



State Tax Treatment of Investment Partnerships

Multistate Tax Commission

2022

This white paper is a draft prepared by the staff of the Multistate Tax Commission (MTC) as part of its uniformity project on state taxation of partnerships, and is subject to revision.

This DRAFT version of the white paper is current as of May 20, 2022.

Sections with important substantive changes or additions are highlighted in green.

EXECUTIVE SUMMARY

The MTC Partnership Work Group

This white paper was prepared by the staff of the Multistate Tax Commission with the advice and assistance of a work group of member states established by the MTC uniformity committee. The work group was created to study how states might tax multistate income arising from partnerships in a more compatible and uniform manner—consistent with established state tax policies and the shared principles for dividing multistate income.

The Reason for the White Paper

The workgroup initially developed a comprehensive outline of issues in taxing partnership income that the states might need to address.¹ The development of that outline showed that specific rules for particular facts and circumstances were often lacking. But one area where there seemed to be specific rules in many states, and some consistency between those rules, was the treatment of partnerships engaged primarily in investment activity—and specifically, the sourcing of investment partnership income to the residence (and sometimes domicile) of limited partners. The workgroup decided to address this special sourcing treatment and produce a white paper evaluating the treatment.

Approach Taken in the White Paper

In order to evaluate the special sourcing treatment, Section I of the white paper first considers the state system for taxing partnership income generally. That system conforms to both the federal substantive tax rules, which often provide special treatment for investment income, and to Subchapter K of the Internal Revenue Code (IRC), which imposes tax on the partners rather than the entity. The state system also relies on established principles for dividing multistate income. The application of these principles will generally result in partnership income being attributed to states where the partnership has its activities and operations. And the system also includes important enforcement mechanisms, including withholding on non-resident partners. Where an investment partnership operates in multiple states or has income from investments in portfolio companies, it may be subject to both the general sourcing rules and to applicable special sourcing treatment.

After outlining the state tax system for taxing partnership income, Section II of the white paper then summarizes information and data to better describe the kinds of entities that might make up the broad category of investment partnerships. Investment partnerships are often thought to consist primarily of private equity and hedge funds, which are lightly regulated and typically formed as partnerships rather than as regulated investment companies. But a comparison of IRS data with that from other industry sources suggests that a significant portion of the partnerships designating themselves as being in the investment sector may be other types of entities, including closely-held partnerships or special purpose entities.

Next, in Section III, the white paper surveys the existing state rules for the special sourcing treatment of investment partnership income. While these rules uniformly source certain defined income to a partner's residence or domicile, they vary in other respects, including the definition of an investment partnership and limitations on application of the sourcing rule to various types of income and partners. A few states appear to have much more well-developed rules. It also appears the basis for, and policy behind, these rules may vary from state to state, which may affect their application.

Finally, in Section IV, the white paper evaluates the special sourcing treatment of investment partnership income and specific differences in that treatment from state to state. The white paper also outlines the various issues addressed by specific rules and analyzes the effectiveness of the rules—making particular findings and recommendations.

¹ Available on the project web page, here: <https://www.mtc.gov/Uniformity/Project-Teams/Partnership-Tax>.

Summary of Findings and Recommendations

States have developed a system for sourcing and taxing partnership income that generally sources the income based on the activities and operations of the entity, while it imposes the tax on the partners. This is consistent with both the federal tax system and the long-established state tax principles for dividing multistate income. The treatment of investment partnership income—sourcing that income to the residence or domicile of the partners— does not appear to be dictated by constitutional principles or limitations, at least not to the extent that this treatment has generally been applied.

Nevertheless, there are principled and policy reasons for the special treatment including establishing bright-line rules where limits may otherwise be difficult to discern, equitable treatment of investment income, and ease of administration and compliance. 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.

Based on the analysis set out more fully in Section IV, the white paper makes the following findings and recommendations: [NOTE – these recommendations, which changes highlighted, are taken from Section IV draft of May 5, 2022.]

- Regardless of how a state applies sourcing rules to investment partnership income, the state should explicitly address this issue to avoid uncertainty.
- 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.
- 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 and corporate partners regularly report other income subject to sourcing (including apportionment) under general state rules.
- States should consider excluding from special sourcing treatment any partners that take an active role in the investment activities.
- The special sourcing 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.
- Because of the general complexity in this area, states should consider including certain details in their rules to address common situations, including:
 - Defining and measuring of any assets for the application of an asset test,
 - Defining and measuring any income for the application of an income test,
 - Defining which partners are subject to the special treatment and that the treatment, if applied only to limited nonresident partners, is applied only to the extent those partners:
 - Are passive and have no role in the investment partnership's activities or the activities of any of the entities in which it might invest,
 - Have no past or current ownership or other relationship to the underlying portfolio companies or investments.
- State tax agencies should have clear authority to issue regulations and to use ad hoc methods to ensure that income sourcing is not being shifted in ways that are unintended.
- States should also address questions of how any investment income which may not qualify for special sourcing treatment will be sourced to help ensure that the line between sourcing treatment is clear and administrable.
- States should consider the application to their residents of credits for taxes paid to ensure a lack of uniformity does not create significant duplication of taxes or burdens.

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INTRODUCTION

Note: Unless otherwise indicated by the context—the term “investment partnership,” as used throughout this paper, refers to a partnership whose activities primarily involve investing, whether or not those partnerships would qualify as “investment partnerships” for particular state tax treatment.

When you imagine a partnership, you may picture a small local business or a professional firm. Such partnerships are numerous, but as a group, the income they generate is only a small fraction of the total income generated by all partnerships. The majority of partnership income is generated by entities whose primary activity, broadly speaking, is investment.

The system that states use to tax the income of partnerships, including investment partnerships, generally conforms to both the federal substantive tax rules and to the federal pass-through system—taxing current income to the partners. A number of federal tax rules distinguish certain types of investment income for particular treatment.

But the state system must also determine the source of multistate income. In general, states determine the source of partnership income based on the operations of the partnership. But many states source the income from certain qualifying investment partnerships to the partner’s residence, instead. This special state-sourcing treatment may take different forms—a specific exemption or exclusion for nonresidents, a special sourcing rule, or a determination that the non-resident partners are not “engaging in business” in the state.

While the form of this special sourcing treatment is important, deciding which types of partnerships to include in this special treatment is critical to achieving equity—both between ordinary and investment partnerships, and between investors who hold investments directly and those who hold investments through a partnership.

Moreover, state rules vary. Some states have no special rule for sourcing investment partnership income. Those that do, may apply the rules to a broader, or narrower, category of partnerships. And investment partnerships themselves differ—ranging from smaller, closely-held partnerships to those that are similar to regulated mutual funds—and everything in between. Also, a substantial amount of the income of these investment partnerships comes from holdings in “portfolio companies” which may be other partnerships, whose income, in turn, may be subject to different state sourcing rules where they operate.

In addition, it would be difficult, if not impossible, to overstate the complexity presented by investment partnerships which often involve dozens or hundreds of separate special-purpose entities and complicated profit-sharing agreements between partners, as well as complex financial deals involving years-long investment strategies and related transactions. At the federal level, this complexity has generally defied the ability of the Internal Revenue Service to ensure compliance through audits. At the state level, rules are often not well developed, nor does the simple absence of specific rules necessarily indicate that the general rules are otherwise applicable, or if so, how they apply.

To evaluate the special sourcing rules used by states for investment partnership income, this white paper begins with an overview of the state partnership tax system—including federal conformity, state sourcing generally, and enforcement mechanisms. The paper then describes the different types of partnerships that may engage in investment activities—their structure, management, and operations. Next, it surveys the state sourcing rules some states have adopted for investment partnership income, noting the differences. Then, finally, it evaluates this special sourcing treatment, the policies it may embody, and the implications of state variations.



SECTION I: THE STATE PARTNERSHIP TAX SYSTEM

Information in this section comes from multiple sources. In addition to sources cited, see the MTC's project page on state taxation of partnerships, here: <https://www.mtc.gov/Uniformity/Project-Teams/Partnership-Tax>

Purpose of this Section I

Section I provides an overview of the three main components of the state system for taxing partnership income, generally, noting differences in the treatment of investment partnerships, and the implications:

- A. Federal Conformity - substantive tax rules, including rules for investment income and entities, and the pass-through system
- B. State Sourcing Rules - methods for sourcing multistate income from partnerships
- C. Necessary Enforcement Mechanisms - mechanisms essential to making the system work
- D. General Implications for Investment Partnerships

I. A. Federal Conformity – Substantive Tax Rules and the Pass-through System

States generally conform to both the federal substantive tax rules found in the Internal Revenue Code (IRC) and to the federal pass-through system, found in IRC Subchapter K, used to tax partnerships.² This Section I. A. describes how the substantive rules and the pass-through system work together. Also, it briefly summarizes particular federal rules applying to certain investment partnerships.

Substantive Tax Rules - Generally

States generally conform to federal substantive rules for the tax treatment of various items of income, expense, gain, and loss from business and investment activities. Items may be exempt or taxable, deductible or amortizable, ordinary or capital, currently recognizable or deferred, etc.³ Examples of the substantive rules include the rules for determining:

- Gross Income - Including compensation, business income, gains, interest, rents, and the “distributive share of partnership gross income,” etc. See IRC § 61 as well as §§ 71-91.
- Exempt or Excluded Income - See IRC §§ 104-140.
- Itemized Deductions - Including ordinary and necessary business expenses (IRC § 162), taxes (IRC § 164), depreciation (IRC § 167), net operating loss deductions (IRC § 172), and others.
- Nondeductible Expenses - Including expenses that must be capitalized and depreciated or amortized. See IRC §§ 261-280H.
- Inventory Expenses - See IRC § 471-475.
- Capital Assets and Gains and Losses - See IRC §§ 1001-1298.

Pass-through Tax System - Generally

Subchapter K creates the system for passing through the partnership's items of income, expense, gain, and loss to the partners. Among other things, the rules provide:

- That items retain their character as they pass through. See IRC § 702.
- That partnerships have flexibility in allocating distributive shares of partnership items to the partners, provided those allocations have substantial economic effect. See IRC § 704.
- How transactions with partners and guaranteed payments are treated. See IRC § 707.
- General non-recognition treatment of contributions to the partnership. See IRC §§ 721-724.
- General non-recognition treatment of distributions from the partnership. See IRC §§ 731-737.
- Treatment of transfers of partnership interests. See IRC §§ 741-743.

² Exceptions are the District of Columbia, New Hampshire, Connecticut, and Texas, which impose entity-level taxes. But Texas also excludes “passive” entities that primarily engage in investment activities. See Tex. Tax Code §§ 171.0002-4.

³ States may make adjustments to certain federal items, e.g. depreciation expense or NOL deductions.

Federal Reporting System

Under the pass-through system created by Subchapter K, the partnership is responsible for reporting the items of income, expense, gain, and loss ("partnership items")⁴ from its activities, applying the federal substantive tax rules to those items. (See the Form 1065 partnership return, below.) But the partnership does not pay tax on the net income that may result from these tax items.

Form 1065 Department of the Treasury Internal Revenue Service		U.S. Return of Partnership Income For calendar year 2020, or tax year beginning _____, 2020, ending _____, 20____ ▶ Go to www.irs.gov/Form1065 for instructions and the latest information.		OMB No. 1545-0123 <div style="font-size: 24pt; font-weight: bold;">2020</div>
A Principal business activity	Name of partnership	D Employer identification number		
B Principal product or service	Type or Print	E Date business started		
C Business code number	Number, street, and room or suite no. If a P.O. box, see instructions. City or town, state or province, country, and ZIP [®] or foreign postal code	F Total assets (see instructions)		
		G Check applicable boxes: (1) <input type="checkbox"/> Initial return (2) <input type="checkbox"/> Final return (3) <input type="checkbox"/> Name change (4) <input type="checkbox"/> Address change (5) <input type="checkbox"/> Amended return		
		H Check accounting method: (1) <input type="checkbox"/> Cash (2) <input type="checkbox"/> Accrual (3) <input type="checkbox"/> Other (specify) ▶		
		I Number of Schedules K-1. Attach one for each person who was a partner at any time during the tax year ▶		
		J Check if Schedules C and M-3 are attached ▶ <input type="checkbox"/>		
		K Check if partnership: (1) <input type="checkbox"/> Aggregated activities for section 465 at-risk purposes (2) <input type="checkbox"/> Grouped activities for section 469 passive activity purposes		
Caution: Include only trade or business income and expenses on lines 1a through 22 below. See instructions for more information.				
Income	1a Gross receipts or sales	1a		
	b Returns and allowances	1b		
	c Balance. Subtract line 1b from line 1a		1c	
	2 Cost of goods sold (attach Form 1125-A)		2	
	3 Gross profit. Subtract line 2 from line 1c		3	
	4 Ordinary income (loss) from other partnerships, estates, and trusts (attach statement)		4	
	5 Net farm profit (loss) (attach Schedule F (Form 1040))		5	
	6 Net gain (loss) from Form 4797, Part II, line 17 (attach Form 4797)		6	
7 Other income (loss) (attach statement)		7		
8 Total income (loss). Combine lines 3 through 7		8		
Deductions <small>(see instructions for limitations)</small>	9 Salaries and wages (other than to partners) (less employment credits)		9	
	10 Guaranteed payments to partners		10	
	11 Repairs and maintenance		11	
	12 Bad debts		12	
	13 Rent		13	
	14 Taxes and licenses		14	
	15 Interest (see instructions)		15	
	16a Depreciation (if required, attach Form 4562)	16a		
	b Less depreciation reported on Form 1125-A and elsewhere on return	16b		
	16c Total depreciation. Add lines 16a and 16b		16c	
17 Depletion (Do not deduct oil and gas depletion.)		17		
18 Retirement plans, etc.		18		
19 Employee benefit programs		19		
20 Other deductions (attach statement)		20		
21 Total deductions. Add the amounts shown in the far right column for lines 9 through 20		21		
22 Ordinary business income (loss). Subtract line 21 from line 8		22		
Tax and Payment	23 Interest due under the look-back method—completed long-term contracts (attach Form 8697)		23	
	24 Interest due under the look-back method—income forecast method (attach Form 8866)		24	
	25 BBA AAR imputed underpayment (see instructions)		25	
	26 Other taxes (see instructions)		26	
	27 Total balance due. Add lines 23 through 26		27	
	28 Payment (see instructions)		28	
	29 Amount owed. If line 28 is smaller than line 27, enter amount owed		29	
	30 Overpayment. If line 28 is larger than line 27, enter overpayment		30	
<div style="display: flex; justify-content: space-between;"> <div style="width: 45%;"> Sign Here Under penalties of perjury, I declare that I have examined this return, including accompanying schedules and statements, and to the best of my knowledge and belief, it is true, correct, and complete. Declaration of preparer (other than partner or limited liability company member) is based on all information of which preparer has any knowledge. </div> <div style="width: 45%;"> <div style="border: 1px solid black; padding: 5px;"> May the IRS discuss this return with the preparer shown below? See instructions. <input type="checkbox"/> Yes <input type="checkbox"/> No </div> </div> </div> <div style="display: flex; justify-content: space-between; margin-top: 10px;"> <div style="width: 45%;"> Paid Preparer Use Only Print/Type preparer's name _____ Preparer's signature _____ Firm's name ▶ _____ Firm's address ▶ _____ </div> <div style="width: 45%;"> Date _____ Check <input type="checkbox"/> if self-employed Firm's EIN ▶ _____ Phone no. _____ </div> </div>				

For Paperwork Reduction Act Notice, see separate instructions. Cat. No. 113907 Form **1065** (2020)

⁴ A "tax item" or "item" is any element or group of elements that has a particular effect on the tax calculation—that is, whose character (e.g., ordinary versus capital, deductible versus depreciable, etc.) determines how it is treated for tax purposes. This paper often uses the term "partnership items" or "partnership tax items" rather than "partnership income" to describe what partnerships report and allocate to their partners. Not only is this technically correct, but it reflects that it is the items' character that effect how partners are taxed, as discussed further below. See IRC § 702.

Instead, after determining the proper tax treatment of the items resulting from its activities, the partnership “allocates” a “distributive share” of those items to each partner, according to the partnership agreement.⁵ The taxpaying partners must then include their share of the items in their own tax returns and use them in their calculation of the total taxable income on which tax is due.⁶ Partnerships must therefore provide their partners with detailed information so they can properly report their shares of the partnership items. (See the federal Schedule K-1, below.)

651121
OMB No. 1545-0123

2021

Schedule K-1
(Form 1065)
Department of the Treasury
Internal Revenue Service

For calendar year 2021, or tax year
beginning / / 2021 ending / /

Partner's Share of Income, Deductions, Credits, etc. ▶ See back of form and separate instructions.

Part I Information About the Partnership		Part III Partner's Share of Current Year Income, Deductions, Credits, and Other Items																									
A Partnership's employer identification number B Partnership's name, address, city, state, and ZIP code C IRS center where partnership filed return ▶ D <input type="checkbox"/> Check if this is a publicly traded partnership (PTP) Part II Information About the Partner E Partner's SSN or TIN (Do not use TIN of a disregarded entity. See instructions.) F Name, address, city, state, and ZIP code for partner entered in E. See instructions. G <input type="checkbox"/> General partner or LLC member-manager <input type="checkbox"/> Limited partner or other LLC member H1 <input type="checkbox"/> Domestic partner <input type="checkbox"/> Foreign partner H2 <input type="checkbox"/> If the partner is a disregarded entity (DE), enter the partner's: TIN <u> </u> Name <u> </u> I1 What type of entity is this partner? I2 If this partner is a retirement plan (IRA/SFP/Kooghs/etc.), check here ▶ <input type="checkbox"/> J Partner's share of profit, loss, and capital (see instructions): <table style="width: 100%; border-collapse: collapse;"> <thead> <tr> <th></th> <th style="text-align: center;">Beginning</th> <th style="text-align: center;">Ending</th> </tr> </thead> <tbody> <tr> <td>Profit</td> <td style="text-align: center;">%</td> <td style="text-align: center;">%</td> </tr> <tr> <td>Loss</td> <td style="text-align: center;">%</td> <td style="text-align: center;">%</td> </tr> <tr> <td>Capital</td> <td style="text-align: center;">%</td> <td style="text-align: center;">%</td> </tr> </tbody> </table> Check if decrease is due to sale or exchange of partnership interest ▶ <input type="checkbox"/> K Partner's share of liabilities: <table style="width: 100%; border-collapse: collapse;"> <thead> <tr> <th></th> <th style="text-align: center;">Beginning</th> <th style="text-align: center;">Ending</th> </tr> </thead> <tbody> <tr> <td>Nonrecourse</td> <td style="text-align: center;">\$</td> <td style="text-align: center;">\$</td> </tr> <tr> <td>Qualified nonrecourse financing</td> <td style="text-align: center;">\$</td> <td style="text-align: center;">\$</td> </tr> <tr> <td>Recourse</td> <td style="text-align: center;">\$</td> <td style="text-align: center;">\$</td> </tr> </tbody> </table> Check this box if Item K includes liability amounts from lower tier partnerships ▶ <input type="checkbox"/> L Partner's Capital Account Analysis Beginning capital account <u> </u> \$ Capital contributed during the year <u> </u> \$ Current year net income (loss) <u> </u> \$ Other increase (decrease) (attach explanation) <u> </u> \$ Withdrawals and distributions <u> </u> \$ (<u> </u>) Ending capital account <u> </u> \$ M Did the partner contribute property with a built-in gain (loss)? <input type="checkbox"/> Yes <input type="checkbox"/> No If "Yes," attach statement. See instructions. N Partner's Share of Net Unrecognized Section 704(c) Gain or (Loss) Beginning <u> </u> \$ Ending <u> </u> \$		Beginning	Ending	Profit	%	%	Loss	%	%	Capital	%	%		Beginning	Ending	Nonrecourse	\$	\$	Qualified nonrecourse financing	\$	\$	Recourse	\$	\$	<table style="width: 100%; border-collapse: collapse;"> <tr> <td style="width: 50%; vertical-align: top;"> 1 Ordinary business income (loss) 2 Net rental real estate income (loss) 3 Other net rental income (loss) 4a Guaranteed payments for services 4b Guaranteed payments for capital 4c Total guaranteed payments 5 Interest income 6a Ordinary dividends 6b Qualified dividends 6c Dividend equivalents 7 Royalties 8 Net short-term capital gain (loss) 9a Net long-term capital gain (loss) 9b Collectibles (28%) gain (loss) 9c Unrecaptured section 1250 gain 10 Net section 1231 gain (loss) 11 Other income (loss) 12 Section 179 deduction 13 Other deductions </td> <td style="width: 50%; vertical-align: top;"> 14 Self-employment earnings (loss) 15 Credits 16 Schedule K-3 is attached if checked <input type="checkbox"/> 17 Alternative minimum tax (AMT) items 18 Tax-exempt income and nondeductible expenses 19 Distributions 20 Other information 21 Foreign taxes paid or accrued 22 <input type="checkbox"/> More than one activity for at-risk purposes* 23 <input type="checkbox"/> More than one activity for passive activity purposes* *See attached statement for additional information. </td> </tr> </table> <div style="border: 1px solid black; height: 100px; width: 100%; margin-top: 5px;"> <div style="position: absolute; left: -20px; top: 50%; transform: translateY(-50%); white-space: nowrap;">For IRS Use Only</div> </div>	1 Ordinary business income (loss) 2 Net rental real estate income (loss) 3 Other net rental income (loss) 4a Guaranteed payments for services 4b Guaranteed payments for capital 4c Total guaranteed payments 5 Interest income 6a Ordinary dividends 6b Qualified dividends 6c Dividend equivalents 7 Royalties 8 Net short-term capital gain (loss) 9a Net long-term capital gain (loss) 9b Collectibles (28%) gain (loss) 9c Unrecaptured section 1250 gain 10 Net section 1231 gain (loss) 11 Other income (loss) 12 Section 179 deduction 13 Other deductions	14 Self-employment earnings (loss) 15 Credits 16 Schedule K-3 is attached if checked <input type="checkbox"/> 17 Alternative minimum tax (AMT) items 18 Tax-exempt income and nondeductible expenses 19 Distributions 20 Other information 21 Foreign taxes paid or accrued 22 <input type="checkbox"/> More than one activity for at-risk purposes* 23 <input type="checkbox"/> More than one activity for passive activity purposes* *See attached statement for additional information.
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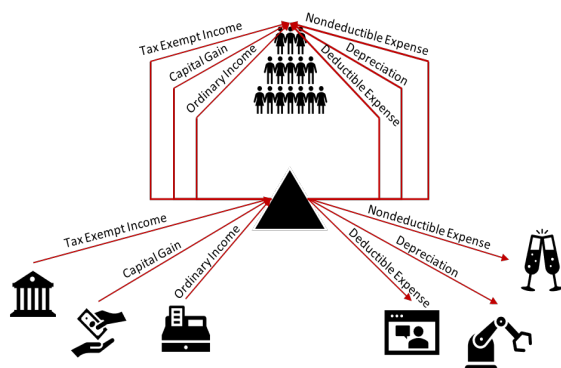
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⁵ As will be discussed further, this represents an important policy underlying the federal pass-through system—that the tax treatment should conform to the economic agreement between the partners, so long as the agreement has real economic substance and business purpose—referred to generally as substantial economic effect. See IRC § 704.

⁶ The terms “distributive share” and “allocate” as used in this white paper have the same meaning as in IRC § 704. Distributive share refers to the portion of partnership items allocated to the partners each year. Distributive share is *not* the same as a “distribution.” Partners will have distributive share of partnership items each year, whether or not they receive any actual distribution from the partnership. “Allocate” is used to describe the assignment of distributive share to the partners. See IRC § 704(b)(2). While “allocate” is often used in the state tax sourcing context as well, we will refrain from that use to avoid confusion.

Partnership Items Retain Their Substantive Character

There is a critical relationship between the federal substantive tax rules and the federal pass-through system. Once the character of partnership items is determined by application of the substantive tax rules at the partnership level, that characterization does not change as the items pass through to the taxpaying partners. This reflects a fundamental policy explicitly embodied in the federal system—that the partners' tax result should be the same as if they earned or incurred the partnership items directly. See IRC § 702. While the graphic below depicts the flow-through of items and their character in simple terms (where there is a single partnership), it also applies where there are multiple partnership tiers.



