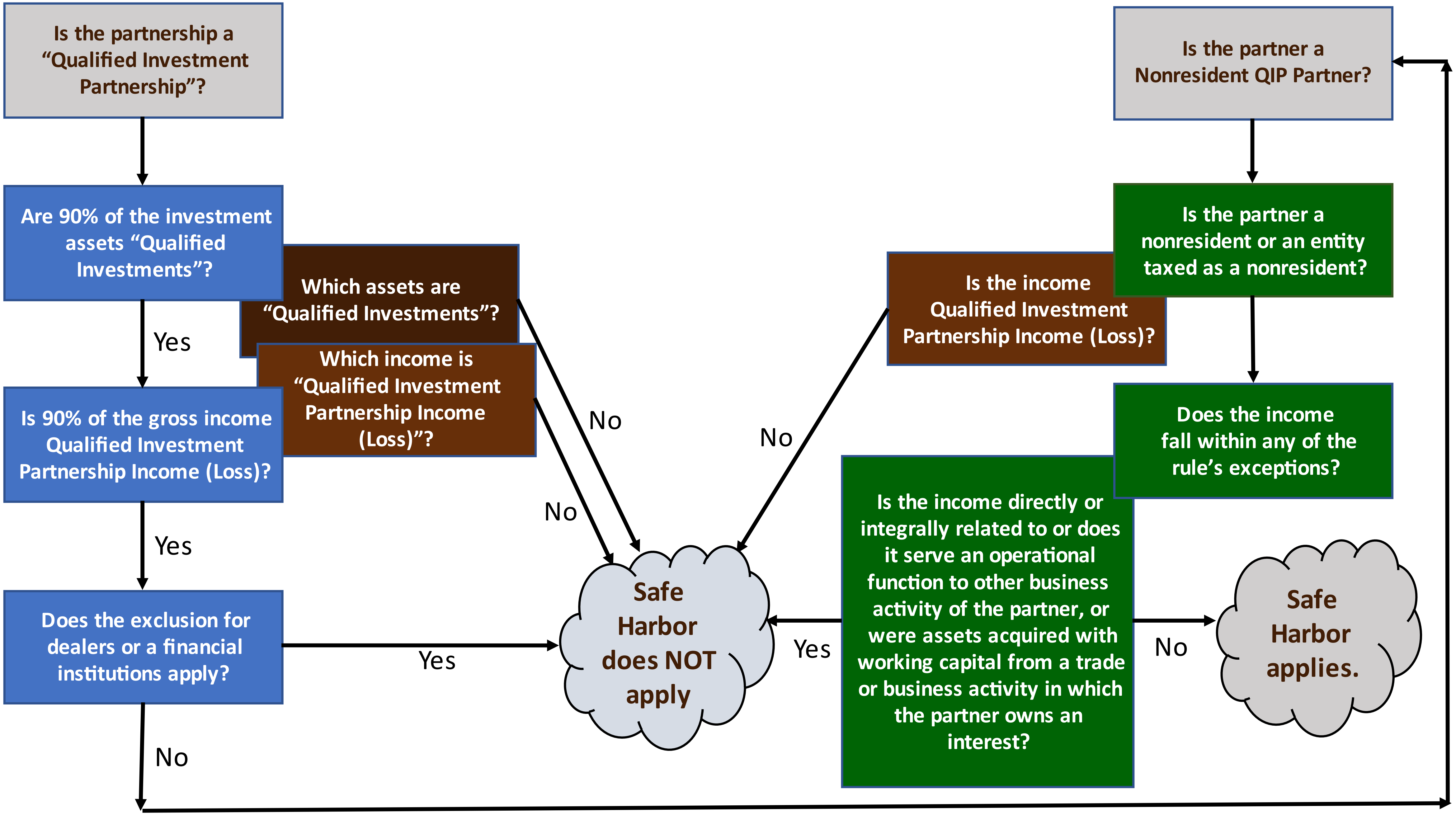
Many of the comments received concerned the definition of "Qualified Investments." Again, as noted with respect to the purpose of the model, above, the goal is not to create an exclusive or exhaustive listing of such investments—and the definition includes a reference to "other similar or related" investments. Nevertheless, the work group may want to discuss whether it wishes to provide specific references to other investments, or alternatively, as some comments received suggested, look to IRC § 864, which concerns the sourcing of income of foreign individuals, and bases the distinction between investment and other income on whether the individual is engaged in a trade or business in the U.S. One option might be to reference this section and related regulations, and note any exceptions. This may also require further study.

