New York State Department of Taxation and Finance
Office of Tax Policy Analysis
Technical Services Division

TSB-A-03(1)I
Income Tax
March 4, 2003

STATE OF NEW YORK
COMMISSIONER OF TAXATION AND FINANCE

ADVISORY OPINION PETITION NO. I021009A

On October 9, 2002, a Petition for Advisory Opinion was received from Eileen O' Reilly, c/o Joseph W. Bencivenga, CPA, 60 East 42nd Street, New York, NY 10165.

The issue raised by Petitioner, Eileen O' Reilly, is whether the amount of her pro rata share of income from a New York S corporation for the year in which a change of residence occurred must be prorated between the resident and nonresident periods.

Petitioner submits the following facts as the basis for this Advisory Opinion.

In February 1999, Petitioner moved from New York State to Connecticut. At that time, Petitioner owned a one-third interest in MEA Inc. (MEA), a New York State S corporation.

MEA held cash and shares in RMS Corporation (RMS), a closely held Canadian corporation. RMS did not pay any dividends. Prior to 1999, MEA's only taxable income was a small amount of interest income. In August 1999, MEA sold its interest in RMS and realized a capital gain. MEA filed a New York franchise tax return for 1999 reporting this gain. Under New York State business corporation franchise tax, MEA's investment allocation percentage was zero. Petitioner states that she did not report her pro rata share of the capital gain as New York source income since she was a resident of Connecticut when the gain was realized by MEA.

Applicable Law

Section 601(e) of the Tax Law imposes a personal income tax for a part-year resident of New York State, and provides, in part:

> Nonresidents and part-year residents. (1) General. There is hereby imposed for each taxable year on the taxable income which is derived from sources in this state of every nonresident and part-year resident individual . . . a tax which shall be equal to the tax base multiplied by the New York source fraction.
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> (2) Tax base. The tax base is the tax computed under subsections (a) through (d) of this section, as the case may be, reduced by the credits permitted under subsections (b), (c), (d) and (m) of section six hundred six, as if such nonresident or part-year resident individual . . . were a resident subject to the provisions of part II of this article.

> (3) New York source fraction. The New York source fraction is a fraction the numerator of which is such individual's . . . New York source income determined in accordance with part III of this article and the denominator of which is such individual's New York adjusted gross income determined in accordance with part II of this article . . . .

Section 632(a)(2) of the Tax Law describes New York source income of electing shareholders of S corporations, and provides:

> In determining New York source income of a nonresident shareholder of an S corporation where the election provided for in subsection (a) of section six hundred sixty of this article is in effect, there shall be included only the portion derived from or connected with New York sources of such shareholder's pro rata share of items of S corporation income, loss and deduction entering into his federal adjusted gross income, increased by reductions for taxes described in paragraphs two and three of subsection (f) of section thirteen hundred sixty-six of the internal revenue code, as such portion shall be determined under regulations of the commissioner consistent with the applicable methods and rules for allocation under article nine-A or thirty-two of this chapter.

Section 638(a) of the Tax Law describes New York source income of a part-year resident individual, and provides:

> Individuals. The New York source income of a part-year resident individual shall be the sum of the following:
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> (1) New York adjusted gross income for the period of residence, determined in accordance with part II of this article as if the taxpayer's taxable year for federal income tax purposes were limited to the period of residence.
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> (2) New York source income for the period of nonresidence, determined in accordance with section six hundred thirty-one as if the taxpayer's taxable year for federal income tax purposes were limited to the period of nonresidence.

Opinion

For taxable years beginning prior to 1988, a nonresident individual computed his or her New York State personal income tax based on the amount of income derived from or connected with New York sources, and a resident individual computed his or her tax based on income from all sources and received a credit for taxes paid to other states. When a taxpayer changed residence, he or she computed a tax for the nonresident period based on the amount of income derived from or

connected with New York sources and computed a tax for the resident period on income from all sources.

Under this statutory scheme, in Matter of McNulty v New York State Tax Commission, 70 NY2d 788, 522 NYS2d 103, the Court of Appeals held former section 148.6 of the Personal Income Tax Regulations (the Regulations) invalid and required that a partner's distributive share of partnership income, gain, loss, and deduction for tax year 1979, the year in which the change of residence occurred, be prorated between the resident and nonresident periods. Former section 148.6 required taxpayers who moved in or out of New York State during the tax year to treat partnership gains or losses as having all accrued in the portion of the taxable year in which the partnership's own tax year ended.

In McNulty, recognizing that the taxpayer's distributive share of partnership income did not indicate actual receipt of the income, the Court of Appeals found harm in requiring taxpayers who move into or out of New York State during the tax year to treat partnership gains and losses as having all accrued in the taxable period in which the partnership's own tax year ends, regardless of when the income was actually received. The court concluded that this was inconsistent with the change of residence status rules which required an allocation that reflects either actual date of receipt and expenditure or encompasses an annual amount distributed on a proportionate basis.

