State Tax Treatment of Gain/Loss Resulting from the Sale of Partnership and LLC Interests

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GENERAL RULES

• **Federal tax treatment of partnership interest sales:**
  - Capital gain or loss generally recognized upon sale of partnership interest – amount of gain or loss calculated by sale amount less basis
  - Amounts realized from a sale include cash, FMV of property received, and the selling partner’s share of liabilities of the partnership
GENERAL RULES

• **Federal tax treatment of partnership interest sales:**
  – Long term gain characterization for any amounts realized from sale if interest was held for more than one (1) year
    • Note: Gain or loss realized from an interest sale will be treated as ordinary in nature to the extent the amounts are attributed to unrealized receivables or inventory items
  – Split holding periods of an interest may exist if contributions were made to the partnership at different times
GENERAL RULES

• **State Tax Gloss:**
  – Sale of interest in pass-through entity is generally treated as a sale of an intangible asset
  – Intangible asset characterization generally means sale is taxable entirely by the seller’s commercial domicile
  – Nonresidents selling partnership interests may be subject to different tax treatment - this treatment can be further bifurcated into nonresidents holding general partnership interests, and those holding limited partnership interests
GENERAL RULES

• **State Tax Gloss:**
  – An important question is always, “Does the partnership have a business situs within a given state?”
  – Business situs is crucial, as some states consider partnerships solely owning rental property, and deriving income therefrom, as not having a business situs in-state - Therefore, gain from the sale of an interest in such a partnership is not taxable by the state
  – Limited partnership interests – passive investments by nature – may be a shield against a state’s taxing authority when the interest is sold
GENERAL RULES

• Distinguish pass-through interest sales from asset sales:
  – Sales of assets of a pass-through entity are generally taxed by the states where the assets are located
  – Residency status of members are generally not dispositive when determining whether a state may tax an asset sale
GENERAL RULES

• Distinguish partnership interest sales from asset sales:
  – Sales of interests may be characterized as deemed asset sales, EVEN WHEN THE INTANGIBLE INTEREST IS SOLD.
  – When might this happen? The sale of an interest in a disregarded entity.
COLORADO

Colorado Dep’t of Rev., PLR-16-006 (April 12, 2016):

- Husband and wife, both residents of Colorado, held joint ownership interests in LLC conducting business within and outside of the state.
- Upon sale of membership interest in LLC by the husband, tax was paid to Ohio, as the LLC conducted business operations within the state.
Colorado Dep’t of Rev., PLR-16-006 (April 12, 2016):

- Colorado Department of Revenue asserted that Colorado law governed the sale, whereby gain from the sale of the interest, an intangible asset, could be sourced to Colorado to the extent that the intangible was used in a trade or business in the state.
- Additionally, the Department acknowledged that the gain could be sourced to another state to the extent that the husband had participated in the LLC’s business operations within that state.
COLORADO

Colorado Dep’t of Rev., PLR-16-006 (April 12, 2016):

- As the amount of gain attributable to Colorado exceeded that of Ohio, the Department determined that the husband was entitled to a credit for the full amount of tax paid to Ohio arising from sale of the membership interest.
COLORADO

Colorado Dep’t of Rev., PLR-16-015 (Sept. 30, 2016):

- Equity investment fund located in Colorado invested in affiliate owning interest in Delaware LLC.
- Affiliate co-owned Delaware LLC with five other members. Delaware LLC, in turn, operated in six states outside of Colorado. The Delaware LLC did not conduct any operations inside Colorado.
COLORADO

Colorado Dep’t of Rev., PLR-16-015 (Sept. 30, 2016):

- Only link affiliate had with Colorado was ownership by equity investment fund.
- Purchaser later acquired ownership of Delaware LLC through one subsidiary LLC, and the affiliate and co-owners of Delaware LLC through a second subsidiary LLC. Following acquisitions, all companies were merged into affiliate.
COLORADO

Colorado Dep’t of Rev., PLR-16-015 (Sept. 30, 2016):

- Department determined that tax was not owed by affiliate to Colorado on the sale of its interest in the Delaware LLC to the second subsidiary LLC.

- The reason stated by the Department was that the affiliate and its co-owners were first acquired by the Purchaser, then directed to sale their interests in the Delaware LLC to the second subsidiary LLC.

- As such, the sales were conducted outside of the state, and therefore, not subject to tax.

- Taxpayers, Michigan residents, owned and operated a shopping mall in Florida through partnership
- Partnership transferred shopping mall to newly-formed LP for interest in LP
- Partnership liquidated, distributing interest in LP to taxpayers
- Partners subsequently sold interest in LP, recognizing gain in excess of $73 million - no gain apportioned to Michigan

- Treasury Department audited, determining entire gain from sale of LP interest was capital gain from sale of an investment, and therefore subject to Michigan tax
- Taxpayers sued the Department in the Michigan Court of Claims, which held for the Department, determining the gain from the sale to be nonbusiness income
MICHIGAN


- On appeal, Michigan Court of Appeals reversed lower court judgment, stating that the transfer of the shopping mall from a General Partnership to an LP did not constitute a change in how the taxpayers conducted business- change of status from a general partner to a limited partner had not stopped taxpayers from engaging in regular business operations related to the shopping mall.
MICHIGAN

Aikens v. Dep’t of Treasury:
- Since Michigan law defined “business income” as including income arising from sale of a business or business property, Court of Appeals concluded that taxpayer’s sale of LP interest was business income—therefore not attributable to Michigan
In re Olsheim, DTA No. 824218 (May 9, 2013), aff’d NY Tax App. Trib. (April 10, 2014):

- Taxpayer, a nonresident of New York, was a LP in partnership containing only one (1) asset, an office building in New York City.
- Partnership sold office building, then dissolved.
- Taxpayer reported gain from sale on personal income tax return, also included capital loss resulting from differences between inside and outside bases of partnership interest.
**NEW YORK**

*In re Olsheim*, DTA No. 824218 (May 9, 2013), aff’d NY Tax App. Trib. (April 10, 2014):

- Law in effect at time of partnership dissolution did not permit capital loss from disposition of interest to be sourced to New York by nonresident interest owner—however, the disposition of the building itself was properly sourced to New York.