Note – Comments Concerning Administrative Rules

A number of comments received concerned the possible administrative requirements. There were no proposed revisions to Section 4 of the model given that the administrative provisions in this section may depend, to some degree, on the substantive provisions still under consideration. However, it should be noted that the special rule for investment income set out in the model may affect whether the partnership is subject to withholding or composite return rules or can take advantage of filing a PTE return. Also, as some comments point out, the information required to make a reliable determination of treatment under the model may require the reporting of information from lower tiered entities.

Note – Structure of the Model

A final note on the model. In order to avoid unintended, unforeseen consequences, some of the limitations or requirements in the model provisions may overlap. That is, in certain cases, the effect of multiple provisions, standing alone, may be that the income will not qualify for the special treatment. Also, as is apparent from the comments, there is certain fundamental information that partnerships, or partners, or both may have—which affects their application. In any situation, any one of the requirements, standing alone, will not suffice. Instead, for the special rule to apply, all of the requirements must be met. This is illustrated, generally, in the graphic, below.



Is the partnership a "Qualified Investment Partnership"?
Are 90% of the investment assets "Qualified Investments"?
Which assets are "Qualified Investments"?
Yes
Which income is "Qualified Investment Partnership Income (Loss)"?
Is 90% of the gross income Qualified Investment Partnership Income (Loss)?
Yes
Does the exclusion for dealers or a financial institutions apply?
Yes
No
No
No
Safe Harbor does NOT apply
No
Is the income Qualified Investment Partnership Income (Loss)?
Is the partner a Nonresident QIP Partner?
Is the partner a nonresident or an entity taxed as a nonresident?
Does the income fall within any of the rule's exceptions?
Is the income directly or integrally related to or does it serve an operational function to other business activity of the partner, or were assets acquired with working capital from a trade or business activity in which the partner owns an interest?
Yes
No
Safe Harbor applies.

Treatment of Investment Partnership Income
For Discussion Purposes Only
Proposed Changes to August 18, 2022 Draft

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/Section/Rule] is to provide a safe harbor for the sourcing of investment income or loss by certain nonresident partners where that income or loss would have been sourced to the nonresident partner's state of residency had the partner directly engaged in the activities of the entity that generated the income or loss. In cases where the requirements of this [Act/Section/Rule] are met, [the State] agrees that the income or loss is properly sourced to the nonresident partner's state of residence under [reference to general state tax and sourcing statutes].~~

Income, expense, gain, and loss earned or incurred from certain investments not made for business purposes are subject to the [state personal income tax] only to the extent the taxpayer is a resident of this state, regardless of whether the investment property or the taxpayer's investment activity has a connection to this state. The distributive share of partnership income, expense, gain, or loss is subject to the [state personal income tax] to the extent these items are properly sourced to this state under [state sourcing rules]. Under Internal Revenue Code Subchapter K, important tax characteristics of items of income, expense, gain, or loss (ordinary or capital, deductible or capitalizable expense, etc.) earned or incurred by a partnership are determined based on the activities of the partnership and these characteristics then apply the partners' distributive shares of these items as well. Following this principle, if a partnership operates to make certain investments and conduct certain investment-related activities, rather than for other business purposes, and if the investments are not otherwise connected to a partner's business so that they would be sourced to this state under [state sourcing rules], then under the [state personal income tax] a taxpayer's distributive share of the partnership's income, expense, gain, or loss from those investments is subject to tax only to the extent the taxpayer is resident in this state. The purpose of this [Act/Section/Rule] is to provide a safe harbor. Nothing in this [Act/Section/Rule] should be construed to limit other provisions of state law that might exclude income of nonresidents from [personal income tax].

NOTES & COMMENTS

Below the comments received have been organized by section or issue along with proposed revisions in response to those comments or for reasons otherwise noted, for consideration by the work group.