In Matter of Wertheimer, Dec St Tax Trib, January 12, 1995, TSB-D-95-(2)I, the issue addressed was whether the petitioners were required to prorate their partnership losses between their nonresident period and resident period for the 1986 tax year. In that case, the petitioners maintained they could properly report all partnership losses in the resident period of their part-year income tax return rather than prorating the losses between their resident and nonresident periods based on the number of months that they resided in New York State, as held in the McNulty decision. The petitioners asserted that the McNulty decision did not mandate proration, but permitted it. As such, the petitioners maintained that they had a choice of prorating their distributive share of partnership losses between their resident and nonresident periods, or allocating all of their share of partnership losses to either the resident or nonresident period depending upon when the loss was deemed to have accrued. The Tribunal disagreed with the petitioners' position. The Tribunal noted that the basic principles of taxation of income earned by a partnership under section 706(a) of the Internal Revenue Code requires that each partner's distributive share of the income, gain, loss, and deduction be included in that partner's taxable income for the taxable year of the partnership ending within or with the partner's tax year. A partner is required to report and pay tax on his distributive share of the net income of the partnership in this manner without regard to whether this amount was actually distributed or distributable to him in that year. In the Tribunal's view, the holding of McNulty, supra, is that where a partner's distributive share of income is reported without regard to actual receipt, the only possible method of allocation when there is a change of residency is on a proportionate basis throughout the year. In McNulty, the accrual date method of allocating the distributive share of partnership income was rejected because this method did not reflect the actual date of receipt of the income.

The New York Tax Reform Act of 1987, Chapter 28 of the Laws of 1987, changed the manner in which nonresidents and part-year residents compute their tax for a taxable year beginning on or after January 1, 1988. Now, under section 601(e) of the Tax Law, the tax imposed on a nonresident or part-year resident individual's taxable income derived from sources in New York State is computed as if the individual were a resident, reduced by certain credits, and apportioned to New York by the New York source fraction, the numerator of which is the individual's New York source income and the denominator of which is the individual's New York adjusted gross income. As a result, when a resident individual changes residence during the taxable year, the New York source income is the sum of (1) the individual's New York adjusted gross income from all sources for the period of residence, determined as if the individual's taxable year for federal income tax purposes were limited to the resident period, plus (2) the individual's New York adjusted gross income derived from New York sources for the nonresident period, determined as if the individual's tax year for federal income tax purposes were limited to the period of nonresidence. The denominator of the New York source fraction used to compute the tax is the individual's New York adjusted gross income from all sources for the entire year.

In 1990, section 148.6 of the Regulations was amended to reflect the Department's view of how the McNulty, supra, and Werthheimer, supra, cases apply under the current law. These regulations provided that where there is a change of residence, the taxpayer's distributive share of partnership income, gain, loss and deduction to be included in the numerator of the New York source fraction should be determined according to the status of the taxpayer as a resident or nonresident at the time the taxable year of the partnership ends.

The Tax Appeals Tribunal found this regulation invalid in Matter of Greig, Dec St Tax Trib, September 16, 1999, TSB-D-99-(21)I. The Tribunal, relying on the Court of Appeals decision in McNulty, supra, stated that the taxpayer's distributive share of partnership income, gain, loss and deduction or pro rata share of New York S corporation income, gain, loss and deduction for the year in which the change of residence occurs must be prorated between the resident and nonresident periods. The decision is reflected in Technical Services Bureau Memorandum entitled New York Tax Treatment of Partnership and New York S Corporation Income of Part-Year Residents, February 23, 2000, TSB-M-00(1)I, which states that, for tax years beginning in 1999 and thereafter, the rules for prorating between resident and nonresident periods is based on the number of days in each period.

Accordingly, following McNulty, supra, Wertheimer, supra, and Grieg, supra, in this case, Petitioner must prorate the amount of her pro rata share of the capital gain realized by MEA from the sale of its interest in RMS between Petitioner's resident and nonresident periods of the year. Pursuant to TSB-M-00(1)I, supra, the amounts prorated are based on the number of days resided in New York State. The pro rata share of the capital gain allocated to the resident period of the year is New York source income pursuant to section 638(a)(1) of the Tax Law. The pro rata share of the capital gain allocated to the nonresident period of the year is not New York source income pursuant to sections 632(a)(2) and 638(a)(2) of the Tax Law since MEA's capital gain is not derived from or

connected with New York sources. MEA's capital gain is not derived from or connected with New York sources because, for New York franchise tax purposes, MEA's investment allocation was zero.

DATED: March 4, 2003

/s/
Jonathan Pessen
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Technical Services Division

NOTE: The opinions expressed in Advisory Opinions are limited to the facts set forth therein.