



Selling a Partnership Interest: State Tax Considerations

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Topics



- Characterization of the Sale
- Apportionment of Proceeds
- Characterization and Apportionment in New York, New Jersey, Massachusetts, and Connecticut
- Other considerations

Characterization of the Sale



- Sale of Partnership Interests or Assets?
- What are the assets being sold?
 - Goodwill and other intangibles
 - Real property
 - Other tangible property
- Who is the seller?
 - Individual
 - Corporate owner
 - Pass-through entity

Characterization of Sale



- If partnership interests are sold by an individual, the sale typically generates intangible income that is only taxed by the state of residency. But be careful of exceptions!
- States may treat the gain on the sale of partnership interests by a corporate owner as apportionable business income (i.e., based on a formula dividing it among all states where the corporation does business).

Apportionment of Proceeds – Corporations



- MTC guidance requires first determining if the gain is apportionable business income as opposed to allocable nonbusiness income.
- States inconsistently tax gains from asset sales (potentially resulting in double taxation or less than 100% state taxation).

Apportionment of Proceeds – Corporations



- MTC guidance on “apportionable income”:
 - (a) “Apportionable income” means:
 - (i) All income that is apportionable under the Constitution of the United States and is not allocated under the laws of this state, including:
 - (A) Income arising from transactions and activity in the regular course of the taxpayer's trade or business, and (B) income arising from tangible and intangible property if the acquisition, management, employment, development or disposition of the property is or was related to the operation of the taxpayer's trade or business; and
 - (ii) Any income that would be allocable to this state under the Constitution of the United States, but that is apportioned rather than allocated pursuant to the laws of this state.

Investee Apportionment



- States often use flow-through sourcing or “investee apportionment” to attribute the underlying apportionment factors of the partnership to its owners.
- Cases challenging investee apportionment focus on whether the owner and the underlying partnership being sold were engaged in a unity business and whether the owner (particularly with a corporate owner) otherwise has nexus in the state.
 - See, e.g. *VAS Holdings*; *Matter of Goldman Sachs Petershill Fund Offshore Holdings* (discussed below)

Apportionment of Proceeds – Individuals



- If sale of a partnership interest is considered a sale of assets or derived from a trade or business conducted in the state, the individual nonresident typically apportions the proceeds based on the partnership's apportionment factors.
- States may use the partnership's apportionment factors in the year of sale or an average of apportionment factors over a period of time.

Characterization of Sale – New York



- Tax Bulletin, TB-IT-615, “New York Source Income of Nonresident Individuals, Estates, and Trusts, and Part-Year Resident Individuals and Trusts”.
 - New York source income does **not** include gains from the sale or exchange of intangible personal property, unless they are part of the income you received from carrying on a business, trade, profession, or occupation in New York State.
 - See *also* N.Y. Tax Law § 631(b)(2); 20 NYCRR 132.5(a).
- But be careful of special rules in New York defining when the sale of a partnership interest is derived from carrying on a business in New York State!

Characterization of Sale – New York



- IRC § 1060 transactions may be treated as New York source income. N.Y. Tax Law § 632(a)(1); TSB-M-18(2)I.
 - A sale or transfer of a partnership interest that causes the partnership's status as a partnership to terminate or that causes the LLC's status as a partnership to terminate (i.e., after the sale, the LLC is treated as a DRE) is considered a transaction subject to the provisions of IRC § 1060.
 - Gains from such transactions treated as the sale of assets subject to allocation based on BAP of partnership.

Characterization of Sale – New York



- Sales of interests in entities with fewer than 100 owners that own real property in New York State exceeding 50 percent of the value of all assets may be treated as New York source income. N.Y. Tax Law § 631(b)(1)(A)(1); TSB-M-09(5)I.
 - Apportionment = $\text{FMV of NYS real property} / \text{FMV of all assets}$.
 - Two-year lookback rule (avoid asset “stuffing”).

