MULTISTATE TAX COMMISSION

State Taxation of Partnerships – Report to the Work Group

MAY 24, 2023

SOURCING GENERALLY

ARE THERE FEDERAL OR STATE PRINCIPLES TO LOOK TO?

GENERAL FEDERAL PRINCIPLES

SUBSTANTIVE TAX RULES

(STATES GENERALLY CONFORM)

- Tax Treatment –
  Treatment of items of income, expense, gain, and loss is based on:
  - Character of the items
  - Attributes of the taxpaying partner.

GENERAL FEDERAL PRINCIPLES

SUBSTANTIVE TAX RULES

(STATES GENERALLY CONFORM)

- Character of Items – Character is determined by the specific activity giving rise to the item.
  - Examples:
    - Gain or loss from sale of a capital asset will be characterized as capital gain or loss.
    - Expenses from a trade or business may be deductible to a greater extent that investment-related expenses.

GENERAL FEDERAL PRINCIPLES

SUBSTANTIVE TAX RULES

(STATES GENERALLY CONFORM)

- Attributes of Taxpaying Partner –
  - Examples:
    - Individual versus corporate,
    - Passive versus active,
    - Other items recognized by the taxpayer from other sources,
    - Effective tax rate.

FEDERAL TAX TREATMENT = CHARACTER + TAXPAYER ATTRIBUTES

EXAMPLE:

Whether a partner can deduct a loss from a partnership against other income may depend on the character of the loss and the other income (ordinary or capital), whether the income or loss are from a trade or business or from investment activity, and whether the partner has an active or passive role in the partnership.

GENERAL FEDERAL PRINCIPLES

PARTNERSHIP

(STATES GENERALLY CONFORM)

- Partnership Determines Character – The character of partnership income is determined based on the activities of the partnership that earns or incurs the items.
  - The fact the income flows through multiple tiers does not change the character of the items.

GENERAL FEDERAL PRINCIPLES

PARTNERSHIP

(STATES GENERALLY CONFORM)

- <u>Conduit Principle</u> – Partnership income retains its character as it flows through and is reported by partners.
  - The partner's role (limited, minority, passive, etc.) does not change the character of the items.

FEDERAL CONDUIT PRINCIPLE

EXAMPLE:

If a partnership recognizes a capital gain from the sale of an asset, any share of that item flowing up through a tiered partnership retains its character and the ultimate taxpaying partner will recognize capital gain.

GENERAL FEDERAL PRINCIPLES

SOURCING

(STATES MAY CONFORM BUT ONLY FOR INTERNATIONAL SOURCING PURPOSES)

- Specific Assignment –
  Items of income are specifically assigned to a jurisdiction based on their character and expenses are allocated to income.

- Sourcing Attaches –
  Sourcing of items, like character, flows through to the partners.

GENERAL FEDERAL PRINCIPLES

SOURCING

(STATES MAY CONFORM BUT ONLY FOR INTERNATIONAL SOURCING PURPOSES)

- General Sourcing Categories – Income may be sourced differently depending on if it is effectively connected income (ECI) versus other fixed, determinable, annual, periodical income (FDAP).
  - ECI – ECI is from a trade or business.
  - Other FDAP – Income from ownership of certain assets not held for use in trade or business in the U.S.

FEDERAL SOURCING PRINCIPLE

EXAMPLE:

If a partnership has trade or business income in the U.S. treated as ECI and sourced to the U.S., foreign direct and indirect partners will also have U.S. sourced income.

GENERAL STATE PRINCIPLES

SOURCING FOR BUSINESSES

- General Sourcing Categories –
  - Business or "Operational" Income – Income that is sourced using formulary apportionment.
  - Nonbusiness or "Investment" Income – Is sourced using rules of assignment.
  - Unitary Income – Net business income sourced using a single formula.

GENERAL STATE PRINCIPLES

SOURCING FOR INDIVIDUALS

- Resident Sourcing –
  All income – with a credit for taxes paid to other states.
- Nonresident Sourcing –
  Separate rules – which sometimes rely on or overlap with rules for businesses.
  - Certain investment income is generally sourced to the state of residence.

INDIVIDUAL PARTNERS NOT SEPARATELY ENGAGED IN BUSINESS
QUESTION 1

- A partnership doing business in States A and B owns real property in State B that is used in the business.
- Smith is a limited, passive, minority partner in the partnership—and resident in State C.
- The partnership sells the real property, recognizing a capital gain.
- Does Smith source the capital gain to State C (his residence), or State B (where the property was), or to States A and B (apportioned as part of the business income of Partnership)?

