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Recent Partnership Determination on Tax Liability of Non-Resident

By: Joseph Lipari

Nothing upsets tax practitioners more than the fear that a simple situation may be subject to an unanticipated tax liability. A recent Administrative Law Judge ("ALJ") Determination[1] demonstrates how the New York Personal Income Tax ("PIT") can adversely affect a straightforward transaction.

Craig Olsheim was a nonresident of New York who owned a Limited Liability Company ("LLC") interest, referred to as Fifth Avenue, that owned one asset, an office building in New York City. The LLC was taxed as a partnership and is referred to in the Determination (and here) as the Partnership. Mr. Olsheim inherited the interest in 2004 as a 50 percent beneficiary of a trust established by his father. By reason of the "step up in basis on death" rules of IRC section 1014, Mr. Olsheim had a tax basis in his interest that was substantially greater that his allocable share of the Partnership's tax basis in the Fifth Avenue property. The Partnership refused to make an election under IRC section 754 to increase the partnership's basis in the property. Many widely held partnerships do not allow section 754 elections, primarily because it can significantly increase accounting costs.

In 2005 the Partnership sold the office building resulting in IRC section 123 1 gain. Mr. Olsheim was allocated $234,674 of the gain on his Schedule K-1 and reported this gain both on his federal income tax return but also on his New York State Nonresident Personal Income Tax return.

Following the sale of the property by the Partnership, the Partnership dissolved. Under the federal income tax rules relating to partnership dissolutions, Mr. Olsheim recognized a capital loss on the dissolution. Without being overly technical, Mr. Olsheim (i) initially had a high basis in his Partnership interest (because he inherited the interest from his father)[2], that basis was then (ii) increased by the amount of the gain allocated to him by the Partnership[3] and (iii) decreased by the amount of cash distributed to him by the Partnership on the dissolution.[4] The amount of the tax basis remaining after the adjustments was deductible as a capital loss for federal income tax purposes.[5] The practical effect of all of these adjustments is that, for federal income tax purposes, Mr. Olsheim had net capital gain equal to the excess, if any, of his share of the proceeds of sale over the value of the Partnership interest reported for estate tax purposes by his father.[6]

In preparing his New York State Non-Resident Personal Income Tax Return, Mr. Olsheim took positions identical to the ones he took for federal income tax purposes. He reported on his non-resident return the full amount of the gain passed through to him on his form K-1. He then claimed a capital loss on the dissolution of the partnership and attempted to net the two items in the same way as was done federally.

That's when everything went sour. The Tax Division audited Mr. Olsheim's return and disallowed the claimed loss on the dissolution of the partnership. Referring to a 1992 Technical Services Bureau Memorandum[7], the Tax Division's letter stated that

> gain or loss on the sale of an interest in a New York partnership does not constitute gain or loss derived from or connected with New York sources and is not includible in the New York source income. Therefore, the capital loss relating to the disposition of the interest in Fifth Avenue Building Associates cannot be allocated to New York State. Furthermore, the gain relating to the sale of the Fifth Avenue Building Associates' property is considered New York source income and should be allocated to New York State.

As a result of the loss disallowance, Mr. Olsheim was hit with a tax bill of $12,058, plus interest.

New York and Non-Residents

To understand Mr. Olsheim's predicament, it is helpful to review the basic principals under which New York nonresident individuals are taxed. In contrast to residents who are taxed on all of their income[8], non-residents are taxed only on certain categories of income, generally referred to as income from New York sources[9]. Income from New

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York sources includes compensation for work performed in New York, profits from business conducted in New York and income from real or tangible personal property located in New York.[10] Income from intangibles such as interest on bonds and gains and dividends on stocks are not New York source income with narrow exceptions.[11]

The application of these principals to partnerships has, for many years, been unsettled because a partnership interest is in some sense, an intangible like a share of stock but also constitutes an indirect interest in the business conducted or property owned by the partnership. People generally refer to these competing views as the entity and aggregate theories of partnerships.

