Tax Clinic

State tax considerations around the sale of a partnership interest

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STATE & LOCAL TAXES

One of the most significant decisions the owner of a business classified as a partnership for U.S. federal and state income tax purposes can make is choosing whether to sell his or her interests. Sale transactions have become more common as the appeal of passthrough entities (PTEs) — including partnerships, limited liability companies (LLCs) taxed as partnerships, and S corporations — to business owners and investors grows due to their benefits, such as a single layer of taxation (unlike with C corporations) and certain legal protections available to some owners. The most recent IRS data shows that the number of PTEs has more than quadrupled since 1980. Approximately 3.8 million entities filed returns as partnerships in 2019, the most recent year for which data is available. Additionally, economic uncertainty caused by the COVID-19 pandemic, potential increases in interest rates and income tax rates, an aging U.S. population heading into retirement, and other factors are spurring owners of PTEs, among others, to consider divesting from or selling certain business operations. However, failing to account for state and local income tax effects can add to the owner's tax liability on these sales and minimize return on investment.

To increase tax efficiency while minimizing risk, owners of PTEs that conduct business in multiple state and local taxing jurisdictions should evaluate how taxing authorities may treat the sale of partnership interests. This item highlights key considerations owners selling partnership interests should address as part of the sale, including which states may attempt to tax the entire gain, how taxation of the gain may be divided among the states where the partnership does business, compliance considerations, and technical developments and trends that may affect the transaction. While states generally tax PTEs similarly to each other, there are nuances among them that are not addressed in this discussion (e.g., entity-level taxation or treating single-member LLCs as regarded entities).

Seller's entity status: Who is selling the partnership?

When determining the applicable taxation rules for the sale of an interest in a PTE operating in multiple states, the first step is to consider whether the interest is being sold by a corporate partner, another PTE, or an individual. Some states may provide a uniform set of apportionment rules that apply to all taxpayers (e.g., Alaska, Kansas, and Massachusetts). However, many states have a separate set of applicable apportionment rules depending on whether the taxpayer is a corporation, a PTE, or an individual (e.g., Arizona, Hawaii, Louisiana, New Jersey, New York, and Pennsylvania).

In states that have different rules for corporate and individual taxpayers, how the gain (or loss) on the sale of a PTE interest is apportioned or allocated may be different for a corporate taxpayer than for an individual. For example, a state may treat the gain on the sale of the interest by a corporate partner as apportionable business income (i.e., based on a formula dividing it among all states where the corporation does business); however, that same state may require an individual partner to allocate gain from the sale of the interest to a specific state (i.e., the gain is assigned and taxed entirely to one state).

Apportionable vs. allocable income

Once the taxpayer and the applicable apportionment/allocation rules for the relevant states are identified, the next question to address is whether the gain is apportionable business income or allocable nonbusiness income. Generally, income is apportionable if it is earned as part of the taxpayer's regular trade or business or is from property integral to that business, including income from an entity or assets that are part of the taxpayer's unitary business, or that serves an operational, not passive investment, function. Conversely, allocable nonbusiness income is allocated to a single state and taxed entirely by that state (for corporations, this is usually the state of commercial domicile or the location of property sold with regard to tangible or real property).

Regarding sales of partnership interests, state taxing statutes may provide specifically enumerated instances instructing where and how the gain on these transactions is allocated. (New Jersey and Pennsylvania provide instances for individual income taxpayers.) Outside any specifically enumerated instances, taxpayers can evaluate whether they can allocate the entire gain to one state.

However, taxpayers should recognize that states generally scrutinize allocable income positions on transactions. Recent state case law and administrative rulings demonstrate the type of in-depth examination taxpayers may face when taking a position that a gain is nonbusiness income allocated to a single state. The Massachusetts Supreme Judicial Court is currently deciding a case on appeal in which the Massachusetts Department of Revenue denied a taxpayer's position that a large capital gain was to be allocated entirely to a jurisdiction other than Massachusetts. The Massachusetts Department of Revenue instead used "investee apportionment" to source the gain (i.e., using the apportionment factors of the underlying partnership), which resulted in 100% apportionment to Massachusetts, since 100% of the underlying partnership's apportionment was to Massachusetts (see *VAS Holdings & Investments LLC v. Commissioner of Revenue*, Nos. C332269 and C332270 (Mass. App. Tax Bd. 10/23/20)).

Additionally, the Virginia Department of Taxation denied a taxpayer's request to correct an assessment that disallowed the taxpayer's claim that a partnership sale gain was nonbusiness income to be allocated to a state other than Virginia (see Virginia Dep't of Tax., Rulings of the Tax Commissioner No. 21-36 (Mar. 16, 2021)). Further, the North Carolina Department of Revenue announced in December 2020 that due to a state statutory change in the definition of "apportionable income," a previous administrative ruling that held that a partnership sale gain was allocable income is no longer applicable law (see North Carolina Dep't of Rev., Important Notice: Corporate Tax — Secretary Announces That New Statute Abrogated Prior Final Agency Decision (Dec. 31, 2020)).