INDIVIDUAL PARTNERS NOT SEPARATELY ENGAGED IN BUSINESS
QUESTION 2

- A partnership domiciled in State A and doing business in State B holds investments that are used in the partnership's business.
- Smith is a limited, passive, minority partner in the partnership—and Resident in State C.
- The partnership has capital gains from investments.
- Does Smith source the capital gain to State C (residence), State A (domicile of partnership), or to States A and B, apportioned as part of the business income of Partnership?

INDIVIDUAL PARTNERS NOT SEPARATELY ENGAGED IN BUSINESS QUESTION 3

- Jones owns stock in X Corporation as a personal investment (and not as part of a separate business)—and properly sources dividends to his state of residence.

- Smith owns a partnership interest in a Partnership Y as a personal investment. Partnership Y invests in the stock of corporations, including X Corporation.

- Should Smith source income from Partnership Y to where Y does business or to Smith's state of residence.

INVESTMENT PARTNERSHIPS

ISSUE – SHOULD THERE BE A SPECIAL RULE FOR THE SOURCING OF INCOME FROM INVESTMENT PARTNERSHIPS, TREATING IT AS SOURCED TO A PARTNER'S RESIDENCE, RATHER THAN THE LOCATION OF PARTNERSHIP ACTIVITIES?

DRAFT MODEL ON
TREATMENT OF INCOME OF INVESTMENT PARTNERSHIPS

- Received comments on a draft circulated in August 2022 from AICPA, ABA, and PwC
- Prepared a summary with notes and proposed changes
- Will discuss at the Uniformity Committee meeting – Tuesday, April 25, 2023, mid-morning
  (see the agenda for that meeting here:
  (https://www.mtc.gov/events-training/2023-spring-committee-meetings/)

GENERAL CONCLUSIONS

- Regardless of how a state applies sourcing rules to investment partnership income, the state should explicitly address this issue to avoid uncertainty.
- Unless the special sourcing treatment is properly designed and implemented, however, it could undermine the general system for taxing partnership income or lead to unintended results.
- States should consider basing the special sourcing rule for investment partnership income on the federal principle that income under the pass-through system should be treated as if it was earned directly.

GENERAL CONCLUSIONS

- States should be explicit that, if they appear to base their special sourcing rule on nexus or apportionment principles generally, the rule is a bright-line standard meant to increase certainty.

- The special sourcing rule should not apply to corporate partners since the rules for sourcing investment income are much more developed in the corporate tax context.

GENERAL CONCLUSIONS

- States should consider excluding from special sourcing treatment any partners that take an active role in the investment activities.

- The special souring rule for investment partnership income should not apply to partnerships that are invested in other non-investment partnerships or to the income which is derived from those non-investment partnerships. Without this limitation, investment partnerships might be used to simply shift the sourcing of other partnership income.