NOTE: The MTC work group on state taxation of partnerships has had a number of discussions about the principles of sourcing partnership income since this version of the model was drafted. This purpose section attempts to more clearly reflect those discussions. (See also the white paper on this subject on the MTC website, project page.)

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 partner that holds an ownership interest in a Qualified Investment Partnership that was acquired in exchange for performing the management of the Partnership including recruiting investors, overseeing investments, performing administrative functions, and similar activities.

(4) "Nonresident QIP Partner" means ~~a person subject to tax under [reference to state income tax law] that holds an ownership interest in a Qualified Investment Partnership and is neither a Dealer in Qualifying Investments nor a QIP Manager at any time during the tax period, provided the person is~~:

(A) an individual who is a nonresident as determined under [reference to applicable state law];

(B) an estate that is a nonresident as determined under [reference to applicable state law];~~ or~~

(C) a trust that is a nonresident as determined under [reference to applicable state law]~~.~~; or

(D) an entity that is owned solely by such individual, estate, or trust and that is disregarded for federal tax purposes;

provided that the person is not a QIP manager at any time during the tax period and has no direct or indirect ownership or interest in any other business activity to which the assets have a unitary relationship or serve an operational function.

[Drafter's Note: States should confirm that the general treatment of taxable estates and trusts and the sourcing of their income would be compatible with the purpose of this safe harbor.]

AICPA comment 1: The reference to "Dealer in Qualifying Investments" be deleted and, the following qualification be substituted, based on 35 Ill. Comp. Stat. 5/305(c-5), which generally provides that the investment partnership rules should not apply:

[I]f such income is from investment activity:

- that is directly or integrally related to any other business activity conducted in this State by the nonresident partner (or any member of that partner's unitary business group);
- that serves an operational function to any other business activity of the nonresident partner (or any member of that partner's unitary business group) in this State; or
- where assets of the investment partnership were acquired with working capital from a trade or business activity conducted in this State in which the nonresident partner (or any member of that partner's unitary business group) owns an interest.

[See also change to Section 3 below.]

ABA 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

(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.

owner or grantor is a nonresident individual and the entity is disregarded for federal and the adopting state's income tax purposes.

(6) "Other Pass-Through Entity" means an entity, other than a Partnership, whose income is taxed to its interest holders and includes corporations properly taxed under Subchapter S of the Internal Revenue Code and certain taxable trusts.

(7) "Qualified Investment Partnership" means a Partnership that meets all the following requirements for the applicable tax ~~period~~ year:

(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 and other intangible property, including accounts receivable, reasonably necessary to carry on its investment activities as well as intangible property from those investment activities, including accounts receivable;

(B) No less than 90 percent of the Partnership's Amount of Gross Income or Proceeds recognized in the tax year are items that give rise to Qualified Investment Partnership Income (Loss). For purposes of this test, only gross income or proceeds recognized by the Partnership are included in the calculation of the percentage;

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

(D) The Partnership is not a financial institution as defined in [reference to applicable state law].

AICPA Comment 2: Update the Proposed Language of the Definition of a QIP to Include Both Tangible Personal Property and Intangible Personal Property Reasonably Necessary to Carry on Its Investment Activities

In its definition of a QIP, the proposed language includes the requirement that "[n]o 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 investment activities." We believe the requirement should also reference intangible personal property reasonably necessary to carry on its investment activities, such as software or seats on a stock exchange. Specifically, we believe the proposed language should be updated to include both tangible personal property and intangible personal property reasonably necessary to carry on its investment activities.

ABA 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.

PWC Comments: Testing Period for Qualified Investment Partnerships [See Note on Comments for Discussion above.]

The current Model Statute provides that a Qualified Investment Partnership must meet both an asset test and income test in addition to not being a dealer in the underlying investment. We request that the Model Statute provide more specificity around the procedures for each of the asset and income tests. For instance, must the asset test be met annually at the end of the tax year or also at interim periods during the tax year? Is the income test required to be met in full each year or is there a potential for more leniency in this test (i.e., two of the last three years)?

As an example, New York City provides a self-trading exemption from the general sourcing provisions in the city's Unincorporated Business Tax. NYC Admin. Code Section 11-502(C)(4)(D) provides a monthly averaging testing mechanism for purposes of the qualifying asset test.