Moreover, unless the partner provides specific notice to the IRS, the treatment of partnership items on a partner's return must be consistent with the treatment of such items on the partnership return in all respects, including the amount, timing, and characterization of such items. Nor can partnerships take one position on the 1065 Return and a separate position on the items when reporting them to the partners on the Schedule K-1s. If a partner fails to satisfy the notice requirements for taking an inconsistent position, the IRS may summarily adjust the item and assess any tax. See IRC § 6222.

Types of Partners and Partner Attributes

Unlike S corporations, there are no federal tax limits on the number or type of persons who may be partners in the typical partnership.

- **Taxpaying (or Exempt) Partners** – Partners may be taxpaying persons—individuals, corporations, or taxable trusts. Or they may be tax-exempt entities, including pension funds and governments. And partners may be domestic or foreign individuals or entities.
- **Tiered Partners** – Partners may also be other partnerships.⁷ In that case, the “lower-tier” partnership’s items of income, expense, gain, and loss flow through any “upper-tier” partnerships until they are allocated to taxpaying or tax-exempt persons (sometimes referred to as “indirect” partners). Tiered partnership structures are common among investment partnerships.

The federal tax treatment of different partners—e.g., individuals, corporations, tax-exempt entities, foreign persons—will ultimately determine how partnership items are reported and taxed.

Effect of State Entity-Level Taxes on the Tax System and on Ultimate Tax Due

While states generally conform to the pass-through system, they have adopted different forms of entity-level taxes for enforcement purposes (i.e., withholding), taxpayer convenience (i.e., composite return elections), and to allow their residents to avoid the TCJA’s federal cap on the state and local tax deduction (so-called “PTE taxes”). These entity-level impositions vary.⁸ The effect of entity-level taxes on sourcing is discussed in Section I.B and their use for enforcement purposes is discussed in Section I.C below. Note, that even though investment partnerships subject to special sourcing treatment may also be excluded from some entity-level taxes, they may hold interests in portfolio companies which may not be excluded.

Entity-level taxes are often imposed only on the distributive share of partnership items allocated to certain partners. But entity-level taxes, even when imposed on total partnership income, can never match exactly the combined taxes owed by the partners on a pass-through basis—and in this sense—these entity-level taxes are disruptive to the functioning of that pass-through system as described above.

⁷ Partners may also be Subchapter S corporations or non-taxable trusts. This paper does not specifically address these other pass-through partners in any detail, but the basic sourcing issues presented by such partners are similar to those presented by partnership partners.

⁸ See, for example, Steven N.J. Wlodychak, “They’re All Different and That’s the Problem: State PTEs,” Tax Notes State, Vol. 101, p. 455, Aug. 2, 2021, available here: [https://www.mtc.gov/MTC/media/Partnership/Wlodychak-Article-on-PTE-Taxes-\(08-02-2021\).pdf](https://www.mtc.gov/MTC/media/Partnership/Wlodychak-Article-on-PTE-Taxes-(08-02-2021).pdf).

What determines the tax under the traditional pass-through system is the combination of the character of partnership items with the partners' own tax attributes. For example, a partner that has capital losses from other sources may receive a tax benefit from an allocation of the partnership's capital gains in a way that a partner with ordinary losses would not. Also, federal tax rates applicable to individual partners vary substantially based on total income, and the rates between individual and corporate partners also vary. At the federal level, progressive rates range from 10-37% for individuals, whereas corporate taxes are a flat 21%. At the state level, while states also have progressive rates, the range is much lower, usually less than 5 percentage points, and the difference between the effective rates for individuals and corporations also varies much less. But, of course, tax-exempt entities may pay no tax on their partnership items.

Specific Federal Provisions Relating to Investment Partnerships

Some federal substantive rules, as well as particular rules under Subchapter K, single out certain types of investment income or investment partnerships for particular treatment. While these federal rules do not dictate any particular state sourcing treatment, the rules may affect the ultimate calculation of the state tax base for investment partnerships. So, while a detailed discussion of these particular federal rules is beyond the scope of this white paper, the summary below may assist in evaluating the effects of state sourcing of investment income. The provisions covered here include:

- Beneficial federal treatment of capital gains and other investment income
- Loss limitation rules and their effect on income from investment partnerships
- Exceptions to the non-recognition rules for partnership contributions and distributions
- Flexible income sharing arrangements and treatment of carried interest
- Investment income versus unrelated business income and effect on some tax-exempt entities
- Effectively connected income and effect on foreign partners
- TCJA's limitation on the deduction of investment expenses
- Publicly traded partnerships
- Non-partnership investment entities

Note that there is no single federal definition of "investment income" or an "investment partnership." Different federal tax provisions are pinned to slightly different definitions or distinctions between investment and non-investment activities. Therefore, when considering the different treatment of an "investment partnership" under federal law, it is important to reference the specific definition used for that purpose.

Beneficial Federal Treatment of Capital Gains and Investment Income

Certain investment income, including capital gains from the sale of portfolio companies, maybe subject to beneficial federal tax treatment. This treatment typically includes either lower tax rates or exclusions or deferrals from tax. Examples include the following:

- The capital gains rate for individuals, which applies to capital gains and to other investment income, is lower than the rate imposed on ordinary income—often less than half the ordinary income tax rate. See IRC § 1(h).
- Certain gains from the sale of stock in certain small businesses may be partially or entirely excluded from tax if the stock was acquired after a particular date and held for a minimum period of years. This exclusion will also apply to persons who have gains from qualifying stock held through a partnership. See IRC § 1202.
- Gains arising in a so-called "like-kind" exchanges may be deferred, with few limits, if the proceeds from the sale is re-invested in similar property. If the property is held by a partnership, the entity must elect the deferral, which will then apply to all the partners. See IRC § 1031.
- The Tax Cuts and Jobs Act (TCJA) provided a tax benefit for those investing gains from appreciated assets into so-called "opportunity zones," designated by states. The gains are then deferred until the end of 2026. Investors may also get a basis step-up in their investment in the opportunity zone, or in the case of investments made for longer than 10 years, may be able to exclude any gains.⁹

⁹ See the IRS webpage on opportunity zone investments, here: <https://www.irs.gov/credits-deductions/businesses/opportunity-zones>.

This federal treatment of investment income can affect state taxation of the same income in various ways. Even beneficial federal tax rates, which are not binding on states, may tend to influence how partnerships are structured and how income is generated so as to obtain that beneficial federal treatment. In other words, the incentive to seek federal investment income status, as opposed to ordinary income status, may have effects on state taxes. An example is the sourcing of deferred gains from like-kind exchanges. States have sometimes grappled with how to source the deferred gains where the sale of property occurs in one state and the reinvestment in other property occurs in a separate state.

Loss Limitation Rules – Limited Effect on Income from Investment Partnerships

Partners may have deductions or losses from one partnership and income or gains from another. A number of important limitations may apply to offsetting these items.

- **Capital Gains & Losses** – Under IRC § 1211, partners cannot simply deduct capital losses against any income, but may use capital losses to offset capital gains, with any unused capital losses carried forward. (Individuals can generally deduct an additional \$3,000 against other income.)
- **Outside Basis** – In addition to the limitation on the use of capital losses, partners can only claim deductions for the expense/loss of ongoing partnerships to the extent of their “outside basis,” that is, their tax basis in their partnership interest. IRC § 705(a)(2). When a partnership is liquidated, or the partner sells the partnership interest, suspended losses may be deducted in full—to the extent of other federal limitations. IRC §§ 731 and 741.
- **At-Risk Loss Limits** – The ability to offset losses may also be limited by the at-risk loss rules of IRC § 465.¹⁰
- **Passive-Loss Limits** – Losses will also be limited if they are “passive” under IRC § 469.¹¹ These limits apply to partners taxed as individuals and closely-held C corporations. (See also the discussion of tax-exempt organizations below).

Most investment income takes the form of capital gain or loss—including sales of securities and sales of interests in partnerships. See IRC § 741. Therefore, the capital loss limitations will apply. However, the passive-loss limits will generally not apply to investment income—sometimes called “portfolio income.” See IRC § 469(e)(1)(A) and § 469(e)(3). Gains or losses from the sale of an interest in another partnership may also be considered portfolio (non-passive) items not subject to the at-risk and passive loss limitations.

States that conform to the federal substantive tax rules may also allow these items of income and loss to be offset, subject to the same general limits—but they would do so only to the extent that the offsetting income or loss are properly sourced to the state. The effects of sourcing income, gains, and losses for state purposes are discussed further in Section I.B. below.

Exceptions to the Non-Recognition Treatment of Contributions and Distributions

Under IRC § 721, contributions to a partnership are generally given non-recognition treatment, meaning that even when property with a built-in gain or loss is contributed in exchange for a partnership interest, there will be no gain or loss recognized by the partner or the partnership. But this non-recognition treatment does not apply to gains that would otherwise be realized on a transfer of property to a partnership which would be treated as an investment company under IRC § 351 if the partnership were incorporated. See IRC § 721(b). Note that the exception applies only to gains and not to losses.¹²

¹⁰ The at-risk rules of IRC § 465 apply broadly to activities that generate income and loss, including to partnerships. The first step in applying the at-risk rules is to determine what activities are considered related for purpose of computing the loss that might be subject to the at-risk limit. There is no limit in offsetting losses and deductions against the income or gains of that related activity. Any resulting loss, however, is limited in terms of being deducted against income from other activities to the extent of the partner’s at-risk investment, as determined under the applicable rules.

¹¹ Passive-loss rules of IRC § 469 provide that losses from passive activities cannot be used to offset income from other unrelated activities. Similar to the at-risk rules, the first step is to determine which activities are both passive and related in terms of calculating any net loss that may, then, be subject to the passive loss rules—limiting its offset against unrelated income. A passive activity is a trade or business in which the taxpayer (partner) does not materially participate. The partnership income of limited partners is typically treated as passive income or loss, with some exceptions.

¹² This exception is designed to prevent use of a partnership to engage in tax-free diversification of a taxpayer’s investments in certain cases, and is similar to an exception provided for transfers to corporations in exchange for stock.

Under IRC § 731, partnership distributions are generally given non-recognition treatment, with certain exceptions—the broadest of which is when the partner receives money in excess of the partner's outside basis (the tax basis in the partner's partnership interest). "Money," for this purpose, includes the fair market value of marketable securities. But there is an exception to the requirement to recognize gain where the distribution is marketable securities made by an investment partnership to an eligible partner.¹³

Flexible Income Sharing Arrangements and Treatment of Carried Interest

Subchapter K allows significant flexibility to partners in sharing partnership items, regardless of their share of the partnership capital. See IRC § 704(b). Nor do the reasons for such "special allocations" change the character of those items. There is a separate, but related, concept employed by investment partnerships. Such partnerships are typically managed by a managing partner or member ("manager"), often a firm that regularly engages in such activities. The manager may make a small capital contribution to the partnership. But the manager will also generally be granted a "carried interest" in the partnership, which is a type of profits interest that represents a right to a distributive share of the partnership's profits, rather than to any of the partnership's capital. Granting this profits interest is a non-recognition event—so the manager will not recognize income for the services that the manager provides. See Rev. Proc. 93-27.

The manager will also typically hire other firms to provide particular services for the investment partnership. The service firms may also receive a profits interest either separately or as part of an arrangement (generally a tiered partnership) with the manager. These carried interest or profits interests entitle the manager and other service partners to distributive share income of the investment partnership—which will consist almost entirely of items subject to beneficial capital gains treatment. The TCJA required managers who received a profits interest to hold that interest for three years in order to receive capital gains treatment.¹⁴ See IRC § 1061. **Also see the TCJA limitation on deduction of investment expenses, discussed below.**

Investment Income Versus Unrelated Business Income and Effect on Tax-Exempt Organizations

As will be discussed further in Section II, investment partnerships often have tax-exempt entities as partners (e.g. pension funds or foundations). When such entities receive unrelated business income from partnerships in which they are invested, they will owe tax. IRC § 512. Certain types of investment income, however, including gains and losses from the disposal of property not used in a business, is exempt from unrelated business income tax (UBIT). IRC § 512(b).

In addition, the TCJA made changes to the rules for how such income is treated—limiting the ability of tax-exempt entities to offset income and losses and to carry forward and use losses in subsequent years. IRC § 512(a). Those changes focused on income from partnerships using debt to finance certain investments. See IRC § 514. The IRS has subsequently issued guidance limiting the application of these provisions, allowing aggregation and offset of gains and losses from similar activities. See IRC § 512(c), IRS Notice 2018-67, and proposed regulations in Notice. 85 Fed. Reg. 23172 (Apr. 24, 2020).

The bottom line, however, is that a tax-exempt entity partner may have unrelated business income or loss from a partnership which is treated as if it were earned or incurred directly. There is generally no distinction made between limited or passive partners and general partners or managing members for this purpose. Also, tax-exempt entities must notify the partnership of their tax-exempt status. The partnership is then required to provide the organization this information on its Schedule K-1.¹⁵

Regulations provide that a partnership is an investment company if immediately after the receipt of property, more than 80% of the value of its assets are readily marketable stocks or securities held for investment purposes.

¹³ "Investment partnership" here means any partnership that has never been engaged in a trade or business and substantially all of the assets of which have always consisted of stock in a corporation, notes, bonds, or debentures, foreign currencies, derivatives, commodities traded on exchanges, and similar assets. A partnership will be deemed to have engaged in a trade or business if it conducts that business through another partnership. IRC § 731(c)(2)(C).

¹⁴ The profits interest may be held directly or indirectly through a tiered structure. IRS Reg. §1.1061-1(a).

¹⁵ See also IRS Publication 598, "Tax on Unrelated Business Income of Exempt Organizations," available here: <https://www.irs.gov/pub/irs-pdf/p598.pdf>.

Effectively Connected Income and Effect on Foreign Partners

Foreign persons may have U.S. source income, including income from U.S. partnerships. That income is generally divided into two categories – effectively connected income (ECI) and fixed, determinable, annual, or periodical income (FDAP). Both are subject to U.S. tax, but the treatment varies.

What may be especially important for our purposes is a change made in the TCJA which now clearly sources the gain (loss) from the sale of domestic partnership interests to the U.S. in certain circumstances. A direct or indirect foreign partner in a partnership engaged in (or is treated as engaged in) a trade or business in the U.S. will have effectively connected gain (loss) sourced to the U.S. when the interest in that partnership is sold. IRC § 864(c)(8). The amount subject to tax in the U.S. is limited to the gain (loss) that would have resulted had the partnership sold all of its assets at fair market value on the date the interest is sold.¹⁶

TCJA's limitation on the deduction of investment expenses

Prior to the TCJA, individuals could deduct certain miscellaneous expenses to the extent that they exceeded 2% of adjusted gross income. TCJA effectively disallowed this treatment for the tax years 2018-2025, so that such expenses are no longer deductible. Miscellaneous expenses include investment related service fees, but not interest. See IRC §§ 67(g) and 212 and related regulations. Disallowing these deductions effectively increases the amount of investment income subject to tax. Nor may individuals get around this limitation by forming a partnership to incur the expense. See IRC § 67(c).

Note that while a profits interest treated as a carried interest, discussed above, reduces the amounts available for allocation to limited partners in the same way that paying an expense would, it would not be treated as an expense of the partnership or the partners, but would instead be treated as a preferential allocation of profits. This is true even if the partners agree to this preferential allocation because of the services rendered to the partnership by the partner receiving this interest. However, if the partnership were to agree to pay these partners an amount not dependent on profits, under IRC § 707 the payment would be treated as an expense of the partnership, and this may affect the treatment by the limited partners, causing them to lose any tax benefit. For this reason, investment partnerships may modify their structures and operations to avoid the expense deduction limitation.

Publicly Traded Investment Partnerships

Ordinarily, publicly traded partnerships—that is entities formed as partnerships whose interests are traded on a public exchange—are taxed as corporations. However, certain publicly traded partnerships that engage primarily in investment activities may be taxed as partnerships. See IRC § 7704.

To qualify to be taxed as a partnership, a publicly traded partnership must have 90% of its income from certain sources—including interest, dividends, real property rents, gain from the sale of real property, income and gains derived from the exploration, development, mining or production, processing, refining, transportation, or the marketing of any mineral or natural resource, and income and gains from certain commodities. Publicly traded investment partnerships taxed as partnerships are subject to the substantive rules discussed in this section.

Non-Partnership Investment Entities

As discussed in Section II, investment partnerships are generally not regulated, although their managing partners may be. Certain regulated investment entities (e.g., mutual funds) are organized as corporations, not partnerships, and are subject to a hybrid form of pass-through taxation. See IRC § 851. As summarized in Section III below, some states have tied their definition of a qualifying investment partnership to the definition of a regulated investment company under § 851.

¹⁶ See also IRS Publication 519, “U.S. Tax Guide for Aliens,” available here. https://www.irs.gov/publications/p519#en_US_2021_publink100016946.

Effects of Federal Conformity on State Taxation

The federal system to which states conform creates complexities that states must deal with. Not only does the system include critical substantive rules that may lead to very different tax treatment of partnership items, it also splits the responsibility for tax reporting and tax payment between the partnership and its partners. Furthermore, it permits large, complex tiered partnership structures and flexible income sharing arrangements, in which partners share different partnership items in different proportions, called “special allocations”. These structures and arrangements may have valid business purposes, but they also provide opportunities for tax avoidance and abuse and can greatly multiply tax enforcement problems.¹⁷ These structures and arrangements are features of investment partnerships, as well, as this paper will outline in Section II.

Nor can states rely on the federal government for adequate enforcement. This same complexity has created problems even for the IRS. One of the most comprehensive studies of pass-through tax information is, “Business in the United States: Who Owns It and How Much Tax do They Pay?”, published in 2016 by the U.S. Treasury Department.¹⁸ That study used detailed federal tax return data from partnerships (including those engaged in investment activities) and partners to determine both the source of the income and the taxpayers that ultimately received it. But despite having access to detailed tax information, the study found this tracing was difficult, due in part to the complex partnership structures involved, noting (at page 3):

Partnership ownership is not only concentrated, but also opaque. First, twenty percent of partnership income is earned by partners that we have not been able to classify in administrative data. Second, following money through partnership structures—between the partnership generating the income and the ultimate owners taxed on that income—proves challenging as well. We develop an algorithm that recursively traces income through partnership structures to ultimate non-partnership owners and attempts to assign that income back to an originating partnership. This recursive algorithm reaches a fixed point before all partnership income has been successfully assigned: fifteen percent of income is in circular structures and cannot be uniquely linked to an originating partnership. Together, the union of income flowing (1) to unclassifiable partners and (2) through circular partnerships amounts to \$200 billion or thirty percent of income earned in the partnership sector overall.

And to quote the 2016 Study at pages 20-21:

After our recursive algorithm reaches a fixed point, there remain 22,417 ‘circular’ partnerships for which we cannot uniquely link all income to non-partnership owners. These [opaque] partnerships issue 9.6 million K-1s. To put this activity’s scale in perspective, our entire K-1 population file includes 25.5 million K-1s issued by 3.6 million partnerships. Thus, less than 1% of partnerships issue nearly 40% of K-1s. Some of these partnerships issue more than 100,000 K-1s.

So states that conform to the federal pass-through system also take on the burdens of this complexity.

But conformity to the federal pass-through system and substantive tax rules is only a part of the existing state partnership tax system. States must also develop rules for dividing the income of multistate partnerships and sourcing that income to particular states for tax purposes. State sourcing of partnership items is covered in Section I.B, below. And, while this sourcing process is somewhat more complicated for partnership income and items taxed on a pass-through basis, it is the principled application of the rules to tiered partnership structures, in particular, that states may struggle with—and this may also affect investment partnerships even when they are subject to simplified sourcing rules in states where they operate.

In response to the complexity of the pass-through system and problems it creates for verifying and tracking income, states have developed certain enforcement tools that have become an important component of the state partnership tax system. These tools may, in turn, have critical effects on the way partnership items are ultimately sourced and taxed, and will be described briefly in Section 1.C, below.

¹⁷ See Gregg D. Polsky and Emily Cauble, “The Problem of Abusive Related-Partner Allocations,” 16 Fla. Tax. Rev. 479 (2014), available at: https://digitalcommons.law.uga.edu/fac_artchop/1086.

¹⁸ Available on multiple public sites, including here: <https://www.mtc.gov/MTC/media/Partnership/NYU-2016-Business-in-US-Analysis-of-tax-paid.pdf>.

I. B. State Sourcing Rules

Multistate income must be divided or “sourced” for state tax purposes. General sourcing methods vary somewhat by state. Sourcing of partnership income may also depend on the type of partnership, the type of income, or the type of partner. This Section I.B. provides an overview of the generally applicable methods for sourcing partnership income, which will help in evaluating the special rules used by some states for sourcing income of certain investment partnerships, set out in Section III.

The following topics are covered in this Section I.B:

- Traditional sourcing treatment of investment income
- General state sourcing methods and principles
- Application to partnerships generally
- Sourcing methods applied in the case of individual, corporate, and tiered partners
- Special problems in applying state sourcing rules to partnership items
 - Difficulties in assigning receipts from investing for purposes of the receipts factor
 - Effect of tiered structures on the sourcing of income of qualified investment partnerships
 - Sourcing of special allocations and guaranteed payments
 - Sourcing of gains (losses) from sales of partnership interests
 - Effect of state sourcing of income, gains, and losses on allowable offsets
 - Effect of “blocker” corporations on state sourcing
 - Effect of entity-level taxes on state sourcing

Traditional Sourcing Treatment of Investment Income

States may tax nonresident individuals and out-of-state corporations on their income derived within the state.¹⁹ Traditionally, this has included income from active businesses in the state. But it has also included income from use or investment in property in the state, including intangibles.²⁰ Certain passive investment income, however, was often sourced to an individual investor’s state of residence—including dividends, capital gains, or interest arising from securities such as corporate ownership shares. Exceptions include taxes imposed on distributions or dividends made to corporate shareholders where the corporation is required to withhold or pay tax.²¹

As described in Section III below, a majority of states appear to have explicitly applied a similar distinction to sourcing of partnership income. In these states, partnership income that is from using property or from business activity in the state is sourced to the state using the generally applicable methods discussed further in this Section I. B. But partnership income that is primarily from passive investments is simply sourced to the partner’s state of residence or domicile—as it generally would be if similar investments were held directly by the partner.

To evaluate this special sourcing treatment of investment partnership income, which is set out in detail in Section III, it is first necessary to understand the general partnership sourcing rules to which this treatment is the exception. Also, even when the income of an investment partnership is subject to special sourcing treatment in states where that partnership operates, the partnership may hold investments in companies where the income from those investments would be sourced using the generally applicable rules discussed below.

¹⁹ *Wisconsin v. JC Penney Co.*, 311 US 435 (1940).

²⁰ See, for example, *New York ex rel. Whitney v. Graves*, 299 US 366 (1937). Also, under the Uniform Division of Income for Tax Purposes Act, FN 23 *infra*, income may be assigned to a state where intangible property is used—as in the case of patent and copyright royalties.

²¹ See, for example, *International Harvester Co. v. Wisconsin Dep’t of Tax’n*, 322 US 435 (1944).

General State Sourcing Methods & Principles

States use two main sourcing methods for multistate income—specific assignment and formulary apportionment.²² These methods have been most extensively developed for taxing multistate corporations at the entity level. Both methods have long been incorporated into the Uniform Division of Income for Tax Purposes Act (UDITPA),²³ on which most state sourcing rules are based.²⁴ Understanding the general methods, and the principles behind these methods, is especially important for sourcing partnership income since since—given the complexity of sourcing income taxed under the pass-through system—states may lack specific rules addressing every situation. So, the application of sourcing methods will often depend on the application of these general principles.

Specific Assignment

Specific assignment can be thought of as a traditional sourcing method—most commonly used at the international level, including by the federal government. See IRC §§ 861-865. Rules of specific assignment source individual items of income, expense, gain, and loss based on the specific characteristics and attributes of each item and the activity to which the item relates—e.g., sourcing rents to the location(s) where the property is located. Specific assignment may also be accomplished by use of discrete ratios.