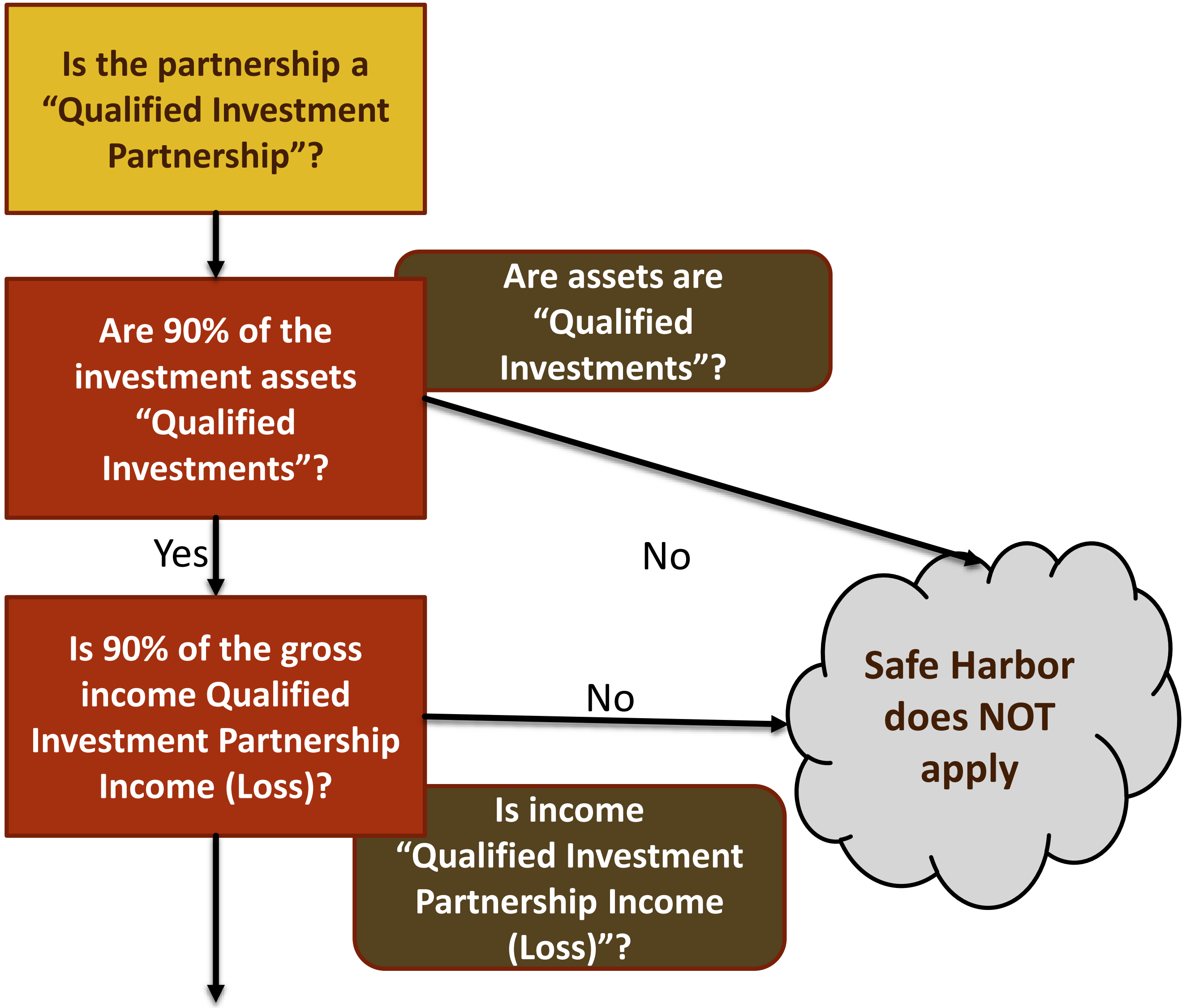
ESSENTIAL CRITERIA

- Nature of the Partnership ☑
- Nature of the Partner ☑
- Nature of the Investment Assets ☑
- Nature of the Investment Income ☑

