STATE OF NEW YORK

DIVISION OF TAX APPEALS

In the Matter of the Petition	:	
of	:	
GREGG M. & STEPHANIE FALBERG	:	DETERMINATION DTA # 818960
for Redetermination of a Deficiency or for Refund of New York State and New York City Personal Income Taxes under Article 22 of the Tax Law and the New York City Administrative Code for the Year 1997.	:	
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Petitioners, Gregg M. and Stephanie Falberg, 256 Sumac Road, Highland Park, Illinois 60035, filed a petition for redetermination of a deficiency or for refund of New York State and New York City personal income taxes under Article 22 of the Tax Law and the New York City Administrative Code for the year 1997.

On November 19, 2002 and November 21, 2002, respectively, petitioners by their representative, Hodgson Russ LLP (Timothy P. Noonan, Esq., of counsel) and the Division of Taxation by Mark F. Volk, Esq. (Peter B. Ostwald, Esq., of counsel), waived a hearing and agreed to submit the matter for determination based on documents and briefs to be submitted by April 11, 2003, which commenced the six-month period for the issuance of this determination. After review of the evidence and arguments presented, Thomas C. Sacca, Administrative Law Judge, renders the following determination.

ISSUE

Whether petitioners, as shareholders, are required to allocate the capital gain recognized on a New York subchapter S corporation's asset sale for the taxable year in which a change of

residency occurred using a proration formula between the resident and nonresident period where the asset sale took place during petitioners' nonresident period.

FINDINGS OF FACT

The parties executed a Stipulation of Facts in connection with this proceeding. These stipulated facts are included in the Findings of Fact herein.

1. On December 26, 2000, following an audit, the Division of Taxation ("Division") issued to petitioners, Gregg M. Falberg and Stephanie Falberg,[1] a Notice of Deficiency which asserted additional New York State and City personal income taxes due for the year 1997 in the amounts of $86,384.66 and $51,670.72, respectively, plus interest.

2. Petitioners changed their residence from New York to Florida on July 20, 1997. Therefore, as of July 21, 1997, petitioners were no longer residents of New York State or City.

3. Petitioners filed a timely Part-Year Resident New York State and City Personal Income Tax Return, Form IT-203, for the year 1997. On the return, petitioners reported a change in filing status during 1997 from resident taxpayers of New York to nonresident taxpayers of New York.

4. During the year 1997, petitioner owned 59% of the shares of International Zinc, Coatings & Chemical Corporation ("International Zinc"), which had in place valid subchapter S elections under section 1372(a) of the Internal Revenue Code and Tax Law § 660(a) for the year 1997. International Zinc reported its income on a calendar year basis, with its tax year ending on December 31, 1997.

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[1] Stephanie Falberg is a petitioner in this matter solely because she filed a joint part-year resident New York State and City personal income tax return with her spouse, Gregg M. Falberg, for 1997. All of the income at issue was paid to Gregg M. Falberg. Accordingly, unless otherwise indicated, all references to petitioner shall refer to Gregg M. Falberg.

5. On July 30, 1997, International Zinc sold its assets to Valspar Corporation. Pursuant to the sale, Valspar made payment to International Zinc of $4,567,670.58, which was effectuated by electronic wire transfer on July 31, 1997. International Zinc reported this transaction as a "Sale of Technology" occurring on "7/30/97" on Form 4797, an attachment to its Federal S corporation tax return. As a result of the sale to Valspar, International Zinc recognized a capital gain of $3,794,500.00 for the year 1997.

6. As International Zinc was a Subchapter S corporation, the capital gain recognized on the sale of the assets to Valspar was passed through to petitioner individually in proportion to his stock ownership.

7. On his 1997 part-year resident return, petitioner reported a Federal capital gain in the amount of $2,244,742.00. According to the Schedule D attached to petitioner's 1997 part-year resident return, $5,987.00 of this amount constituted short-term capital gains derived from miscellaneous "trades." The remaining amount was reported on Line 12 of petitioner's Schedule D and constituted a long-term capital gain of $2,238,755.00. This was the amount which was passed through to petitioner by International Zinc and represented petitioner's 59% pro rata share of the $3,794,500.00 capital gain resulting from the sale to Valspar.

