New York State Department of Taxation and Finance
Taxpayer Services Division
Technical Services Bureau

TSB-A-89 (9) I
Income Tax
October 16, 1989

STATE OF NEW YORK
COMMISSIONER OF TAXATION AND FINANCE

ADVISORY OPINION PETITION NO. I890727A

On July 27, 1989, a Petition for Advisory Opinion was received from Arthur R. Rosen, Roberts & Holland, 30 Rockefeller Plaza, New York, New York 10112.

The issue raised is whether the maximum tax provisions contained in section 603-A of the Tax Law, as in effect prior to repeal, apply to a limited partner's distributive share of partnership income for 1985 and 1986, where the partnership's income is derived from services performed on its behalf by its partners, where the limited partner had relatively little capital invested in the partnership, and where he was allocated his distributive share as compensation for personal services actually rendered by him to and on behalf of the partnership.

The following are the hypothetical facts as set forth by the Petitioner. Mr. X, during the years 1985 and 1986, was a limited partner of a limited partnership organized under Article 8 of the New York Partnership Law (the "Partnership"). The Partnership, which is headquartered in New York City, is an investment banking firm affiliated with several entities located in various foreign countries. More than 80 percent of the Partnership's income is derived from fees and commissions received from its corporate clients to whom it gives advice relating to capital acquisitions and for whom it performs underwriting services. The Partnership's clients pay fees and commissions in consideration for the personal services rendered on behalf of the Partnership by its partners, assisted by its employees. The Partnership does not generally invest its own funds; capital is not a material income-producing factor in the Partnership's business

Under its operating practice and partnership agreement, Partnership management is vested entirely in a few of the general partners. Accordingly, neither most of the general partners nor any of the limited partners take part in control of the business. Both general and limited partners render services to the Partnership including introducing business to the Partnership. Thus, the services performed by limited partners, such as Mr. X, are of the same type as the services performed by most of the firm's general partners and are completely permissible under section 96 of the Partnership Law. (Section 96 provides that a limited partner is not liable as a general partner unless he takes part in the control of the business.) The only significant distinction between Mr. X, as a limited partner, and a typical general partner of the Partnership is the limitation on a limited partner's personal liability.

Mr. X, during the years in question, performed services that did not significantly differ from those of a general partner with similar "line" responsibilities. He maintained communication with potential, past and current clients and offered advice and underwriting services in connection with

capital acquisitions. In the course of this "deal-making" or "salesman" function, Mr. X actively sought business for the Partnership and participated in meetings and negotiations. Mr. X's activities in foreign countries on behalf of the Partnership were central to the Partnership's business presence in those countries.

Mr. X maintained an office, staffed by a full-time secretary, at the Partnership's New York headquarters, where he attended important meetings. He was in constant telephone contact with his New York office (as well as offices of affiliates of the Partnership) when out of the city. The nature of Mr. X's function does not require maintenance of regular business hours, nor is the value of such services determined by the gross amount of time devoted. Instead, Mr. X was allocated his distributive share (all shares are determined by a small group of general partners) for the amount of consulting and underwriting business he produced, directly or indirectly, over extended periods of time.

Mr. X paid the federal self-employment tax and the New York City nonresident earnings tax for each of the years in question, demonstrating that Mr. X and the Partnership consistently treated the income as compensation for personal services even though, on their returns, they included the amounts as distributive shares rather than guaranteed payments or salaries.

The majority of Mr. X's "capital contributions" to the firm were made by simply withholding ten percent of his distributive share of income each year and crediting the amount to his capital account. This method of crediting the capital account is the identical method used with respect to the compensation of general partners. The withheld amounts were incidental as compared with the value of the services Mr. X personally rendered. Thus, although a limited partner, Mr. X was in no sense an inactive partner or a mere passive investor.

The rationale for Mr. X's being a limited partner rather than a general partner was entirely unrelated to the nature or value of the services he rendered. During the period in question, Mr. X also served as a member of the board of directors of several corporations and also served as chairman of a state-owned enterprise of a foreign country. Neither the policy of the foreign government (nor the policy of any of the corporations on whose boards he served) nor his status as a limited partner prevented Mr. X from actively engaging in the other duties described above.

Section 617(b) of the Tax Law provides that each item of partnership income, gain, loss or deduction shall have the same character for a partner under Article 22 as for federal income tax purposes. In addition, where an item is not characterized for federal income tax purposes, it shall have the same character for a partner as if realized directly from the source from which realized by the partnership or incurred in the same manner as incurred by the partnership. Therefore, earned income cannot include items of income or gain that would be characterized as unearned income if realized by the taxpayer directly from the source from which realized by the partnership.

Accordingly, a partner's distributive share of income is to be determined as "earned" or "unearned" at its source. The fact that a partner performs services for the partnership would not alter the character of income determined to be "unearned" at its source. The characterization of such income is a factual question.

Questions of fact are not susceptible of determination in an Advisory Opinion. An Advisory Opinion merely sets forth the applicability of pertinent statutory and regulatory provisions to "a specified set of facts". Tax Law, §171, subd. twenty-fourth; 20NYCRR 901.1(a).

Section 603-A of the Tax Law, prior to its repeal by Laws of 1987 (ch 28), provided for a maximum tax rate on New York personal service taxable income. Section 603-A(b)(1) as amended by Laws of 1981 (ch 1043) defined "New York personal service income", in part, as:

> wages, salaries, or professional fees, and other amounts received as compensation for personal services actually rendered, but does not include that part of the compensation derived by the taxpayer for personal services rendered by him to a corporation which represents a distribution of earnings or profits rather than a reasonable allowance as compensation for the personal services actually rendered. In the case of a taxpayer engaged in a trade or business in which both personal services and capital are material income-producing factors.., a reasonable allowance as compensation for the personal services rendered by the taxpayer shall be considered as earned income .... (Emphasis added)

When 603-A was added to the Tax Law in Laws of 1978 (ch 28 and amended ch 729) "New York personal service income" was defined as items of income includible as personal service income for purposes of section 1348 of the Internal Revenue Code (hereinafter "IRC")

In an analogous federal maximum tax provision, section 1348(b)(1)(A) of the IRC, prior to its repeal effective for taxable years beginning after December 31, 1981, defined "personal service income" as any income which is earned income within the meaning of section 401(C)(2)(C) of the IRC or section 911(b) of the IRC.