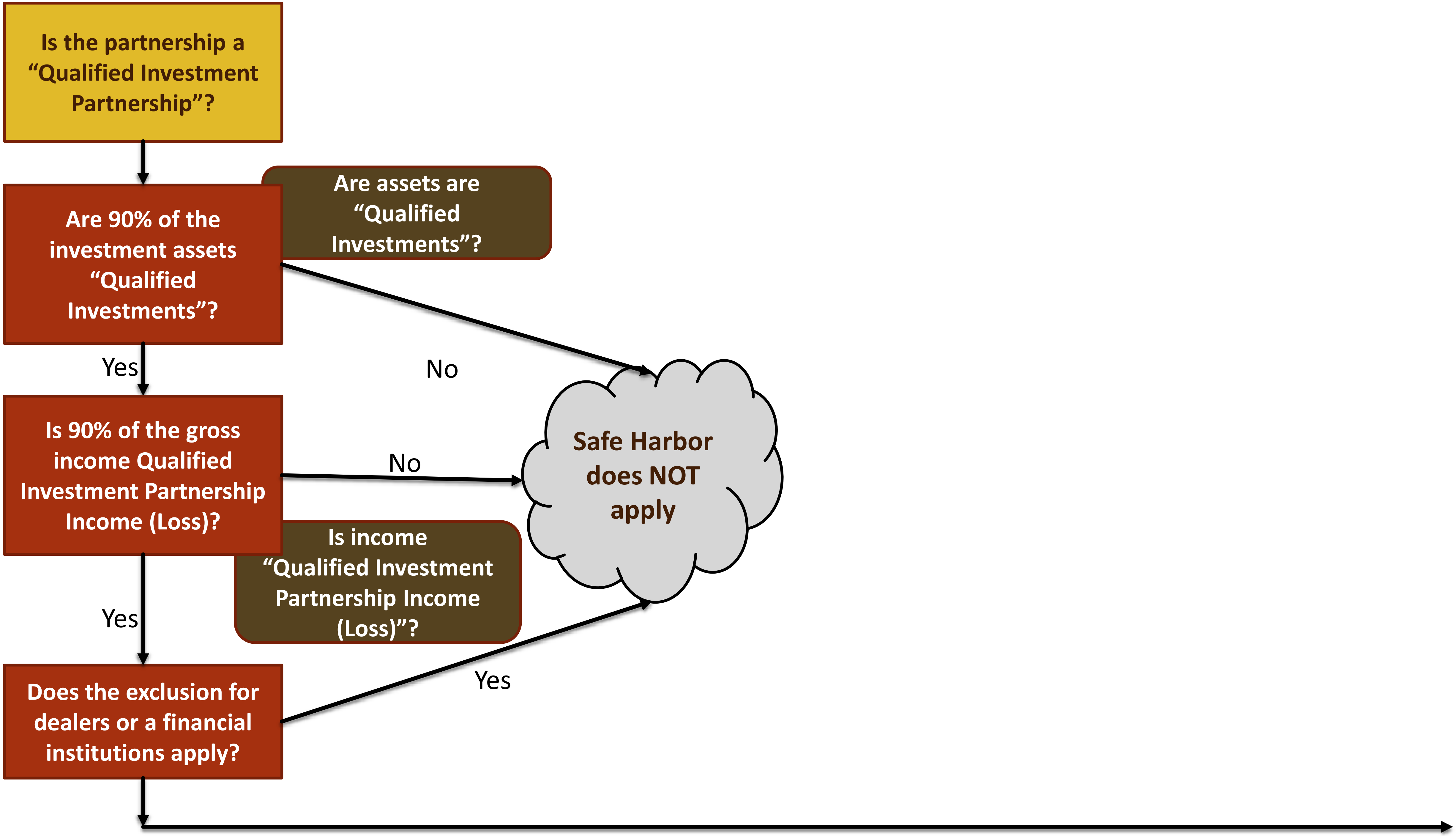
DRAFT MODEL – TREATMENT OF INVESTMENT PARTNERSHIPS

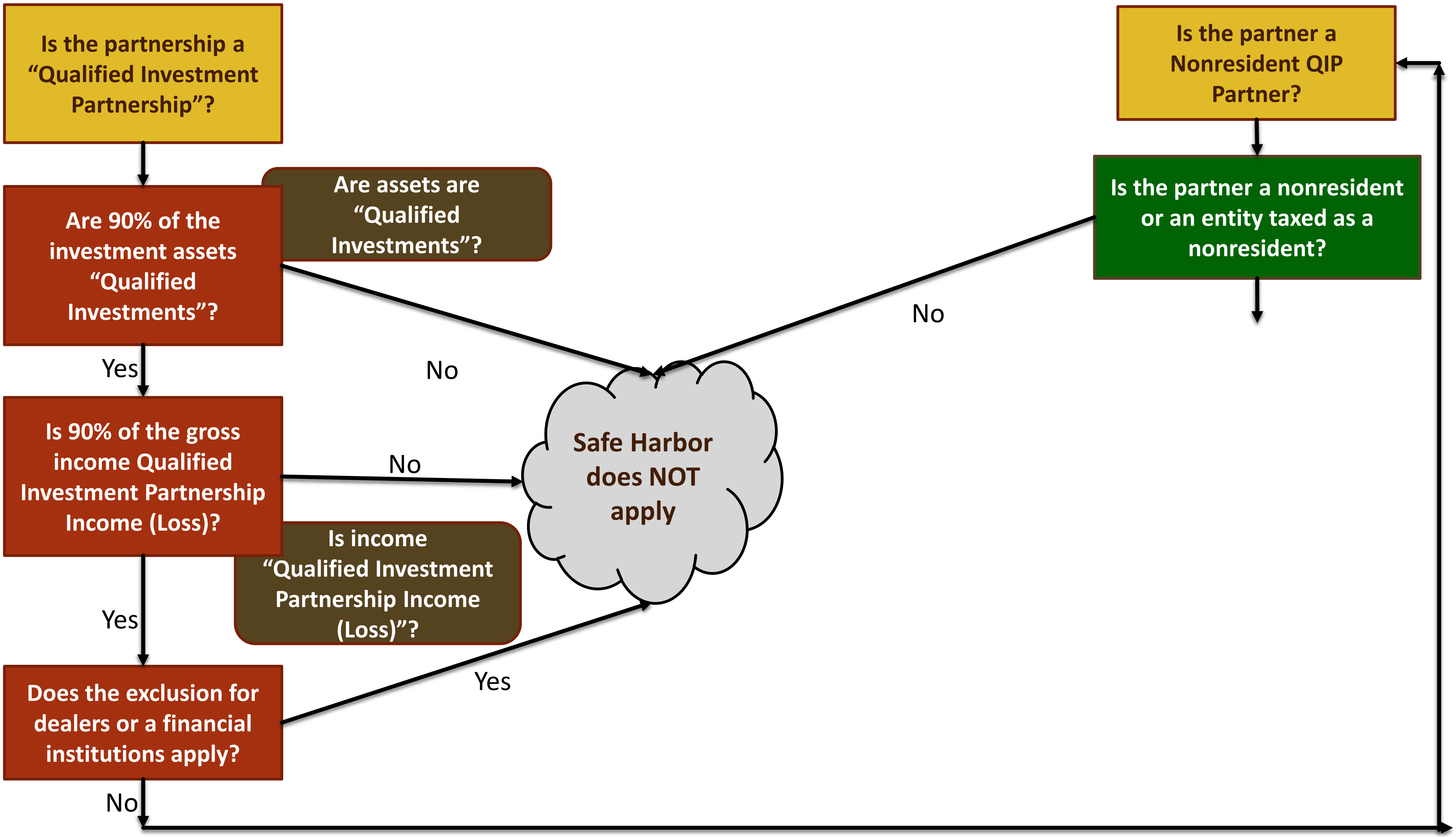
- Essentially works as a safe harbor sourcing rule—so that the residence of the qualifying partner is used, rather than the location of investment activities or the underlying investment assets.

