



State Tax Treatment of Investment Partnerships

Proposed Draft Rule - Regulation Form

Revised Version

Prepared by MTC Staff for Discussion by the Partnership Work Group
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(Major revisions are highlighted in yellow.)

NOTE ON DRAFT OF RULE IN REGULATION FORM

The model rule for sourcing investment partnership income previously circulated was in a form that could be adopted as a statute. Subsequent discussions, however, indicate that the basis for the rule is well-enough established that it could be adopted as a regulation. Drafting the rule as a regulation has other advantages. The goal here is to provide greater certainty in certain fact-specific situations, which is what regulations are typically used for. States that currently have explicit statutory provisions could also adopt the rule in regulation form. And, unlike statutes, regulations may include examples, which would be very useful here.

BACKGROUND

This summary will assist the review of the model regulation, which follows below.

General Sourcing Issue:

How should income of partnerships engaging primarily in investment activities be sourced?

Work Group Process to Date:

So far, the MTC work group on the taxation of partnerships has:

- Conducted discussions on the issue – starting in January, 2022 and ongoing.
- Issued a draft white paper analyzing the treatment – published in May, 2022.
- Circulated a draft model rule (statutory form) – in August, 2022.
- Taken comments on model rule – summarized in April, 2023.

See information on the project website – here: <https://www.mtc.gov/uniformity/project-on-state-taxation-of-partnerships/>.

Important General Principles:

From discussions of the issue, there appears to be consensus as to the following general principles which should be considered in addressing the issue:

1. States conform to Subchapter K's conduit approach.	States generally conform to Subchapter K which provides that partnership activities determine the character of items of income, expense, gain, or loss (e.g. whether income is ordinary or capital, etc.), and this character attaches to the partner's distributive share of these items as well and affects the calculation of the partner's taxable income.
2. States do not apply the federal sourcing rules to partnership items in the interstate context.	While states conform to the conduit approach (general principle No. 1), the federal sourcing of partnership items, which is part of their federal character, does not affect the state sourcing of these items in the interstate context since those rules apply only to foreign taxpayers and states have adopted different sourcing rules.
3. States source direct nonbusiness investment income of nonresidents using specific rules based on the type of income or asset.	A nonresident who engages directly in investing activities that are not part of a business but have a connection to a state will determine the amount of income sourced to that state based on the state's specific sourcing rules, which typically look to the type of income (e.g., rents, dividends, interest, royalties, etc.) and/or the type of asset (e.g., real property, tangible property, intangible property, securities, commodities, etc.).
4. States generally source partnership income using an entity approach.	A nonresident's distributive share of partnership income is sourced to the state by applying allocation and apportionment rules at the partnership level, apportioning all items of business income, expense, gain, or loss connected to the partnership's unitary business, and allocating items of non-business income based on partnership activities. This sourcing approach applies regardless of whether the partner is active or passive, general or limited, or holds a majority or minority interest.

Application of Principles to the Issue:

Under general principle No. 4 above, income of investment partnerships might be sourced to where the partnership conducts its activities. But the states that have explicitly addressed the issue provide that, in certain circumstances, those activities do not affect the sourcing of the partnership's income. Instead, the income is sourced as if the partners had earned it directly. This is most appropriate when all of the following are true:

- The partner is a nonresident individual (or taxed as a nonresident individual).
- The partner does not engage in managing the investment partnership.
- The partner is not a dealer in investments.
- The investment partnership interest is not held as part of the business of the partner.
- The partnership is not unitary with any other business.

Under these circumstances, the income would, instead, be sourced applying general principle No. 3 above—based on the type of income or asset.

Other Notes on the Draft Rule in Regulation Form:

- **The regulation, like the prior draft, does not apply to all investment partnership income.**
While some states apply their sourcing rule to all income of a qualifying partnership, the prior draft and the draft regulation do not take this approach.
- **The general rule in Section 1 is restatement of the general principles above.**
The first section of the draft regulation is the general rule which follows the general principles discussed above.
- **“Qualified investment partnership” is defined generally.**
The definition of a qualified investment partnership reflects the application of the principles generally, so that the rule will apply to any partnership that meets these principles.
- **The safe harbor is formulated as a rebuttable presumption.**
Many of the comments received have been addressed to the definition of the qualifying investments a partnership may hold, formulated as a detailed list. Determining all investments that may qualify, however, exceeds the project's scope in that it requires an analysis of the sourcing of investment income when earned directly—so that the treatment will be consistent. Therefore, the draft in regulation form, below, uses a rebuttable presumption and includes a drafter's note that states may add investments.
- **Examples are used to illustrate application.**
As noted above, the advantage of formulating the rule as a regulation is the ability to use examples—which are included in the draft model.