8. On his 1997 part-year resident return, petitioner did not allocate the gain earned by International Zinc on its asset sale to Valspar between his resident and nonresident periods, but instead treated it as being received entirely during his nonresident period. Petitioner treated 11.97%, or $267,979.00, as the New York source portion of his distributive share of the capital gain recognized on the asset sale and paid full New York State and City taxes on this allocated amount. This 11.97% allocation was based on the business allocation percentage reported by International Zinc on its 1997 New York corporation franchise tax report.

In addition to the capital gain, International Zinc also passed through to petitioner interest in the amount of $64,728.00, of which petitioner reported $7,748.00 as New York source income, ordinary losses in the amount of $3,198.00, of which petitioner reported $383.00 as an offset to New York source income and other income of $4,425.00, of which petitioner reported $530.00 as New York source income. In determining the amount of the interest, ordinary loss and other income to be used in computing his New York adjusted gross income, it appears petitioner treated these items as having been received during his nonresident period and applied International Zinc's business allocation percentage to the amount passed through to him.

9. In the year 2000, the Division commenced an audit of International Zinc for the 1997 tax year, resulting in a refund of $658.00 plus interest. The refund resulted from the Division's recomputation of the business allocation percentage International Zinc reported on its 1997 corporation franchise tax report. As a result of this recomputation, International Zinc's business allocation percentage for the year 1997 was reduced to 10.4511%.

10. During the same year, the Division also initiated an audit of petitioners' 1997 part-year resident tax return. By statement of personal income tax audit changes, dated October 13, 2000, the Division determined that petitioners had changed their domicile from New York State and City to Florida as of July 21, 1997. The Division also determined that as a result of the Tax Appeals Tribunal's decision in ***Matter of Greig*** (September 16, 1999), it was necessary to change the allocation of the capital gain.

Specifically, the Division prorated petitioner's $2,238,755.00 capital gain between his residency period (January 1 through July 20) and his nonresidency period (July 21 through December 31). Accordingly, it allocated $1,232,849.00 to his resident period and $1,005,906.00 to his nonresident period. The full amount of the gain allocated to petitioner's residency period

($1,232,849.00) was added to petitioner's New York adjusted gross income, while only 10.4511% of the $1,005,906.00 gain allocated to petitioner's nonresidency period ($105,128.00) was included in petitioner's adjusted gross income. The allocation was based upon the revised business allocation percentage computed as a result of the audit of International Zinc. In addition, the Division recomputed the amount of interest income subject to New York tax to $11,609.00. This amount was arrived at by the Division by allocating to petitioner's residency period interest earned of $5,407.00, and adding to that figure 10.4511% (International Zinc's revised business allocation percentage) of the amount of interest earned during petitioner's nonresidency period ($59,347.00). The Division did not adjust the amount of ordinary loss and other income which petitioner reported on his 1997 part-year resident return in determining his New York adjusted gross income.

11. On December 26, 2000, the Division issued a Notice of Deficiency to petitioners assessing additional tax due of $137,670.72, plus interest.

SUMMARY OF THE PARTIES' POSITIONS

12. The Division argues that petitioners do not have the choice of either using the actual date of receipt in reporting the income received from the S corporation or of prorating such income between the resident and nonresident periods. Citing ***Matter of McNulty v. State Tax Commission*** (70 NY2d 788, 522 NYS2d 103); ***Matter of Montgomerie v. Tax Appeals Tribunal*** (291 AD2d 129, 740 NYS2d 141, ***lv denied*** 98 NY2d 606, 746 NYS2d 456); ***Matter of Greig*** (Tax Appeals Tribunal, September 16, 1999); and ***Matter of Wertheimer*** (Tax Appeals Tribunal, January 12, 1995) and Technical Services Bureau Memorandum (TSB-M-00[1]), the Division states that petitioners are required to prorate the S corporation income.

13. It is the position of petitioners that part-year residents are required to prorate their income from partnerships or S corporations only when there is no proof of when they actually received such income, relying on the same cases cited by the Division. As the sale of the assets by International Zinc is ascertainable, petitioners claim they may use the actual date of sale in determining whether to report the capital gain during their resident or nonresident period.