Formulary Apportionment

Formulary apportionment, as the term is used in this white paper, refers to a specific method designed to apply not to discrete items of income, but as the means of sourcing a taxpayer's entire multistate net income (loss).²⁵ Formulary apportionment identifies certain elements or “factors” of a taxpayer's multistate activities and operations giving rise to this net income—typically total sales, property, and/or payroll—and then determines the ratio of those factors that are located in the taxing state. This general apportionment ratio is then multiplied times the taxpayer's total multistate net income to compute the amount of that income derived from the state.

Constitutional Limits on Use of Formulary Apportionment

Formulary apportionment is the primary sourcing method used by states. But constitutional principles impose certain limits on its use. In brief, items of income (or expense) that make up the apportionable base must have a sufficient connection to the taxpayer's operations and to the factors used to apportion that base.²⁶ This connection is generally referred to as a “unitary” connection. We refer to the items that lack this unitary connection as “non-apportionable.”²⁷ Non-apportionable items should be distinguished from those that may result from a separate business of a single taxpayer to which a separate formula and general apportionment ratio might be applied.²⁸ Non-apportionable items are generally sourced using rules of specific assignment, which, again, may include use of discrete ratios.²⁹

²² States sometimes use different terms for these methods.

²³ Available here: <https://www.uniformlaws.org/committees/community-home?CommunityKey=f2ef73d2-2e5b-488e-a525-51be29fbee47>. See also the MTC's recommended version of UDITPA, here: <https://www.mtc.gov/Uniformity/Article-IV>.

²⁴ The MTC has developed detailed regulations for its proposed version of UDITPA. See the Model General Allocation and Apportionment Regulations (hereafter, MTC model regulations) – available here: <https://www.mtc.gov/MTC/media/AUR/FINAL-APPROVED-2018-Proposed-Amendments-042020.pdf>.

²⁵ See *Underwood Typewriter Co. v. Chamberlain*, 254 U.S. 113 (1920), and *U.S. Steel Corp. v. Multistate Tax Comm'n*, 434 U.S. 452, 473 (1978).

²⁶ See *Allied-Signal, Inc. v. Director, Div. of Taxation*, 504 U.S. 768 (1992). MTC Model Regulations, *supra* FN 24, incorporate unitary principles. See Reg. IV.1.(b). pages 18-22.

²⁷ Those items that may, constitutionally, be sourced using formulary apportionment versus those items that may not are referred to using various terms including “operational” versus “investment,” and “business income” versus “non-business income.” The MTC's recommended version of UDITPA uses the terms “apportionable income” versus “non-apportionable income,” tying the definition of these terms directly to the constitutional standard.

²⁸ See MTC Model regulations, *supra* FN 24.

²⁹ See UDITPA, *supra* FN 23, Sec.s 4-8.

Sourcing Methods Applied to Partnerships - Generally

As discussed further below, since it is the partners who will ultimately report and pay tax on their shares of partnership items, they must obtain necessary sourcing information from the partnership. Also, the nature of the partner—whether individual, corporation, or tiered—may affect the sourcing of partnership income. Tiered partnership structures, in particular, present sourcing questions not fully addressed by state rules and can also affect the sourcing of the income and items of investment partnerships.

Partnership Information Reporting

For partnership items subject to the general sourcing methods discussed in this section, partnerships must provide partners with the necessary sourcing information. This information may take one of two forms, depending on particular state requirements and whether the partner is an individual, corporation, or tiered partner (and in some cases whether the partner is tax-exempt). The partnership may simply provide to partners the state-sourced amounts of the partners' shares of partnership items as determined at the partnership level. Alternatively, the partnership may provide information required to compute the state-sourced amounts of those shares. In addition to reporting this information to partners, states may require that partnerships also report this sourcing information as part of their partnership returns, including withholding information, discussed further in Section I. C below.

Sourcing for Individual Partners

An individual partner must file and pay tax on partnership items in states where the partnership operates and in the partner's state of residence, if different.

- Reporting in Nonresident States – In the states where the partnership operates but the partner is a nonresident, the individual partner will pay tax on the partner's share of the amounts of state-sourced partnership items,³⁰ whether sourced using formulary apportionment or rules of specific attribution, applying the partnership's sourcing information at the partnership level. (Taxable trusts are often treated as nonresident partners.)
- Reporting in Resident State – In the partner's state of residence, the individual partner typically reports tax on 100% of the partner's income regardless of the source. The partner may then take a credit for tax paid to other states on that same income, including partnership items, with certain limitations.³¹

Sourcing for Corporate Partners

Unlike individual partners, corporate partners generally do not report 100% of their multistate income to their state of domicile and take a credit—instead applying the general sourcing rules to that income in every state. But sourcing a corporate partner's share of partnership items is complicated by the fact that corporations, unlike individuals, have their own sourcing information, including apportionment factors. States must therefore decide whether to source items using the partnership's sourcing information, the corporate partner's information, or some combination. States may use alternative approaches in applying both the methods of formulary apportionment and specific assignment to corporate partners, as described below.

³⁰ States may also have partnership “withholding” requirements or elections for partnerships to pay tax for partners.

³¹ See *Comptroller of Treasury of Md. v. Wynne*, 575 U.S. 542 (2015). One common limit is that the credit cannot exceed the amount that would be due if the resident state's own tax rate were applied. Some states also limit the credit to the amount that would have been paid if the taxing state had used sourcing rules compatible with the resident state's own rules. But states might also simply apportion the business income of resident partners in the same way they do the income of nonresidents or corporations. See, for example, New Mexico's approach – N.M. Stat. Ann. § 7-2-11.

Formulary Apportionment – Alternatives:

The three basic alternatives for applying formulary apportionment to the partnership items of corporate partners include:

- Blended Apportionment – The corporate partner includes its share of apportionable partnership items in its apportionable net income. It then computes a blended apportionment ratio by including a similar share of partnership apportionment factors with its own factors in computing that ratio. This blended ratio is then applied to the total apportionable income. This appears to be the most commonly used approach.³²
- Corporate-Level Apportionment – The corporate partner simply includes its share of apportionable partnership items in its apportionable net income, but does not include any share of partnership factors in computing its apportionment ratio. This approach might be allowed where the corporate partner lacks the necessary partnership information.
- Partnership-Level Apportionment – The corporate partner’s partnership items are sourced using the partnership’s general apportionment ratio. This is similar to the approach used by nonresident individual partners (above). Sometimes referred to as “look-through” or “investee apportionment,” this method might be used where the corporation has no other income derived from the state, especially where the tax is administered through withholding at the partnership level. This approach may also be used as a rule of specific assignment. (See further discussion below.)

All things being equal, the actual amount of the corporate partner’s partnership items sourced to the state will vary depending on which of these methods is used.

Application of Specific Assignment – Alternatives:

Items earned or incurred by a partnership may be apportionable in the hands of the partnership, but non-apportionable in the hands of the corporate partner—that is, they may bear a sufficient connection to the partnership’s general apportionment factors, but not to the corporate partner’s factors. Alternatively, partnership items might also be non-apportionable in the hands of the partnership—so that it would not be proper to apply the partnership’s apportionment factors to source the items.

- Items Non-apportionable Only at Corporate Partner Level – As noted in the discussion of formulary apportionment alternatives above, an approach to sourcing partnership items that are considered non-apportionable in the hands of the corporate partner, but not the partnership, is to use partnership-level or “investee” apportionment (similar to the method used by nonresident individuals).
- Items Non-apportionable at Partnership Level – Items that bear no relationship to the partnership’s own apportionment factors might be sourced using rules of specific assignment applied at the partnership level. This state-sourcing information would pass through to the corporate partner and be used to source the partner’s share of that item. Or states may provide other alternatives.

Sourcing for Tiered Partners

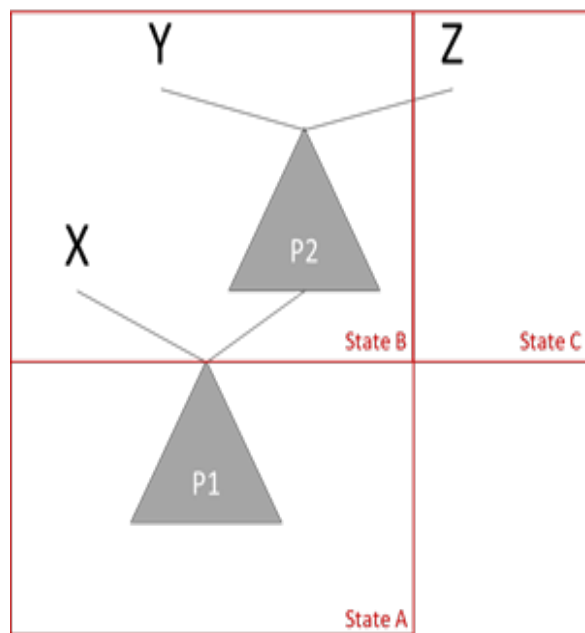
As with corporate partners, when partnerships have other partnership as partners, (“tiered partners”), this complicates the application of the general state sourcing methods, multiplying the number of potential alternative approaches that could be used. States sometimes lack specific rules indicating which approach to apply, and application of general principles to particular facts may not always point to the same approach. Take the very simple example below.

³² See the MTC’s models for combined corporate reporting, both of which take this approach. here: https://www.mtc.gov/uploadedFiles/Multistate_Tax_Commission/Uniformity/Uniformity_Projects/A_Z/Combined%20Reporting%20-%20FINAL%20version.pdf; and here: <https://www.mtc.gov/Uniformity/Project-Teams/Model-Statute-for-Combined-Filing-Finnigan-Adp.aspx>.

Example – Tiered Partnership Sourcing:

- P1 is a partnership operating a business entirely in State A (which imposes an income tax).
- Initially, P1 has two partners—X and Y both residents in State B (which has no income tax).
- X and Y recruit Z, a corporation doing business in State C, which has an income tax, to contribute to P1's business.
- Rather than having Z contribute to and receive an interest in P1, Y and Z form P2. Z contributes money to P2, and Y contributes his interest in P1 in exchange for his interest in P2.
- P2 has its operations entirely in State B.
- So P1 is owned by X and P2, and P2 is owned by Y and Z.

Assume P1 generates ordinary income of \$1 million. Shares of that income are allocated to its partners, X and P2. P2 then allocates shares of its income, including its share of P1 income, to partners, Y and Z.



How might Y's indirect share of the P1 income be sourced? There are at least three alternatives:

- Using an apportionment ratio including only P1's apportionment factors, applied to Y's indirect share of P1 income.
- Using an apportionment ratio including only P2's apportionment factors, applied to Y's share of total P2 income (including P2's share of P1 income).
- Using a blended apportionment ratio including P2's factors and a share of P1's factors, applied to Y's share of total P2 income including P2's share of P1 income.

And how might Z's indirect share of this income be sourced? Here, because Z is a corporation and has its own apportionment factors, there are at least six alternatives. First, there are the three general approaches described above (which would not involve the use of Z's own apportionment factors). But then there are three additional methods:

Z could include its share of P2 income (including P2's share of P1's income) in Z's apportionable income and apportion that total amount:

- Using Z's apportionment factors alone,
- Using Z's apportionment factors blended with a share of P2's, or
- Using Z's apportionment factors blended with a share of P2's and P1's.

How should general sourcing principles be applied when choosing between these approaches? We might need additional facts—such as whether P2 is essentially a holding company, whether P1's income otherwise has a unitary connection to P2's factors, or whether Z is a passive or active partner.

State rules may not clearly address the apportionment of partnership income flowing through tiered structures. If there is a general rule, however, it appears that it is to source partnership items using the information and factors of the partnership that generated those items, regardless of whether they pass through tiered partners before being allocated to individual nonresident partners. This rule might prevent inserting a tiered partnership partner, operating in a different state, simply to shift the sourcing of partnership income.

Special Problems in Applying State Sourcing Rules to Partnership Items

The general sourcing principles and methods described above do not fully address a number of issues that may arise in sourcing multistate partnership income. Some of these issues are commonly found in the context of investment partnerships. This section summarizes some of these problems—many of which had not been fully addressed by state rules.

Difficulties in Assigning Receipts from Investing for Purposes of the Receipts Factor

The states' general apportionment ratio is often entirely or significantly based on sales or receipts. Computation of the "receipts factor" for use in this ratio is therefore critical. This ratio requires rules allowing the assignment of receipts to particular states based on the character of the receipts and where they are deemed to be derived—e.g., the customer's location or where the use of some item occurs. Assignment of receipts from investment activities, such as dividends, interest, or capital gains, can be more difficult. Rather than looking to the location of a customer, or even the underlying assets, other criteria may need to be applied.

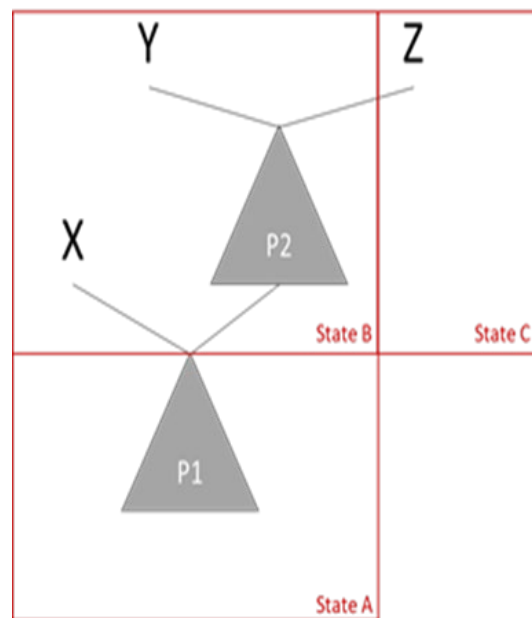
For example, in MTC's model Formula for the Apportionment and Allocation of Net Income of Financial Institutions, investment receipts are assigned "to a regular place of business" where the "day-to-day decisions regarding an investment asset or activity or trading asset or activity occur," and if more than one such place exists for a particular item of income then the receipts are assigned "where the investment or trading policies or guidelines with respect to the asset or activity are established." Furthermore, unless the taxpayer demonstrates to the contrary, such policies and guidelines shall be presumed to be established at the commercial domicile of the taxpayer.³³

Another example is found in the MTC's Model General Allocation & Apportionment Regulations, adopted in 2018. Under these model regulations, receipts from investments are often excluded from the receipts factor. One exception is where the taxpayer would otherwise have a *de minimis* receipts factor. In that case, Reg. IV. 18.(c) provides for the assignment of investment receipts for the purpose computing a receipts factor, including dividends from a related party (as defined by the state) and capital gains from a 20% or greater ownership share in another entity. Other receipts, including those from the holding, maturity, redemption, sale, exchange, or other disposition of marketable securities or cash, are assigned to a state consistent with the financial institutions apportionment model or to where the investments are managed.³⁴

Effect of Tiered Structures on the Sourcing of Income of Qualified Investment Partnerships

Questions as to how items should be sourced through tiered partnership structures are relevant even for investment partnerships that may qualify for special sourcing methods in some states. Investment partnerships, broadly defined, are often formed in tiered structures and may also hold investments in other partnerships or pass-through entities. These multi-tiered structure may also operate in multiple states. (See Section II, below.) This means that the special rules for sourcing the income of these investment partnerships applicable in one state may not apply to the investment partnership's operations or investments in other states. Take the example discussed above and make two modifications:

- Assume that State B has an income tax and a rule for investment partnerships allowing the income from those partnerships to be sourced solely to residence or domicile, and
- Also assume that P2, qualifies as an investment partnership under this rule.



³³ See the model, last updated in 2015, on the MTC website, here: <https://www.mtc.gov/MTC/media/AUR/Financial-Institutions-Apportionment-Rule-Amended-2015.pdf>.

³⁴ Supra, F.N. 24.

In this case, you might conclude Y's share of income from P2, including the income passing through from P1, would be sourced to State B, and Z's share would be sourced to State C. Of course, whether States A or C might tax the income from P1 would not necessarily depend on the rule in State B, but on the rules in States A and C. If State A were to require that the income of P1 be sourced to State A, including any shares allocated to indirect partners, then the fact that this income flows through P2 in State B would not change that determination.

Now assume State A also had a special sourcing rule for investment partnerships identical to State B's. Even then, depending on how that rule is drafted, State A might tax Y and Z's indirect shares of P1 income, since P1 is not an investment partnership. Similarly, if State C requires that corporations apportion all partnership items, like Z's share of income from P2 (including Z's share of P2's share of P1 income), using a blended apportionment factor, then presumably Z would use this method when filing and paying tax in State C, regardless of the special sourcing rule that might apply in States A or B.

In short, because partnerships engaged in investing often do so through tiered structures which invest in other partnerships, operated on a multistate basis, income flowing through such partnerships may not always be sourced to its partners' states of residency or domicile, even if that income would be subject to a special sourcing rule in the states where the investment partnership operates.

Sourcing of Special Allocations and Guaranteed Payments

State sourcing rules often appear to assume that a partner's distributive share will always match the partner's interest in the partnership. However, as noted in Section I. A. above, Subchapter K allows significant flexibility to partners in sharing partnership items, regardless of their share of the partnership capital. See IRC § 704(b). These so-called special allocations may apply differently to different items of partnership income, expense, gain, or loss—so that partners are allocated a greater or lesser share of certain items. Or they may represent preferential allocations of certain items. And partners may agree that, regardless of income, certain allocations will be made to partners for their role as partners. See IRC § 707(c). These so-called guaranteed payments may represent services performed by partners for or on behalf of the partnership.

So the question arises whether partnership apportionment factors, generally, would properly represent the source of special or preferential allocations of certain items, or of guaranteed payments.

Example:

- Assume, for example, that A and B form a partnership to invest in real property in States 1 and 2.
- A and B agree they will each primarily oversee certain properties.
- A and B also agree, therefore, that the partnership will make special allocations so that A will receive greater allocations of partnership items (income, expense, gain, and loss) related to the properties A oversees and B will receive greater allocations of partnership items related to properties B oversees.
- Now assume the properties A oversees are primarily in State 1 and the properties B oversees are primarily in State 2.

Should the partnership items allocated to A and B be apportioned using the partnerships overall apportionment factors—or should some other method of sourcing be used?

Where the activities and operations of a partnership are fully integrated, application of the partnership's general apportionment ratio, even to special allocations of partnership items, may make sense—rather than trying to source those individual items. However, in the case of investment partnerships, the individual holdings of the partnership may be entirely unrelated to each other.

Sourcing of Gains (Losses) from Sales of Partnership Interests

So far in this Section I. B, the discussion of state sourcing rules has focused on the tax items recognized by partnerships and passed through to partners. Partners may also recognize gains (losses) from the sale of their partnership interests. When a partnership interest is sold, the gain is not a partnership item of the partnership that is sold and doesn't pass through that partnership to its partner. Rather, the gain is recognized directly by the partners.³⁵

States have different general rules for sourcing gains from sales of partnership interests, which may depend on whether the ultimate taxpaying partner is a corporation or individual. As discussed further in Section II, investment partnerships (defined broadly) often hold interests in other partnerships and therefore may have significant gains from sales of those interests. Also, differences in state sourcing treatment of may affect sourcing of these gains for the partners of an investment partnership, even if that partnership otherwise qualifies for special sourcing in states where it operates.

Corporate and Individual Partners

In the past, disputes over sourcing of gains (losses) from sales of partnership interests focused on corporate partners and whether the gain was “business” or “nonbusiness” under UDITPA or similar rules.³⁶ If the gain was business income, it was included in the corporate partner's apportionable net income and apportioned using the corporate partner's factors, with or without including the gain in the receipts factor.³⁷ If it was nonbusiness income, it was typically sourced to the taxpayer's domicile under the rules of specific assignment in UDITPA Section 6(c), or similar rules.

What has been less clear is how states might source gains from the sale of partnership interests by nonresident individual partners. Most states appear to simply source such gains to the partner's state of residence. Individuals lack apportionment factors, so any apportionment of the gain would have to be based on the transferred partnership's own factors, or its assets. This approach, often called “investee apportionment,” is similar to the sourcing of partnership items by individuals in nonresident states discussed above. Today, about a dozen states use this investee apportionment method of sourcing, with some limitations but without any requirement that the gain be “business” or apportionable income.³⁸

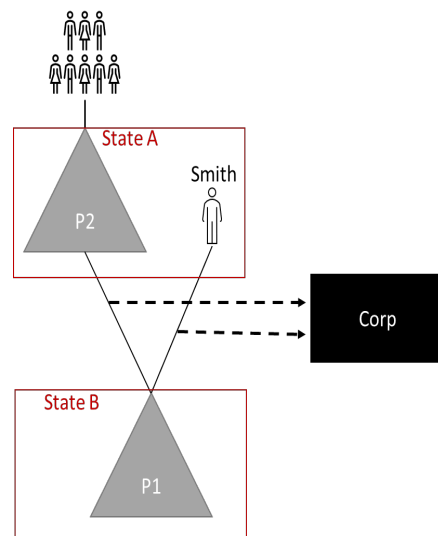
Tiered Partners – Including Investment Partnerships

What about partnership partners that sell a partnership interest? As noted, investment partnerships often invest in other partnerships and would have such gains. The following example illustrates the issue.

Example: P1, a partnership, operating entirely in State B has two partners—P2 (another partnership) and Smith. P2 and Smith each sell their interests in P1 to Corp for a gain.

Assume State B uses “investee apportionment,” requiring the gain to be sourced to that state based on P1's apportionment factors. Smith would report the gain in both State B and State A (residence), and claim a credit in State A for taxes paid to State B.

What about P2—how would its partners source the gain? Presumably, under State B's rule, P2's partners would also source their shares of P2's gain to State B. But State B, might instead treat P2 as a qualified



³⁵ Gains may also result from distributions in excess of the partner's outside basis. See IRS Reg. § 1.731-1.

³⁶ See, for example, *Ex parte Uniroyal Tire Co.*, 779 So. 2d 227 (Ala. 2000).

³⁷ See MTC model regulations, *supra* FN 24, Reg. IV.18.(c), which addresses this issue generally.

³⁸ Disputes involving this approach are ongoing and have focused on whether it is consistent with constitutional limits. See, for example, *Corrigan v. Testa*, 2016-Ohio-2805, 73 N.E.3d 381 (2016); *Noell Indus., Inc. v. Idaho Tax Comm'n*, 167 Idaho 367, 470 P.3d 1176 (2020); and *VAS Holdings & Investments, LLC v. Commissioner of Revenue*, Massachusetts Appellate Tax Board, Tax Appeal Decision, No. C332269 (2021). And see also Walter Hellerstein, “Substance and Form in Jurisdictional Analysis: *Corrigan v. Testa*,” Tax Notes State, Jun. 13, 2016, available here: [https://www.mtc.gov/MTC/media/Partnership/Hellerstein-\(June-13-2016\).pdf](https://www.mtc.gov/MTC/media/Partnership/Hellerstein-(June-13-2016).pdf).

investment partnership—sourcing its income, including the gain, to its partners’ residence/domicile. Note that this would depend on the definition of a qualified investment partnership that B uses. The fact that State A has an investment partnership rule would not necessarily affect how State B might source or tax the gain from the sale of P1.

And finally, as with any items of income—if the gain recognized by P2 here flowed through additional partnership tiers before reaching taxpaying partners, the methods for sourcing items through tiered structures, described briefly above, might alter the state(s) to which the gain is sourced.

Effect of State Sourcing of Income, Gains, and Losses on Allowable Offsets

As discussed in Section I. A above, taxpayers may generally offset income, gains, and losses from different sources within limits (and may carry forward unused losses). Like other forms of investment or portfolio income, the gains and losses generated from the sales of partnership interests, discussed above, may generally be offset as capital gains and losses (either long-term or short-term) in computing federal taxable income—not limited by passive loss rules. Corporate partners that include such gains and losses in their apportionable income would also offset those gains and losses against other capital gains and losses in computing their apportionable base. Similarly, individual partners filing in their state of residence would generally be able to offset investment gains and losses in computing the partner’s tax in that state. But for nonresident individual partners (or corporate partners treating certain gains and losses as non-apportionable income), the ability to offset gains and losses in computing income in a particular state would depend on the portions of the gains and losses sourced to that state.

