

IN THE MATTER OF THE PETITION OF MR X AND MR Y
("The Petitioners")
FOR A DECLARATORY RULING
Doc. No. 7707, Effective 6/13/02

Pursuant to RSA 541-A:1, IV, RSA 541-A:16, II(b) and administrative rule Rev 209.01, the Petitioners request a declaratory ruling which determines: (1) whether the sale of a 50% partnership interest to the other partner gives rise to taxable business profits and if so how are such profits measured and how should such income be reported, and (2) Does the sale of the 50% partnership interest give rise to the imposition of the real estate transfer tax and if so, on which amounts?

Pursuant to N.H. Code of Admin. Rules Rev 209.02, this declaratory ruling is issued to the petitioners, with respect to the particular transactions and facts discussed herein and represents a holding of the department on those transactions and facts for those petitioners only.

Determination Requested by the Petitioners

Mr. X and Mr. Y each own a 50% interest in a two person partnership, "The Partnership". The Partnership is engaged in the business of owning and operating commercial rental realty. Under a proposed transaction, Mr. Y (Buying Partner) will purchase Mr. X's 50% interest in the Partnership plus the assumption of Mr. X (Selling Partner) share of partnership debt.

Petitioners request a response to the following questions:

(1) Does the sale of Mr. X's partnership interest give rise to business profits taxable by the State of New Hampshire and, if so, how are such profits measured and how should such income be reported, i.e. by the partnership, Mr. X, or Mr. Y(as a step up in basis)?

(2) Does the sale of Mr. X's partnership interest to Mr. Y and accompanying liquidation of the partnership give rise to the imposition of the real estate transfer tax, and if so, on which amounts?

Facts Presented by the Petitioners

The Partnership was organized by Mr. Y and Mr. X for the principal purpose of acquiring and operating commercial rental realty, including certain personal property and has so operated without interruption

since that time. The Partnership leases the realty and personal property to Z, a N.H. corporation.

Revised Statutes Annotated (RSA) at Issue

The following New Hampshire statutes are relevant to the Petitioners' request for a declaratory ruling:

- RSA 77-A: 1, III(c);
- RSA 77-A: 1, XX;
- RSA 77-A: 4, XIV;
- RSA 78-B: 1, I(a);
- RSA 78-B: 1-a; and

RSA 78-B: 1-a, IV.

Rules at Issue

The following administrative Rules are relevant to the Petitioners' request for a declaratory ruling:

Rev 209.01

Petitioner's Representations

To the best knowledge of the Petitioners and the Petitioners' representative, identical or similar issues:

- (1) Have not been included in a ruling request that is currently under examination by the New Hampshire Department of Revenue Administration;
- (2) Have not been previously examined by the New Hampshire Department of Revenue Administration;
- (3) Have not been under consideration by the New Hampshire Department of Revenue Administration in connection with a return or a prior period; or
- (4) Are not pending in litigation.

Business Profits Tax Consequences of Sale of Partnership Interest

PETITIONER'S POSITION

Petitioners represent that pursuant to IRC Section 708, the sale of a fifty percent interest will terminate the partnership. Petitioners also state that under IRC Section 751 upon the sale of a partnership interest, the Selling Partner recognizes income to the extent the gain is attributable to unrealized receivables and substantially appreciated inventory items. Unrealized receivables include: rights to payment to the extent previously includible in income under the method of accounting used by the partnership to the extent the proceeds would be treated as ordinary income; and depreciation recapturable under IRC Sections 1245 and 1250. Further, that for purposes of determining the tax treatment of the purchasing partner in a two person partnership, the partnership is deemed to make a liquidating distribution of all of its assets to each partner, and following the distribution, the purchaser is treated as acquiring the assets deemed to have been distributed in liquidation of the selling partner=s interest. Rev. Rul. 99-6; *Edwin E. McCaulsen v. Commissioner*, 45 T.C. 588 (1966) and Rev Rul 67-65, 1967-1 C.B.B. 168. Thus, all of the assets of the partnership would be deemed to have been distributed to Mr. Y for federal income tax purposes.