Apportionment – Corporate Partners (New York)



- N.Y. Tax Law § 210-A(G) Dividends and net gains from sales of stock or partnership interests. Dividends from stock, net gains (not less than zero) from sales of stock and net gains (not less than zero) from the sale of partnership interests are not included in either the numerator or denominator of the apportionment fraction unless the commissioner determines that inclusion of such dividends and net gains (not less than zero) is necessary to properly reflect the business income or capital of the taxpayer.

Apportionment—Corporate Partners (New York)



- ALTERNATIVE APPORTIONMENT EXAMPLE 3:
 - Corporation C is a corporate partner in Partnership X and for tax years 2015 through 2018 it computes its tax with respect to its interest in such partnership under the aggregate method.
 - In tax year 2019, Corporation C's only activity for the year is the selling of its financial investments that results in \$5,000,000 of business receipts. Seventy-five percent of its business receipts, or \$3,750,000, is the net gain from the sale of its partnership interest in Partnership X.
 - Corporation C did not make the fixed percentage election. As such, net gains from the sale of a partnership interest are not included in the numerator or denominator of the BAF unless the commissioner determines that inclusion of such net gains is necessary to properly reflect the taxpayer's business income or capital.
 - The sale of Partnership X will be treated as the sale of the underlying assets owned by Partnership X. Corporation C must reasonably divide the net gain from the sale of its interest among the types of underlying assets owned by Partnership X. The receipts or net gains from each type of asset must be apportioned using the applicable apportionment rules.

Case Study – New York City Sale of Partnership Interest



Matter of Goldman Sachs Petershill Fund Offshore Holdings (Delaware) Corp., TAT(E) 16-9(GC), New York City Tax App. Trib. (March 12, 2021):

- Goldman Sachs Petershill Fund Offshore Holdings (Delaware) Corp. owes New York City GCT on its capital gain from the 2010 sale of its interest in a hedge fund manager, Claren Road Asset Management LLC.
- The New York City Tax Appeals Tribunal ruled that the Petershill fund's capital gain was attributable to the “capital appreciation” of Claren's city business and, thus, had nexus to the city.

Apportionment – Partnerships (New York)



- TSB-A-07(1)I (02/07/2007):
 - ISSUE: Whether a gain from the sale by Petitioner of an interest in a lower-tier partnership constitutes gain from the sale of intangible personal property employed in a trade or business carried on in New York State.
 - HOLDING: A gain or loss (whether treated as a capital gain or loss or ordinary gain or loss for federal income tax purposes) from the sale of an interest in a New York partnership, except in certain situations not present here, does not constitute gain or loss derived from or connected with New York sources and is not includible as New York source income.
 - EXCEPTIONS INCLUDE: Partnerships owning real property; partnerships owning shares in New York cooperative housing corporations.

Apportionment – Individuals (New York)



- Tax Law 632(a)(1) states that gain from the sale of a partnership interest subject to IRC § 1060 are subject to allocation subject to existing allocation rules and methods in the year of sale.
- 20 NYCRR 132.15 establishes the rules for allocating income from partnerships: use books and records or otherwise use three-factor formula.

Characterization of Sale – New Jersey Gross Income Tax Example



- NJAC 18:35-1.3(h), Example 11
 - “The gain or loss from the sale of a partnership interest is from an intangible *not employed in a trade or business*, therefore, not subject to tax for a nonresident.”

Apportionment – Corporate Partners (New Jersey)



- Operational or nonoperational under NJSA 54:10A-6.1?
- “Operational income” subject to allocation to New Jersey means income from tangible and intangible property if the acquisition, management, or disposition of the property constitutes an integral part of the taxpayer's regular trade or business operations and includes investment income serving an operational function.
- New Jersey has unique definitions
 - Business Income = Operational Income
 - Nonbusiness Income = Nonoperational Income
 - Apportionment = Allocation
 - Allocation = Assignment

Apportionment – Corporate Partners (New Jersey)



