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

TSB-A-92 (9) I
Income Tax
October 13, 1992

STATE OF NEW YORK
COMMISSIONER OF TAXATION AND FINANCE

ADVISORY OPINION PETITION NO. I920721A

On July 21, 1992, a Petition for Advisory Opinion was received from Christopher L. Doyle, Esq., c/o Hodgson, Russ, Andrews, Woods & Goodyear, 1800 One M & T Plaza, Buffalo, New York 14203.

The issue raised by Petitioner, Christopher L. Doyle, is what are the personal income tax ramifications of the liquidation of a New York S corporation owned by nonresident shareholders pursuant to Article 22 of the Tax Law under the fact pattern hereinafter presented.

Taxpayers are individuals who are not residents of New York State. In Year 1, for $100x, Taxpayers purchased all the stock of a New York corporation for which the previous shareholder had made a proper and timely election under section 660(a) of the Tax Law to be treated as a New York S-Corporation (hereinafter "NYS-Corp"). Taxpayers filed all required notices and consents for continued treatment of NYS-Corp as a New York S-Corporation after the acquisition of the NYS-Corp stock. Taxpayers are not in the business of trading stock.

The sole asset held by NYS-Corp is a general partnership interest (hereinafter "Partnership Interest") in a partnership which owns rental real estate located in New York. NYS-Corp has no employees. NYS-Corp's sole source of revenue is distributions from the partnership. The partnership's sole source of revenue is rents received on the New York property. NYS-Corp has a business allocation percentage which allocates 100 percent of its income, gain, loss and deduction to New York State for franchise tax (Article 9-A) purposes.

For valid business reasons, Taxpayers wish to liquidate NYS-Corp, and operate the rental real property business as a partnership owned directly by Taxpayers. At the time of the liquidation, the Partnership Interest will have a fair market value of $100x and NYS-Corp will have a $5x basis in the Partnership Interest. Immediately prior to the liquidation, Taxpayers will have in the aggregate a $100x basis in their stock of NYS-Corp.

When NYS-Corp liquidates and distributes the Partnership Interest, NYS-Corp is deemed under section 336 of the Internal Revenue Code (hereinafter "IRC") as having sold the Partnership Interest at its fair market value. As a result, NYS-Corp will realize a $95x gain from the hypothetical sale of the Partnership Interest (the excess of the $100x fair market value of the Partnership Interest over NYS-Corp's $5x basis in the Partnership Interest).

Section 1366(a) of the IRC requires that Taxpayers take the $95x gain realized by NYS-Corp into their personal adjusted gross incomes for federal income tax purposes.

Section 1367(a) of the IRC permits Taxpayers to increase their basis in NYS-Corp stock by $95x (the amount passed through as income). Therefore, Taxpayers will have in the aggregate a $195x basis in their NYS-Corp stock (their $100x original basis increased by $95x).

Under section 331 of the IRC, the liquidation will cause Taxpayers to be deemed to have sold their stock in NYS-Corp for the fair market value of the property received in liquidation. At the time of the hypothetical stock sale, the fair market value of the Partnership Interest will be $100x, and Taxpayers will have a $195x basis in their NYS-Corp stock. Therefore, Taxpayers will realize a $95x loss on the hypothetical sale of their NYS-Corp stock.

Section 601(e)(1) of the Tax Law provides that personal income tax is imposed for each taxable year on the taxable income which is derived from sources in New York State of every nonresident individual which shall be equal to the tax computed under sections 601(a) through (d) of the Tax Law, as the case may be, reduced by the credits permitted under section 606(b) and (c) of the Tax Law, as if such nonresident were a resident, multiplied by a fraction, the numerator of which is such individual's New York source income determined in accordance with sections 631 through 638 of the Tax Law and the denominator of which is such individual's federal adjusted gross income for the taxable year.

Section 631(a) of the Tax Law provides that the New York source income of a nonresident individual shall be the sum of the net amount of items of income, gain, loss and deduction entering into the individual's federal adjusted gross income derived from or connected with New York sources including, where the election provided for in section 660(a) of the Tax Law is in effect, an individual's pro rata share of S corporation income, loss and deduction, increased by reductions for taxes described in section 1366(f)(2) and (3) of the IRC, and shall be determined under section 632 of the Tax Law.

Section 632(a)(2) of the Tax Law provides that, in determining New York source income of a nonresident shareholder of an S corporation where the election provided for in section 660(a) of the Tax Law 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 the shareholder's federal adjusted gross income, increased by reductions for taxes described in section 1366(f)(2) and (3) of the IRC, as such portion shall be determined under the Business Corporation Franchise Tax Regulations, promulgated under Article 9-A of the Tax Law, consistent with the applicable methods and rules for allocation under Article 9-A.

Section 631(b)(2) of the Tax Law and section 132.5(a) of the Personal Income Tax Regulations provides that items of income, gain, loss and deduction attributable to intangible personal property of a nonresident individual, including annuities, dividends, interest, and gains and losses from the disposition of intangible personal property; do not constitute items of income, gain, loss and deduction devised from or connected with New York State sources, except to the extent attributable to property employed in a business, trade, profession or occupation carried on in New York State.

Herein, NYS-Corp allocates 100 percent of its income, gain, loss and deduction to New York State for franchise tax purposes. Therefore, all of Taxpayers pro rata share of NYS-Corp's $95x gain from the deemed sale of the Partnership Interest is New York source income under section 632(a)(2) of the Tax Law.

However, the Taxpayers $95x loss attributable to the deemed sale of the NYS-Corp stock is a loss from the disposition of intangible personal property that was not employed by Taxpayers in a business trade, profession or occupation carried on in New York State and is not New York source income under section 631(b)(2) of the Tax Law and section 132.5(a) of the Personal Income Tax Regulations.

There is no provision in Article 22 of the Tax Law that gives the Commissioner of Taxation and Finance the authority to accept alternative methods for determining New York source income.

It should be noted that if Taxpayers, as nonresidents, had not made the election pursuant to section 660(a) of the Tax Law, the $95x gain from the disposition of the Partnership Interest would not be New York source income. By making the election pursuant to section 660(a) of the Tax Law, the Taxpayers have subjected themselves to personal income tax as provided herein and are bound by the consequences of such election.

The laws of New York State are presumed to be constitutional by the Commissioner of Taxation and Finance. There is no jurisdiction at the administrative level to declare such laws unconstitutional; therefore, it must be presumed that the relevant sections of the law are constitutional to the extent that they relate to the imposition of the tax liability on Taxpayers.

DATED: October 13, 1992

s/PAUL B. COBURN
Deputy Director
Taxpayer Services Division

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