As the ALJ observed in his Determination, in years prior to 1992, the Tax Division argued that an interest in a partnership that owned property or conducted business in New York constituted an interest in New York property or an intangible employed in a business in New York. As a result, during those years the Tax Division treated gain or loss from the sale of a partnership interest as New York source income. This position was largely disputed by taxpayers and their professionals who successfully argued in a number of cases that gain from the sale of a partnership interest was not subject to New York State Personal Income Tax.[12] The Tax Division eventually relented and issued the 1992 Technical Services Memorandum.

For most nonresidents of New York, the rule laid out in the 1992 Technical Services Bureau Memorandum was the preferred result. Nonresidents who own interests in partnerships that had gains could, in many cases, sell their partnership interests and avoid New York Personal Income Tax. Individuals who owned interests in partnerships with losses often had no other New York source income so did not care whether or not the losses were sourced to New York.

Even Mr. Olsheim, with sufficient foresight, might have avoided the adverse result in this case. If, prior to the sale of the property, he sold his partnership interest to a New York resident, he would have no gain on the sale of the partnership interest and his purchaser, being a New York resident would be entitled to offset the capital loss on the dissolution of the partnership against the allocable share of the partnership's gain. He probably also could have formed a New York corporation and contributed the partnership interest to it. Although there would have been some transactional costs, the corporation would, like a New York resident individual, have been able to offset the loss against the gain for New York State Franchise Tax purposes.

2009 Amendment

It should also be noted that in 2009, the Legislature amended the Tax Law by adding a new section which reversed the 1992 Technical Services Bureau memorandum.[13] Under the amendment, which applies currently to partnerships, LLC's as well as S corporations and C corporations with 100 or fewer shareholders , if more than 50 percent of the fair market value of the assets of the entity, consists of real property located in New York, all or a portion of the gain or loss on the sale of the interests in such partnership or LLC (or stock of such corporation) are characterized as New York source income. Unfortunately for Mr. Olsheim, that amendment was not effective retroactively.

It should also be kept in mind that the 2009 amendment and the Tax Division's interpretation of it (reflected in a 2009 Technical Services Bureau Memorandum[14] are highly controversial. Most significantly, the State's attempt to tax gain on sales of stock by nonresident individuals may be subject to challenges under the Due Process and Commerce Clauses of the United States Constitution. Another controversial provision is that in determining whether New York real property exceeds 50 percent of the fair market value of the assets of the entity, only assets held for more than 2 years are taken into account. This was done to prevent a real estate entity from "stuffing" other assets into the entity shortly before a sale of the interests in the entity. However, it also means that if an entity owns real property worth say $10 million and a stock portfolio worth $100 million where the stock portfolio is traded on a regular basis, the entity may be viewed as a real estate company (because none of the stocks in the portfolio at the time of sale may have been held for 2 years). The 2009 Memorandum also addresses a number of computational issues. Significantly, the Memorandum concludes that the portion of gain that is New York source income under this provision is determined by the proportion of real estate assets to total assets of the entity. As a result, gain could be New York source income even if the real estate has gone down in value (but there are gains in other non-real estate assets). Many of these issues may be the subject of future litigation.

The main lesson to be learned from Mr. Olsheim's unfortunate situation is that even simple transactions can have surprising consequences and it is important to review the relevant tax provisions before it is too late.

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[1] *Craig A. Olsheim*, DTA #824218 (May 9, 2013).
[2] IRC section 1014(A)(1).
[3] IRC section (a)(1)(A).
[4] IRC section 733.
[5] IRC section 731(a)(2).
[6] With minor adjustments for operating income, deductions and distributions between the date of death and the date of sale.
[7] TSB-M-92(2) I.
[8] Tax Law section 612.
[9] Tax Law section 631.

[10] Tax Law section 631(b)(1).

[11] Tax Law section 631(b)(2). Income from an intangible employed in a New York trade or business constituted New York source income. Examples of this include, taxi medallions, liquor licenses and stock exchange seats.

[12] *See, Matter of Pastor*, 115 AD 2nd 144 (Third Div. 1985); *Matter of Delmhorst*, 92 AD 2nd 981 (Third Div. 1983) and *Matter of Epstein*, 89 AD 2nd 256 (Third Div. 1982).

[13] Tax Law section 631(b)(1)(A)(1).

[14] TSB-M-09(5) I.

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