So, for example, assume Partner A, an individual, has investment gains that would be sourced to State 1 and investment losses that would be sourced to State 2. Partner A would generally be able to offset these gains and losses when filing her federal return and filing in her state of residence. But when filing as a non-resident, A would not be able to offset losses sourced to State 2 against gains sourced to State 1.

Effect of “Blocker” Corporations on State Sourcing

As noted in Section I. A above, taxable “blocker” corporations may be used to prevent tax-exempt investors from having UBI on which they would owe tax and foreign investors from having to report and pay U.S. tax on ECI. Rather than the tax exempt entity or foreign individual investors holding interests in an investment partnership that, in turn, invests in other portfolio companies, those investors would hold shares in a taxable blocker corporation which, in turn, would hold the investment partnership interest. The corporation then pays the tax on items of income from the investment partnership—a separate cost that will ultimately affect the amount of profits available for distribution to the owners. But while there is an additional layer of tax, those corporate distributions will be treated as investment income to both the tax-exempt entity and foreign individual, effectively insulating those shareholders from the effects of any UBI or ECI that might be associated with the lower-tier or portfolio company. The blocker corporation would also shield the foreign investor from the need to report and pay tax on any gains from the sales of partnership interests in U.S. partnerships under IRC § 864.

Blocker corporations can also be used to simplify the state sourcing, reporting, and payment of tax on partnership income.³⁹ Use of such entities would potentially allow offsetting of income, gain, and loss that, for nonresident individuals, might be sourced to separate states and, therefore, not be subject to netting in calculating the taxes in those separate states. But it also appears that no states have specifically addressed the use of blocker corporations or how their use might otherwise affect sourcing of any underlying partnership income.

Effect of Entity-Level Taxes on State Sourcing

As noted in Section I. A above, states have adopted different forms of entity-level taxes for enforcement purposes (i.e. withholding), convenience (i.e. composite return elections), and to allow their residents to avoid the TCJA’s federal cap on the deduction for state and local taxes (so-called “PTE taxes”). Use of entity-level taxes for enforcement purposes is discussed further in Section I. C below. While investment

³⁹ See Carolyn Joy Lee, Bruce P. Ely, and Dennis Rimkunas, “State Taxation of Partnerships and LLCs and Their Members,” *Journal of Multistate Taxation and Incentives* (WG&L), Feb. 2010, available here: <https://www.bradley.com/-/media/files/insights/publications/2010/02/state-taxation-of-partnerships-and-llcs-and-their-members/-/files/reprint/fileattachment/state-taxation-of-partnerships-and-llcs-and-their-members.pdf>.

partnerships that are subject to special sourcing treatment in a state may also be excluded from entity-level taxes in that state, it may nevertheless be the case that the portfolio companies in which those partnerships are invested are operating partnerships and are not excluded from such taxes in the states where they operate.

In addition to affecting the computation of tax generally, entity-level taxes can also affect the sourcing of income subject to state tax. As summarized above, the application of state sourcing rules may depend on whether the partners to whom those items are allocated are resident or nonresident individuals or corporations, and whether the items pass through tiered partners. Entity-level tax cannot easily take into account the blended apportionment ratios that might be used where the partners are corporations or where the items flow through a tiered partnership structure to the ultimate taxpaying partners. So an entity-level tax may effectively change the sourcing.

Entity level taxes also raise questions as to whether individual partners can claim a credit for taxes paid in that partner's state of residence. States often impose general limits on such credits. But relevant for this purpose is the statutory language of many of these credit provisions, which make the credit available only to the resident "taxpayer" who properly "pays the tax" on his or her own income to another state.⁴⁰ Assuming the state's credit provision is internally consistent—that is, assuming it would give its residents a credit that represents the extent to which it would tax nonresidents on similar income—it need not give any additional credit. Nevertheless, failing to credit residents for entity-level taxes paid may ultimately undermine the general usefulness of these taxes, including for enforcement, on a multistate basis.

I.C. Necessary Enforcement Mechanisms

Discussions in Sections I. A. and B above make clear that combining the complex federal pass-through system with the general state sourcing rules creates not only complexity and uncertainty, but also potential compliance and enforcement problems. States have therefore incorporated essential enforcement mechanisms to address these problems. These mechanisms may also affect the tax due.

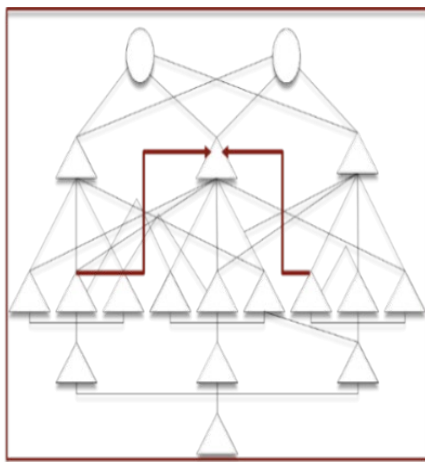
States that provide special sourcing treatment of investment partnership income sometimes exclude qualified investment partnerships from particular enforcement mechanisms. But it would be a mistake to assume that investment partnerships or their income will never be subject to these types of enforcement mechanisms. Indeed, even in states that have adopted special sourcing rules for investment partnership income, the partnership may still be subject to detailed information reporting requirements. Also, as discussed in Section I. B above, just because a partnership may qualify for special sourcing treatment in one state where it operates does not mean that it will qualify under the laws of every state in which it has offices or operations. Moreover, such partnerships may have holdings in other partnerships, and the income that flows up from those partnerships may be subject not only to the general state sourcing rules but also to any state-level enforcement mechanisms.

The topics covered in this section include:

- The role of federal enforcement mechanisms
 - Federal information reporting
 - Federal centralized partnership audit regime
 - Federal withholding on foreign partners
- The role of state enforcement mechanisms
 - State information reporting
 - State auditing
 - State entity-level impositions
 - Add-back statutes

⁴⁰ See *Individual Taxpayer (Redacted) v. Maine Revenue Services*, Docket No. BTA-2020-1 (Bd. Tax. App. Mar. 1, 2021).

Role of Federal Enforcement Mechanisms in State Enforcement



Because states conform generally to federal substantive rules and to the federal pass-through system, they depend upon the IRS to enforce the proper reporting of partnership tax items. It has become increasingly apparent, however, that the IRS has not had the tools necessary to deal with large, complex partnership structures or with the flexibility in income-sharing arrangements allowed by Subchapter K.

The diagram at right depicts a tiered partnership structure that also includes circular ownership relationships between the tiered partners (shown by the red lines). As was discussed in Section I. A above, such structures may make tracing income exceedingly difficult, even with properly filed information reports. (Of course, these complex structures pose compliance burdens for taxpayers too—but taxpayers presumably have more information and can control the complexity of the structures they create.)

Federal Information Reporting

To demonstrate compliance with federal substantive provisions and the requirements of Subchapter K, partnerships must increasingly use more detailed record-keeping and tracking methods, and must also comply with increased information-reporting requirements.⁴¹ The IRS is also reported to be developing enhanced tools to evaluate the information filed in order to identify potential problems.⁴²

Federal Centralized Partnership Audit Regime

Information-reporting, alone, is insufficient to ensure compliance. However, the IRS has been unable to conduct regular partnership audits of large partnerships. This led Congress to pass the federal Bipartisan Budget Act of 2015 giving the IRS substantial new authority to audit and assess taxes at the partnership level.⁴³ This centralized partnership audit regime shifts much of the burden of proving that the proper tax was paid by taxpaying partners to the partnership.⁴⁴ The IRS has only recently initiated audits under this program, so its potential effectiveness is still unknown.⁴⁵

Federal Withholding on Foreign Partners

Partnerships with effectively connected income in the U.S. must withhold tax on the share of that income allocable to foreign partners. A partnership determines if a partner is a foreign partner based on a certification of the partner. The tax rate is typically the highest federal rate. Publicly traded partnerships, in contrast, withhold tax on actual distributions of effectively connected income. And FDAP income is subject to a 30% withholding. Also, under IRC § 1446(f)(1), a transferee of an interest in a partnership must now withhold 10% of the amount paid for the purchase of a partnership interest subject to IRC § 864(c)(8). If the transferee fails to withhold, the partnership must deduct and withhold from distributions to the transferee the amount the transferee failed to withhold (plus interest).⁴⁶

⁴¹ See IRS tax basis capital account reporting requirement information in the IRS website, here: <https://www.irs.gov/newsroom/irs-releases-draft-form-1065-instructions-on-partner-tax-basis-capital-reporting>; and new reporting required for foreign income, here: <https://www.irs.gov/forms-pubs/changes-to-the-2021partnership-instructions-for-schedules-k-2-and-k-3-form-1065>.

⁴² See “The Case for a Robust Attack on the Tax Gap,” U.S. Treasury Dep’t, Sep. 7, 2021, available here: <https://home.treasury.gov/news/featured-stories/the-case-for-a-robust-attack-on-the-tax-gap>.

⁴³ See “Large Partnerships: With Growing Number of Partnerships, IRS Needs to Improve Audit Efficiency,” U.S. Government Accountability Office, GAO-14-732, Sep. 18, 2014, available here: <https://www.gao.gov/products/gao-14-732>.

⁴⁴ See the IRS BA Centralized Partnership Audit Regime webpage, here: <https://www.irs.gov/businesses/partnerships/bba-centralized-partnership-audit-regime>.

⁴⁵ See memorandum of Theodore D. Setzer, Re: Interim Guidance on Implementation of the Large Partnership Compliance Pilot Program, Oct. 21, 2021, available here: <https://www.irs.gov/pub/foia/ig/lmsb/lbi-04-1021-0017.pdf>.

⁴⁶ See information on these requirements on the IRS website, here: <https://www.irs.gov/individuals/international-taxpayers/partnership-withholding>.

State Enforcement Mechanisms

Even effective federal enforcement won't ensure that partnership income is properly sourced, nor will it guard against strategies aimed primarily at avoiding state, rather than federal taxes. States, therefore, must have their own enforcement tools. These tools are often focused on ensuring that nonresident partners, including indirect partners, accurately report partnership items properly sourced to the state. State enforcement mechanisms include: (1) information reporting, (2) auditing, (3) entity-level impositions (including partnership "withholding"⁴⁷), and (4) so-called "add-back" statutes. In addition to contributing to enforcement, entity-level taxes and add-back statutes may also effectively override the pass-through system or alter how the partnership income is sourced and taxed.

State Information Reporting

State information reporting requirements—including returns filed with the state and the reports required to be provided to partners—are fundamental to making the state pass-through system work and to ensuring that sourcing rules are properly applied. These information reporting requirements vary considerably state to state. States may provide general authority to the tax agency to establish detailed requirements for what information partnerships must file and provide to their partners.

Just as state rules for sourcing partnership income through tiered structures may be under-developed, similarly, state information reporting requirements for such income may not be sufficiently robust to allow states to ensure that the sourcing rules are properly applied and income is properly reported by tax-paying partners. Partners receive information reports only from the partnerships in which they are directly invested. Therefore, when there are tiered partnership structures, indirect taxpaying partners depend on the upper-tier partnership to properly report lower-tier partnership items, including any sourcing information related to those items. States also depend on the information reported and the records kept by these upper-tier partnerships to be able to verify proper treatment and sourcing of lower-tier partnership items.

State Auditing

As noted above, the pass-through system poses particular challenges for tax audits and eventually led to Congress granting additional powers to the IRS to audit large complex partnerships. For states the challenges are even greater, since these partnerships and partnership structures often operate in interstate commerce. But with only a few exceptions, states do not have a centralized partnership audit regime similar to the new IRS audit regime.⁴⁸ This, inevitably, puts pressure on other enforcement mechanisms.

State Entity-Level Impositions

Most states that tax partnership income provide for one or more entity-level taxes that may be imposed on that income including: withholding and estimated payments, composite return reporting, and so-called "PTE taxes."⁴⁹ These entity-level impositions have different purposes, including enforcement. An entity-level tax has the enforcement advantage of re-connecting the tax reporting and tax payment functions separated by the pass-through system. But as noted in Sections I.A and I.B above, entity-level taxes may also change, fundamentally, the how the tax is determined and may also change the sourcing of partnership income for state tax purposes.

Entity-level taxes used for enforcement purposes are generally applied to the partnership's net income amount—but only to the extent of the distributive shares of partnership items for partners subject to the imposition. And often only nonresident partners are included—so that the distributive shares of resident partners, corporate partners, or tiered partners are excluded from income subject to the entity-level tax. Exclusion of the distributive shares of tiered partners, in particular, limits the effectiveness of the entity-level tax as an enforcement tool. But including tiered partners may complicate the entity-level tax considerably—requiring a credit or offset so that tax is not withheld on the same income by multiple tiers.

⁴⁷ This tax is typically applied to net distributive share—which may or may not actually be distributed to partners.

⁴⁸ See Georgia's law allowing state audits of partnerships, GA L. 2018, Act 381 (HB 849) and Pennsylvania's long-standing partnership audit regime, 72 P.S. §7306.2.

⁴⁹ Entity-level taxes may also apply in the context of assessing state taxes on federal partnership audit adjustments under the new IRS centralized audit regime. See the MTC model approach, here: [https://www.mtc.gov/MTC/media/Uniformity/AUR/Proposed-Model-RAR-Statute-Technical-Corrections-\(FINAL\).pdf](https://www.mtc.gov/MTC/media/Uniformity/AUR/Proposed-Model-RAR-Statute-Technical-Corrections-(FINAL).pdf).

Depending on their purpose (enforcement, ease of compliance, etc.), an entity-level tax may be mandatory or elective. Most states make withholding mandatory for nonresidents, but many still allow partners to opt out if they file a written “consent” to being taxed on their partnership income and agreeing to file a state return. Similarly, states may allow the partnership to file a so-called composite return for partners who wish to be included in that return. PTE taxes—a type of composite return tax—have also become common in recent years for other reasons, but are almost always elective.⁵⁰

Entity-level taxes may be imposed as a substitute for the taxes owed by the taxpaying partners—effectively exempting the partners from filing and reporting tax on distributive share on which the entity-level tax has been paid. Alternatively, they may act as withholding, or a pre-payment of the partners’ own tax, providing an offset credit of the tax owed by the partners in that state.

States may weigh the trade-offs between enforcement and the creation of these additional issues and decide that entity-level taxes are, on balance, worth it. But entity-level taxes may also exacerbate the risks of income shifting between states, created by the existence of complex multi-tiered partnership structures and intercompany special allocations or transactions. A detailed explanation of this problem is beyond the scope of this white paper. Suffice it to say, one partial solution to this problem are add-back requirements.

State Add-Back Statutes

Partners may agree to special allocations of partnership items for a host of reasons—e.g., to compensate active partners for their roles or to give preferential returns of certain items to encourage investments. Partnerships may also engage in transactions with their partners, including tiered partners. Unlike special allocations, these transactions are not allocations of partnership items. Rather, they give rise to partnership items (income, expense, gain, or loss). See IRC § 707(a). So, for example, a partnership might purchase services from its tiered partner resulting in income to the tiered partner and an expense for the partnership. These intercompany allocations and transactions can lead to the same types of income-shifting between states that were prevalent in the state corporate income tax system, prior to combined filing.

These issues can affect state taxation of investment partnerships as well. Take a very simple example:

- Assume, that IP is a qualified investment partnership in the state where it operates, so that under that state’s sourcing rules—its income would be sourced entirely to the states where its partners reside or are domiciled.
- IP’s only investment is a 60% interest in OP, which is not an investment partnership, operating in State X.
- Assume State X would not consider IP to be an investment partnership due to IP’s holding of OP, and would source the income of OP that flows through IP to State X—requiring IP’s partners to file and pay tax in that state.
- Now assume, IP provides services to OP, for which it charges a fee, creating a deductible expense for OP. This reduces the taxable net income of OP subject to tax in State X and increases the income of IP that may be sourced to the states of residence of IP’s partners.

Note that in some states, the definition of a qualified investment partnership would limit the amount of income the partnership receives in fees for services.

But to address income shifting more generally, states have often adopted rules requiring the “add-back” of expense from certain intercompany transactions. Add-back statutes have typically been adopted by states that allow separate corporate filing and are, therefore, applied to related corporations. They might also be applied to related partnerships with certain modifications.⁵¹

⁵⁰ See a discussion of these PTE taxes in the Tax Notes-State article, “They’re All Different and That’s the Problem: State PTEs,” Steve N.J. Wlodychak, 2021, available here: [https://www.mtc.gov/MTC/media/Partnership/Wlodychak-Article-on-PTE-Taxes-\(08-02-2021\).pdf](https://www.mtc.gov/MTC/media/Partnership/Wlodychak-Article-on-PTE-Taxes-(08-02-2021).pdf).

⁵¹ See, for example, the MTC’s Model Statute Requiring the Add-back of Certain Intangible and Interest Expenses, which includes partnerships and certain individuals in its definition of related entities, available here: https://www.mtc.gov/uploadedFiles/Multistate_Tax_Commission/Uniformity/Uniformity_Projects/A_-_Z/Add-Back%20-%20FINAL%20version.pdf.

One important modification has to do with control. In corporate structures, control is generally indicated by direct or indirect ownership of a majority of voting shares. But control may differ from partnership to partnership. Because partnerships are governed by agreement of the partners and because state law, as well as tax law, allow flexibility in control structures, the rules for what is a “related partnership” would need to be flexible.

Section I.D. Implications of the State Partnership Tax System for Sourcing of Investment Partnership Income

Note that this section has been substantially revised.

The special rules for sourcing investment partnership income are surveyed and analyzed in Sections III and IV. But the state partnership tax system, as described in this Section I, has certain implications for the sourcing of investment income that are worth noting here. The different elements of the state partnership tax system—conformity to federal substantive tax rules, conformity to Subchapter K’s pass-through system, general state sourcing methods, and certain enforcement mechanisms including entity-level taxes—all interact. So, changes in one element—like a change in sourcing treatment—can have effects on the tax result that are difficult to predict.

Sourcing of Partnership Income May Alter the Effect of Substantive Rules

As discussed in this Section I, states generally conform to the federal substantive tax rules, with some exceptions. The federal rules often distinguish investment income, gains, expense, and loss and treat those items differently from other non-investment related items—often more beneficially. But even if a state otherwise conforms to these federal rules, the choice in how to source partnership income and items may alter the effects these rules have on the determination of state taxes owed.

For example, assume two partnerships engaging in investment activities—one in State A and the other in State B. The partnership in State A has investment-related gains, the partnership in State B has investment-related losses. Now assume a partner owns limited interests in both partnerships so that the amounts of that partner’s share of the gains and losses are equal. Also assume the federal substantive rules allow the partner’s gains and losses to be fully offset.

Whether the gains and losses will be offset in determining the state taxes owed, however, will depend on whether the partner is a corporation or an individual and what method of sourcing is used. A corporate partner may simply include the gains and losses in the apportionable income, offsetting them, and therefore effectively paying no state tax on the gains. But while an individual partner might offset gains and losses when filing a resident return, she would not be able to do so when filing as a non-resident in State A, assuming State A applies the general sourcing methods for partnership income. And since she would owe no tax in her state of residence, she would also not benefit from a credit for tax paid to State A. But if State A, instead, sources this type of investment income to the partner’s residence, then the individual partner would not owe tax on the separate gains in State A.

Sourcing may affect Whether Partnership Income is Taxed as if Earned Directly

States also generally conform to the federal pass-through system. An overarching principle of this system is that items once characterized at the partnership level retain their tax characteristics as they flow through to the partners, so that a partner’s tax liability will be the same as if the partner had engaged in the related activities directly. This also has implications for sourcing.

Corporate partners will apply general principles and methods to sourcing partnership items, depending on whether those items are apportionable or non-apportionable, so that the treatment will generally be the same as if the items were earned or incurred directly. If apportionable, the partnership items will be included in the base to which the general apportionment ratio is applied and often a share of the partnership’s factors will also be included in calculating that ratio. If non-apportionable, the partnership items will be sourced by the corporation applying the rules of specific assignment, in much the same way as if those items were earned or incurred directly.

But as this Section I has described, because individuals do not have apportionment factors in the same way businesses do, states generally source partnership items allocated to individual partners using only the information related to partnership's activities. In most cases, this is also how states would source the same items if earned directly by the partner—as in the case of a sole-proprietorship. But traditionally, states have sourced certain passive investment income that is earned directly by individuals entirely to their state of residence. So, where the partner is an individual, it may be more consistent with the principle of taxing partnership income as if it were earned directly to use the special sourcing treatment applied to investment income by some states. But even this will be true only to the extent the income is of a kind that would be sourced to residence. For example, income from investment in real property, if earned directly, would generally be sourced to where the real property is located, and so that same income earned through a partnership should also be source to the location of the real property.

Sourcing has Other Important Uniformity and Functionality Implications

As this Section I no doubt reflects, the state system for taxing partnership income—relying as it does on the federal pass-through approach and attempting to apply traditional state sourcing methods—is extremely complex. To the extent state rules are uniform or compatible, the inherent overall complexity and related costs for tax compliance and administration are reduced. In turn, greater uniformity is also likely to increase voluntary compliance and make tax enforcement easier, including cooperation between states.

Although in comparison to the general methods for sourcing partnership income, the special sourcing treatment for income of investment partnership income is simpler—that is, sourcing the income to the partner's state of residence—still, differences in the application of this treatment from state to state can increase complexity. This is especially true since many investment partnerships have investments in other entities, including partnerships, operating in interstate commerce. Lack of uniformity has effects on states as well as taxpayers. As noted throughout this paper, partnership structures can be extremely complex, with dozens or even hundreds of tiered partnerships, circular ownership structures, and special allocations or intercompany transactions. And as noted in the discussion of state enforcement mechanisms, above, the information reports that a tax-paying partner may receive come only from the partnership in which that partner holds an interest, and not from the lower-tier partnerships, whose income may eventually flow up to that partner. So it is incumbent on that partnership to properly report the partnership items from lower tiers and provide sufficient information for sourcing these items to the tax-paying partner. The greater the differences or lack of clarity in state sourcing rules, the less likely this will be done correctly for any state.

Special Sourcing Rules May Undermine Generally Applicable Sourcing Rules

Finally, as the discussion of sourcing rules in Section I. B. above shows, state tax policy has generally been to source partnership income in the same way as corporate income, looking to the activities of the entity or entities giving rise to that income. The special sourcing treatment afforded to investment partnership income is the exception to this general rule. It is also an exception that both partnerships and their partners might wish to take advantage of to ease compliance or to lower the amount of state taxes owed. This is probably the most important reason for states to carefully draw the lines around this treatment so that the exception doesn't swallow the general rule—making sourcing, effectively, elective. For example, if it were possible to change the sourcing of an operating partnership's income by inserting a qualifying investment partnership between that operating partnership and its owners, then neither state partnership law nor federal tax law would impose any barriers to doing so.

SECTION II. INVESTMENT PARTNERSHIPS – DESCRIPTION OF THE INDUSTRY

NOTE: The summary description of common investment partnerships provided in this section is taken from multiples sources including information available on SEC and IRS websites and other government and industry sources, including published papers and reports, as well as private subscription sources such as Bloomberg Tax Portfolios and books on the topic. Critical sources are noted.

Purpose of this Section

Section I of this white paper described the state tax system for taxing partnership income, including federal conformity and the general state income sourcing principles commonly applied to multistate partnerships. Later, in Section III, the special state sourcing rules for certain investment partnerships are reviewed and compared.

The purpose of this Section II is to:

- Briefly describe the general attributes and activities of investment partnerships, and
- Summarize data from the IRS and industry sources on the size of partnerships that may designate themselves as being engaged in investment activities.

As will be discussed below, these partnerships are typically lightly regulated and there is often little public information available on them.

Section II. A. General Attributes and Activities of Investment Partnerships

Investment partnerships must be distinguished from partnerships that may hold investments or that may have limited partners whose primary role is investing their capital. These facts alone do not make a partnership an “investment partnership” even in a broad sense—or if they did, virtually all but the smallest partnerships would be investment partnerships. Rather, it is the entity’s primary purpose and overall activities that determine whether it is an investment partnership. Such entities typically limit their activities to investing in particular assets or in other businesses, called portfolio companies, and may have other distinguishing characteristics as well.

