

Michigan Court of Appeals – Individual’s Sale of Limited Partnership Interest Resulted in Business Income for Michigan Individual Income Tax Purposes

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Overview

On January 28, 2014, the Michigan Court of Appeals in *Robert B. Aikens & Ann S. Aikens v. Michigan Department of Treasury* (“Aikens”) reversed a Michigan Court of Claims’ decision which had previously held that an individual’s sale of a limited partnership interest resulted in non-business income for Michigan Individual Income Tax (“IIT”) purposes. In holding that gain recognized upon the sale of a limited partnership interest resulted in apportionable business income for IIT purposes, the Michigan Court of Appeals cited two earlier Michigan court decisions in which distributable income/loss earned at the subchapter S corporation/partnership level was characterized as apportionable business income/loss at the partner level.¹

In this Tax Alert we summarize the Michigan Court of Appeals’ decision and highlight other taxpayer considerations.

Background

In the instant case, the individual taxpayers had been partners in Pensacola Associates (“Pensacola”) which had held title to a Florida shopping mall, originally developed in 1968. In 1998, Pensacola deeded its ownership of the mall to a limited partnership in exchange for an interest in the limited partnership. From 1998 to 2003, Pensacola’s sole asset was the limited partnership interest. Pensacola was liquidated in 2003, with the partners in Pensacola receiving interests in the limited partnership in exchange. In 2004, certain individuals disposed of their interests in the limited partnership recognizing significant capital gain for federal income tax purposes.²

On the individual’s 2004 Michigan income tax return, the capital gain was characterized as business income apportionable to Michigan with application of an apportionment factor (of 0%) based on the limited partnership’s lack of property, payroll or sales in Michigan. On audit, the Michigan Department of Treasury (“Department”) determined that the capital gain resulted from the individual’s sale of an investment and therefore was not business income. Because the individuals were Michigan residents, an assessment was issued based on the capital gain being 100% allocable to Michigan.³

Business Income Definition

Both courts’ analysis focused on the Michigan IIT definition of “business income” pursuant to Mich. Comp. Laws § 206.4(4). For the tax year in question, business income was defined to mean:

[A]ll income arising from transactions, activities, and sources in the regular course of taxpayer’s trade or business and includes:

- (a) All income from tangible and intangible property if the acquisition, rental, management, or disposition of the property constitutes integral parts of the taxpayer’s regular trade or business operations.
- (b) . . .
- (c) Income derived from isolated sales, leases, assignment, licenses, divisions, or other infrequently occurring dispositions, transfers, or transactions

¹ *Robert B. Aikens & Ann S. Aikens v. Michigan Department of Treasury*, Michigan Court of Appeals (Unpublished Decision, Docket No. 310528, January 28, 2014), available at:

http://publicdocs.courts.mi.gov:81/opinions/final/coa/20140128_c310528_27_310528.opn.pdf

² *Id.*, at 3-4.

³ *Id.*, at 1-2.

- involving property if the property is or was used in the taxpayer's trade or business operation.
- (d) Income derived from the sale of a business.

The Court of Claims' Decision⁴

In analyzing the IIT definition of business income, the Michigan Court of Claims determined that the individuals ceased to own business property as of the date in 1998 that Pensacola deeded title in the shopping mall to the limited partnership. Furthermore, the limited partnership agreement barred the limited partners from taking part in the management of the business, in addition to containing a provision whereby each limited partner expressly acknowledged that their limited partnership interest was obtained for investment purposes only. In concluding that the individuals neither owned business property nor were engaged in a trade or business operation, the Court of Claims held that the capital gain recognized upon the sale of the limited partnership interest was non-business income⁵ allocable entirely to Michigan based on the Michigan residency of the individuals.⁶

The Court of Appeals' Decision

In reversing the lower court, the Michigan Court of Appeals stated that the lower court "ignored" two earlier Michigan court decisions, a Court of Appeals decision involving individual ownership in a limited partnership,⁷ and a Michigan Supreme Court decision involving individual ownership in a subchapter S corporation.⁸ In the earlier court decisions, a loss earned at the partnership and income earned at the S corporation level (i.e., distributable loss/income to the individuals in the respective cases) were held to be apportionable business income for Michigan IIT purposes.

In the opinion of the Court of Appeals, these two earlier decisions support the proposition that "it would seem unnecessary to be actively involved in a business to be considered a participant rather than a passive investor."⁹ The Court of Appeals held:

[A]ccordingly, we must reject the trial court's conclusion that the plaintiffs were no longer engaged in a trade or business merely because their status had changed to that of a limited partner.¹⁰

Interestingly, the Michigan Court of Appeals did not address a potentially significant distinction that existed in both the *Chocola* and the *Grunewald* cases relative to *Aikens*. In both earlier cases, the income/loss at issue was earned directly at the S corporation/limited partnership level and taxable as distributable income/loss at the individual level. In the instant case, however, the capital gain was not earned at the limited partnership level, but was triggered directly at the individual level upon the individual's sale of the limited partnership interest. The logic characterizing income/loss recognized at the flow-through entity level as business income (with apportionment accordingly based on the business activity of the flow-through entity itself) would appear to be somewhat attenuated when extended to the capital gain earned by a limited partner upon their own sale of a limited partnership interest. The relevance of this distinction may well be considered if the Department seeks leave to appeal to the Michigan Supreme Court.¹¹

Taxpayer Considerations

As an unpublished decision, the Court of Appeals' holding in *Aikens* is persuasive though not controlling upon another Michigan court.¹² Notwithstanding, individuals that are contemplating selling (or have previously sold) an interest in a flow-through entity such as a partnership or subchapter S corporation should consider whether the logic of the *Aikens* decision may be applicable to their particular situation.

⁴ Michigan Court of Claims (LC No. 08-000081-MT.)

⁵ "Nonbusiness income" means all income other than business income. Mich. Comp. Laws § 206.14(1).

⁶ *Id.*, at 3.

⁷ *Grunewald v. Michigan Department of Treasury*, 305 NW2d 269 (1981).

⁸ *Chocola v. Michigan Department of Treasury*, 369 NW2d 843 (1985).

⁹ *Id.*, at 4.

¹⁰ *Id.*

¹¹ It is anticipated that Treasury will seek leave to appeal the Court of Appeals' decision to the Michigan Supreme Court, although the Michigan Supreme Court has discretion over whether to accept the case.

¹² Rule 7.215, Michigan Court Rules of 1985.

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