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Special Commentary: State Tax Treatment of Investment Partnerships

By Bruce P. Ely and Kelvin M. Lawrence2022-07-29T04:45:23000-04:00

As we previously reported, the Multistate Tax Commission has undertaken an ambitious project on the state taxation of partnerships. Their partnership work group consists of volunteers from numerous state revenue departments, with the able assistance of MTC Counsel Helen Hecht and Chris Barber. Its first milestone was developing an outline that divided the work group's charge into four groups of issues: taxation of partnership income and items; taxation of gain (loss) from the sale of a partnership interest; entity-level tax issues; and administration and enforcement.

The first subject MTC staff chose and the work group endorsed for detailed analysis was "the trillions of dollars flowing through investment partnerships." MTC staff prepared an extensive white paper, State Tax Treatment of Investment Partnerships, which is useful reading to understand the depth and breadth of the issues. Section II.B. indicates that investment partnerships, broadly defined as the finance and holding company industry segment, accounted for 70% of all reported partnership income during the years studied, making the case for why investment partnerships and their partners should be analyzed first.

These investment partnerships typically fall into one of three groups: 1) private equity funds, 2) hedge funds, and 3) closely held, often family-owned, investment partnerships such as family limited partnerships, special purpose entities, or holding companies organized as partnerships. However, common law and statutory or business trusts are also common investment vehicles, as discussed below.

The outgrowth of the white paper is a proposed model that may be enacted as a statute or regulation that was in its fourth iteration as of the July 25 work group virtual meeting. The remainder of this article focuses on three major issues with the draft model the authors have identified, and in part parallels the comment letter the principal author of this article submitted to the MTC on July 6. We first provide a broad overview of the draft model before delving into these issues.

The draft model, as most recently amended, contains a helpful road map:

This draft model is designed to impose three independent qualifications for the safe-harbor sourcing. First, the partnership must be a Qualified Investment Partnership. Second, the partner must be a Qualified Investment Partner. Third, the income or loss subject to the sourcing rules must be a [sic] Qualified Investment Partnership Income (Loss). …If the partnership, or the partner, or the income does not qualify, then the income or loss is not sourced to residence under this safe-harbor rule. Again, it may still be sourced to residence under other rules or general state sourcing principles. But to determine if the income would be sourced to residence, it has to come from a Qualified Investment Partnership, must flow to a Qualified Investment Partner, and must be Qualified Investment Partnership Income.

There are approximately 20 states that have a minimal statutory framework for taxing investment partnerships and their partners. However, as the white paper points out, while there is some uniformity among those states, there are also disparities. For example, only four of these states—Alabama, Idaho, Kentucky, and New Jersey—refer to investment partnerships as qualified investment partnerships, or QIPs, while a dozen or so other states recognize the same or similar definition of a QIP as an investment partnership or investment pass-through entity. The draft model is said to be based on and indeed draws extensively, albeit selectively, from the language of the Alabama Investment Partnership Act of 2009.

The states' disjointed treatment of the central issues in the draft model are why MTC member states are acting to bring greater uniformity around these issues.

Ambiguous Prohibitions on Self-Dealing

A major area of concern in the draft model stems from its material variance from both the Alabama Act and other state investment partnership acts in ways that create, rather than resolve, ambiguity. For example, Section 3(b) overrides the general rule that a nonresident QIP partner may exclude from that state's income tax that partner's distributive share of QIP income:

"The exclusion ... does not apply to the distributive share of Qualified Investment Partnership income to the extent derived *directly or indirectly* from an investment in an entity if the Nonresident QIP Partner holds or has held *within the last five years* a direct ownership interest in that entity, unless the entity is a publicly traded entity or the Nonresident QIP Partner does not or did not actively participate in the entity's activities. *For this purpose, active participation means being an officer or director, or holding an ownership interest greater than 20%* (emphasis added).

This language is ambiguous in several respects and materially different than the Alabama Act, which was heavily negotiated between the private equity investment industry, the Alabama Department of Revenue, the Alabama Society of CPAs, and other parties. To their credit, the drafters of the draft model have somewhat narrowed the exclusion from the previous draft by reducing the look-back period from 10 years to five years, and defining "active participation," albeit to include the QIP partner having served as an officer or director of the targeted entity within the previous five years.

In contrast, the Alabama Act doesn't employ such ambiguous terms as "directly or indirectly." It also doesn't impose any look-back period or consider previous service as an officer or director as a tainted act, nor does it prohibit anything less than majority ownership of the targeted entity by the Nonresident QIP Partner. The authors recommend that the draft model adopt the more workable Alabama Act language. Moreover, only a handful of the 20 states impose similar restrictions, among them California, Arkansas, and Illinois.

Anti-Abuse Language on Steroids

Section 4(b) is also troublesome. It allows the state taxing authority to revoke a QIP's certification if it "determines that this Act has been used to avoid [state] income tax liability." If so, the state tax director can "distribute, apportion, or allocate the partnership's income" according to state law.

Consistent with the law in Alabama and several other states, the draft model should at least require the alleged abuse to be "principally" for the purpose of avoidance or have as a "principal purpose" avoidance of that state's income tax through the use of a QIP. Several other states have anti-abuse provisions generally applicable to pass-through entities using similar language, including New York, Ohio, and Connecticut. However, most of the state laws specific to investment partnerships don't contain any sort of anti-abuse language, and we understand that even some of the work group members questioned the need for that.

Finally, if the draft model is to be based on the fair and balanced Alabama Act, the drafters should parallel that act's limitation on the state tax director's authority if it is determined that the principal purpose of the QIP was to avoid that state's income tax liability. The Alabama Act clearly limits the Commissioner of Revenue's powers to those analogous to IRC Section 482, to "clearly, fairly, and equitably reflect" the income of the QIP or other entity engaged in such tax avoidance. We believe statutory guidance like this would be helpful to both the states and the taxpayers.

Need for Self-Correction Procedure

Despite the helpful drafter's notes stating on several occasions that the sourcing rule under the draft model is only a "safe harbor," in the authors' experience, many state DOR auditors view the failure to meet the criteria of a particular safe harbor as automatically creating liability for tax based on that failure. The principal author's July 6 comment letter raised that concern.

Thus, there is a need for some administrative grace when the QIP, for example, discovers after year-end that it fell below one of the 90% thresholds, or the managing partner failed to timely file the QIP certification. Similar to the self-correction procedures afforded to qualified retirement plans and IRAs by the Internal Revenue Service, there should be a comparable procedure to allow QIP status to be restored retroactively within some limited period of time after year-end, such as nine months. *See* IRS Rev. Proc. 2021-30, IRB 2021-31.

Conclusion

We commend the MTC staff for their hard work not only on the draft model but on their thoughtful white paper. We also commend the staff for making several needed changes to previous drafts of the draft model, such as expanding the definition of a qualifying QIP Partner to include nonresident estates and trusts.

While the authors agree there is a need for uniformity among the states in dealing with investment partnerships and their nonresident investors, we urge the MTC staff and the partnership work group to consider the ability of taxpayers—and the states—to implement these provisions. Given the time spent in perfecting this model, it would be unfortunate if it goes unused because it is rendered unworkable or undesirable by its intended audience.

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