Factor representation

If the gain on the sale is determined to be apportionable business income, the apportionment rules of the relevant states must be evaluated. The first question is whether the gain is included in the sales factor of the taxpayer's apportionment formula at all. Even though the gain is included in the taxpayer's base, many states' statutes or regulations exclude the gain entirely from the apportionment factor.

Some states may exclude the sale of a partnership interest from the factor through a number of means, such as excluding receipts earned outside the regular course of business from the sales factor, excluding certain sales of intangible property from the sales factor entirely, having specific occasional/isolated sale exclusions for transactions outside the regular course of business, and providing bright-line rules for transactions to exclude from the factor (e.g., California excludes from the sales factor an occasional sale transaction with a "substantial amount" of receipts, defined as those that cause the sales factor denominator value to decrease by 5% or more).

Other states may exclude from the factor any transaction that is outside the ordinary course of business (e.g., Georgia, Illinois, and New York). Taxpayers may take issue with these rules, however, given that the gain is included in the base without having simultaneous apportionment factor representation.

If the sale transaction is included in the factor, the next question to address is whether the net gain on the transaction or the gross proceeds are included in the factor. If the gross proceeds from the transaction are included, this may provide taxpayers the benefit of watering down the apportionment percentage in states where the gain is not sourced to the sales factor numerator.

If the state provides that the net gain is included in the factor, the taxpayer has some additional questions to address. First, if the sale transaction resulted in a net loss, how is that treated for apportionment purposes? States may provide that net losses are excluded from the factor, even if net gain transactions are included. Second, if the partnership sale transaction was a net gain and the taxpayer had other transactions that resulted in a net loss, how are those net losses treated? States have different rules on whether net losses offset gains in determining the amounts from net gain/loss transactions that are included in the apportionment factor.

Sourcing

If the net gain or gross proceeds are included in the sales factors of the states where the gain is subject to income tax, the final question to address is which states the gain or proceeds on the transaction should be sourced to for sales factor purposes (i.e., which states' sales factor numerator). With the sale of a partnership interest being a sale of other than tangible personal property, sourcing these transactions generally falls into one of two buckets.

The first bucket is cost-of-performance sourcing, which will generally source the sale to the states where the direct costs that produce the revenue are incurred. Direct costs that factor into this determination include (but are not limited to) the costs of personnel, equipment, and facilities involved with the transaction, such as those taxpayer-personnel who negotiated and closed the deal. Taxpayers should be aware that cost-of-performance sourcing varies among the states. Some states may source the entire gain to the one state where the greatest portion of the costs are incurred, while other states may source the gain to multiple states based on the percentage of costs incurred in each state.

The trend among states continues to move toward the second methodology — market-based sourcing. As its name implies, market-based sourcing generally looks to the location of the customers or beneficiaries of the transaction. Taxpayers should also note that various iterations of market-based sourcing exist among the states, whose statutes couch sourcing in language such as "where the benefit is received" (e.g., California and Indiana) or "where the transaction is delivered" (e.g., Alabama, the District of Columbia, and Pennsylvania). Taxpayers are cautioned to pay attention to definitions within these provisions but especially definitions in any state regulations, as these are usually far more detailed, cover different types of transactions, and may yield different sourcing results even among the market-based sourcing states.

With all the allocation/apportionment methods discussed above, readers may be wondering about the possibility of double taxation. For example, if one state claims the gain to be allocable income, can others try to obtain some or all of the taxable share? Also, with the varying apportionment methodologies, can the sums of the state apportionment percentages exceed 100%? Sadly, in the area of apportioning/allocating sales of other than tangible personal property, double taxation is not only possible but is rather common.

Recommended best practices

Taxpayers who sell interests in multistate partnerships have plenty to consider from a state and local income tax standpoint. If 2021 was any indication (based on the sampling of developments provided above), there will likely be additional case law and administrative decisions addressing this area in the future. Further, the Multistate Tax Commission (MTC), an intergovernmental state tax agency that strives to promote uniformity in state tax law, has formed a focus group specifically addressing partnership taxation; the state tax treatment of partnership interest sales is one area of focus. While the state taxing authorities are not bound by MTC recommendations, many states may choose to follow the recommended guidance. With the complexity and continued developments in this area, taxpayers are advised to discuss with their tax consultants the state tax considerations around these transactions (e.g., the apportionment/allocation considerations above and installment sale considerations as to when the tax should be paid). Reviewing each of the highlighted focus areas above, taxpayers may be able to avoid double-taxation pitfalls, potentially uncovering opportunities.

Editor Notes

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