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

TSB-A-87 (10) C
Corporation Tax
TSB-A-87 (3) I
Income Tax
May 14, 1987

STATE OF NEW YORK
STATE TAX COMMISSION

ADVISORY OPINION PETITION NO. Z861008A

On October 8, 1986, a Petition for Advisory Opinion was received from Herbert Paul, P.C., 805 Third Avenue, New York, New York 10022.

Petitioner has presented the following hypothetical set of facts and requests an advisory opinion as to the New York corporate and income tax consequences.

Facts

1. Mr. X is a resident of State A (not New York).

2. Mr. X is the sole shareholder of a foreign corporation (Y corporation), an S corporation for federal income tax purposes. Y corporation is also an S corporation for New York purposes. Y corporation maintains an office in upstate New York. Mr. X is also an employee of Y corporation and performs 25% of his work in New York. Y corporation provides consulting services.

3. Y corporation is a general partner in a New York partnership (Z partnership).

4. Z partnership is the managing partner of a foreign partnership (Q partnership). Q partnership conducts 35% of its business within New York and the balance in States A, B & C.

5. Q partnership sells all its assets and generates capital gain and ordinary income. A portion of these items flow through to Z partnership and then to Y corporation by way of a schedule K-1. The results then pass to Mr. X also by a schedule K-1.

6. As a result of conducting business in States A,B, & C the following tax results will occur:

States A & B- No tax consequences to either Z or Q partnerships or to Y corporation since they are pass-thru entities. Mr. X is required to file a nonresident individual income tax return in each state for the portion of flow through income (including capital gain) attributable to the particular state (So stated in Petition).

State C- Q partnership is required to file a return and pay business taxes. Z partnership and Y corporation are not required to file returns. Mr. X is required to file a nonresident individual income tax return for the portion of flow through income which is attributable to State C.

Issues

(a) How are any of the above entities and Mr. X taxed in New York. Does everything flow through to Mr. X.

(b) What portion of the income is taxable to Mr. X.

(c) Will he apportion the income based on the three factor formula. If so, will this be determined at the partnership or corporate level. How is it calculated. If at the partnership level, is it at partnership Z or Q's level.

(d) To what extent is Mr. X required to report capital gain to New York which he receives from corporation Y.

Law

Section 601(b) of the Tax Law and section 119.1 of the New York State Personal Income Tax under Article 22 of the Tax Law regulations (hereinafter Income Tax regulations) provide that a partnership itself does not pay a New York State personal income tax, but the individual partners are taxed on their respective distributive shares of the partnership income, whether or not such shares are actually distributed to them.

Section 658(c)(1) of the Tax Law provides that every partnership having a resident partner or having any income derived from New York sources shall make a return for the taxable year setting forth all items of income, gain, loss and deduction and such other pertinent information as the State Tax Commission may prescribe.

Under section 660(a) of the Tax Law, shareholders of a federal S corporation are permitted to make an election to treat the corporation as a New York S corporation whereby the corporation would be exempt from the corporation franchise tax and the shareholders would be taxed under the Personal Income Tax Law on their pro rata share of the S corporation's items of income, loss, deduction and reduction for taxes described in section 1366(f)(2) and (3) of the Internal Revenue Code which are taken into account for federal income tax purposes.

Section 658(c)(2) of the Tax Law provides that every S corporation for which the election provided for in section 660(a) is in effect shall make a return for the taxable year setting forth all items of income, loss and deduction and such other pertinent information as the State Tax Commission may prescribe.

The New York taxable income of a resident or nonresident individual is computed by subtracting from its New York adjusted gross income, the individual's New York deduction and New York personal exemptions.

The New York adjusted gross income of a resident individual is the individual's federal adjusted gross income with the modifications required by section 612 of the Tax Law. Section 632 of the Tax Law sets forth the computation of a nonresident individual's New York adjusted gross income. An individual's federal adjusted gross income includes a partner's distributive share of the partnership's income, gain, loss and deduction and also includes a shareholder's pro rata share of a S corporation's income, loss, deduction and reduction for taxes, described in section 1366(f)(2) and (3) of the Internal Revenue Code.

Section 617(a) of the Tax Law provides that when computing New York adjusted gross income and New York taxable income of a resident partner or a resident shareholder of an S corporation not subject to tax under Article 9-A, any modification described in section 612(b), (c) or (d) or section 615(c) or (d) (2) or (3) which relates to an item of partnership or S corporation income, gain, loss or deduction shall be made in accordance with the partner's distributive share or the shareholder's pro rata share, for federal income tax purposes, of the item to which the modification relates. Section 617(b) of the Tax Law provides that each item of partnership and S corporation income, gain, loss or deduction shall have the same character for a resident partner or shareholder under Article 22 as for federal income tax purposes.

Section 637(c) of the Tax Law provides that when computing New York adjusted gross income of a nonresident partner or S corporation shareholder, any modification described in section 612(b) or (c) which relates to an item of partnership or S corporation income, gain, loss or deduction shall be made in accordance with the partner's distributive share or the shareholder's pro rata share for federal income tax purposes of the item to which the modification relates, but limited to the portion of such item derived from or connected with New York sources. Section 637(e)(1) provides that the provisions of section 617(a) apply when determining a nonresident partner's distributive share or shareholder's pro rata share of income, gain, loss or deduction. Section 637(e)(2) provides that section 617 (b) applies when determining the character of partnership or S corporation items for nonresident partners or shareholders.