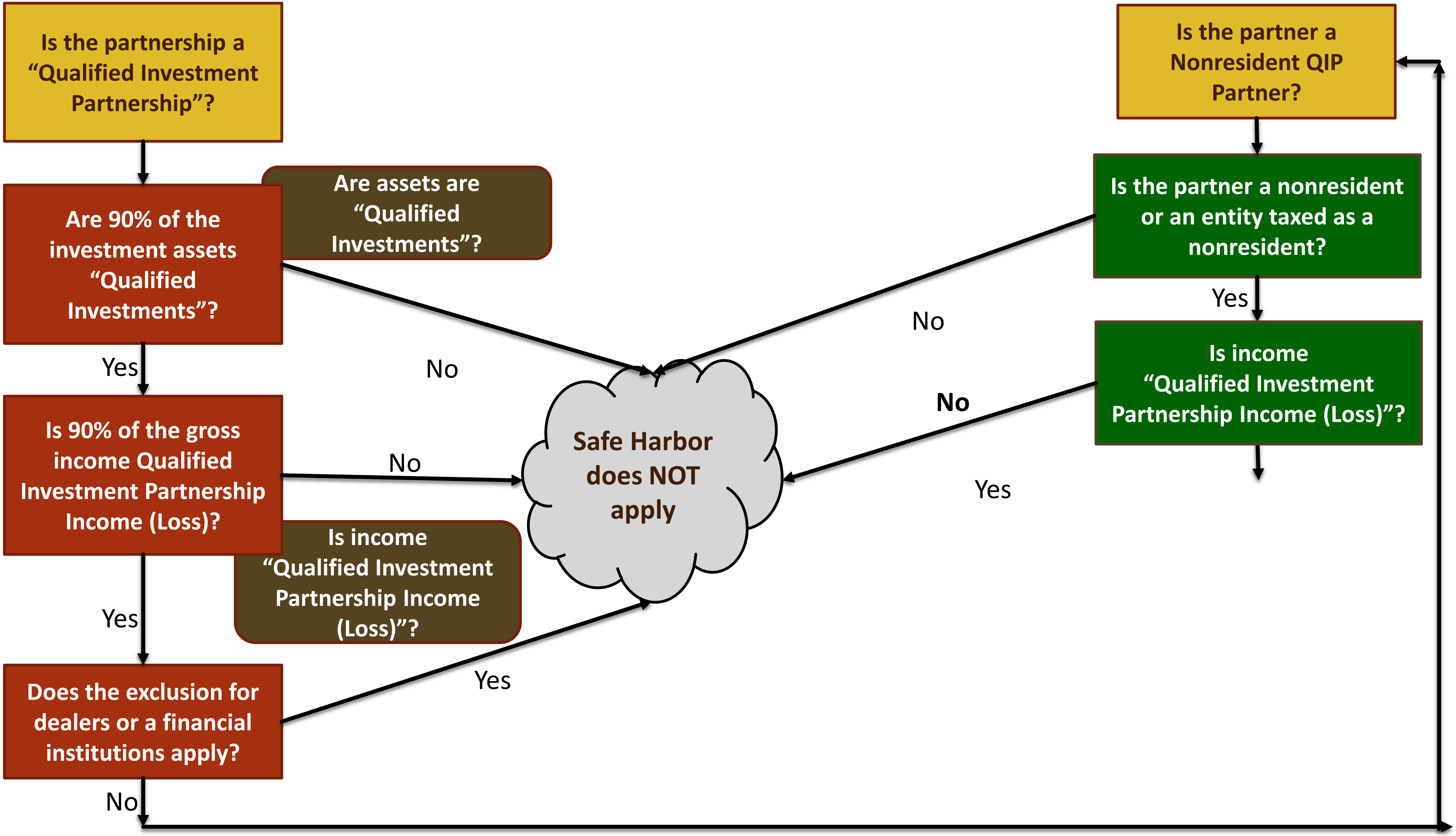
Is the partnership a “Qualified Investment Partnership”?