DRAFT MODEL REGULATION:

When the Activities of an Investment Partnership in this State will not Affect the Sourcing of Distributive Share Income of Certain Nonresident Partners.

(a) General Rule.

Under the [reference to state’s individual income tax], a nonresident partner’s distributive share of partnership income is generally allocated and apportioned to this state at the partnership level based on the partnership’s business or other activities in this state. See [insert reference to applicable statutes and regulations, including UDITPA if applicable, and to IRC § 702]. But the investment related activities of a qualified investment partnership in this state do not affect how certain nonresident partners source their distributive share of that partnership’s investment income. Rather, the sourcing rules for nonresidents apply to the items of income making up the partner’s distributive share from the qualified investment partnership as though the partner earned (or incurred) the items directly. See [reference to applicable statutes and regulations governing sourcing of income for nonresidents].

(b) Applicability to Certain Nonresident Partners.

This rule, which provides that the investment related activities of a qualified investment partnership in this state will not affect the sourcing of distributive share income from that partnership, applies to the partners of the qualified investment partnership who are nonresident individuals [and trusts and/or estates, if applicable], and therefore pay tax on a source basis to the state, and who do not actively engage in the management of the qualified investment partnership, including recruiting investors, overseeing investments, performing administrative functions, and similar activities.

(c) “Qualified Investment Partnership.”

A qualified investment partnership, as used in this regulation, means a partnership that:

- (1) does not act as a dealer under 26 U.S.C. § 475(c);
- (2) does not act as a financial institution as defined by [reference to state law]; and
- (3) holds assets solely for investment purposes and:
 - (i) does not materially participate or otherwise actively engage in the activities of the businesses in which it holds interests;
 - (ii) is not unitary with a business in which it holds interests; and
 - (iii) does not use or employ assets in any way other than for investment.

[DRAFTER’S NOTE – The terms “materially participate” and “activities” are used under federal tax law to limit the ability to offset expenses/losses against income/gains in certain circumstances.]

(d) Safe Harbor.

A partnership will be presumed to be a qualified investment partnership if, during the tax period in which the income is recognized, no less than 90 percent of the cost of the partnership's total assets consists of the following:

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

(2) Bonds, debentures, and other debt securities such as certificates of deposit and collateralized securities available for sale or trade through public markets;

(3) 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;

(4) Corporate stock and bond index securities, future contracts, derivative securities, warrants or options on securities, and other similar financial securities and instruments available for sale or trade through public markets;

(5) Interests in partnerships or other pass-through entities but only if those partnerships or entities would meet the requirements of this safe harbor;

(6) Other similar or related financial or investments contracts, instruments, or securities; and

(7) Office facilities and other tangible and intangible personal property reasonably necessary to carry on its investment activities, including accounts receivable.

[DRAFTER's NOTE: The state may wish to include other types of investments in this safe harbor provision to the extent their inclusion would be consistent with state sourcing rules generally.]

The presumption provided here is intended to act as a safe harbor and does not limit the application of the general rule provided in Section (c) of this regulation. The presumption provided by this Section (d) can be rebutted if the [state tax agency] can show that the investment partnership lacks economic substance or was put into place to evade tax.

(e) Examples.

General Assumptions: In each of the examples below, assume Smith is a nonresident partner that holds an interest in Partnership X which has offices and activities in this state.

(1) Simple Example:

- Smith meets the criteria of Section (b) of this regulation.
- X meets the safe harbor of Section (d) of this regulation.
- X has dividends from corporate stock.

The activities of X in this state do not determine how Smith's distributive share of the dividends are sourced. Rather, under state statutes and regulations, such dividends from investment in corporate stock recognized by an individual would be sourced to the individual's state of residence. [Insert reference to statutes and regulations.] Therefore, Smith's distributive share of the dividend income of X is not sourced to this state.