Section 131.15 of the Income Tax regulations provides that where a partnership carries on a business, trade, profession or occupation both within and without New York State and maintains books and records from which the New York income of the business can be determined, a nonresident partner's distributive share of partnership items derived from New York sources will be determined from the books of account. Where the partnership does not maintain books and records from which New York income can be determined, it will use the business allocation percentage or an authorized alternative method to determine a nonresident partner's distributive share of partnership items derived from New York sources. The business allocation percentage consists of three percentages: property, payroll and gross income. The percentages are described in subdivisions (d), (e) and (f) of section 131.15 of the Income Tax regulations.

Pursuant to section 637(a)(2) of the Tax Law, an S corporation that has nonresident shareholders and business activities outside New York State determines a nonresident shareholder's pro rata share of items of the S corporation's income, loss and deduction entering into the shareholder's adjusted gross income, increased by reduction for taxes described in section 1366(f)(2) and (3) of the Internal Revenue Code derived from or connected with New York sources by using the business allocation and investment allocation percentages used under Article 9-A of the Tax Law. Such business allocation percentage consists of four factors: a real and tangible personal property factor, a business receipts factor, a payroll factor, and an additional factor equal to the business receipts factor. The business allocation percentage is described in Subparts 4-2, 4-3, 4-4, 4-5, and 4-6 of the Business Corporation Franchise Tax regulations. The investment allocation percentage is described in Subpart 4-7 of the Business Corporation Franchise Tax regulations.

Section 181.1 of the Tax Law provides that a foreign New York S corporation must pay a license fee for the privilege of exercising its corporate franchise or carrying on its business in New York State. This fee is payable only once unless the capital share structure changes or the amount of capital stock employed in New York State has increased since the last license fee report was filed.

Section 181.2 of the Tax Law requires that a foreign New York S corporation, that is authorized to do business in New York State pursuant to Article 13 or Article 15-a of the Business Corporation Law, shall pay annually a maintenance fee of $200.

Discussion

For New York income tax purposes, Q partnership, itself, is not subject to tax. However, Q partnership carries on business within and without New York and has a resident partner, Z partnership. Therefore, Q partnership must file a New York partnership return pursuant to section 658(c)(1) of the Tax Law. Even though Q partnership carries on business both within and without New York, Z partnership's distributive share of Q's ordinary income and capital gain cannot be allocated within and without New York because Z partnership is a resident partner.

For New York income tax purposes, Z partnership, itself, is not subject to tax. However, Z partnership is a New York partnership and as such must file a New York partnership return pursuant to section 658(c)(1) of the Tax Law. Z partnership must include in its computation of income, its distributive share of ordinary income from Q partnership. Z partnership's distributive share of capital gain from Q partnership is included in Z partnership's computation of capital gains and losses. Z partnership has a nonresident partner, Y corporation. Therefore, Z partnership will determine Y corporation's distributive share of Z's ordinary income and capital gain derived from New York sources.

If Z partnership is not carrying on business outside New York, all income and capital gain is from New York sources. If Z partnership is carrying on business both within and without New York and Z partnership's New York income

can be accurately determined from Z's books and records, as described in section 131.15(b) of the Income Tax regulations, that is the allocation method to be used. If the books and records are not maintained so that New York income can be determined, Z partnership will use the business allocation percentage described in section 131.15(c) of the Income tax regulations or some other authorized alternative method.

For New York corporation franchise tax purposes, Y corporation is exempt from Article 9-A, pursuant to sections 209.8 and 660(a) of the Tax Law. However, Y corporation must pay annually a maintenance fee, pursuant to section 181.2 of the Tax Law. In addition, Y corporation must pay a license fee and file a license fee report as required by section 181.1 of the Tax Law.

For New York personal income tax purposes, Y corporation, itself, is not subject to tax, but pursuant to section 658(c)(2) of the Tax Law, Y corporation, must file a S corporation return. Y corporation must include in its computation of income, its distributive share of Z partnership's ordinary income from New York sources. Y corporation's distributive share of Z partnership's capital gain from New York sources is included in Y corporation's computation of capital gains and losses. Since Mr. X, the shareholder of Y Corporation, is a nonresident, Y corporation must determine Mr. X's pro rata share of Y corporation's ordinary income and capital gain from New York sources. If Y corporation does not have business activities outside New York, all income and capital gain is from New York sources. If Y corporation has business activities both within and without New York, Y corporation allocates its ordinary income and capital gain by the business allocation and investment allocation percentages used pursuant to Article 9-A of the Tax Law described in Subparts 4-2, 4-3, 4-4, 4-5, 4-6 and 4-7 of the Business Corporation Franchise Tax regulations.

For New York personal income tax purposes, Mr. X must file a New York nonresident return and include in his New York adjusted gross income his wages derived from New York sources as well as his pro rata share of Y corporation's ordinary income and capital gain from New York sources.

DATED: May 14, 1987

s/FRANK J. PUCCIA
Director
Technical Services Bureau

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