After section 1348 of the IRC was repealed in 1981, section 603-A of the Tax Law was amended to incorporate substantially the same definition of earned income that was contained in section 911(b) of the IRC.

Therefore, it is appropriate to apply precedent set under sections 1348 and 911 of the IRC with regards to the definition of earned income.

Treasury Regulation 1.1348-3(a)(3)(ii), while in effect, provided that:

> [w]hether capital is a material income producing factor must be determined by reference to all the facts in each case. Capital is a material income-producing factor if a substantial portion of the gross income of the business is attributable to the employment of capital in the business, as reflected, for example, by a substantial investment in inventories, plant, machinery or other equipment. In general, capital is not a material income-producing factor where gross income of the business consists principally of fees, commissions, or other compensation for personal services performed by an individual.

In Rev. Rul. 74-231, 1974-1 CB 240, it was determined that consulting fees received by a partnership, in which capital is not a material income-producing factor, Constitutes "earned income" within the meaning of section 1348(b)(1) of the IRC and each partner must take into account separately his distributive share of this income. Therein, the partnership's income was derived solely from professional fees for its consulting services performed by engineer, draftsmen, architects and administrative personnel under the supervision of two partners and no substantial portion of the gross income of the partnership was attributable to the employment of capital in its business.

The issue as to whether a trade or business is one in which "both personal services and capital are material income-producing factors" is fundamentally factual in nature. George Rousku v Commissioner [Dec 30,839], 56 TC 548, 551 (1971). Capital is not material to the production of income where the activity generating income is essentially personal services or professional skills. See Fried v Commissioner [Dec 45,943(M)], TC Memo 1989-430; Crowell v Commissioner [Dec 44,897(M)], TC Memo 1988-305; and Bruno v Commissioner [Dec 35,529], 71 TC 191, 200-201 (1978). If capital is utilized merely to pay the cost of salaries, wages, office space and general business expenses, it is not a material income-producing factor but is only incidental to the production of income. Id. 551; Warren R. Miller, Sr. 51 TC 755, 759 (1969). Capital required to meet regulatory mandates is not necessarily a material income-producing factor. See Crowell v Commissioner, supra and Bruno v Commissioner, supra. As previously noted, it is not within the scope of an Advisory Opinion to decide questions of fact.

Section 100.4(c)(1)(v) of the personal income tax regulations provides that "[w]here an individual is engaged in an unincorporated trade or business in which both personal services and capital are material income-producing factors, a reasonable allowance as compensation for the personal services actually rendered is personal service income from the trade or business." However, such allowance cannot be more than the net profits of the business.

The personal income tax regulations do not specify any test to determine the portion of income received from an unincorporated trade or business that

represents a reasonable allowance for salaries and other compensation for personal services actually rendered. Nor do the regulations contain any provisions restricting "New York personal service income" to amounts reported on W-2 forms.

The determination of what represents a reasonable allowance for salaries and other compensation for personal services actually rendered is a factual question which must be answered on a case by case basis based upon a review of the relevant facts and circumstances of each case. Factors which may be taken into account in arriving at a reasonable allowance include: the nature, extent and scope of the taxpayer's work, the taxpayer's qualifications, the size and complexities of the trade or business, a comparison of the taxpayer's compensation to the compensation of other employees, a comparison of the taxpayer's income from the partnership to the income of other partners of the Partnership and the prevailing rates of compensation for comparable positions in comparable companies. However, the above list is not intended to be an exhaustive list. Zalman C. and Elaine K. Bernstein, Advisory Opinion of the Commissioner of Taxation and Finance, December 15, 1987, TSB-A-87(10)I.

It should be noted that the burden of proving that income received represents a reasonable allowance for compensation for personal services actually rendered falls upon the taxpayer. Antonio and Frances Coppola, Joseph and Marie Coppola, Decision of the State Tax Commission, February 18, 1986, TSB-H-86(44)I; Migliore v. Commissioner; 36 TCM 1004 (1977) (applying the provisions of former Internal Revenue Code section 1348 relating to the definition of "earned income" which is substantially the same as section 603-A of the Tax Law); Paula Construction, Co. v. Commissioner, 58 T.C. 1055 (1972).

Inasmuch as the factual questions presented herein, namely: (1) the characterization of the limited partner's distributive share of the partnership's income, (2) whether capital is a material income-producing factor and (3) if so, the determination of what represents a reasonable allowance for salaries and other compensation for personal services actually rendered, arise within the context of an audit, the necessary factual determination will be made within such context, in accordance with the principles outlined above.

Accordingly, if it is determined that Mr. X's distributive share of partnership income is derived from personal services actually performed, is earned income of the partnership and capital is not an income-producing factor, the maximum tax rate provisions of section 603-A of the Tax Law, for the taxable years at issue, are applicable to Mr. X's distributive share of the partnership's income. If in addition to the personal services performed, capital is an income-producing factor, the maximum tax rate provisions of section 603-A of the

Tax Law, for the taxable years at issue, are applicable to the amount that represents a reasonable allowance as compensation for the personal services actually rendered by Mr. X.

DATED: October 16, 1989

s/FRANK J. PUCCIA
Director
Technical Services Bureau

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