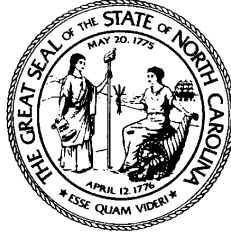

North Carolina Department of Revenue



DIRECTIVE

Subject: Investment Partnerships
Tax: Individual Income
Law: G.S. 105-154
Issued By: Personal Taxes Division
Date: November 4, 2004
Number: PD-04-2

This Directive supplements and clarifies Directive PD-02-1, issued on November 6, 2002. Directive PD-02-1 addressed a change in the Department of Revenue's position regarding the determination of when an "investment partnership" is considered to be doing business in North Carolina for purposes of filing a North Carolina partnership return and paying North Carolina income tax on behalf of its nonresident partners. PD-04-2 clarifies when a partnership is an "investment partnership" for North Carolina tax purposes.

The general rule is that any partnership operating in North Carolina is doing business in this State and the manager of the partnership is required to pay the income tax due on each nonresident partner's share of partnership income derived from North Carolina. Recognizing that some partnerships are formed to function solely in the nature of an investment account in which stocks, bonds, and other securities are bought, held, and sold for capital appreciation and income, the Department decided to allow an exception to the general rule, holding that the receipt of dividends and interest and the occasional sales of stocks and bonds by such investment partnerships does not constitute carrying on a trade or business in this State. For many years, the Department used a somewhat cumbersome "facts and circumstances" test to determine if a partnership was considered to be carrying on a trade or business in this State if its principal business activity was "investments." In an effort to replace the facts and circumstances test with a "bright-line" test, the Department issued Directive PD-02-1.

Directive PD-02-1 carves out a narrow exception to the established tax principle that a partnership is always carrying on a trade or business. Under the Directive and administrative rule 17 NCAC 6B .3503, as amended, an "investment partnership" is a partnership in which **all** income or loss is derived from changes in the value of its investments in intangible assets (capital appreciation) or from intangible income derived from the assets in which the partnership invests (i.e.,

North Carolina Department of Revenue

dividends or interest) and such income is solely for the benefit of the partnership's owners. If **any** of the partnership's income is from other activities, either within or outside this State or either received directly or flowing through from other pass-through entities, the partnership is not an "investment partnership" for North Carolina income tax purposes. Other activities include but are not limited to providing services or products to customers and holding real property for appreciation and income.

If you have questions about this directive, you may call the Personal Taxes Division of the North Carolina Department of Revenue at (919) 733-3565. You may also write to the Division at P.O. Box 871, Raleigh, N.C. 27602-0871.