- The result? Gain recognized by the taxpayer on the sale of building, loss arising from liquidation of partnership disallowed. Tax owed.
In re Olsheim, DTA No. 824218 (May 9, 2013), aff’d NY Tax App. Trib. (April 10, 2014):

- Note: Prior to 1992, and currently since 2009, New York law required gain or loss from disposal of a partnership interest to be sourced to the state (depending, of course, on whether property owned by the entity can be characterized as NY income upon sale).

- Mr. Olsheim unfortunately succumbed to an unfavorable (for him) interlude between changes in NY taxing schemes.
In re Ronald K. and Maxine H. Line, DTA No. 823300 (May 24, 2012):

- Taxpayers were residents of Arizona, members in LLC which served as a hotel management company headquartered in Chicago
- LLC sold properties located in New York and other states in 2005
- LLC apportioned income from operations and gain from sale of properties in NY to the state on its 2005 partnership tax return; taxpayers did likewise on their NY individual returns
In re Ronald K. and Maxine H. Line, DTA No. 823300 (May 24, 2012):

- On challenging an assessment issued by NY, Taxpayers asserted that allocating 100% of gain from sale of NY properties to the state was inappropriate, as NY law only required gain from sale of rental properties to be fully allocated to NY - and the properties were not “rental” properties

- After appealing an unsuccessful challenge of the assessment in front of the Department’s Administrative Law Judge, the NY Tax Appeals Tribunal upheld the decision of the ALJ that the entire gain from the sale was allocable to New York - as the properties’ situs was New York
**NEW YORK**

*In re Ronald K. and Maxine H. Line, DTA No. 823300 (May 24, 2012):*

- If rental property was part of LLC’s business, why not apportion gain from sale by business allocation percentage (i.e., property, payroll, and income)?

**Answer:**

NY rule, 20 NYCRR 132.16, prevented allocation of gain and loss from sale or exchange of real property. The same rule also prevented allocation of income derived from operating the rental property.

- Nonresident owned membership interest in an LLC conducting business within Ohio. Subsequent sale of interest resulted in realization of capital gain.
- Ohio Supreme Court held for taxpayer, stating Ohio Department of Revenue was constitutionally barred from taxing a portion of the capital gain realized by taxpayer from sale of membership interest.

- Supreme Court distinguished impermissible attempt to tax gain realized by sale of interest from permissible taxation of distributions made by LLC arising from income earned through activities conducted within Ohio.

- Supreme Court rejected assertion by Ohio Tax Commissioner that taxpayer’s sale of membership interest was in substance an asset sale, which could then possibly give rise to constitutionally-permissible taxation by the state.
FirstCity Funding L.P. v. North Carolina Dep’t of Revenue, OAH No. 09 REV 5669, Final Agency Decision (April 21, 2011):

- Texas LP sold interest in North Carolina LP doing business in NC
- Department of Revenue assessed corporate income tax on gain from sale of interest
FirstCity Funding L.P. v. North Carolina Dep’t of Revenue, OAH No. 09 REV 5669, Final Agency Decision (April 21, 2011):

- Taxpayer appealed decision to administrative law judge, which reversed Department’s assessment, determining that the Texas LP merely held the interest in the North Carolina LP passively, and was not in a unitary relationship with the business of the North Carolina LP - the Texas LP did not participate in the day-to-day operations of the North Carolina LP
FirstCity Funding L.P. v. North Carolina Dep’t of Revenue, OAH No. 09 REV 5669, Final Agency Decision (April 21, 2011):

- ALJ also noted that the Texas LP had previously paid corporate income tax on income it received from the North Carolina LP, but declined to accept such payment as an admission that the capital gain realized from the sale of its interest in the LP was taxable by North Carolina

- **Note:** The ALJ distinguished non-apportionable *gains* from non-apportionable *income*, holding that because the gain from the sale of the LP interest was non-apportionable *income*, it was properly allocated *entirely* to the taxpayer’s domicile, Texas.
TENNESSEE


- Taxpayer, a TN resident, began employment with Corporation. Stock options provided to taxpayer as part of compensation. In year following exercise of options, Corporation formed subsidiary LLC, then later sold 25% of its interest to third-party.
- At same time and following sale of 25% interest, Corporation made multiple cash distributions, characterized as “proceeds from LLC interest sale” to shareholders.

- Distributions to taxpayer-shareholder did not reduce individual proportionate interest or number of shares owned in Corporation.

- TN Department of Revenue determined that distributions to taxpayer were dividends for purposes of TN individual income tax.

- Department stated no portion of distributions could be characterized as tax-exempt return of capital.

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- Husband and Wife, nonresidents of VA, owned interest in non-VA LP. LP conducted business both within and outside of VA.
- LP liquidated in 2005, taxpayers reported gain from sale of assets, operating loss, and interest income. Income and losses were apportioned to VA on 2005 PTE return.
- Taxpayers subsequently filed VA individual income tax return. VA assessed deficiency relating to unstated income from in-state sources.

- Department upheld assessment on taxpayer appeal, determining that state could properly tax unstated income due to the income accruing from assets held by the LP in VA and business conducted within the state. Due to the PTE return apportioning a part of its income and loss to VA, such income and loss was determined to be income from VA sources.