(2) Partnership X Meets General Criteria but not Safe Harbor:

- Smith meets the criteria of Section (b) of this regulation.
- X does not meet the safe harbor of Section (d) of this regulation, but otherwise meets the definition of a qualified investment partnership under Section (c).
- X has dividends from corporate stock.

The fact that X is not presumed to be a qualified investment partnership does not prevent it from being treated as one. The activities of X in this state do not determine how Smith's distributive share of the dividends are sourced. Rather, under state statutes and regulations, such dividends from corporate stock recognized by an individual would be sourced to the individual's state of residence. [Insert reference to statutes and regulations.] Therefore, Smith's distributive share of the dividend income of X is not sourced to this state.

(3) Partnership X has Gain from Sale of Real Property in this State:

- Partner Smith owns an interest in Partnership X.
- Smith meets the criteria of Section (b) of this regulation.
- X does not meet the safe harbor of Section (d) of this regulation, but otherwise meets the definition of a qualified investment partnership under Section (c).
- X has a capital gain from the sale of real property in this state.

The fact that X is not presumed to be a qualified investment partnership does not prevent it from being treated as one. As such, the activities of X in this state do not determine how Smith's distributive share of the capital gain is sourced. Rather, under state statutes and regulations, such capital gains from real property in the state that are recognized by an individual would be sourced to this state. [Insert reference to statutes and regulations.] Therefore, Smith's distributive share of the capital gains is sourced to this state.

If X were found not to meet the definition of a qualified investment partnership under Section (c), then X's activities in the state might affect the sourcing of the gain from the sale of real property. If the gain were determined to be part of X's unitary business, then the gain would be apportioned as part of X's business income using [reference to state's apportionment rules applied to partnerships]. If the gain were

determined to be nonbusiness [or nonapportionable] income of X, then the gain would be allocated under [reference to state's rules for sourcing nonbusiness income].

(4) Partnership has in Distributive Share Income from Another Partnership:

- Smith meets the criteria of Section (b) of this regulation.
- X does not meet the safe harbor of Section (d) of this regulation, but otherwise meets the definition of a qualified investment partnership under Section (c).
- X has distributive share income from an interest in Partnership Y, doing business in this state.

The fact that X is not presumed to be a qualified investment partnership does not prevent it from being treated as one. The activities of X in this state do not determine how Smith's distributive share of the capital gain is sourced. Rather, under state statutes and regulations, such distributive share income recognized by an individual would be sourced to this state based on the activities of Partnership Y. [Insert reference to statutes and regulations.] Therefore, Smith's distributive share of the income of Partnership Y, flowing through Partnership X, is sourced to this state based on the activities of Partnership Y.

(5) Partnership X is a Qualified Investment Partnership but Smith is a Dealer:

- Smith meets the criteria of Section (b) of this regulation.
- X meets the safe harbor of Section (d) of this regulation.
- Smith acts as a dealer in investments and has customers in this state.

The activities of X in this state do not determine how Smith's distributive share of the dividends are sourced. Rather, under state statutes and regulations, Smith's investment in X would be considered part of the inventory of assets with respect to which Smith acts as a dealer. [Insert reference to statutes and regulations.] Therefore, Smith's distributive share from X is sourced to this state as part of the income of Smith's business as a dealer in this state.

(6) Smith Uses Investment in Partnership X in Another Business:

- Smith meets the criteria of Section (b) of this regulation.
- X meets the safe harbor of Section (d) of this regulation.
- Smith operates Business Y, a sole proprietorship, in this state.
- Under state statutes and regulations, Smith's investment in X would be considered part of the business income of Business Y. [Insert reference to statutes and regulations.]

The activities of X in this state do not determine how Smith's distributive share of the dividends are sourced. Rather, under state statutes and regulations, the distributive share from X would be sourced to this state as part of the income of Business Y.

(7) Smith Participates in the Management of the Qualified Investment Partnership:

- Smith is a minority partner but participates in the management of X and receives a carried interest (profits interest) for the services Smith performs.
- X has dividends from corporate stock.

Because Smith is engaging in the management of X, Smith's distributive share of income from X, including the share of dividends from corporate stock, is allocated and apportioned to this state based on the activities of X in this state.

(8) Smith Owns a Share of an S Corporation which Owns an Interest in Partnership X.

Because the partner in this case, the S corporation, does not meet the criteria of Section (b) of this regulation, this regulation does not apply. Instead sourcing rules under [reference to sourcing of S Corporation income] would apply.