More specificity in the testing mechanisms would allow Investment Partnerships to plan accordingly and help ultimate taxpayers in their structures to timely receive state income information, which would allow for more appropriate and timely

	tax reporting. Similarly, the move toward uniformity in this testing approach across state tax jurisdictions could provide more certainty for impacted taxpayers.
(8) "Qualified Investment Partnership Income (Loss) means items of income, expense, gain, or loss that are derived from Qualified Investments held by a Qualified Investment Partnership, including interest, dividends, or gains or losses from exchange of those Qualified Investments. Whether the items meet the requirements of this definition is determined when those items are first recognized ~~by a Partnership or Other Pass-Through Entity regardless of whether those items then flow through other Partnerships or Other Pass-Through Entities~~.	**NOTE:** The change to "Qualified Investment Partnership Income (Loss) was made to clarify and simplify.
(9) "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, provided that the corporation is taxed under the Internal Revenue Code Subchapter C; (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 or Other Pass-Through Entity but only if that Partnership or Other Pass-Through Entity would meet the requirements to be 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	**The AICPA, ABA, and PWC provided a number of comments on the definition of qualified investments, including debt securities. See below. [See Note on Comments Concerning Qualified Investments above at page 2.]** **<u>General Comments</u>** **AICPA Comment 3 -** Clarify that Qualified Investments Include Investments in Gold, Other Precious Metals, Gems, and Collectibles and Consider Addressing Investments in Non-Captive REITs and RICs In its definition of Qualified Investments, we believe the language should clarify that Qualified Investments include investments in gold, other precious metals, gems, and collectibles and should consider addressing investments in non-captive REITs and RICs. **PWC Comment** - We encourage the workgroup to consider adopting more conformity to existing US federal income tax statutes and regulations in relation to the "Qualifying Investment" definition included in the Model Statute. IRC Section 864(b)(2) provides certain securities and commodities trading "safe harbors" for foreign investors. If a safe harbor test is met, a foreign investor is not considered to be conducting a trade or business in the United States for federal income tax purposes merely as a result of engaging in the activity covered by the safe harbor. The federal foreign investor safe harbor exemptions provide a corollary to the type of state tax treatment that is being considered in the Model Statute (i.e., income that may be treated as being allocable to an individual income taxpayer's domicile for state income tax purposes).

(H) Loans that are not debt securities.	However, IRC Section 864(b)(2) and the draft regulations issued thereunder provide a broader definition of qualifying investments than currently included in the Model Statute.

(Comments on "Qualified Investments"- General, Cont'd)

In addition to the items of note below, we also urge the MTC to consider adopting the safe harbors in whole to better align the state tax treatment with the underlying federal income tax provisions. Such conformity to the federal definitions and requirements would make the monitoring and compliance of state rules administratively simpler and allow flexibility for states to conform to future federal changes. To that end, we urge you to consider more consistency with the federal provisions noting in the model that such conformity is intended solely to apply to the Qualifying Investment definition to avoid any unintended consequences to unrelated statutes.

Commodity Investments – As drafted, the Model statute focuses on investment "securities" when defining Qualifying Investments. We suggest that the MTC consider including commodity investments in the Model Statute. Commodity investments are covered by the previously noted IRC Section 864(b)(2) provisions. Further, commodity investments are treated similarly to security investments for federal income tax purposes under IRC Sections 475(f)(1) and 475(f)(2).

It appears in line with the MTC's goals in drafting the Model Statute to source commodity investments as the income would be sourced if it had been earned directly by the ultimate taxpayer. Such treatment under the Model Statute would then be treated similarly to security investments for state income tax purposes if earned by an Investment Partnership. A number of existing state Investment Partnership statutes specifically reference commodities in their definitions (Connecticut, Illinois, New Jersey, and New York); thus, addressing commodities in the model statute would lead to further consistency across taxing jurisdictions.

Foreign Currencies – We appreciate the inclusion of foreign currencies in the definition of Qualifying Investments in the most recent draft of the Model Statute. Foreign currencies meet the qualifying definitions in the previously mentioned IRC Section 475 definitions.