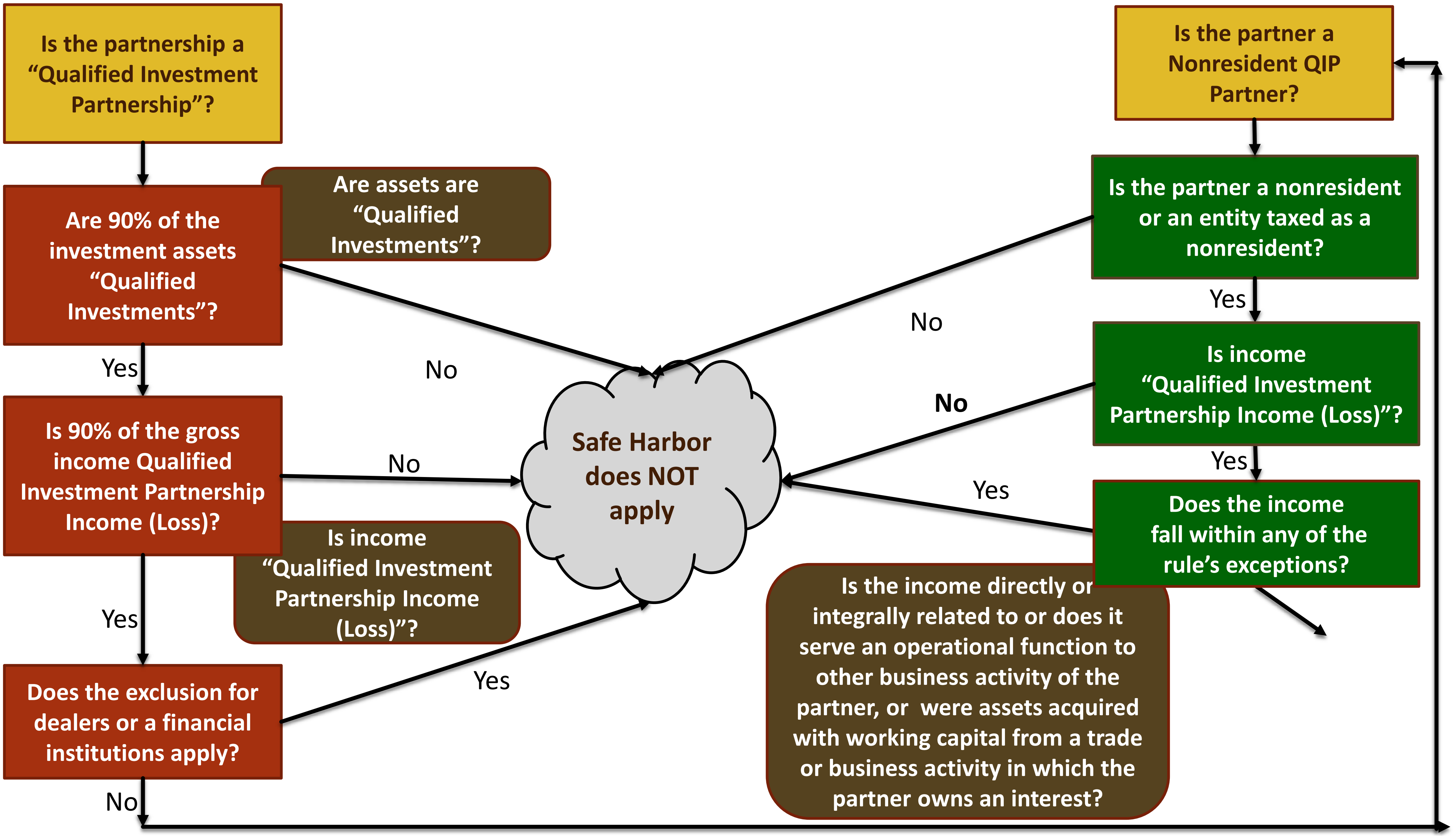


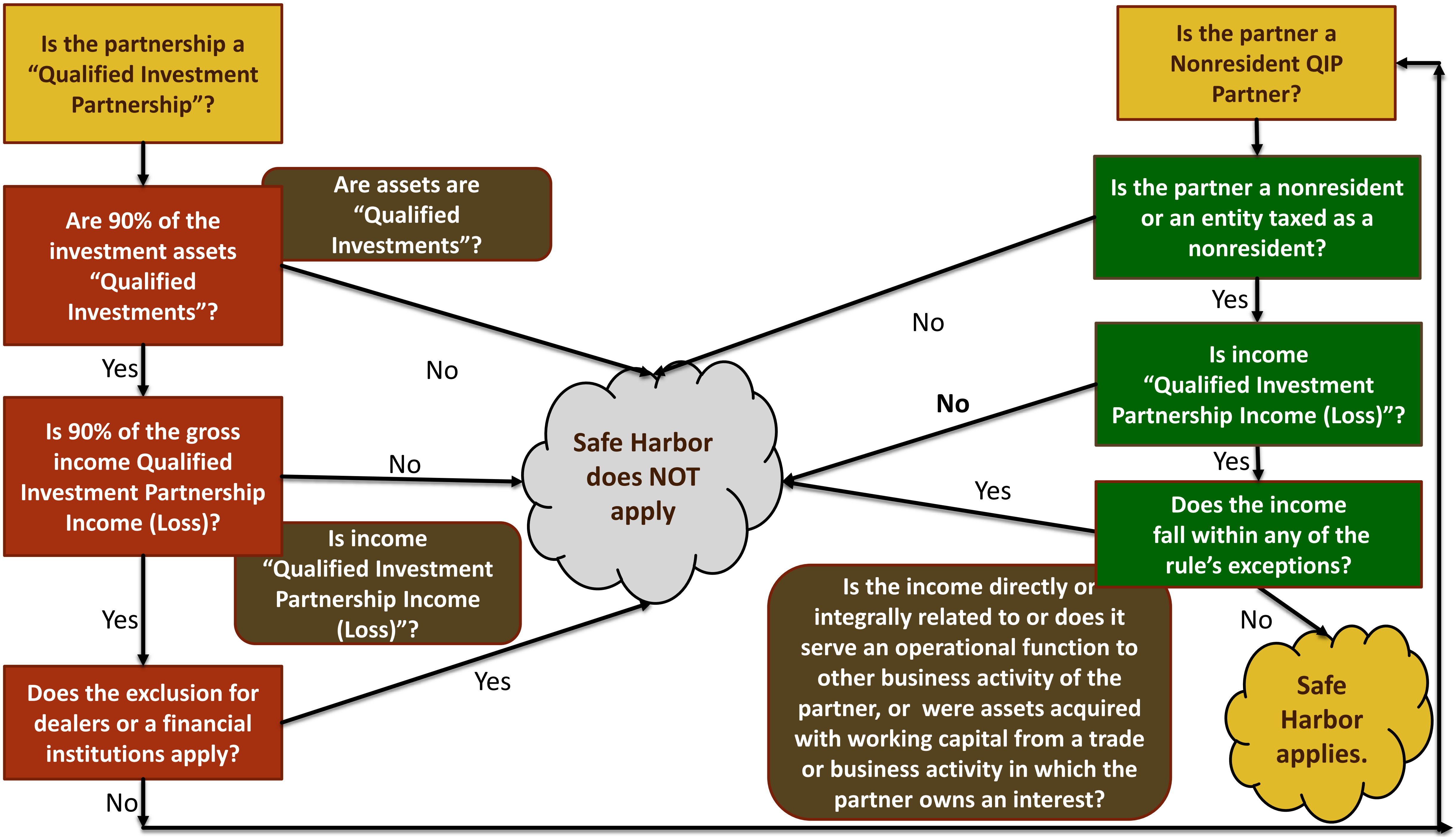
Is the partnership a "Qualified Investment Partnership"?
Are 90% of the investment assets "Qualified Investments"?
Are assets are "Qualified Investments"?
Yes
No
Is 90% of the gross income Qualified Investment Partnership Income (Loss)?
No
Is income "Qualified Investment Partnership Income (Loss)"?
Safe Harbor does NOT apply