The general descriptions and categories of partnerships discussed in this Section II may be similar to, but broader than the specifically defined category of partnerships that qualify for special state tax sourcing treatment in some states. This fact—that there are partnerships engaged in very similar activities with similar structures that may be subject to different treatment under state law—highlights the importance of carefully drafting applicable definitions and rules and doing so in a way that is consistent with any underlying policy rationales.

Form of Entity and Management

As the name amply implies, investment partnerships are formed not as corporations but as partnerships both under state law and for federal tax purposes. They are most often limited partnerships or LLCs—so that they have passive, limited partners or members as well as a general partner or managing member. This form distinguishes them from some other common types of investment entities—including regulated investment companies (corporations) and real estate investment trusts (trusts).

In non-closely-held investment partnerships, the limited partner or managing member is typically a professional investment firm. That firm is also sometimes the “sponsor” of the investment partnership or “fund,” meaning that it recruits investors to contribute to the fund. Sometimes, the manager has affiliates that may provide additional services to the fund or to its portfolio companies. Often the manager and its affiliates enter into a separate partnership which then invests in the fund for this purpose and receives a profits interest. (See the discussion of the treatment of profits interests in Section I. A. above.)

Investment partnerships are often found in tiered partnership structures. This allows investors to diversify their investments, and it also allows fund managers and service providers to engage in activities related to multiple funds at the same time.

Assets and Income

The various regulatory and tax definitions of investment partnerships typically look to the types of assets held and the nature of the income generated. An asset test to define an investment partnership for a given purpose generally consists of the types of assets held and the percentage they comprise of the total assets.

Assets may include (broadly):

- Securities, which are generally defined under applicable state and federal statutes. Under state law “securities” may include notes, stocks, futures, bonds, debentures, and similar representations of ownership including commodities and currency held for investment and “investment contracts” which term typically includes interests in a limited partnership, a limited liability company, or a limited liability partnership;⁵²
- Securitized debt;
- Real estate held for investment purposes;
- Other tangible or intangible assets held for investment, including works of art, copyrights, etc.

Income may also be limited to income directly derived from these assets, and/or income may be limited in terms of its nature or tax character. Income categories that may be included in various definitions include:

- Dividends or distributions;
- Interest;
- Rents and royalties;
- Capital gains; and
- Other passive income.

General Categories

Investment partnerships are typically categorized for general descriptive purposes as follows:

Private Equity Funds

Private equity funds are “closed-end” investment vehicles, meaning that there is a limited amount of investment that the fund will accept and interests are generally not traded. Private equity funds pool capital for investment in privately held businesses at various stages of development. Some funds diversify but many focus on particular sectors of the market or individual businesses. Private equity funds are often divided into subcategories:

- Angel funds which invest in start-ups;
- Venture capital funds which invest in more established businesses or technology;
- Leveraged buyout funds which invest in mature privately held businesses;
- Private label or captive funds which invest on behalf of a single investor; and
- Multi-manager funds which invest in other funds.

Often, investors in these funds have no liquidity, that is, they cannot sell their shares and must wait for any return until the fund sells its underlying investments.

Hedge Funds

Like private equity funds, hedge funds are not traded. But unlike private equity funds, hedge funds typically hold a range of different investment assets including publicly traded securities and may employ a number of investment strategies. They are typically focused on creating some amount of liquidity for investors seeking shorter-term investment returns and may function over longer times.

⁵² States have generally adopted some version of the uniform state law on securities, often called “Blue Sky Laws.” See the Uniform Securities Act of 2002 as approved by the Uniform Law Commission, available here: <https://www.uniformlaws.org/HigherLogic/System/DownloadDocumentFile.ashx?DocumentFileKey=af36852d-457e-db56-3fc2-b2485cdc47e9&forceDialog=0>.

Closely Held, Special Purpose, and Holding Company Partnerships

Closely held partnerships may be created for investment purposes or other related purposes for a number of reasons including economic, tax, or regulatory purposes. Closely held investment partnerships may include related entities or persons, including family members. For example, family limited partnerships (FLPs) are often created to pass on a family business to the next generation while providing estate tax and other related benefits.⁵³ Certain special purpose entities (SPEs) or holding companies (HCs) organized as partnerships might also fall under a broad description of investment partnerships. For example, corporations may form an SPE or HC partnership or joint venture (treated as a partnership) to hold investments in other businesses.

Note that while a more comprehensive discussion of closely held investment partnerships and SPE/HCs is beyond the scope of this white paper, such entities may not be “investment partnerships” in the sense that they conduct investment activities, but simply act to facilitate the holding of other businesses. But suffice it to say, the broader a state’s tax definition of “investment partnership,” the more likely it will include these types of partnerships.

Other Common Characteristics

Investors

Investors in these partnerships are generally limited partners with no direct involvement in the partnership’s functions. Such investors may include accredited institutional or sophisticated private investors such as domestic and foreign high-wealth individuals, corporations, and certain tax-exempt entities. They may also include sovereign wealth funds, pension funds, and other governmental investors.

Regulation

Unlike mutual funds, investment partnerships are generally lightly regulated. The fund managers themselves may be regulated firms. But the funds may offer investments without significant regulatory oversight, in large part because the investors are typically sophisticated investors. This means that reliable data on assets and activities often comes from the fund managers and may be limited.

Section II. B. Investment Partnership Data

As noted above, there is little public information on individual investment partnerships and their activities. This section relies on IRS data, broken down by industry segment, and also on certain general investment industry reports.

Partnership Ownership Generally

The 2016 study, “Business in the United States: Who Owns It and How Much Tax do They Pay?”, published by the U.S. Treasury Department,⁵⁴ discussed in Section I, attempted to trace income reported by partnerships to the ultimate taxpaying partners. Of the total of all partnership income that could be traced, the report found the biggest chunk went to U.S. individuals—about 43%. Only slightly more than 10% of all partnership income was ultimately allocated to domestic taxable corporations. The remainder was split between foreign partners, trusts, Subchapter S-corporations, tax-exempt entities, and unidentified persons. (See 2016 Study, p. 33.)

The study also notes that pass-through participation and pass-through income, in general, are especially concentrated among high-earners. As the report notes: “Relative to households in the bottom half of the income distribution, households in the top-1% of the income distribution are over fifty times as likely to receive positive partnership income. And the average top-1% household earns over six-hundred times the amount of partnership income as the average household in the bottom half.” (See 2016 Study, p. 3.)

⁵³ FLPs are often used as a way to give younger family members an interest in a family business or other assets of the family while potentially reducing gift and estate taxes. See Report: New Data on Family Limited Partnerships Reported on Estate Tax Returns, on the IRS website here: <https://www.irs.gov/pub/irs-soi/11pwcompench2cfam.pdf>.

⁵⁴ Supra FN 18.

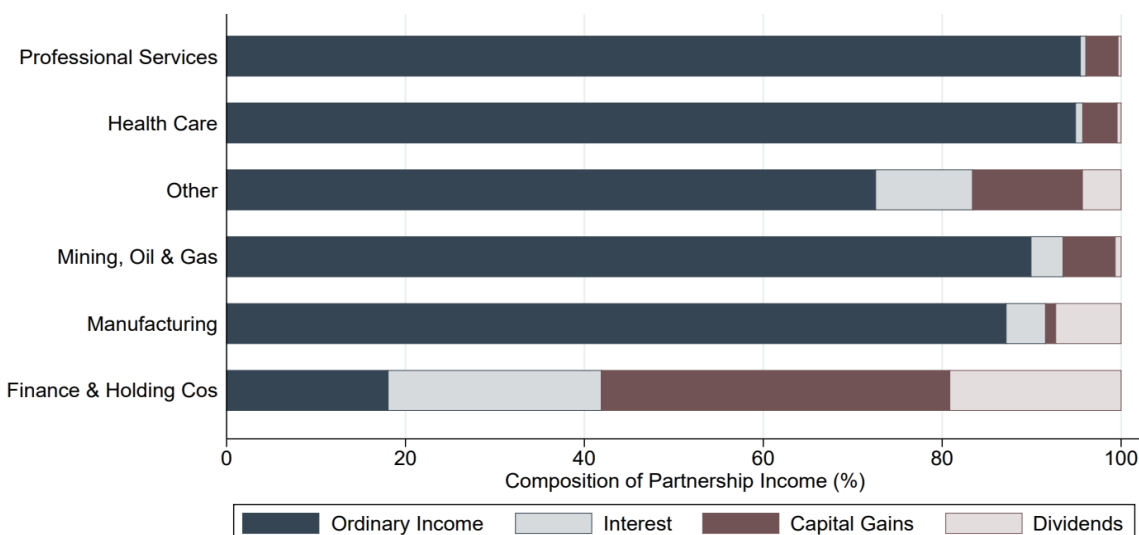
Investment Partnership Industry Segment

The 2016 Study also categorized partnership data into industries by NAICS code as reported by the entity. The Study consolidated certain industry groups for this purpose. The industry group most closely aligned with the investment partnership category, with which this white paper is concerned, was the Finance & Holding Company industry, which also included the real estate investment and insurance industry segments. The Study set out industry information in graphic form. (See 2016 Study, pp. 34 and 39 and the graphs reproduced on the following page).

As these graphs show—the Finance and Holding Company industry group, as categorized by the report, is estimated to account for 70% of all partnership income in the years studied. This income is also more highly diversified between ordinary income, interest, capital gains, and dividends compared to all other industry groups.



Notes: This figure shows the distribution of partnership income across partnership industry. We divide total partnership income received for partnerships in each industry by total partnership income received. These shares exclude income received by other partnerships. Industry groupings and NAICS codes are as follows: Finance & Holding Cos (NAICS 52, 55, and 531); Professional Services (NAICS 54); Manufacturing (NAICS 31, 32, and 33); Health Care (NAICS 62); Mining, Oil, & Gas (NAICS 21).



Other IRS Statistics and Industry Segment Information

The 2016 Study cited above relies on detailed IRS data. The IRS also regularly publishes certain statistical information related to partnerships on the IRS website.⁵⁵ For 2019, this source estimated that the total value of assets held by domestic partnerships was about \$36 trillion. The Finance & Insurance, Real Estate, and Holding Company industry segments held \$20.6 trillion, \$7.8 trillion, and \$1 trillion, respectively, for a total of about \$29.4 trillion, or 82% of all partnership assets.

The total ordinary income reported by partnerships was estimated to be \$292 billion while “portfolio income,” which includes interest, dividends, royalties and capital gains (losses) from investments, but not real property rental income (loss), was estimated to be \$1.2 trillion – approximately 4 times the amount of ordinary income recognized by all partnerships. Of that portfolio income, \$935 billion was estimated to be reported by the Finance & Insurance industry, \$95 billion by the Real Estate Industry, and \$52 billion by the Holding Company industry.

IRS SOI Bulletin

The IRS also publishes a quarterly SOI, or Statistics of Income, bulletin that analyzes trends in certain tax data. In its Fall 2021 bulletin,⁵⁶ the IRS reported the following information for the Finance, Insurance, and Real Estate business segments—reproduced here, which also shows that, year-over-year, while the growth in total partnership income was negative 14%, the Finance sector grew 3.3%

Figure D

Partnership Returns: Total Assets, Total Receipts, and Total Net Income (Loss), by Selected Industrial Group, Tax Years 2018 and 2019

[Money amounts are in thousands of dollars]

Industrial group	Total assets		Percentage change	Total receipts		Percentage change	Total net income (loss)		Percentage change
	2018	2019		2018	2019		2018	2019	
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)
All industries	34,348,006,740	36,048,324,019	5.0	8,721,758,922	8,081,449,499	-7.3	884,709,693	760,646,448	-14.0
Finance and insurance	18,954,124,306	20,670,032,817	9.1	2,032,212,084	1,958,954,883	-3.6	426,317,947	440,439,592	3.3
Securities, commodity contracts, and other financial investments and related activities	16,272,592,851	18,004,651,872	10.6	1,722,106,877	1,687,208,123	-2.0	357,509,117	382,072,662	6.9
Securities and commodity contracts and exchanges	680,870,047	704,083,504	3.4	129,834,164	77,716,670	-40.1	3,135,215	9,704,621	209.5
Other financial investment activities	15,591,722,804	17,300,568,368	11.0	1,592,272,713	1,609,491,453	1.1	354,373,902	372,368,042	5.1
Funds, trusts and other financial vehicles	2,319,414,827	2,253,303,980	-2.9	211,120,692	170,197,965	-19.4	53,841,089	42,125,761	-21.8
Other finance and insurance	362,116,628	412,076,965	13.8	98,984,515	101,548,795	2.6	14,967,741	16,241,169	8.5
Real estate and rental and leasing	7,628,478,572	7,864,054,742	3.1	784,722,621	748,808,529	-4.6	97,954,738	41,929,237	-57.2
Real estate	7,380,340,393	7,608,434,999	3.1	703,809,034	669,874,957	-4.8	86,988,620	35,535,894	-59.1
Lessors of residential buildings and dwellings and cooperative housing	2,150,580,855	2,303,869,636	7.1	143,330,835	140,786,321	-1.8	-20,042,681	-31,798,007	58.7
Lessors of nonresidential buildings (except miniwarehouses)	3,297,609,363	3,324,973,028	0.8	250,505,822	213,311,478	-14.8	90,590,576	67,447,682	-25.5
Lessors of miniwarehouses and self-storage units	84,884,720	80,343,263	-5.4	6,450,058	12,691,234	96.8	3,125,745	1,321,313	-57.7
Lessors of other real estate property	264,328,052	228,064,680	-13.7	19,651,661	21,806,553	11.0	2,984,401	2,853,599	-4.4
Other real estate activities	1,582,937,403	1,671,184,391	5.6	283,870,658	281,279,371	-0.9	10,330,579	-4,288,694	-141.5
Rental and leasing services and lessors of nonfinancial intangible assets (except copyrighted works)	248,138,180	255,619,743	3.0	80,913,587	78,933,572	-2.4	10,966,118	6,393,343	-41.7

NOTES: Detail may not add to totals because of rounding. For data on additional industries, see Table 10.

SOURCE: IRS, Statistics of Income Division, Partnerships, April 2021.

⁵⁵ Available here: <https://www.irs.gov/statistics/soi-tax-stats-partnership-statistics-by-sector-or-industry>.

⁵⁶ Available here: <https://www.irs.gov/pub/irs-pdf/p1136.pdf#page=58>.

Comparison with Industry Data on Investment Funds

IRS data does not appear to break out income and assets by types of common investment funds—private equity and hedge funds. A 2020 report by McKinsey & Company sheds some additional light on the size of private equity funds. The report notes that private equity funds (excluding hedge funds) have an estimated amount of assets under management equaling \$6.5 trillion worldwide. The report goes on to note that while this represents only about 8% of the total public market capitalization, the balances of these funds are growing almost three times as fast as public markets.⁵⁷ Other sources estimate the total assets managed by hedge funds are in the range of about \$4 trillion worldwide.⁵⁸

Comparison of these types of industry data to IRS data is difficult because the categories used are not often aligned. For example, the 2020 McKinsey report includes data on funds investing primarily in real estate. Nevertheless, it appears that industry data, particularly assets under management, generally comes in lower than IRS industry segment data. In other words, it appears IRS segment data includes a significant number of partnerships other than the typical hedge funds and private equity funds. Again, this simply points out the difficulty in drawing lines to categorize particular types of investment partnerships.

⁵⁷ See “A new decade for private markets,” McKinsey Global Private Markets Review 2020, available here: <https://www.mckinsey.com/~media/mckinsey/industries/private%20equity%20and%20principal%20investors/our%20insights/mckinseys%20private%20markets%20annual%20review/mckinsey-global-private-markets-review-2020-v4.pdf>.

⁵⁸ See, for example, <https://www.statista.com/statistics/271771/assets-of-the-hedge-funds-worldwide/>.

SECTION III: STATE TREATMENT OF INVESTMENT PARTNERSHIPS

A majority of states that tax partnership items on a pass-through basis and source the items based on the partnership's apportionment factors make an exception for certain defined "investment partnerships" or "qualified investment partnerships" (here abbreviated "IPs"), or certain income of those partnerships. The qualifying income generated by these partnerships is sourced, instead, to residence (or sometimes domicile) of the partners. While this sourcing treatment is common, there are differences, including exactly how such partnerships or their income are defined and whether the exception applies only to individual partners or also to corporations.

This Section III sets out in detail the state rules that are applicable and also provides a summary of the different issues which the rules may address, depending on the state.

Section III. A. Summary of Issues Addressed

Below is a general summary of issues that may be raised by the special sourcing treatment of investment partnership income which states may have explicitly addressed in their particular rules. While there are similarities between state rules, the rules may also vary both in their general approach and in the extent to which they specifically address certain issues.

But also note that, depending upon the general approach taken by the state, some separate issues listed may not be relevant in that state. For example, if the state's definition of an "investment partnership" generally excludes partnerships in which corporations hold interests, then there would be no need to exclude corporate partners themselves from the special treatment for investment partnership income. Likewise, if the definition excludes partnerships that have interests in other non-IP partnerships, there is no need to explicitly address which sourcing rules control for the income of the non-IP partnership which passes through the IP. In short, the approach taken may require addressing, or alleviate the need to address specific issues in greater detail.

Therefore, rather than attempt to characterize every state's specific treatment of each issue, we have noted examples of particular states that have rules (as set out fully in Section III. B) that may specifically address the particular issue. In some cases, we also note whether there appears to be a clear majority rule among states that have addressed the issue.

Also, in some cases states' rules may reference provisions of the Internal Revenue Code, with or without modifications. In particular, IRC § 851, the section governing regulated investment companies, is sometimes referenced by states as part of its definition for an "investment partnership." Presumably, the state is also adopting any federal regulatory rules that would interpret or apply this provision.

In the following Section IV, we discuss in more general terms the different approaches states have taken and the extent to which those approaches reflect similar policies, or may or may not fully address the issues raised.

Summary of Issues:

- 1) Apparent basis for the sourcing treatment of IP income:
 - a) Exemption or exclusion from the tax base
Examples include: Alabama, Arkansas, California, Georgia
 - b) Determination that IP income is nonbusiness income or non-unitary income
Examples include: Connecticut, Illinois
 - c) Determination the IP is not doing business in the state
Examples include: Colorado, Connecticut, North Carolina, Oregon
(See also Issue 3.A.i below—which looks to how income would be sourced if it had been earned directly by the partner.)
- 2) Sourcing treatment applies to:
 - a) IP income generally

- b) Only to qualifying income of the IP
Examples include Alabama, Idaho, Illinois
- 3) Definition of IP includes:
 - a) Assets held test –
 - i) Assets, the income from which would be sourced to the partner’s residence if recognized by partners directly
For example: Idaho, Kentucky, Utah
 - ii) Specified or listed assets:
 - (1) Listing specific types (e.g. stocks and bonds, index securities, futures contracts, options on securities, and other similar financial securities and instruments)
Examples include: Alabama, Illinois
 - (2) Allowable – offices as necessary
Examples include: Alabama, Illinois
 - iii) Assets that disqualify the IP
 - (1) Captive REITs
For example: Alabama
 - (2) Interests in non-investment partnerships
Examples include: Alabama, Arkansas
 - (3) Loans that are not debt securities
For example: Alabama
 - (4) Deposits with unregulated institutions
For example: Alabama
 - iv) Percentage qualifying assets of total assets
90% is most common
 - v) Rules include how value is calculated
For example: Alabama
 - b) Income test –
 - i) Definition of income (gross, net, etc.)
For example: Alabama
 - ii) Type or character of income
Most commonly:
 - (1) Interest
 - (2) Dividends
 - (3) Distributions
 - (4) Management fees paid by owners of the entity
 - (5) Gains or losses from the sale or exchange of qualifying investment securities (QIS).
 - iii) Percentage of total income
90% is most common
 - iv) Rules include how income (or gross income) is calculated
For example: Alabama
 - c) Ownership test – limiting certain ownership structures
For example: New Jersey
 - d) Tied to IRC § 851 (related to RICs) – which uses 50% asset and 90% income tests

Examples include: Connecticut, New York

- e) Owners that may disqualify the entity –
 - i) Corporation
Examples include: Alabama, New Mexico
 - ii) Dealers
Examples include: Alabama, Connecticut
 - iii) Publicly traded partnerships
Examples include: Alabama, Idaho
 - iv) Common trust fund
For example: Alabama
 - v) Partnerships electing out under 761
For example: Alabama
 - vi) Financial institution
For example: Alabama
- f) Certification required?
For example: Alabama.
- g) Filing required?
For example: Alabama
- h) Are any partners excluded from the special treatment?
 - i) Corporations
For example: Connecticut
 - ii) Managers or non-limited partners
Examples include: Connecticut and Idaho
 - iii) Majority interest holders
For example: Alabama
- i) Special rules with respect to IP income
 - i) Rules do not apply if the IP partner also invests in an underlying business in the state
Examples include: Alabama, Arkansas, California, Illinois
 - ii) Income from the IP is taxable to a nonresident member if assets are acquired with working capital of an in-state trade or business in which the nonresident member owns an interest
Examples include: Alabama, Arkansas, California, Illinois
 - iii) Only income of the type qualifying (on a pass-through basis) is subject to the treatment
For example: Alabama
 - iv) Ability to use IP losses to offset income requires the filing of a state return
For example: Alabama
- j) Anti-abuse authority (including add-back requirements)
Examples include: Alabama, Virginia

Section III. B. Specific State Rules

This section sets out the statutory or regulatory rules in states that have explicitly adopted special sourcing treatment of investment partnership income. Text highlighted in yellow is especially relevant to the outline in Section III. A, above.

Alabama

Rule 810-3-24.2-.02. Qualified Investment Partnerships.

(1) Definitions.

(a) **Qualified Investment Partnership (QIP)**. A partnership or other entity classified as a subchapter K entity, or a business trust as defined in § 40-18-1, Code of Alabama 1975, that for a tax period which begins on or after January 1, 2009, meets the gross income and asset tests for a Qualified Investment Partnership as prescribed by § 40-18-24.2, Code of Alabama 1975; and, **for which an authorized officer, partner, member or manager of the entity has certified for the tax period that the entity meets the gross income and asset tests**. The proper form of the QIP certification and the due date for filing the certification are explained in this regulation.

1. The following restrictions apply concerning entities eligible to be a QIP:

(i) **There is a rebuttable presumption that an entity is disqualified as a QIP as abusive when fifty percent (50%) or more of the ownership interest or voting interest of an entity is owned or controlled, directly or indirectly, by a corporation**, as defined in § 40-18-1, Code of Alabama 1975, or a controlled group of corporations, as defined in 26 U.S.C. §1563, at any time during the tax period. For purposes of this definition, own or control means to own or control directly, indirectly, beneficially, or constructively fifty percent (50%) or more of the voting power or value of an entity. The Department will review written applications or requests to the Commissioner that this presumption not be applied to a particular entity's situation on a case-by-case basis. If the entity establishes that the distributive shares of the income attributed to and owned by the corporate partner are being reported to Alabama for income tax purposes by each of the owners having such interests, the presumption of abuse in this section will have been rebutted.

(ii) **An entity that is classified as a dealer** in qualifying investment security at any time during a tax period, shall not qualify as a QIP for that tax period. An entity is a dealer in qualifying investment securities if it regularly purchases qualifying investment securities from or sells qualifying investment securities 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 investment securities with customers in the ordinary course of a trade or business. The definition provided in 26 U.S.C. § 475(c) can also be relied upon to determine if an entity shall be classified as a dealer in qualifying investment securities.

(iii) An entity that is a **publicly-traded partnership** that is taxed as a corporation for Alabama income tax purposes at any time during the tax period cannot be a QIP for that tax period.

(iv) A **common trust fund**, as defined in 26 U.S.C. §584, cannot be a QIP.

(v) An **unincorporated entity that has elected out of the provisions of Subchapter K in accordance with 26 U.S.C. §761**, at any time during a tax period, cannot be a QIP for that tax period.

