Blog Post

You Can't Touch This: Sale of Partnership Interest by Nonresident Corporate Partner Deemed Subject to NYC Tax Despite Lack of Unitary Business

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The decision by the New York City Tax Appeals Tribunal in *Goldman Sachs Petershill Fund Offshore Holdings Corp* (*Petershill Fund*), unfortunately, does not involve parachute pants or any reference to the "Running Man" dance. Setting this disappointment aside, the case does address a critical constitutional issue impacting passive investors in partnerships. The crux of the dispute was whether the U.S. Constitution prevented New York City (NYC) from imposing its General Corporation Tax (GCT) on a nonresident corporate partner's sale of its interest in a partnership actively conducting business in the City.

The taxpayer was a Delaware corporation with no direct physical presence or business activity in NYC. The taxpayer owned a limited partnership interest in a partnership (LP) formed to acquire equity interests in investment management companies. In 2008, LP purchased a 9.99% interest in Claren Road Asset Management, LLC (Claren). Claren was an investment management company doing business in NYC. Neither the taxpayer nor LP participated in the management, control, or operation of the day-to-day business of Claren. Moreover, other than LP's

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minority investment, neither taxpayer nor LP entered into any transactions with Claren.

In 2010, LP sold its minority interest in Claren generating a capital gain of over $50 million. During the period 2008 through 2010, the taxpayer paid the GCT on its distributive share of income, deductions, gains, and losses from Claren. However, on its 2010 return, the taxpayer excluded from its GCT tax base the capital gain from the sale of its partnership interest in Claren.

In defense of its reporting position, the taxpayer relied on the seminal case of *Allied-Signal* decided by the U.S. Supreme Court in 1992. In that case, the Court held that a New Jersey corporation could not impose its corporate tax on a nonresident corporation's gain on the sale of an interest in an in-state entity absent a showing that the nonresident corporation and the in-state entity were in a "unitary business." The hallmarks of a unitary business, as articulated by the Court in *Allied-Signal*, are centralization of management, functional integration, and economies of scale.

The taxpayer argued that there was no evidence to support the conclusion that it was engaged in a unitary business with Claren. NYC conceded this point. Yes, you read that sentence correctly. NYC did not dispute the taxpayer's conclusion on the existence of a unitary business.

NYC boldly contended that the *Allied-Signal* case was not binding and the administrative law judge (ALJ) agreed. In 1991, one year before the U.S. Supreme Court issued its decision in *Allied-Signal*, the New York Court of Appeals held that there was no constitutional prohibition to imposing tax on the identical capital gain that was the subject of the *Allied-Signal* case (*Allied-Signal NY*). The New York Court of Appeals ruled that the unitary business analysis was irrelevant. The constitutional analysis merely required that New York contributed to the increase in value of the stock held by the nonresident corporation. In *Allied-Signal*, the Court briefly discussed this theory of taxation, but expressly declined the invitation to pass on its constitutionality.

In *Petershill Fund*, the ALJ seized on the Court's inaction in *Allied-Signal* to sustain the GCT assessment. The ALJ relied on *Allied-Signal* NY for its holding that there is no constitutional bar to imposing the GCT where NYC contributed to the increased value of the ownership interests held by the taxpayer, a nonresident corporation. This is true, according to the ALJ, whether or not the taxpayer, LP, and Claren were engaged in a unitary business.

The ALJ's holding is controversial to say the least. Let's assume it could be proven that NYC measurably contributed to the increase in value of the Claren business. Any such contribution by NYC ***directly*** benefited Claren, the limited liability company actually doing business in NYC. Expanding the scope of taxation to reach patently ***indirect*** benefits realized by nonresident corporate taxpayer creates the proverbial slippery slope. At what point is the connection between the local NYC business and a nonresident too tenuous to support taxation of purported indirect benefits?

In this case, NYC wholly ignored the Court's guidance in *Allied-Signal* and relied on the reasoning in its own *Allied-Signal* NY decision. If you read between the lines of the *Petershill Fund* decision, you can almost hear that ALJ saying, "You Can't Touch This."

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