- Operational (Business Income) from the sale of assets is allocated (apportioned) based on the type of asset:
 - NJAC 18:7-8.9 - Only net gains from the sale of capital assets are included in the receipts factor.
 - NJAC 18:7-8.12(d) - Receipts from the sale of real property situated in New Jersey are included in the numerator.
 - NJAC 18:7-8.12(e) - Intangible income is included in the numerator if the “taxable situs” of the intangible is in New Jersey.
 - The taxable situs of an intangible is the commercial domicile of the owner unless the intangible has been integrated with a business carried on in another state.
 - Even if the commercial domicile is outside New Jersey, the taxable situs is in New Jersey to the extent that the intangible has been integrated with a business carried on in New Jersey.

Apportionment – Partnerships (New Jersey)



- For partnership apportionment, different rules apply to partnership income from asset sales versus a “complete liquidation.”
- NJSA 18:35-1.3(d)(2) - A complete liquidation of a partnership is deemed to occur in the tax year when the following events have occurred:
 1. The partnership and all its partners discontinue all partnership activities;
 2. All partnership assets have been distributed to the partners; and
 3. The partners are required to recognize gain or loss on the disposition of their partnership interests for Federal income tax purposes.

Apportionment – Partnerships (New Jersey)



- Under NJAC 18:35-1.3(d)(4)(v) - if a “complete liquidation” occurs:
 - The gain or loss from the sale of real and tangible assets located in New Jersey is sourced to New Jersey.
 - The gain or loss from the sale of motor vehicle equipment is sourced to the state where the vehicle is registered, unless the vehicle was used predominantly in another state.
 - The gain or loss from the sale of intangibles is allocated using the average of the business allocation used for the last three years.

Apportionment – Partnerships (New Jersey)



- Under NJAC 18:35-1.3(d)(4)(iv) - if no “complete liquidation” then:
 - If a partnership's activity is carried on solely within New Jersey, all items of income, gain, expense, or loss of the partnership are deemed to have been derived from sources within New Jersey.
 - If a partnership's activity is carried on both inside and outside New Jersey, use three-factor apportionment on Form NJ-1040-NR-A *or request alternative apportionment*.
 - Partnership income or loss from the sale or disposition of real property located in New Jersey is sourced to New Jersey.

Characterization of Sale - Massachusetts



- Income from a trade or business may include income that results from the sale of a business or an interest in a business. This rule generally applies to the sale of an interest in a sole proprietorship, general partnership, limited liability partnership, a general or limited partner's interest in a limited partnership... or an interest in a limited liability company. Mass. Regs. Code 62.5A.1(3)(c)(8).

Example (3)(c)(8.1). Limited Liability Partner, a non-resident, owns a 25% partnership interest in a Massachusetts limited liability partnership that operates a computer consulting business in Massachusetts. Partner contributed funds to the limited liability partnership upon its creation, but took no part in its management or operations. Partner sells his interest in the partnership and recognizes a capital gain for federal tax purposes. Partner is taxable in Massachusetts on the gain.



Case Study – Massachusetts Sale of Partnership Interest

VAS Holdings & Investments LLC v. Commissioner of Rev., 489
Mass. 669 (2022)

- Massachusetts lacked authority to impose corporate excise and nonresident composite taxes on gain that an out-of-state LLC (treated as an S corporation) and its nonresident owners realized from selling interests in an in-state LLC treated as a partnership.
- “Thus, although the Constitution does not prevent the taxes asserted by the commissioner . . . a corporate excise tax in the amount of \$914,489, and a nonresident composite tax in the amount of \$1,717,40619 -- are invalid because there is no statutory authority for the taxes so asserted.”
- Massachusetts high court relied on the unitary business principle, holding that VAS and the underlying LLC were not engaged in a unitary business.

After *VAS Holdings*



- Massachusetts DOR issued TIR 22-14 discussing the implications of *VAS Holdings*.
- TIR identified areas where it would not apply the *VAS Holdings* decision:
 - Where the partnership (or other PTE) and owner are engaged in a unitary business;
 - If the selling owner of the partnership is an individual actively engaged in the operations or management of the partnership (either in the year of sale or previously);
 - If the gain is allocable (rather than apportionable) to Massachusetts by a corporate partner.