Digital or Intangible Assets – We encourage the MTC to consider a broader definition of qualifying digital or intangible assets. In practice, taxpayers in the investment industry that appear to be the target for state Investment Partnership sourcing provisions invest in many types of intangible investments. As noted below, the US Department of Treasury recently has begun exploration of certain investment classes for US purposes. Certain of these arrangements may not have been in existence at the time state statutes and regulations were drafted by states with existing

- In particular, we recommend the work group consider including references to investments in the following categories:
- Digital assets
- Life insurance contracts purchased in the secondary market (i.e., stranger owned life insurance)
- Revenue strips (i.e., contractual royalty/rent rights without ownership in the
- underlying assets)
- Synthetic royalty deals (i.e., capital provided to a company in exchange for payments based on certain milestones being met, as is common in the life sciences industry).

Derivative Securities – We encourage the MTC to provide a more detailed definition of the types of derivative securities that meet the Qualified Investment test. In general, for federal tax purposes, where investments in a certain asset class are intended to be covered under IRC Sections 475 or 864, the rules extend this protection to derivatives that reference such investments.

In defining the term "security." IRC Section 475(c)(2)(E) provides the following language which may prove useful for this definition: "evidence of an interest in, or a derivative financial instrument in, any security described in subparagraph (A), (B), (C), or (D), or any currency, including any option, forward contract, short position, and any similar financial instrument in such a security or currency."

Proposed regulations under Treas. Reg. § 1.864(b)-1(b)(2) apply the security and commodity trading safe harbor to derivatives that reference securities or commodities. Taxpayers may currently reasonably rely on these regulations.

Investment Partnership provisions. As a result, the MTC Model Statute provides an opportunity for the modernization of existing state tax statutes.

Comments on Debt Securities

AICPA Comment 4 - Clarify the Definitions of a "Loan" and a "Debt Security"

A. Provide More Specific Definitions for a "Loan" and a "Debt Security" in Order to Clarify the Type of Loans Not Included in the Definition of Qualified Investments

We believe the proposed language should provide more specific definitions for a "loan" and a "debt security" to clarify the type of loans not included in the definition of Qualified Investments. The proposed language treats debt convertible into stock as a Qualified Investment. However, a conversion feature is not the sole criteria for treating a debt as an equity (stock) investment for federal income tax purposes.

B. Follow the Federal Income Tax Treatment of Financial Instruments and Treat as Stock under the Model Act a Debt Instrument that is Treated as an Equity Investment for Federal Income Tax Purposes

The Model Act should follow the federal income tax treatment of financial instruments, so that a debt instrument that is treated as an equity investment for federal income tax purposes is also treated as stock under the Model Act.

C. Treat Notes, Mortgages, Receivables and Other Forms of Debt Purchased on a Secondary Market as Meeting the Definition of a Debt Security Considered a Qualified Investment

We believe notes, mortgages, receivables and other forms of debt purchased on a secondary market should meet the definition of a debt security considered a Qualified Investment. Many states with QIP rules specifically make it clear that mezzanine debt, loan participations, repurchase agreements, and asset-backed securities meet the definition of a debt security considered a Qualified Investment.

D. Clarify that Accounts Receivable with Brokers, Dealers, and Trading Partners are Either Debt Securities or are Considered an Asset Necessary to the Business of a QIP

The proposed language should also make it clear that accounts receivables with brokers, dealers, and trading partners are either debt securities or are considered an asset necessary to the business of a QIP.

ABA 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.

This would provide greater consistency from state to state, and as between state and federal income tax treatment for these investments.

PWC – Comment on Debt Security Definition

We encourage the MTC to further refine the definition of debt security as provided in the Qualified Investments definition. The previously mentioned IRC Section 864(b)(2) provisions include a definition of debt security meeting the foreign trading safe harbor requirements. Broadly, for this purpose any instrument that is indebtedness for tax is considered a debt security. We urge the MTC to adopt the IRC Section 864(b)(2) provisions in defining debt securities. Alternatively, we recommend that the MTC clarify which types of loans would not be considered debt securities for purposes of meeting the Qualifying Investment definition with examples or more detailed definitions.

(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 Nonresident QIP Partner may exclude from tax under [reference to state income tax] the partner's distributive share of Qualified Investment Partnership Income (Loss) from a Qualified Investment Partnership except income that:

(a) is directly or integrally related to any other business activity conducted by the partner;

(b) serves an operational function to any other business activity of the partner; or

(c) is from assets that were acquired with working capital from a business activity in which the partner owns an interest.