(vi) Any entity meeting the definition of a **Financial Institution** under Section 40-16-1, Code of Alabama 1975, cannot be a QIP.

(b) **Qualifying Investment Securities (QIS)**. Financial investments as defined by § 40-18-24.2, Code of Alabama 1975, that must be owned by an entity; and must make up a specified percentage of the entity's total assets; in order for the entity to qualify as a QIP, in accordance with § 40-18-24.2, Code of Alabama 1975.

1. The term "qualifying investment securities" does not include:

- (i) An investment in a captive REIT, as defined by § 40-18-1, Code of Alabama 1975.
- (ii) An interest in a partnership unless the partnership is a Qualified Investment Partnership, as defined in § 40-24.2, Code of Alabama 1975
- (iii) Loans that are not debt securities.
- (iv) Deposits with a bank or other financial institution that is not regulated by the United States government, a state, a governmental agency or by any political subdivision thereof.

(c) Tax Period. Same definition as "taxable year" as defined in § 40-18-1.

(2) QIP Requirements.

(a) All of the following requirements must be met for a tax period in order for an entity to qualify as a QIP for the tax period:

1. Asset Test. No less than 90% of the cost of the total assets owned by the entity consists of qualifying assets: qualifying investment securities (QIS); office facilities; and, tangible personal property reasonably necessary to carry on the activities of the entity as an investment partnership in the State of Alabama.

2. Gross Income Test. No less than 90% of the gross income of the entity consists of qualifying gross income: interest; dividends; distributions; management fees paid by owners of the entity; and gains or losses from the sale or exchange of qualifying investment securities (QIS).

3. Certification. An authorized officer, partner, member, or manager of the entity certifies that for the tax period the entity meets the Asset Test and the Gross Income Test, in the proper form and by the time specified in this regulation. The certification must be filed as part of the annual Alabama partnership income tax return for the entity, on Alabama Schedule QIP-C, by the due date (including extensions) of the Alabama partnership income tax return for the entity. Filing a certification with a composite return for an entity is not a proper filing of the QIP certification.

(i) If the QIP holds an investment in another Subchapter K entity or business trust which is not subject to tax by the State of Alabama, but which qualifies as a QIP under both the Asset Test and the Gross Income Test, the annual certification as to its qualification as a QIP may instead be filed by an authorized officer, partner, member or manager of the QIP, in a manner prescribed by the Department.

(b) Required QIP Filings.

1. A QIP must file an annual Alabama partnership income tax return, properly reporting the required Schedule K-1 information for each resident member and each nonresident member, that held an interest in the QIP, at any time during the tax period.

2. A QIP must file an annual composite income tax return, as required by § 40-18-24.2, Code of Alabama 1975, if the QIP is required to make a composite payment for one or more nonresident members.

(c) Application of the Asset Test.

1. For purposes of applying the Asset Test, the cost of an asset will generally be the entity's basis, computed in accordance with Alabama income tax law (See §§ 40-18-24 and 40-18-6, Code of Alabama 1975). For office facilities, other tangible personal property, any assets subject to amortization and any assets subject to depletion; the cost to be used will be the entity's basis before any reductions for depreciation, amortization or depletion. The cost of qualifying investment securities shall include any accrued interest or discount and shall be reduced by any premium amortization,

that has been recognized in the computation of Alabama taxable income of the entity and that is included on the entity's balance sheet as of the date the asset's cost was determined.

2. The Asset Test is applied for each tax period, and is computed using the ratio of the entity's cost of its qualifying assets to the entity's cost of its total assets, expressed as a percentage; as of the beginning of the tax period and as of the end of the tax period. The average of the percentages is then computed. The average is referred to as the Average Qualifying Asset Percentage for the Tax Period.

(d) Application of the Gross Income Test.

1. **The Gross Income Test** is applied for each tax period, and is computed using the ratio of the entity's qualifying gross income to its total gross income, expressed as a percentage. The ratio is referred to as the Qualifying Gross Income Percentage.

2. Calculations for the Gross Income Test are to be based on information from the Alabama partnership income tax return filed by the entity for the tax period.

3. Gross income means income minus costs of sales or basis in an asset sold or traded, but without reduction for any other expenses or deductions.

4. Gross income does not include any item of income that is excluded in computing the Alabama taxable income of the entity.

5. The Gross Income Test is calculated using the method of accounting used for Alabama income tax purposes for the tax period.

6. Gross income derived from an investment in a qualifying investment partnership, subchapter S corporation, trust or estate shall be characterized as if the entity received the income directly.

7. Gross income derived from a qualifying investment partnership, subchapter S corporation, trust or estate for purposes of the Gross Income Test shall be reduced by related expenses and computed in accordance with Alabama income tax law.

Rule 810-3-24.2-.01. Composite Returns of Pass-through Entities.

...

(n) State Explanations An annual composite return is due for a Qualified Investment Partnership (QIP), only if the QIP is required to remit a composite payment for one or more nonresident members.

...

Rule 810-3-24.2-.03. Other Qualified Investment Partnership Matters.

(1) Every nonresident member of a Qualified Investment Partnership (QIP) that has Alabama source income must file an Alabama income tax return and report the Alabama source income even if the income earned in Alabama is included on a composite return filed by the QIP, unless the member is a nonresident individual who has no other Alabama source income. **For a nonresident individual to claim the benefit of any net operating losses generated by a QIP, the nonresident individual must establish those losses by filing an Alabama individual income tax return.**

(2) The QIP Alabama income tax reporting requirements do not change the Alabama income tax return filing requirements for business entities.

(3) **In accordance with § 40-18-24.3, Code of Alabama 1975, a nonresident member of a QIP will be exempt from Alabama income tax on its distributive share of QIP income unless the nonresident member actively participates in the day-to-day management of the QIP or the QIP invests in the qualifying investment securities of an entity that is majority owned by the nonresident member.**

(a) The term "majority owned" is defined in § 40-18-24.3, , Code of Alabama 1975, and includes the attribution rules of 26 U.S.C. §318.

(b) Income from a QIP is taxable to a nonresident member of the QIP if the income is from investment activity that is interrelated with an Alabama trade or business in which the nonresident member owns an interest even if the primary activities of the trade or business are separate and distinct from the acts of acquiring, managing, or disposing of qualified investment securities.

(c) Income from a QIP is taxable to a nonresident member of the QIP if any part of the qualifying investment securities of the QIP are acquired with the working capital of an Alabama trade or business in which the nonresident member owns an interest.

(d) A financial institution, as defined in § 40-16-1, Code of Alabama 1975, if a nonresident member of a QIP, is taxed on its distributive share of income from the QIP if it participates in the management of the investment activities of the QIP; if it is engaged in a unitary business with another taxpayer that participates in managing the investment activities of the QIP; or, if the financial institution has income from Alabama sources.

(e) A corporation, as defined in § 40-18-1 , Code of Alabama 1975, if a nonresident member of a QIP, is taxed on its distributive share of income from a QIP if it participates in the management of the investment activities of the QIP; if it is engaged in a unitary business with another taxpayer that participates in managing the investment activities of the QIP; or, if the corporation has income from Alabama sources.

(4) The allocation and apportionment requirements set out in the Multistate Tax Compact, codified in Chapter 27, Title 40, Code of Alabama 1975, and all rules pertaining to such laws are applicable to Alabama income tax returns and composite returns required to be filed by pass-through entities, including those required to be filed by Qualified Investment Partnerships.

(5) Business Trust. The term "business trust" is defined in § 40-18-1 , Code of Alabama 1975.

(a) For federal income tax purposes, a business trust is classified as a business entity, not as a business trust. A business trust may only be classified as a disregarded entity, a partnership, or a corporation.

1. A business trust that has made a federal election to be treated as a corporation, at any time during the tax period, cannot qualify as a QIP for the tax period.

2. A business trust that is treated as a disregarded entity for federal income tax purposes, at any time during the tax period, cannot qualify as a QIP for the tax period.

3. A business trust that is treated as a partnership for federal income tax purposes can qualify as a QIP, if the entity satisfies the requirements of Section 40-18-24.2, Code of Alabama 1975 , and the rules promulgated thereunder.

(6) In order to correct the effect and result of a tax-avoidance or a tax abusive arrangement, or series of transactions, the Commissioner of Revenue shall have the authority to distribute, apportion, or allocate the gross income of any pass-through entity, QIP, or pass-through entity member in order to clearly, fairly, and equitably reflect the income of any entity, pass-through entity, QIP, or QIP member, whose income may have been significantly distorted by the application of the tax-avoidance or tax abusive arrangement, or series of transactions. The Commissioner of Revenue may recast QIP transactions if it is determined the transactions do not have a substantial business purpose or it is determined that the form of the transactions yield results that have the substance of tax-avoidance or tax abuse.

(7) The Commissioner of Revenue may revoke an entity's QIP status for one or more tax periods if it is determined that the entity did not meet the QIP requirements for that or those tax periods.

Arkansas

§ 26-51-202 -- Nonresidents.

(a) A tax is imposed and shall be assessed, levied, collected, and paid annually at the rates specified in § 26-51-201 upon and with respect to the entire net income as defined in this chapter, except as provided in this section, from all property owned and from every business, trade, or occupation carried on in this state by individuals, corporations, partnerships, trusts, or estates not residents of the State of Arkansas.

(b)

(1) Each nonresident as defined in § 26-51-102 shall file income tax returns with the State of Arkansas and pay the tax without distinction, or incident to the laws of the nonresident's resident state.

(2) It is the specific intention of the General Assembly that the tax shall be collected from property owned and from the conduct of every business, trade, or occupation, whether or not the individuals, corporations, partnerships, trusts, or estates are qualified to do business in the State of Arkansas and whether or not such business, trade, or occupation shall be conducted in interstate commerce.

(c)

(1) However, the payment of the tax shall be based upon net income properly allocated as net income arising from the ownership of property and the conduct of a business, trade, or occupation in the State of Arkansas.

(2) CAUTION: Subsection (c)(2) is eff. for tax years beginning on or after 1-1-2021.

A nonresident individual who is paid a salary, lump sum payment, or any other form of payment that encompasses work performed both inside and outside of Arkansas shall pay Arkansas income tax only on the portion of the individual's income that reasonably can be allocated to work performed in Arkansas.

(3) CAUTION: Subsection (c)(3) is eff. for tax years beginning on or after 1-1-2021.

A nonresident individual performs work in Arkansas when that individual is physically located in Arkansas when performing the work.

(d) Additionally, no income tax shall be due the State of Arkansas from a nonresident beneficiary on income received from a trust or estate being administered by a resident trustee or personal representative except on income derived by the trust or estate from:

(1) Lands situated in this state, including gains from any sale of the lands situated in this state;

(2) Any interest in land situated in this state, including, without limitation, chattels real, including gains from any sale of an interest in land situated in this state;

(3) Tangible personal property located in Arkansas, including gains from any sale of the tangible personal property located in Arkansas; and

(4) Unincorporated businesses domiciled in Arkansas.

(e)

(1) No income tax shall be due the State of Arkansas from a nonresident partner with respect to that partner's distributive share of dividends, interest, or gains and losses from qualifying investment securities owned by an investment partnership, whether or not the partnership has a usual place of business located in this state.

(2) As used in this subsection:

(A) "Investment partnership" means a partnership that meets both of the following requirements:

(i) No less than ninety percent (90%) of the value of the partnership's total assets consists of qualifying investment securities and office space and equipment reasonably necessary to carry on its activities as an investment partnership; and

(ii) No less than ninety percent (90%) of its gross income consists of interest, dividends, and gains from the sale or exchange of qualifying investment securities; and

(B) "Qualifying investment securities" includes all of the following:

(i) Common stock, including preferred or debt securities convertible into common stock, and preferred stock;

(ii) Bonds, debentures, and other debt securities;

(iii) Deposits and any other obligations of banks and other financial institutions;

(iv) Stock and bond index securities, futures contracts, options on securities, and other similar financial securities and instruments; and

(v) Other similar or related financial or investment contracts, instruments or securities. Qualifying investment securities shall not include an interest in a partnership unless that partnership is itself an investment partnership.

(3)(A) The provisions of subdivision (e)(1) of this section shall not apply to income derived from investment activity that is interrelated with any trade or business activity of the nonresident or an entity in which the nonresident owns an interest in this state, whose primary activities are separate and distinct from the acts of acquiring, managing, or disposing of qualified investment securities, or if those securities were acquired with working capital of a trade or business activity conducted in this state in which the nonresident owns an interest.

(B) Likewise, the provisions of subdivision (e)(1) of this section shall not apply to corporate partners of an investment partnership except as provided by regulations adopted by the Director of the Department of Finance and Administration.

California

§ 17955 -- Amounts excluded from gross income in specified circumstances; "Investment partnership"; "Qualifying investment securities".

(a) For purposes of computing "taxable income of a nonresident or part-year resident" under paragraph (1) of subdivision (i) of Section 17041, notwithstanding Sections 17951, 17952, and 17953, gross income of a nonresident (as defined in Section 17015) from sources within this state shall not include dividends, interest, or gains and losses from qualifying investment securities if any of the following apply:

(1) In the case of an individual, with respect to the qualifying investment securities, the taxpayer's only contact with this state is through a broker, dealer, or investment adviser located in this state.

(2) In the case of a partner's distributive share of income from qualifying investment securities, the partnership qualifies as an investment partnership, whether or not the partnership has a usual place of business located in this state.

(3) In the case of a beneficiary of a qualifying estate or trust, the taxpayer's only contact with this state is through an investment account managed by a corporate fiduciary located in this state.

(4) In the case of a unit holder in a regulated investment company (as defined in Section 851 of the Internal Revenue Code), to the extent of the dividends distributed by the regulated

investment company, whether or not the regulated investment company has a principal place of business in this state.

(b) This section shall not apply to income derived from investment activity that is interrelated with any trade or business activity of the nonresident or an entity in which the nonresident owns an interest in this state, whose primary activities are separate and distinct from the acts of acquiring, managing, or disposing of qualified investment securities, or if those securities were acquired with working capital of a trade or business activity conducted in this state in which the nonresident owns an interest.

(c) For purposes of this section:

(1) "Investment partnership" means a partnership that meets both of the following requirements:

(A) No less than 90 percent of the partnership's cost of its total assets consist of qualifying investment securities, deposits at banks or other financial institutions, and office space and equipment reasonably necessary to carry on its activities as an investment partnership.

(B) No less than 90 percent of its gross income consists of interest, dividends, and gains from the sale or exchange of qualifying investment securities.

(2) "Qualifying estate or trust" means an estate or trust that meets both of the following requirements:

(A) No less than 90 percent of the estate's or trust's cost of its total assets consist of qualifying investment securities, deposits at banks or other financial institutions, and office space and equipment reasonably necessary to carry on its investment activities.

(B) No less than 90 percent of its gross income consists of interest, dividends, and gains from the sale or exchange of qualifying investment securities.

(3)(A) "Qualifying investment securities" include all of the following:

(i) Common stock, including preferred or debt securities convertible into common stock, and preferred stock.

(ii) Bonds, debentures, and other debt securities.

(iii) Foreign and domestic currency deposits or equivalents and securities convertible into foreign securities.

(iv) Mortgage- or asset-backed securities secured by federal, state, or local governmental agencies.

(v) Repurchase agreements and loan participations.

(vi) Foreign currency exchange contracts and forward and futures contracts on foreign currencies.

(vii) Stock and bond index securities and futures contracts, and other similar financial securities and futures contracts on those securities.

(viii) Options for the purchase or sale of any of the securities, currencies, contracts, or financial instruments described in clauses (i) to (vii), inclusive.

(ix) Regulated futures contracts.

(B) "Qualifying investment securities" does not include an interest in a partnership unless that partnership is itself an investment partnership.

Colorado

39 Colo. Code Regs. § 22-109(3)(c)(vii) Investment Partnerships. A partnership whose sole activity is to buy and sell securities for its own account is not carrying on a Business in Colorado. Therefore, a Nonresident individual partner of such a partnership is not subject to Colorado income tax on their distributive share of such partnership income. § 39-22-109(2)(a)(V), C.R.S. A partnership that engages in other activities in Colorado that are neither the described activities here nor entirely ancillary to such activities is carrying on Business in Colorado.

Connecticut

Conn. Gen. Stat. § 12-214(a)(3)(C) A company that is not otherwise carrying on or doing business in this state, either directly or by virtue of being a partner in a partnership described in subparagraph (A) or (B) of this subdivision is not carrying on or doing business in this state solely by virtue of being a limited partner of one or more investment partnerships.

Conn. Gen. Stat. § 12-213(a)(26) "Investment partnership" means a limited partnership that meets the gross income requirement of Section 851(b)(2) of the Internal Revenue Code, except that income and gains from commodities that are not described in Section 1221(1) of the Internal Revenue Code or from futures, forwards and options with respect to such commodities shall be included in income which qualifies to meet such gross income requirement, provided such commodities are of a kind customarily dealt with in an organized commodity exchange and the transaction is of a kind customarily consummated at such place, as required by Section 864(b)(2)(B)(iii) of the Internal Revenue Code. To the extent that such a partnership has income and gains from commodities that are not described in Section 1221(1) of the Internal Revenue Code or from futures, forwards, and options with respect to such commodities, such income and gains must be derived by a partnership which is not a dealer in commodities and is trading for its own account as described in Section 864(b)(2)(B)(ii) of the Internal Revenue Code. The term "investment partnership" does not include a dealer, within the meaning of Section 1236 of the Internal Revenue Code, in stocks or securities;

Conn. Gen. Stat. § 12-218e(a)(4)(B) The distributive share of income received by a limited partner from an investment partnership shall not be considered to be derived from a unitary business unless the general partner of such investment partnership and such limited partner have common ownership. To the extent that the limited partner is otherwise carrying on or doing business in Connecticut, it shall apportion its distributive share of income from an investment partnership in accordance with subdivision (2) of subsection (g) of section 12-218. If the limited partner is not otherwise carrying on or doing business in Connecticut, its distributive share of income from an investment partnership is not subject to tax under this chapter.

Conn. Gen. Stat. § 12-219a(b)

(1) Any company that is (A) a limited partner in a partnership, other than an investment partnership, that does business, owns or leases property or maintains an office within this state and (B) not otherwise carrying on or doing business in this state shall apportion the average value of its partnership interest within and without this state under the provisions of subsection (a) of this section, except that the numerator and the denominator of its apportionment fraction shall be its proportionate part of the partnership's apportionment factors. For purposes of this section, the partnership shall compute its apportionment fraction and the numerator and the denominator of its apportionment factors as if it were a company taxable both within and without this state. However, if the commissioner determines that the company and the partnership are, in substance, parts of a unitary business engaged in a single business enterprise, or, if the company is a member of a combined group that files a combined unitary tax return, the company shall be taxed in accordance with the provisions of subdivision (3) of this subsection and not in accordance with the provisions of this subdivision.

(2) Any company that is (A) a limited partner (i) in an investment partnership or (ii) in a limited partnership, other than an investment partnership, that does business, owns or leases property or maintains an office within this state and (B) otherwise carrying on or doing business in this state shall apportion its additional tax base, including the average value of its partnership interest, within and without the state under the

provisions of subsection (a) of this section, except that the numerator and the denominator of its apportionment factors shall include its proportionate part of the numerator and the denominator of the partnership's apportionment factors. For purposes of this section, the partnership shall compute its apportionment fraction and the numerator and the denominator of its apportionment factors, as if it were a company taxable both within and without this state.

Conn. Gen. Stat. § 12-711(f)

Any nonresident, other than a dealer holding property primarily for sale to customers in the ordinary course of his trade or business, shall not be deemed to carry on a trade, business, profession or occupation in this state solely by reason of the purchase or sale of intangible property or the purchase, sale or writing of stock option contracts, or both, for his own account.

Georgia

O.C.G.A. §48-7-24(c) Notwithstanding any other provision of this chapter to the contrary, the distributive share of a nonresident member of a resident limited partnership or other similar nontaxable entity which derives income exclusively from buying, selling, dealing in, and holding securities on its own behalf and not as a broker shall not constitute taxable income under this chapter. For purposes of this subsection, a resident limited partnership or similar nontaxable entity shall not include a family limited partnership or similar nontaxable entity the majority interest of which is owned by one or more natural or naturalized citizens related to each other within the fourth degree of reckoning according to the laws of descent and distribution. This subsection shall not apply to a person that participates in the management of the resident limited partnership or other similar nontaxable entity or that is engaged in a unitary business with another person that participates in the management of the resident limited partnership or other similar nontaxable entity.

Idaho

Idaho Code § 63-3026A(3)(c) Nonresident individuals shall not be taxable on investment income from a qualified investment partnership. For purposes of this paragraph, a "qualified investment partnership" means a partnership, as defined in section 63-3006B, Idaho Code, that derives at least ninety percent (90%) of its gross income from investments that produce income that would not be taxable to a nonresident individual if the investment were held by that individual.

Idaho Regs. § 35.01.01.275.

01 In General.

a. For taxable years beginning on or after January 1, 2007, the Idaho taxable income of a nonresident individual does not include the distributive share of investment income of a qualified investment partnership. The distributive share of noninvestment income of a qualified investment partnership derived from or related to sources within Idaho is included in Idaho taxable income. See Rule 250 of these rules for information on when pass-through income from a partnership is deemed to have been received. (7-1-21)T

b. The exemption from tax on investment income from a qualified investment partnership does not apply to gains or losses derived from the sale of a nonresident individual's interest in a qualified investment partnership. The source of these gains and losses is governed by Section 63-3026A(3)(a)(vii), Idaho Code, and Rule 266 of these rules. The source of investment income that is not from a qualified investment partnership is determined as provided in Rule 263 of these rules. (7-1-21)T

02. Qualified Investment Partnership. An entity is a qualified investment partnership only if it meets both of the following criteria: (7-1-21)T

a. The entity is classified as a partnership for federal income tax purposes, but is not a publicly traded partnership taxed as a corporation under Section 63-3006, Idaho Code. (7-1-21)T

b. The gross income from investments of the entity is derived at least ninety percent (90%) from investments that when held by a nonresident individual directly, would not produce income subject to the Idaho income tax. See Rules 263 and 266 of these rules. (7-1-21)T

03. Investment Income. For purposes of this exclusion, an item of partnership income is investment income only if it would not be Idaho taxable income of a nonresident individual if the individual held the investment directly. (7-1-21)T

04. Examples. (7-1-21)T

a. A is a nonresident individual member of ABC, a partnership operating solely within Idaho. The taxable income of ABC for the taxable year consists of ninety thousand dollars (\$90,000) of dividend income and ten thousand dollars (\$10,000) of capital gains from stock trading through a brokerage account. If A held the stock directly, Section 63-3026A(3)(a)(iii), Idaho Code, provides that the dividends and capital gains would not be included in Idaho taxable income. Since at least ninety percent (90%) of ABC's income is from investments that would not be taxable to a nonresident individual if held directly by that individual, ABC is a qualified investment partnership and none of A's distributive share of the income is included in Idaho taxable income even though ABC is an Idaho partnership. (7-1-21)T

b. Assume the same facts as in Paragraph 275.04.a. of this rule, except that the ten thousand dollars (\$10,000) of capital gains is from the sale of Idaho real property. Since at least ninety percent (90%) of ABC's income is from investments that would not be taxable to a nonresident individual if held directly by that individual, ABC is a qualified investment partnership. A's distributive share of ABC's dividend income is excluded from A's Idaho taxable income, but A's distributive share of ABC's gain from the sale of Idaho real property is included in Idaho taxable income because Section 63-3026A(3), Idaho Code, provides that such income would be taxable to A if A had owned the property directly. (7-1-21)T

c. A is a nonresident individual member of ABC, a partnership operating solely within Idaho. The taxable income of ABC for the taxable year consists of eighty thousand dollars (\$80,000) of dividend income and twenty thousand dollars (\$20,000) of capital gains from the sale of Idaho real property. ABC is not a qualified investment partnership because less than ninety percent (90%) of ABC's income is from investments that would not be taxable to a nonresident individual if held directly by that individual. A's distributive share of ABC's dividend income and capital gain income is included in Idaho taxable income as provided in Rule 263 of these rules. (7-1-21)T

d. A is a nonresident individual partner in ABC, a partnership with a fifty percent (50%) Idaho apportionment factor. The gross income of ABC consists of ninety thousand dollars (\$90,000) of dividend income, five thousand dollars (\$5,000) of capital gain from the sale of non-Idaho real property used in the trade or business, and five thousand dollars (\$5,000) of gross business income. Since at least ninety percent (90%) of ABC's gross income is from investments that would not be taxable to a nonresident individual if held directly by that individual, ABC is a qualified investment partnership. A's distributive share of ABC's dividend income is excluded from A's Idaho taxable income, but fifty percent (50%) of A's distributive share of ABC's gain from the sale of non-Idaho real property (which is business income under the facts of this example) and fifty percent (50%) of A's distributive share of ABC's other business income is included in Idaho taxable income, based on the Idaho apportionment factor of the partnership as provided in Section 63-3026A(3)(a)(i) and Rule 263 of these rules. (7-1-21)T

Taxable income of an investment partnership, as defined in Section 1501(a)(11.5) of this Act, that is distributable to a nonresident partner shall be treated as nonbusiness income and shall be allocated to the partner's state of residence (in the case of an individual) or commercial domicile (in the case of any other person). However, any income distributable to a nonresident partner shall be treated as business income and apportioned as if such income had been received directly by the partner if the partner has made an election under Section 1501(a)(1) of this Act to treat all income as business income or if such income is from investment activity:

(1) 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);

(2) 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

(3) 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.