Characterization of Sale - Connecticut



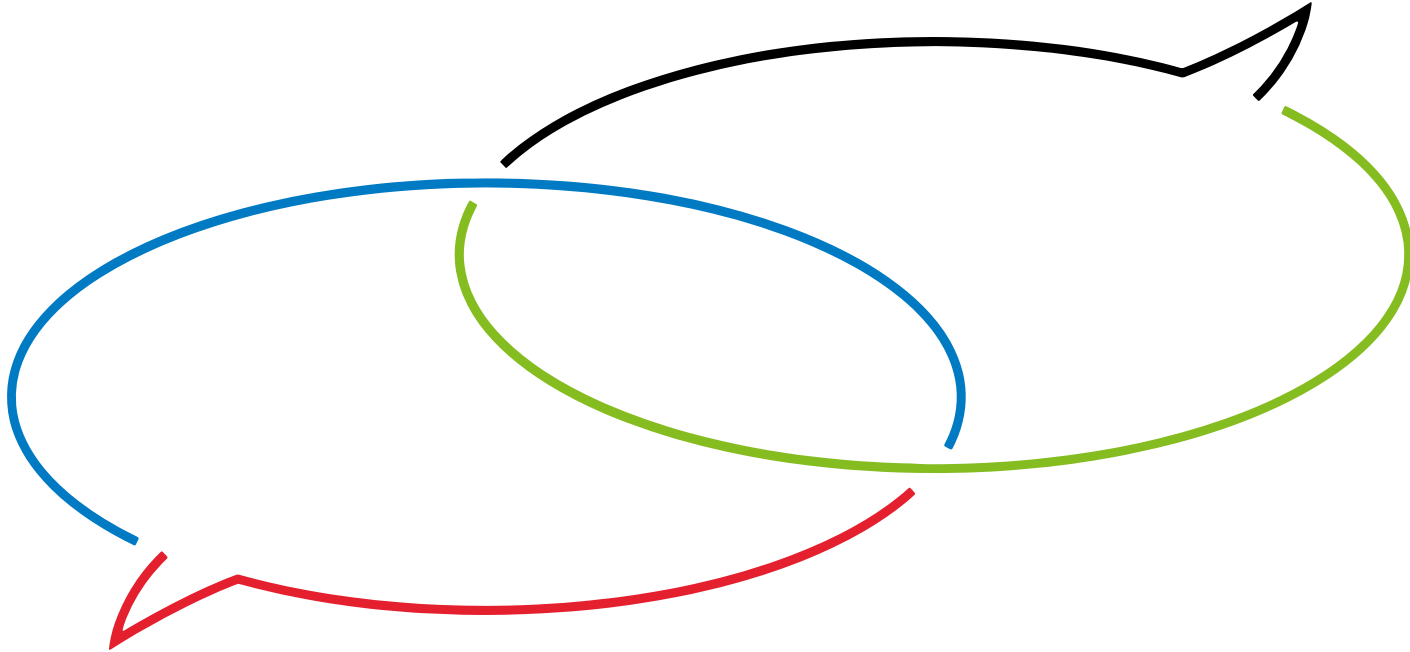
- Income from intangible personal property, including... interest and gains from the disposition of intangible personal property, shall constitute income derived from sources within this state only to the extent that such income is from property employed in a business trade or profession carried on in this state...
Conn. Gen. Stat. § 12-711(b)(3)(A).
 - Includes an entity owning directly or indirectly Connecticut real property whose FMV is 50% or more of the entity's total assets (using a 2-year average).

Other Considerations when Selling a Partnership Interest



- Sales tax – be careful of hot assets and bulk sales rules where occasional sales rules don't apply or don't exist (e.g. New York).
- Real Property Transfer Taxes.
- Accrual rules where sale by an individual after a residency change.

Q & A



Thank You



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