Is the partnership a "Qualified Investment Partnership"?
Are 90% of the investment assets "Qualified Investments"?
Are assets are "Qualified Investments"?
Yes
No
Is 90% of the gross income Qualified Investment Partnership Income (Loss)?
No
Safe Harbor does NOT apply
Is income "Qualified Investment Partnership Income (Loss)"?
Yes
Yes
Does the exclusion for dealers or a financial institutions apply?


Is the partnership a “Qualified Investment Partnership”?
Are 90% of the investment assets “Qualified Investments”?
Are assets are “Qualified Investments”?
Yes
No
Is 90% of the gross income Qualified Investment Partnership Income (Loss)?
No
Is income “Qualified Investment Partnership Income (Loss)”?
Safe Harbor does NOT apply
Yes
Does the exclusion for dealers or a financial institutions apply?
Yes
No
Is the partner a Nonresident QIP Partner?
Is the partner a nonresident or an entity taxed as a nonresident?
No


Is the partnership a "Qualified Investment Partnership"?
Are 90% of the investment assets "Qualified Investments"?
Are assets are "Qualified Investments"?
Yes
No
Is 90% of the gross income Qualified Investment Partnership Income (Loss)?
No
Is income "Qualified Investment Partnership Income (Loss)"?
Yes
Does the exclusion for dealers or a financial institutions apply?
Yes
No
Safe Harbor does NOT apply
Is the partner a Nonresident QIP Partner?
Is the partner a nonresident or an entity taxed as a nonresident?
Yes
No
Is income "Qualified Investment Partnership Income (Loss)"?
No
Yes


Is the partnership a “Qualified Investment Partnership”?
Are 90% of the investment assets “Qualified Investments”?
Are assets are “Qualified Investments”?
Yes
No
Is 90% of the gross income Qualified Investment Partnership Income (Loss)?
No
Is income “Qualified Investment Partnership Income (Loss)”?
Yes
Does the exclusion for dealers or a financial institutions apply?
Yes
No
Safe Harbor does NOT apply
Is the partner a Nonresident QIP Partner?
Is the partner a nonresident or an entity taxed as a nonresident?
No
Yes
Is income “Qualified Investment Partnership Income (Loss)”?
No
Yes
Does the income fall within any of the rule’s exceptions?
Yes
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?


Is the partnership a "Qualified Investment Partnership"?
Are 90% of the investment assets "Qualified Investments"?
Are assets are "Qualified Investments"?
Yes
No
Is 90% of the gross income Qualified Investment Partnership Income (Loss)?
No
Is income "Qualified Investment Partnership Income (Loss)"?
Yes
Does the exclusion for dealers or a financial institutions apply?
Yes
No
Safe Harbor does NOT apply
Is the partner a Nonresident QIP Partner?
Is the partner a nonresident or an entity taxed as a nonresident?
No
Yes
Is income "Qualified Investment Partnership Income (Loss)"?
No
Yes
Does the income fall within any of the rule's exceptions?
Yes
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?
No
Safe Harbor applies.

DRAFT MODEL – PURPOSE SECTION

- The model contains a "Purpose" section,
- The purpose section was revised somewhat to reflect recent discussions and clarify the basis for the special treatment provided by the model.
- As this section has stated in the past, the model's purpose is to:
  - Create a safe harbor.
  - Not provide an exclusive or exhaustive list of sourcing rules for investment-related income.

SIGNIFICANT DRAFTING QUESTIONS

How to ensure that the model cannot be used to simply restructure a business that has operational investments and, by doing so, change the sourcing?

How to make sure the “interlocking parts” don’t contradict or overlap in a way that causes ambiguity.

How to structure the definition of “Qualified Investments” – whether a comprehensive list, a description, or something in between.

How to address administrative issues – certification, filing, withholding, PTE filing, etc.

STRUCTURING DEFINITION OF "QUALIFIED INVESTMENTS"

- Detailed listing
- General description – with examples
- Tie it to state treatment of investment income generally
- Tie it to federal treatment – IRC § 864 – with any exceptions

HOW TO ADDRESS ADMINISTRATIVE ISSUES

- Delegation to agency with specific instructions
- Divide issues and provide delegation only on some
- Provide detailed instructions for all administrative issues