35 ILCS 5/1501(11.5) Investment partnership.

(A) The term "investment partnership" means any entity that is treated as a partnership for federal income tax purposes that meets the following requirements:

(i) no less than 90% of the partnership's cost of its total assets consists of qualifying investment securities, deposits at banks or other financial institutions, and office space and equipment reasonably necessary to carry on its activities as an investment partnership;

(ii) no less than 90% of its gross income consists of interest, dividends, and gains from the sale or exchange of qualifying investment securities; and

(iii) the partnership is not a dealer in qualifying investment securities.

(B) For purposes of this paragraph (11.5), the term "qualifying investment securities" includes all of the following:

(i) common stock, including preferred or debt securities convertible into common stock, and preferred stock;

(ii) bonds, debentures, and other debt securities;

(iii) foreign and domestic currency deposits secured by federal, state, or local governmental agencies;

(iv) mortgage or asset-backed securities secured by federal, state, or local governmental agencies;

(v) repurchase agreements and loan participations;

(vi) foreign currency exchange contracts and forward and futures contracts on foreign currencies;

(vii) stock and bond index securities and futures contracts and other similar financial securities and futures contracts on those securities;

(viii) options for the purchase or sale of any of the securities, currencies, contracts, or financial instruments described in items (i) to (vii), inclusive;

(ix) regulated futures contracts;

(x) commodities (not described in Section 1221(a)(1) of the Internal Revenue Code) or futures, forwards, and options with respect to such commodities, provided, however, that any item of a physical commodity

to which title is actually acquired in the partnership's capacity as a dealer in such commodity shall not be a qualifying investment security;

(xi) derivatives; and

(xii) a partnership interest in another partnership that is an investment partnership.

Ill. Admin. Code tit. 86, § 100.3500(d)(1)

Investment Partnerships. For taxable years ending on or after July 30, 2004 (the effective date of Public Act 93-840), in the case of an investment partnership, as defined in Section 100.9730 of this Part:

1) Except as provided in subsection (d)(2), taxable income that is distributable to a nonresident partner shall be treated as nonbusiness income and shall be allocated to the partner's state of residence (in the case of an individual) or commercial domicile (in the case of any other person). (IITA Section 305(c-5)) IITA Section 203(e)(3) shall not require recapture of business expenses if the income from an investment partnership was treated as business income in years prior to July 30, 2004 (the effective date of Public Act 93-840) and is treated as nonbusiness income under this subsection (d).

2) Any income distributable to a nonresident partner shall be treated as business income and apportioned as if such income had been received directly by the partner if the partner has made an election under Section 1501(a)(1) of the IITA to treat all income as business income or if such income is from investment activity:

A) 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) (IITA Section 305(c-5)(1));

B) 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 (IITA Section 305(c-5)(2)); or

C) 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 (IITA Section 305(c-5)(3)).

3) Income treated as business income received directly by a partner under subsection (d)(2) shall be apportioned using the apportionment factors of the partner, without regard to any factors of the partnership.

Kentucky

Ky. Rev. Stat. Ann. § 141.206(14)

(a) Nonresident individuals shall not be taxable on investment income distributed by a qualified investment partnership. For purposes of this subsection, a "qualified investment partnership" means a pass-through entity that, during the taxable year, holds only investments that produce income that would not be taxable to a nonresident individual if held or owned individually.

(b) A qualified investment partnership shall be subject to all other provisions relating to a pass-through entity under this section and shall not be subject to the tax imposed under KRS 141.040 or 141.0401.

Massachusetts

830 CMR 62B.2.2

(2) Definitions .

...

Distributive Share , income, gain, loss, deduction, or credit from a pass-through entity for a taxable year allocated to a member taxable under M.G.L. c. 62 or c. 63.

Investment Partnership , a partnership, including a limited liability company with any member treated as a partner under Massachusetts tax law, that meets the following three criteria:

- (a) **substantially all** of the partnership's assets consist of investment securities, deposits at banks or other financial institutions, or office equipment and office space reasonably necessary to carry on the activities of an investment partnership;
- (b) substantially all of the partnership's income is from interest, dividends and capital gains; and
- (c) the partnership is not engaged in a trade or business in Massachusetts.

Massachusetts-source Income , Massachusetts gross income derived from or effectively connected with:

- (a) any trade or business, including any employment, carried on by a pass-through entity in Massachusetts, whether or not the entity is actively engaged in a trade or business or employment in Massachusetts in the year in which the income is received;
- (b) the participation in any lottery or wagering transaction in Massachusetts; or
- (c) the ownership of any interest in real or tangible personal property located in Massachusetts.

Pass-through entities with income from sources both within Massachusetts and elsewhere must allocate and apportion the income according to 830 CMR 62.5A.1 (6) to determine the amount of Massachusetts-source income.

Member , a member of a pass-through entity, including a shareholder of an S corporation; a partner in a partnership, including a limited partner in a limited partnership and a partner in a limited liability partnership; a member of a limited liability company treated as a partner under Massachusetts tax law; and a beneficiary of an estate.

Nonresident, any natural person, estate, or trust that is not a resident or domiciliary of Massachusetts; any pass-through entity without a usual place of business in Massachusetts; or any corporation that is not required to file or does not file a tax return in Massachusetts with regard to distributive share derived from a pass-through entity that is subject to the provisions of 830 CMR 62B.2.2.

Pass-through Entity , an entity whose income, loss, deductions and credits flow through to members for Massachusetts tax purposes, including a general partnership, limited partnership, limited liability partnership, or limited liability company with a member treated as a partner under Massachusetts tax law, an S corporation, an estate not taxed at the entity level, and a trust not taxed at the entity level, including a grantor-type trust.

Publicly Traded Partnership , an entity defined as a publicly traded partnership by § 7704(b) of the Internal Revenue Code that is treated as a partnership for the taxable year under the Internal Revenue Code.

Qualified Securities Partnership , a limited partnership that is engaged exclusively in buying, selling, dealing in or holding securities on its own behalf, and not as a broker, as described in M.G.L. c. 62, § 17(b) or 830 CMR 63.39.1 (8)(b) .

Tiered Structure , a pass-through entity that has a pass-through entity as a member. As between two entities, the pass-through entity that is a member is the upper-tier entity, and the entity of which it is a member is the lower-tier entity. A tiered pass-through entity arrangement may have two or more tiers; in such cases, a single entity can be both a lower-tier and an upper-tier entity.

(3) Pass-through Entities Required to Withhold; Members Subject to Withholding .

(a) General Rule . A pass-through entity that maintains an office or engages in business in Massachusetts must deduct and withhold Massachusetts tax from the member's pro-rata share of the pass-through entity's Massachusetts-source income, unless:

1. the pass-through entity is exempt from this requirement under 830 CMR 62B.2.2(3)(b); or
2. the member is exempt from this requirement under 830 CMR 62B.2.2(3)(c).

(b) Exempt Pass-through Entities . The following pass-through entities are not required to participate in pass-through entity withholding:

1. An Investment Partnership or a partnership that only invests in Investment Partnerships and has no Massachusetts-source income from other sources;
2. A trust or estate that is already required to withhold on nonresident members, if it has any, under M.G.L. c. 62, § 10(g);
3. An upper-tier pass-through entity in a tiered structure that can demonstrate that a lower-tier pass-through entity has previously withheld and made estimated payments of all of the Massachusetts tax on Massachusetts-source income derived by the upper-tier pass-through entity that would otherwise be subject to withholding by the upper-tier entity. (See tiered structures at 830 CMR 62B.2.2(5).)
4. A Publicly Traded Partnership; and
5. An entity that is prohibited under federal or state law from withholding tax from distributions to members as otherwise required under 830 CMR 62B.2.2, such as certain for-profit entities that provide low-income housing which are funded by or through Mass-Housing or the United States Department of Housing and Urban Development; the exemption applies only for years in which distributions are prohibited under federal or state law. Contractual restrictions on distributions, such as loan covenants or organizational documents, do not qualify an entity for this exemption.

Maryland

Maryland Administrative Release No. 6

II. Exemptions

B. Partnerships

Partnerships whose activities and assets are limited to investment in stocks, bonds, futures, options or debt obligations other than debt instruments directly secured by real or tangible personal property are not subject to the nonresident member tax merely because the investment decisions, trading orders, research and the like are conducted by a general partner from a Maryland location. Partnerships, however, such as brokerage firms which deal with the general public, are not exempt if the business is conducted within Maryland.

a. Income from sources within this State for a nonresident individual, estate or trust means the income from the categories of gross income enumerated and classified under chapter 5 of this act to the extent that it is earned, received or acquired from sources within this State:

- (1) By reason of ownership or disposition of any interest in real or tangible personal property in this State; or
- (2) In connection with a trade, profession, occupation carried on in this State or for the rendition of personal services performed in this State; or
- (3) As a distributive share of the income of an unincorporated business, profession, enterprise, undertaking or other activity as the result of work done, services rendered or other business activities conducted in this State except as allocated to another state pursuant to regulations promulgated by the director under this act; or
- (4) From intangible personal property employed in a trade, profession, occupation or business carried on in this State; or

c. For purposes of paragraphs (2) through (4) of subsection a. of this section, a nonresident taxpayer shall not be deemed to be carrying on a trade, profession, occupation, business, enterprise, undertaking or other activity in this State, or to be rendering personal services in this State, solely as a result of the purchase, holding and sale of intangible personal property by the trade, profession, occupation, business, enterprise or undertaking, to the extent that (1) the activities related to the intangible personal property are for the account of the trade, profession, occupation, business, enterprise, or undertaking and (2) the trade, profession, occupation, business, enterprise, or undertaking does not hold the intangible personal property for sale to customers. For the purposes of this subsection: "intangible personal property" includes, but is not limited to, "commodities", as defined in paragraph (2) of subsection (e), and "securities," as defined in paragraph (2) of subsection (c), of section 475 of the federal Internal Revenue Code of 1986, 26 U.S.C. s.475; and "purchase, holding and sale of intangible personal property" includes activities incidental thereto giving rise to income, including commitment fees, breakup fees, income from securities lending, and any other incidental activities as prescribed or authorized by the director. The director shall adopt such regulations as the director deems necessary to accomplish the purposes of this section.

N.J. Rev. Stat. § 54:10A-4(r) "Qualified investment partnership" means a partnership under this act that has more than 10 members or partners with no member or partner owning more than a 50% interest in the entity and that derives at least 90% of its gross income from dividends, interest, payments with respect to securities loans, and gains from the sale or other disposition of stocks or securities or foreign currencies or commodities or other similar income (including but not limited to gains from swaps, options, futures or forward contracts) derived with respect to its business of investing or trading in those stocks, securities, currencies or commodities, but "investment partnership" shall not include a "dealer in securities" within the meaning of section 1236 of the federal Internal Revenue Code of 1986, 26 U.S.C. s.1236.

N.J. Admin. Code tit. 18, § 7-1.21

(a) "Qualified investment partnership" means a partnership under this Act that has more than 10 members or partners with no member or partner owning more than a 50 percent interest in the partnership and that derives at least 90 percent of its gross income from dividends, interest, payments with respect to securities loans, and gains from the sale or other disposition of stocks or securities or foreign currencies or commodities or other similar income (including, but not limited to, gains from swaps, options, futures or forward contracts) derived with respect to its business of investing or trading in those stocks, securities, currencies, or commodities, but "investment partnership" shall not include a "dealer in securities" within the meaning of I.R.C. § 1236. 26 U.S.C. § 1236 .

1. If a partnership would otherwise qualify as a "qualified investment partnership," except that it has 10 or fewer partners, such partnership is deemed a "qualified investment partnership," if:
 - i. It is managed by an independent third party for a fee;

ii. There is no direct or indirect relationship between the manager and any of the partners; and

iii. There is no direct or indirect affiliation between or among the partners.

New Mexico

N.M. Code R. § 3.3.11.14

A. Income of an individual, other than a dealer holding securities for sale to customers in the ordinary course of the dealer's trade or business, from the purchase or sale of securities for the individual's own account or from the writing of securities option contracts for the individual's own account is deemed to be income other than income from engaging in a trade or business. The income is allocable to the individual's state of residence.

B. Income of an investment entity from the purchase or sale of securities for the entity's own account or from the writing of securities option contracts in the entity's own account is deemed to be income other than income from engaging in a trade or business. The income attributable to each of the entity's owners is allocable to that owner's state of residence.

C. For the purposes of this regulation, the term "investment entity" means a pass-through entity, as that term is defined in Section 7-3-2 NMSA 1978, meeting the following criteria:

(1) the entity is not a dealer holding securities for sale to customers in the ordinary course of the entity's trade or business;

(2) each of the entity's owners during the taxable year is an individual; and

(3) ninety percent or more of the entity's income during the taxable year derives from the purchase or sales of securities or from writing of securities option contracts.

New York

N.Y. Comp. Codes R. & Regs. tit. 20, § 1-3.2(a)(6)

(i) A foreign corporation is doing business, employing capital, owning or leasing property or maintaining an office in New York State if it is a limited partner of a partnership, other than a portfolio investment partnership, which is doing business, employing capital, owning or leasing property or maintaining an office in New York State and if it is engaged, directly or indirectly, in the participation in or the domination or control of all or any portion of the business activities or affairs of the partnership. A foreign corporation is engaged in such manner in the business activities or affairs of the partnership if one or more of certain factual situations, including but not limited to the following, exist during the taxable year or, except for clause (a) of this subparagraph, any previous taxable year:

(iii) As used in this paragraph, the following terms have these meanings:

(d) The term portfolio investment partnership means a limited partnership which meets the gross income requirement of section 851(b)(2) of the Internal Revenue Code. For purposes of the preceding sentence, income and gains from commodities (not described in section 1221[1] of such Code) or from futures, forwards, and options with respect to such commodities shall be included in income which qualifies to meet such gross income requirement. Such commodities must be of a kind customarily dealt in on an organized commodity exchange and the transaction must be of a kind customarily consummated at such place, as required by section 864(b)(2)(B)(iii) of such Code. To the extent that such a partnership has income and gains from commodities (not described in section 1221[1] of such code) or from futures, forwards, and options with respect to such commodities, such income and gains must be derived by a partnership which is not a dealer in commodities and is trading for its own account as described in section 864(b)(2)(B)(ii) of the Internal Revenue

Code. The term portfolio investment partnership shall not include a dealer (within the meaning of section 1236 of the Internal Revenue Code) in stocks or securities.

North Carolina

N.C. Admin. Code tit. 17, r. 06B.3503(c) Investment Partnerships -- A partnership whose only activity is as an investment partnership shall not be considered to be doing business in North Carolina. An investment partnership means a partnership that is not a "dealer in securities," as defined in section 475(c)(1) of the Internal Revenue Code, and that derives income exclusively from buying, holding, and selling securities for its own account. If any of the partnership's income is from other activities, either within or outside this State, either received directly or flowing through from other pass-through entities, the partnership is not an investment partnership for North Carolina tax purposes. Other activities include providing services or products to customers and holding real property for appreciation and income. An investment partnership shall not be required to file an income tax return in North Carolina or pay income tax to North Carolina on behalf of its nonresident partners.

Ohio

Ohio Rev. Code Ann. § 5733.401

(A) As used in this section:

(1) "Investment pass-through entity" means a pass-through entity having for its qualifying taxable year at least ninety per cent of its gross income from transaction fees in connection with the acquisition, ownership, or disposition of intangible property, loan fees, financing fees, consent fees, waiver fees, application fees, net management fees, dividend income, interest income, net capital gains from the sale or exchange of intangible property, or distributive shares of income from pass-through entities; and having for its qualifying taxable year at least ninety per cent of the net book value of its assets represented by intangible assets. Such percentages shall be the quarterly average of those percentages as calculated during the pass-through entity's taxable year.

(2) "Net management fees" means management fees that a pass-through entity earns or receives from all sources, reduced by management fees that the pass-through entity incurs or pays to any person.

(B) For the purposes of divisions (A) and (C) of this section only, an investment in a pass-through entity shall be deemed to be an investment in an intangible asset, and sections 5733.057 and 5747.231 of the Revised Code do not apply for the purposes of making the determinations required by division (A) of this section or claiming the exclusion provided by division (C) of this section.

(C) (1) Except as otherwise provided in division (C)(2) of this section, for the purposes of division (A) of section 5733.40 of the Revised Code, an investment pass-through entity shall exclude from the calculation of the adjusted qualifying amount the portion of the investment pass-through entity's net income attributable to transaction fees in connection with the acquisition, ownership, or disposition of intangible property; loan fees; financing fees; consent fees; waiver fees; application fees; net management fees; dividend income; interest income; net capital gains from the sale, exchange, or other disposition of intangible property; and all types and classifications of income attributable to distributive shares of income from other pass-through entities. Nothing in this division shall be construed to provide for an exclusion of any item from adjusted qualifying amount more than once.

(2) Notwithstanding division (C)(1) of this section, the portion of the investment pass-through entity's net income attributable to net management fees shall not be excluded from the calculation of the adjusted qualifying amount if such net management fees exceed five per cent of the entity's net income calculated in accordance with generally accepted accounting principles.

Ohio Rev. Code Ann. § 5733.402

(A) Notwithstanding section 5733.40, 5733.41, 5747.41, or 5747.43 of the Revised Code, but subject to divisions (B), (C), and (D) of this section, for taxable years beginning after 1997, a qualifying pass-through entity, hereinafter the "exempt entity," is not subject to the taxes imposed by and required to be paid under those sections with respect to distributive shares of income and gain that pass through from the qualifying pass-through entity to another qualifying pass-through entity, hereinafter the "investing entity," if the investing entity irrevocably acknowledges that it has nexus with this state under the Constitution of the United States during the exempt entity's entire taxable year.

(B) (1) Division (A) of this section does not apply to the extent that the investing entity fails to make a good faith and reasonable effort to comply on a reasonably timely basis with section 5733.41 and sections 5747.41 to 5747.453 of the Revised Code.

(2) The investing entity and the exempt entity bears the burden of establishing by a preponderance of the evidence that the investing entity made a good faith and reasonable effort to comply on a reasonably timely basis with section 5733.41 and sections 5747.41 to 5747.453 of the Revised Code.

(3) This section does not modify, reduce, abate, defer, postpone, or bar the imposition of and the required payment of any fee, interest, or penalty otherwise due under Title LVII [57] of the Revised Code.

(C) Except as otherwise provided in division (D) of this section, nothing in this section shall be construed to deny the application of division (A) of this section to the distributive share of income and gain of an investing entity that, with respect to that distributive share, is itself an exempt entity with respect to another qualifying pass-through entity, hereinafter the "upper level investing entity," if the upper level investing entity irrevocably acknowledges that it has nexus with this state under the Constitution of the United States during the investing entity's entire taxable year. Division (B) of this section also applies to the upper level investing entity. This division applies regardless of the number of levels of investing entities.

(D) An investing entity or upper level investing entity does not include an investment pass-through entity as defined in section 5733.401 of the Revised Code, and division (A) of this section does not apply with respect to any distributive shares of income or gain that pass through to an investment pass-through entity.

Oregon

Oregon Revenue Bulletin No. 2010-02

Partnership minimum tax

Investment partnerships: A partnership whose purpose is investing (often called an investment club) generally isn't doing business in Oregon if it simply pools resources to hold stocks and securities for long-term investment. Therefore, it generally isn't required to pay the partnership minimum tax. The club still must file a partnership return if it has Oregon-source income or one of the partners is an Oregon resident. Many investment clubs don't owe the partnership minimum tax. However, labels are not determinative, and one must consider the partnership's facts and circumstances. An investment club may be doing business in Oregon—and subject to the partnership minimum tax—if it regularly conducts short-term trading for profit, or conducts substantial and continuous activities marketing portfolio investments.

Texas

Tex. Tax Code § 171.0002. Definition Of Taxable Entity

(a) Except as otherwise provided by this section, "taxable entity" means a partnership, limited liability partnership, corporation, banking corporation, savings and loan association, limited liability company, business trust, professional association, business association, joint venture, joint stock company, holding company, or other legal entity. The term includes a combined group. A joint venture does not include joint operating or co-ownership arrangements meeting the requirements of Treasury Regulation Section 1.761-2(a)(3) that elect out of federal partnership treatment as provided by Section 761(a), Internal Revenue Code.

(b) "Taxable entity" does not include:

- (1) a sole proprietorship;
- (2) a general partnership:
 - (A) the direct ownership of which is entirely composed of natural persons; and
 - (B) the liability of which is not limited under a statute of this state or another state, including by registration as a limited liability partnership;
- (3) a passive entity as defined by Section 171.0003; or
- (4) an entity that is exempt from taxation under Subchapter B.

Tex. Tax Code § 171.0003

(a) An entity is a passive entity only if:

- (1) the entity is a general or limited partnership or a trust, other than a business trust;
- (2) during the period on which margin is based, the entity's federal gross income consists of at least 90 percent of the following income:
 - (A) dividends, interest, foreign currency exchange gain, periodic and nonperiodic payments with respect to notional principal contracts, option premiums, cash settlement or termination payments with respect to a financial instrument, and income from a limited liability company;
 - (B) distributive shares of partnership income to the extent that those distributive shares of income are greater than zero;
 - (C) capital gains from the sale of real property, gains from the sale of commodities traded on a commodities exchange, and gains from the sale of securities; and
 - (D) royalties, bonuses, or delay rental income from mineral properties and income from other nonoperating mineral interests; and
- (3) the entity does not receive more than 10 percent of its federal gross income from conducting an active trade or business.

(a-1) In making the computation under Subsection (a)(3), income described by Subsection (a)(2) may not be treated as income from conducting an active trade or business.

(b) The income described by Subsection (a)(2) does not include:

- (1) rent; or
- (2) income received by a nonoperator from mineral properties under a joint operating agreement if the nonoperator is a member of an affiliated group and another member of that group is the operator under the same joint operating agreement.

34 Tex. Admin. Code § 3.582

(c) Qualification as a passive entity. To qualify as a passive entity:

- (1) the entity must be one of the following for the entire period on which the tax is based:
 - (A) general partnership;
 - (B) limited partnership;
 - (C) limited liability partnership; or
 - (D) trust, other than a business trust; and

(2) at least 90% of an entity's federal gross income for the period on which margin is based must consist of the following sources of income:

(A) dividends, interest, foreign currency exchange gain, periodic and nonperiodic payments with respect to notional principal contracts, option premiums, cash settlements or termination payments with respect to a financial instrument, and income from a limited liability company;

(B) distributive shares of partnership income to the extent that those distributive shares of income are greater than zero;

(C) net capital gains from the sale of real property, net gains from the sale of commodities traded on a commodities exchange, and net gains from the sale of securities; and

(D) royalties from mineral properties, bonuses from mineral properties, delay rental income from mineral properties and income from other nonoperating mineral interests including nonoperating working interests not described in subsection (d)(2) of this section.