FINDINGS

The issues regarding the treatment of the income from the sale of the partnership interest depend upon whether the entity theory or aggregate theory of taxation governs. Under federal law, either the entity theory or the aggregate theory may govern the tax treatment of a particular transaction depending upon the circumstances. While the starting point for New Hampshire taxation of partnership income is the federal income tax code, for the most part New Hampshire's taxation is based upon the entity theory of taxation.

The issues are further complicated by the fact that a two-person partnership is terminated under New Hampshire law when one partner sells the interest in the partnership to the remaining partner. See generally RSA 304-A:6.

The New Hampshire Supreme Court has stated that the starting point in the interpretation of the business profits tax statute is the language of the statute itself . *Bradley Real Estate Trust v. Taylor* (1986) 128 N.H. 441, 515, A2d, 1212. Accordingly, it is appropriate to turn to the relevant statutory and regulatory language to consider the affect of New Hampshire law upon the facts stipulated by the Petitioners.

RSA 77-A: 1, III defines gross business profits in the case of a partnership as "the amount of ordinary income as would be determinable under the provisions of the United States Internal Revenue Code as defined in RSA 77-A: 1, XX increased by the amounts shown as payments to partners on the federal partnership return of income, the net amount of any gains from the sale of partnership assets, items of income specifically allocated to partners and decreased by any deductions specifically allocated to partners or losses on the sale of partnership assets."

Additionally, RSA 77- A: 4, XIV states:

- (1) In the case of a business organization where an interest or beneficial interest in the organization has been sold or exchanged;
- (2) An addition to gross business profits of an amount equal to the net increase in the basis of all underlying assets transferred or sold through the sale or exchange of the interest; and
- (3) The increase in the basis of the assets shall be determined in accordance with the provisions of the Internal Revenue Code as defined by RSA 77-A: 1, XX.

The following is an analysis of the statutory requirements:

(a) Sale or Exchange Requirement.

The proposed transaction meets the sale or exchange requirement since it is based upon the sale of the Selling Partner's 50% partnership interest to the Buying Partner plus the assumption of the Selling Partner's share of partnership debt. For both federal and New Hampshire tax purposes, the partnership is treated as having made a liquidating distribution of the assets of the partnership to each partner and the buyer is treated as having purchased the selling partner's share of partnership assets.

(b) Increase in Basis of Underlying Assets.

This section is best addressed by answering the following question: Will the proposed transaction result in an increase in the basis of the assets underlying the purchase of the 50% partnership interest?

Petitioners submitted a worksheet which sets forth the Partnership's basis and the fair market value of the underlying assets of the Partnership as part of their declaratory ruling request. The basis of the

business organization's assets after the sale of the interest in the partnership must be calculated in order to determine if there is an increase in the basis of the underlying assets.

The starting point is the Partnership's basis in one half of the partnership assets because that is the amount that is deemed to be distributed to the Selling Partner and then sold to the Buying Partner. Next, add the amount of consideration paid by the Buying Partner which is deemed to be payment for one half of the assets of the Partnership. The business organization's basis in the assets will equal the partnership's basis in one half of the assets before the sale of the partnership interest plus the consideration paid by the Buying Partner for the partnership interest. The consideration paid by the Buying Partner replaces the Partnership's basis in one half of the assets of the business organization. This replacement of basis with the consideration paid occurs because the Buying Partner is deemed to have purchased those assets from the Selling Partner even though what was actually purchased was a 50% interest in the partnership. See *Edwin E. McCaulsen v. Commissioner*, 45 T.C. 588 (1966).

In this case it is price plus the amount of additional partnership debt assumed by the Buying Partner. From the worksheet provided it is clear that the amount of consideration to be paid exceeds the Partnership's basis in one half of the assets. Therefore, the proposed transaction will result in an increase in the basis of the assets underlying the purchase of the Selling Partner's 50% partnership interest and thereby meets the second requirement of the statute.