AICPA comment 1 states: The reference to "Dealer in Qualifying Investments" be deleted and, the following qualification be substituted, based on 35 Ill. Comp. Stat. 5/305(c-5), which generally provides that the investment partnership rules should not apply:

[I]f such income is from investment activity:

- that is directly or integrally related to any other business activity conducted in this State by the nonresident partner (or any member of that partner's unitary business group);
- that serves an operational function to any other business activity of the nonresident partner (or any member of that partner's unitary business group) in this State; or
- where assets of the investment partnership were acquired with working capital from a trade or business activity conducted in this State in which the nonresident partner (or any member of that partner's unitary business group) owns an interest.

[See also change to definition of QIP Partner above.]

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 the purpose of 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 or estimated payments [and/or composite returns] by Qualified Investment Partnerships when any income of such Partnerships is subject to

The AICPA, ABA, and PWC provided a number of comments on the administrative rules. See below. [See Note on Comments Concerning Administrative Rules above at page 2.]

<u>Comments on Administrative Rules</u>

AICPA Comment 5 - Do Not Require Detailed Lists of Information in Information Returns to be Filed by QIPs

The proposed language in Section 4 related to the authority delegated to the state to issue regulations and other guidance to carry out these rules includes requirements for information returns to be filed by QIPs, 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." We believe requiring this type of information may be an administrative burden for certain taxpayers with high frequency trading funds, particularly if this information is required to be provided on an annual basis. The volume of information and time required to process such information may also be an administrative burden on the state tax departments. Additionally, certain taxpayers will prefer not to tax in this state and as provided by this Section and [reference to state law] waiver of requirements and related penalties in cases where a previously qualifying Partnership fails to qualify.

(b) A Partnership must state on its tax return whether it asserts that it meets the requirements to be treated as a Qualified Investment Partnership for the tax period. It must also provide information to its partners sufficient so that they can determine the proper amount of any Partnership items of income, expense, gain, or loss that are not Qualified Partnership Investment Income (Loss), as well as any other information determined by the [state revenue agency] to allow proper reporting of income or loss that would be taxable in the state.

(c) Upon a properly completed and timely filed application, as directed by the [state revenue agency], the [state revenue agency] may certify that a Partnership meets the requirements to be treated as a "Qualified Investment Partnership" for a particular tax period. In granting this certification, the [state revenue agency] has discretion to waive one or more of the requirements for a particular tax period for a Partnership that might fail to meet the qualification, provided that the Partnership demonstrates that this failure would not alter the treatment of the Qualified Investment Partnership Income (Loss) by Nonresident QIP Partners under [reference to applicable state income tax provisions], and such qualifying income (loss) can be properly determined.

disclose such information to protect investment strategies or investor confidentiality. The requirement of such details and lists should not be included.

AICPA Comment 6 - Provide that to the extent a lower-tier partnership (LTP) is required to file a state partnership return in the partner's residence state, a LTP is required to explicitly state (on the state Schedule K-1 or wherever appropriate) that it met the qualified investment partnership definition.

The definition of qualified investments includes interests in another partnership (lower-tier partnership or LTP) if it itself meets the requirement to be treated as a qualified investment partnership. That is similar to the federal tax rule to determine whether an interest in a LTP is treated as a qualified asset for section 704(c) aggregation purposes. In practice, certain partnerships may not be provided information from the LTP on a Schedule K-1 to indicate whether it itself is a qualified asset and may not know enough about the LTP to know whether it met the 90% test. In tiered structures, it is often difficult to obtain timely, if at all, insight into details from lower-level tiers, and there is a great amount of disparity amongst the information states require to be provided on Schedule K-1s. We suggest the model act should provide that to the extent a LTP is required to file a state partnership return in the partner's residence state, a LTP is required to explicitly state (on the state Schedule K-1 or wherever appropriate) that it met the qualified investment partnership definition.

ABA 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.
(Comments on Administrative Rules, cont'd) **ABA 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 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. **ABA 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	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. ABA 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.

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

(Comments on Administrative Rules, cont'd)

ABA 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.