(3) An entity with no federal gross income does not qualify as a passive entity under paragraph (2) of this subsection.

(d) The income described by subsection (c)(2) of this section, does not include:

(1) rent; or

(2) income received by a nonoperator from mineral properties under a joint operating agreement if the nonoperator is a member of an affiliated group and another member of that group is the operator under the same joint operating agreement.

(e) Conducting an active trade or business. To be considered a passive entity, an entity may not receive more than 10% of its federal gross income for the period on which margin is based from conducting an active trade or business. Income described by subsection (c)(2) of this section, may not be treated as income from conducting an active trade or business.

Utah

Utah Code Ann. R865-9I-13. Pass-Through Entity Withholding Pursuant to Utah Code Ann. Sections 59-10-116, 59-10-117, 59-10-118, 59-10-1403.2, and 59-10-1405

(1) A pass-through entity must withhold and pay over to the state a tax on:

(a) the business income of the pass-through entity to the extent the business income is derived from Utah sources in accordance with Section 59-10-116; and

(b) the nonbusiness income of the pass-through entity derived from or connected with Utah sources.

(i) "Nonbusiness income of the pass-through entity derived from or connected with Utah sources" does not include portfolio income if the income would not be reportable to Utah on the pass-through entity taxpayer's Utah state tax return or the Utah state tax return of any downstream pass-through entity taxpayer.

(ii) "Downstream pass-through entity taxpayer" means a pass-through entity taxpayer that is a pass-through entity taxpayer of any entity that is itself a pass-through entity taxpayer.

Previous rulings have held that pass-through entities that are established solely to invest in intangible personal property, such as stocks and bonds, and that have no employees, and no real or tangible property (hereafter referred to as “investment pass-through entities”) are not considered to be carrying on a trade or business. See Public Documents (P.D.) 94-275 (9/16/94), 95-280 (11/3/95), and 96-42 (4/10/96). Thus, the income from the intangible property held by an investment pass-through entity is not income from Virginia sources, and these types of pass-through entities will not be required to file the new Form 502.

The person who manages the investments of such a pass-through entity will be subject to taxation in Virginia if the manager carries on any business in Virginia and will be required to file the appropriate return. The fact that the manager of an investment pass-through entity is located in Virginia will not cause the income of the investment pass-through entity to be considered income from Virginia sources, whether the manager is one of the owners of the investment pass-through entity or an unrelated party.

The income, deductions and other attributes of an investment pass-through entity will pass through to its owners and be included in the federal adjusted gross income or federal taxable income of each individual or corporate owner. The impact of such income on the Virginia tax liability of the owner is as follows:

Residents: Individuals who are residents of Virginia will file a Form 760 reporting their federal adjusted gross income. Any income from an investment pass-through entity that is included in federal adjusted gross income will not be considered income derived from another state based solely on the fact that the state in which the investment PTE is organized or managed is other than Virginia.

Nonresidents: Individuals who are not residents of Virginia will not be required to file a nonresident Virginia income tax return solely because of income from an investment pass-through entity. If they have other income from Virginia sources requiring the filing of a nonresident income tax return, the income derived from an investment pass-through entity will not be considered income from Virginia sources even if the [sic] an investment pass-through entity is organized under Virginia law or managed by a person located in Virginia.

Corporations:

Nexus: Corporations will not be required to file a Virginia income tax return solely because of income from an investment pass-through entity. If a corporation has other income from Virginia sources requiring the filing of a Virginia income tax return, the income derived from such a pass-through entity will not be considered gross receipts attributable to Virginia for purposes of the sales factor solely because an unrelated party located in Virginia is managing the intangible assets of the investment pass-through entity or otherwise conducting income-producing activity on behalf of the investment pass-through entity.

Apportionment Factors: In general, corporations that are limited partners do not include their shares of partnership property, payroll and sales in the numerator or denominator for purposes of determining their Virginia apportionment factors. Under P.D. 95-19 (2/13/95), however, when the limited partner and the general partner are related parties and the affiliated group holds a substantial amount of the partnership interests, the limited partner may be required to include its proportionate share of the limited partnership's property, payroll and sales for purposes of determining its Virginia apportionment factor.

Apportionable Income: Under Virginia law, all income of a multistate corporation, other than dividends, is generally apportionable. Corporations may request an alternative method of allocation and apportionment in which certain investment function income is allocable to specific states. This requires a facts and circumstances analysis and general rules cannot be provided. The relationship between the corporate owner and the manager of the investment pass-through entity would be one of many relevant factors in the determination as to whether an alternative method will be allowed as well as whether an adjustment to taxable income is required under Va. Code §§ 58.1-445 or 58.1-446.

Royalty addback: If the intangible assets of the investment pass-through entity consist of patents, copyrights, trademarks and similar assets, any royalties or other payments by a corporate owner or its affiliated entities to the investment pass-through entity with respect to such assets may be subject to the addback requirements of Va. Code § 58.1-402 C (8).

SECTION IV: ANALYSIS SOURCING OF INVESTMENT PARTNERSHIP INCOME

Section III above describes the rules for sourcing investment partnership income used by about half the states, which source that income to the residence, or sometimes domicile, of the partners. This Section IV analyzes this special sourcing treatment and, in particular:

- If there is a principled basis for this treatment,
- If there are policy reasons for this treatment,
- Whether the treatment can be applied equitably,
- To what extent is there a need for uniformity,
- What processes or other tools are necessary to ensure the rules work as intended,
- What should states do if they chose not to apply the special sourcing treatment.

Based on the analysis of these questions, as summarized in subsection A below, this Section IV also sets out findings and recommendations in subsection B.

Section IV. A. – Analysis

This Section IV. A. analyzes the special sourcing treatment of investment partnership income.

NOTE: This analysis often refers to “limited/passive” partners. Traditionally, partners that wanted to have limited liability for partnership debts could not take an active role in the partnership activities. That is no longer true. Nevertheless, the common distinction made with respect to partners, including with respect to partners of investment partnerships, is whether they are general or limited, often with the assumption that limited partners are also passive investors. For the analysis below, the critical distinction is that they are passive.

Is there a Principled Basis for the Sourcing Treatment?

As summarized in Section III above, some states sourcing rules for investment partnership income appear to be based on certain general tax principles.⁵⁹ This may not always be the case. In addition, there may be policy reasons for the sourcing treatment, discussed separately below. But to the extent the rules appear based on general principles—those principles include:

- Nexus or state tax imposition (“doing business”) standards,
- Limitations on the use of apportionment to source income,
- The federal pass-through principle that partnership items should be taxed as if earned directly by partners.

Nexus or State Doing-Business Standards

To tax income, states must have both a constitutional jurisdiction (nexus) and must impose the tax by statute. Many states use a broad statutory standard for imposition of tax often based on whether the taxpayer is “doing business in the state.” In some states, the statutory standard may be interpreted co-extensive with the constitutional limits, although in others the statutory standard may be interpreted as somewhat broader or narrower than those limits.⁶⁰ This analysis focusses primarily on the constitutional limits.

Perhaps most importantly, however, application of constitutional nexus or doing-business standards to partnership income taxed on a pass-through basis raises a critical question: Can states impute nexus over the partnership to its nonresident limited/passive partners? In general, views on this question appear to have shifted over time. It now appears states generally take the position that nexus with the partnership

⁵⁹ These rules may be set out in statutes or in regulations—but even statutory rules may be a response to certain general principles, or may solely be adopted for other policy reasons.

⁶⁰ See, for example, *Telebright Corp. v. Director, Div. of Taxation*, 38 A.3d 604 (N.J. Super. Ct. App. Div. 2012) and *Target Brands, Inc. v. Dep’t of Revenue of Colo.*, No. 2015CV33831, 2017 BL 487167 (D. Colo. Jan. 27, 2017);

can be imputed to the entity's partners, including its limited partners.⁶¹ So if the entity is subject to the state's taxing jurisdiction, its limited/passive partners would also be subject to that jurisdiction. One leading state tax expert puts it this way:

"Courts and administrative tribunals almost invariably apply the jurisdictional principles described above to limited partners as well as to general partners. Indeed, the seminal cases establishing states' jurisdiction to tax nonresident partners involved limited partners. Accordingly, if a partnership has substantial nexus with the state, so does the limited partner. Hence, the taxability of a nonresident limited partner, and the deductibility of his losses, in a particular state turns (as in the case of a general partnership) on the question of whether, and the extent to which, the partnership is carrying on its business within the state, not on whether the partner is individually engaged in activity in the state." Hellerstein, Hellerstein & Appleby, *State Taxation*, Thomson Reuters/Tax & Accounting, 3rd ed. 2001 & Supp. 2022-1, ¶ 20.08[2][a][ii].

This logic seems applicable to state doing-business standards as well.

State sourcing rules for investment partnership income often include a statement that the rules will apply even if the investment partnership has offices in the state, provided those offices are reasonably necessary to carry on the partnership's investment activities. Indeed, no special sourcing rules would be necessary unless the income might be sourced, instead, based on the investment partnership's activities in the state.

So the first question is whether the investment partnership's offices and "reasonably necessary" activities in the state provide nexus over that partnership. There does not appear to be any principled basis for the conclusion that such presence would not give rise to nexus. Therefore, some states may base the special sourcing rules for investment partnership income, instead, on the view that the investment partnership's activities cannot be imputed to its partners. This view is inconsistent with the general view that partnership activities can be imputed, even to limited partners. At the very least, given the numerous factors that might go into the constitutional analysis, such a general rule is overly broad.

Of course, states may adopt bright-line rules, which may be overly broad in some cases, in order to create more certainty and avoid controversy. But, unless the state also makes clear that the basis for the special sourcing rule cannot be relied upon as a general interpretation of state's taxing authority, the rule could be misinterpreted or misapplied. This especially true in the partnership tax area where the state rules are generally less well-developed.

In addition, the rule that an investment partnership may have offices or carry on reasonably necessary activities in the state that, in effect, will not be imputed to nonresident limited partners still leaves many questions: What activities, exactly, would be allowed? Would such activities include having portfolio companies in the state? What if the investment partnership regularly advises or provides other services to those portfolio companies? What if a nonresident limited partner also has related activities in the state or a relationship to the partnership's portfolio companies?

Limitations on the Use of Apportionment

As discussed in Section I. B., there are also constitutional limits on the ability of states to use a taxpayer's or business's general apportionment ratio to source its net income. There must be a sufficient connection between the general apportionment ratio, as well as the activities of the business which it represents, and the items that go into the net apportionable income. If that connection with some item is lacking, it may not be apportioned using the general ratio, but would instead be sourced using other methods—including separate ratios or other rules of assignment.

The U.S. Supreme Court has established constitutional limits for what is apportionable income in this sense, but has generally done so in the context of corporate taxpayers that have income or gains from investments in other entities. A detailed analysis of this precedent is beyond the scope of this white paper. Suffice it to say, the Court has sometimes distinguished income from investments that serve an "operational" function from those investments that serve a purely "investment" function, treating the former as

⁶¹ This subject is also covered in more detail in the draft Issue Outline of the work group, available on the project page, here: <https://www.mtc.gov/Uniformity/Project-Teams/Partnership-Tax>.

apportionable using the taxpayer's factors and the latter as non-apportionable. See *Allied-Signal, Inc. v. Director, Div. of Taxation*, 504 U.S. 768, 787 (1992). But the dividing line between these categories of investment income is based on a number of factors. Nor is it entirely clear how to draw this line when a taxpayer's activity primarily involves investing.⁶²

Under this Supreme Court precedent, investment partnership income might be subject to apportionment depending on the circumstances and the method used. For example, a corporate limited partner of an investment partnership may have invested in that partnership for an operational purpose. In that case, the income might be apportionable using the corporate taxpayer's general ratio—which might also be a blend of the corporate and partnership factors as discussed in Section I. B.

Also, as noted in Section I. B., application of apportionment in the partnership context often does not involve the use of the taxpayer's (partner's) factors—but the partnership's own factors—especially when the partner is a non-resident individual. While it is certainly possible that an item of partnership income would not have a sufficient connection to the partnership's own general apportionment ratio to meet the constitutional standard, this would be the exception.

So, as with nexus, it appears that any determination that investment partnership income is always non-apportionable, whether using the partner's or the entity's factors, and must therefore be sourced to a partner's residence or domicile would be an overly broad reading of the constitutional standard. Again, states might adopt such a bright-line rule to create more certainty. But states should be clear that this is the nature of the rule, which may help avoid arguments as to whether the state's interpretation of the related principle should apply in other contexts.

Conformity to the Federal Principle that Partnership Items should be Taxed as if Earned Directly

As discussed in Section I. A., the federal pass-through system is based on an expressed goal of taxing partnership items as if they were earned or incurred directly by partners. This means that the substantive tax rules that apply to the treatment of different items, determining their amount, timing, character, etc., will apply to the share of those items allocated to each partner as well.

This is an important principle of the pass-through system which may be viewed as having a bearing on the proper state sourcing of partnership items as well. To the extent such items, if earned directly, would be sourced to the partner's state of residence or domicile, then sourcing them in the same way when they are allocated from an investment partnership would be consistent with this federal principle. And while each state's sourcing rules for such items would control, most states do source certain types of investment income (e.g. dividends, sales of stock, etc.) to an individual owner's residence.

Special sourcing rules based on this principle may be slightly different than rules based on nexus/doing-business standards or limitations on apportionment. Rather than looking solely at the nature of the investment partnership, it would also be necessary to look at the nature of the income allocated to partners. But again, states might impose a bright-line standard to avoid uncertainty and controversy.

Note that basing the rules on this principle might also help to avoid the use of the special sourcing rules to shift income sourcing through the use of investment partnership structures. For example, it would not be possible for partners in a business partnership to simply contribute their interests in the business to an investment partnership in order to shift the sourcing of their income. The income allocated from the business partnership through the investment partnership, if earned directly, would still be the type of income which would be sourced to where the business operated.

⁶² A related question has been raised in litigation over whether states may use investee apportionment when sourcing gains from the sale of partnership interests, discussed in Section I. B. above. In these cases, those opposing investee apportionment have sometimes argued that the gain should not be sourced to the location of the partnership's operations—but rather to the location of the partner/owner who is making the investment decision to sell the interest in the partnership. Applying that same logic to the sourcing of investment partnership income, the proper location to source that income would be the state where the investment partnership has offices and where it makes investment decisions—not the residence of the limited/passive partners in that partnership.

Are there Other Policy Reasons for Special Sourcing Treatment?

States may also have other policy reasons for granting special sourcing treatment to investment partnership income. Such reasons might include ease of compliance and administration, economic development, and equity. Equity concerns are addressed in the separate subsection below.

Relative Ease of Compliance and Administration

It may be difficult to apportion certain kinds of investment partnership income. As discussed in Section I. B., taxpayers with regular investment activities, such as financial institutions, must attribute receipts from investments to particular offices, which may be in different states, in order to compute their receipts factor. Receipts from publicly traded securities, commodities, or certain kinds of debt securities (e.g., dividends, capital gains, interest, etc.) are generally attributed to where the taxpayer manages the investments—or if this is not clear—to the taxpayer's domicile. States may reasonably conclude that for some investment partnerships, applying this type of sourcing to the partnership's income is not worth the complexity of compliance and administration, and that simply sourcing the income to the partner's residence or domicile is therefore preferable.

Economic Development

States may also consider the potential effect of different sourcing policies on economic development within the state. It is not clear that this policy goal has influenced the rules in states that have adopted special sourcing treatment of investment partnership income. In most states, the investment partnership may only take advantage of the sourcing treatment where they have limited assets and activities in the state. And in a number of states, the investment partnership may not qualify if it holds interests in other non-investment partnerships. Also, there may be exceptions for income of the managing or general partner that require it to be sourced where that partner's activities are conducted. Nor does it appear that there is, at least in most states, any reason to believe that the sourcing treatment would influence investment or location decisions for investment partnerships.

Can the Special Sourcing Treatment be Applied Equitably?

Special sourcing rules that vary the general sourcing treatment of partnership income for state tax purposes would appear, by their nature, to be inequitable. States that apply special sourcing treatment to investment partnership income often use bright-line rules which invariably limit the application of this treatment using strict asset and income tests or by imposing other qualifications. These limitations will inevitably lead to different treatment of the income of partnerships that may otherwise be very similar.

But an important reason for the limitations imposed by states on the special sourcing treatment is the need to avoid the shifting of income sourcing through the use of an investment partnership structure. If it were simple to change the general sourcing of partnership income by simply inserting a tiered partnership above a business partnership, and to qualify that tiered partner as an investment partnership, then state sourcing requirements would become elective.

Nevertheless, the special sourcing treatment of investment partnership income may lead to greater tax equity in certain instances, depending on how it is applied. But equitable considerations also depend on the type of partner, whether the partner holds the interest directly or indirectly, and the nature of the partner's role in the partnership. There are reasons to limit application of the special sourcing treatment and not apply it to corporate partners, tiered operating partnerships, or individual who, directly or indirectly, take an active role in the investment partnership.

Application to Corporate Partners and Tiered Operating Partnerships

There appears to be no compelling reason to apply the special sourcing treatment to investment partnership income that is allocated to corporate partners. There is a well-developed line of precedent for determining when the income (loss) of corporations from investing excess capital will be treated as apportionable income and included in the apportioned base, or whether that income will be treated as non-apportionable and sourced using rules of specific assignment—which may result in the income being sourced to the corporation's domicile. Introducing a special bright-line rule applicable in every case will create inequity between investment partnerships versus other investment income and likely create additional complexity rather than reducing complexity.

Tiered Operating Partnership Partners

Similarly, non-investment partnerships—that is operating partnerships—may also hold interests in investment partnerships. As described in Section I. B. above, when income passes through tiered partnership structures, sourcing becomes much more complicated and states may not have sufficiently detailed rules. But assuming an operating partnership has income from an investment partnership, it would appear that the same general principles for sourcing the income that apply to corporations would apply to that income. Depending on the situation, the investment partnership income allocated to the operating partnership might simply be included in the apportionable income of that operating partnership and apportioned using that partnership's general ratio. In that case, the direct partners of the operating partnership would source the allocation of their indirect shares of the investment partnership's income using the operating partnership's sourcing information, rather than sourcing that income to their residence.

Individual Active Versus Passive Partners

In contrast with corporate or operating partnership partners, when investment partnership income allocated to individual partners is sourced to their residence, this may often result in treatment similar to investment income earned directly. It may also be consistent with the way similar income is sourced when earned through other entities, particularly regulated investment companies. As set out in Section III above, some states tie their definitions of what is a qualified investment partnership directly to the federal definition of a regulated investment company.

But states may want to consider applying the special sourcing treatment only to limited/passive partners, if equity is the chief concern. For example, assume an investment partnership with offices and activities in State A contracts with a professional firm, comprised of individual members, located in State B to provide various management services. The service income of that firm might be sourced to State A, the location of the investment partnership, and the firm's members would therefore owe tax on that income to State A. Assume, however, that instead of contracting with the firm to perform the services, the firm takes an interest in the investment partnership and agrees to receive a guaranteed payment as a partner, or receives a preferential profits interest, while performing the same management duties for the investment partnership. If State A allows income from the investment partnership to be sourced to the residence of individual partners (and does not impose any restriction for tiered partnership partners, discussed above), whether those partners are active or passive, then the members of the professional firm (indirect partners in the investment partnership) would source the income to State B, assuming this is their state of residence.

To What Extent is there a Need for Uniformity

Lack of uniformity in this area may increase non-compliance and inhibit tax enforcement. Not only does the pass-through system itself create challenges, but unduly broad rules for special sourcing treatment in some states might create additional enforcement problems.

For example, as discussed above, one potential enforcement problem is the use of investment partnerships to shift the sourcing of other partnership income. A number of states have therefore excluded from their definition of a qualified investment partnership any partnership that holds an interest, directly or indirectly, in a non-investment partnership. But indirect partners do not receive partnership sourcing information—such as state Schedule K-1s—from lower-tier partnerships. Rather, they receive information only from the partnership in which they are directly invested. An investment partnership operating in a state that lacks any limitation on the ownership of other non-investment partnerships may, improperly, assume that its partners can simply source all income to their state of residence and neglect to provide information on the sourcing of income allocated from its non-investment partnership holdings.

Lack of uniformity can also increase the likelihood of duplicative taxation caused by strict limitations on resident credits for taxes paid to other states. Some states do not give full credit for taxes paid if the sourcing rules used by the taxing state are substantially different than their own. In other cases, a standard of reciprocity may be imposed to limit any credit. Not only do these restrictions increase the chance of double taxation, but they can also create compliance and administrative complexity since the state of residence would need to properly interpret the sourcing rules in other states, or those states' credit rules, in order to determine if the resident is entitled to a credit for any taxes paid in those states. To the extent states can achieve sufficient uniformity in the sourcing of investment partnership income, this problem is reduced. But states should also consider whether restrictions on credits are always merited.

Necessary Processes and Tools

As discussed in Section I. C. above, states need certain mechanisms to ensure that the pass-through system for taxing partnership income works. Often, however, investment partnerships are excluded from such mechanisms due to the special sourcing of their income. States should consider whether they have the means to ensure that partnerships using special sourcing rules are fully complying with those rules and with any limitations. A review of the state rules in Section III shows that some states have anticipated this need.

In particular, state administrative agencies should have the authority to require partnerships to register and/or file information in order to qualify for treatment as investment partnerships. They also need the authority to require these partnerships to supply specific information for that purpose—even though their income will not be sourced to that state. This also means that such partnerships may need to file yearly information reports so that their qualifications can be verified for each reporting period. If partnerships fail to qualify in a particular tax period—the state should have authority to revoke the special treatment and may also need to provide for how this will affect sourcing of income and losses.

What Should States do if they Choose Not to Apply Special Sourcing Treatment

States that choose not to apply special sourcing treatment, and states that apply such treatment only on a very narrow basis, should make this clear. Even states that do not wish to alter the sourcing provided for in their general rules for partnership income may need to say this explicitly. Not only do half of the states have special sourcing treatment, but as discussed above, this treatment sometimes appears to have been based on the application of general principles, including constitutional limits on nexus and apportionment. Taxpayers may therefore take the position that these same principles would apply similarly in other states who are silent on the treatment of investment partnership income.

In addition, states that do not apply special sourcing treatment or apply that treatment only very narrowly may also need to consider how the general sourcing rules will be applied instead. For example, the following questions may need to be explicitly addressed:

- Will the income of the investment partnership be sourced to where that partnership does business?
- If so, will apportionment using a receipts factor be used?
- If so, how will certain receipts—dividends, capital gains, interest, etc.—be attributed to the state for purposes of determining that factor?
- How will the sourcing rules be applied to complex tiered structures involving multiple investment partnerships?

Section IV. B. – Findings and Recommendations

Based on the analysis above, we make the following findings and recommendations:

- Regardless of how a state applies sourcing rules to investment partnership income, the state should explicitly address this issue to avoid uncertainty.
- 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.
- 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 and corporate partners regularly report other income subject to sourcing (including apportionment) under general state rules.
- States should **consider excluding** from special sourcing treatment any partners that take an active role in the investment activities.
- The special sourcing 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.

- Because of the general complexity in this area, states should consider including certain details in their rules to address common situations, including:
 - Defining and measuring of any assets for the application of an asset test,
 - Defining and measuring any income for the application of an income test,
 - Defining which partners are subject to the special treatment and that the treatment, if applied only to limited nonresident partners, is applied only to the extent those partners:
 - Are passive and have no role in the investment partnership's activities or the activities of any of the entities in which it might invest,
 - Have no past or current ownership or other relationship to the underlying portfolio companies or investments.
- State tax agencies should have clear authority to issue regulations and to use ad hoc methods to ensure that income sourcing is not being shifted in ways that are unintended.
- States should also address questions of how any investment income which may not qualify for special sourcing treatment will be sourced to help ensure that the line between sourcing treatment is clear and administrable.
- States should consider the application to their residents of credits for taxes paid to ensure a lack of uniformity does not create significant duplication of taxes or burdens.