(c) Determination of the Increase Under the Code.

The increase in the basis of the assets shall be determined in accordance with the provisions of the Internal Revenue Code of 1986 in effect on December 31, 2000. Here it is necessary to calculate the new basis of the assets used by the business organization after the completion of the transaction and compare such basis to the basis of the assets prior to the transaction. To the extent that there is an increase in the basis of the assets, such basis increase falls within the parameters of the statutory language.

Ruling

Based upon the facts as presented by the petitioner and the statutory provisions discussed above, the department makes the following ruling:

The gain on the proposed transaction as represented by the increase in basis of the assets as determined in accordance with the provisions of the Internal Revenue Code shall be reported by Partnership, a New Hampshire partnership on its final NH1065 subject to NHBPT and NHBET pursuant to RSA 77-A:2 and RSA 77-E:2.

Real Estate Transfer Tax Consequences of Sale of Partnership Interest

Does the sale of Mr. X's partnership interest to Mr. Y and accompanying liquidation of the partnership give rise to the imposition of the real estate transfer tax, and if so, on which amounts?

FINDINGS

Before the sale of the partnership interest, the Partnership owns real property in N.H. Upon the sale of the interest, the Partnership will no longer exist under state law and the real property will be owned by the Buying Partner. This transaction occurs by operation of law. RSA 78-B:1,I(a) provides that the tax is imposed upon the sale or transfers of real property including those that occur by operation of law. Additionally, RSA 78-B:1-a provides that Contractual transfers subject to the tax include transfers from a partnership to a partner. Therefore, the transfer of real estate as the result of the sale of the Selling Partner's partnership interest is subject to the real estate transfer tax.

The remaining issue is what amount is subject to the tax. In order to determine what amount is subject to the tax, the interest that is being transferred must be determined and the amount of consideration to be paid for the interest must be determined. Before the sale, the Buying Partner has a beneficial interest in the real estate through the ownership of his partnership interest. After the sale the Buying Partner will own the real estate outright. Therefore, although the Buying Partner is purchasing a 50% interest in the partnership, he will own 100% of the real estate after the sale. So the interest in the real estate that is being transferred is the entire ownership interest in the real estate.

The amount of consideration paid for the interest must be determined according to RSA 78-B:1-a,IV. RSA 78-B:1-a,IV provides as follows:

'Price or consideration' means the amount of money, or other property and services, or property or services valued in money which is given in

exchange for real estate, and measured at a time immediately after the transfer of the real estate. The value of such consideration in contractual transfers where the property exchanged includes the surrender of rights or choses-in-action by the transferee, including the surrender of shareholder or beneficial interest holder rights in liquidation of a corporation or other entity, the forgiveness of an obligation owed to the transferee, or the assumption of an obligation by the transferee, shall be no less than the fair market value of the real estate or interest in such real estate as determined by the department pursuant to RSA 78-B:9, III; except that in the case of a deed given in lieu of a foreclosure, the value of such consideration shall be the amount by which the debt of the obligor secured by the real estate or interest in the real estate is reduced plus the amount of such debt which is assumed by the transferee in exchange for the real estate, if any. (underline added)

As the underlined language indicates, where the consideration includes the assumption of an obligation by the transferee, the value of the consideration shall be the fair market value of the real estate or interest therein. In this case the consideration paid includes the assumption of the Selling Partner's share of partnership debt by the Buying Partner. Therefore the consideration is determined by the fair market value of the real estate, and the amount of the tax is based upon the fair market value of the real estate.

RULING

Based upon the facts as presented by the petitioner and the statutory provisions discussed above, the department makes the following ruling.

The transfer of the real estate resulting from the sale of a 50% partnership interest to the buying partner is subject to the real estate transfer tax imposed under RSA 78-B:1. The amount of the real estate transfer tax shall be determined based upon the fair market value of the entire ownership interest in the real estate transferred.

June 13, 2002

Stanley R. Arnold, Commissioner