CONCLUSIONS OF LAW

A. Tax Law § 601(e) imposes personal income tax for a part-year resident on the individual's taxable income that is derived from New York sources. New York source income of a nonresident individual includes the net amount of items of income, gain, loss and deduction entering into his Federal adjusted gross income, including his pro rata share of New York S corporation income, loss and deduction (Tax Law § 631[a]). Pursuant to Tax Law § 631(b), items of income, gain, loss and deduction derived from or connected with New York sources are those items attributable to the ownership of any interest in real or tangible property in this state or a business, trade, profession or occupation carried on in this state. The New York source income of a nonresident shareholder of an S corporation includes 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 (Tax Law § 632[a][2]).

B. In ***McNulty,*** the taxpayers, whose sole source of income in 1979 was a distributive share of the earnings of a New York partnership, moved their residence from New York to New Jersey in August of 1979. In accordance with Tax Law former § 654, the taxpayers filed a resident return for January 1, 1979 through August 1979 and a nonresident return for the period August 1979 through December 31, 1979. However, the taxpayers did not comply with the related tax regulation, 20 NYCRR former 148.6, which required taxpayers who moved in or out

of the 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 (***id.***, 522 NYS2d at 103). Pursuant to the regulation, taxpayers were prohibited from prorating gains and losses between their resident and nonresident periods. As stated by the ***McNulty*** Court, the effect of this regulation was "to compel the taxpayer who has changed residence during the tax year to report all of his partnership income on one or the other of his separate tax returns for that year - regardless of when the income was actually received" (***id.***, 522 NYS2d at 104). The ***McNulty*** Court concluded that the regulation was an invalid exercise of the Tax Commission's authority and held that the taxpayers must be allowed to report their partnership distributions in a manner that "either reflects the actual date of receipt and expenditure or encompasses an annual amount distributed on a proportionate basis" (***id.***, 522 NYS2d at 104).

C. The Tax Appeals Tribunal applied the Court of Appeals decision in ***McNulty*** when it rendered its decision in ***Matter of Wertheimer*** (January 12, 1995). At the time the taxpayers in ***Wertheimer*** filed their 1986 personal income tax return, the statutory and regulatory scheme was the same as that found in ***McNulty***, with the regulation (20 NYCRR former 148.6) prohibiting taxpayers from prorating gains or losses between their resident and nonresident periods.

The Wertheimers became New York residents on October 1, 1986. Accordingly, they filed a nonresident return for the nine-month period from January 1, 1986 through September 30, 1986 and a resident return for the period from October 1, 1986 through December 31, 1986. Mr. Wertheimer was a limited partner in several limited partnerships all of which had a December 31st taxable year ending date. These partnerships generated large losses, resulting in an allocation to Mr. Wertheimer of losses in excess of $1.5 million. Following 20 NYCRR former

148.6, Mr. Wertheimer reported all of the losses on the resident return since he was a resident of New York on the last day of the partnership's taxable year.

Shortly after the return was filed by the Wertheimers, the Court of Appeals issued its decision in ***McNulty***. On audit, the Division, relying on ***McNulty***, prorated Mr. Wertheimer's distributive share of partnership losses between the resident and nonresident periods based on the number of months in each period. As a result, the Division allowed only 25% of the partnership losses to be taken on the resident return, i.e., 3/12 of the total losses representing the three months that the taxpayers were residents of New York State during 1986.

The Administrative Law Judge's determination in ***Wertheimer*** held that ***McNulty*** did not mandate proration of partnership distributions between a partner's New York resident and nonresident returns. Rather, the Administrative Law Judge held that the taxpayers had the option to either prorate the income or loss or follow the rule of 20 NYCRR former 148.6. The Tax Appeals Tribunal reversed the determination of the Administrative Law Judge, and the case was remanded to the Administrative Law Judge to determine whether ***McNulty*** could be applied retroactively as was contended by the Division.

The Tax Appeals Tribunal, in ***Wertheimer***, discussed the relationship of section 706(a) of the Internal Revenue Code (which requires that each partner's distributive share of the income, gain and loss be included in that partner's taxable income for the taxable year of the partnership ending within or with the partner's tax year), the Court of Appeals' decision in ***McNulty*** and the Tax Law and regulations as they existed at that time. The Tribunal stated that:

> Recognizing that the taxpayer's distributive share of partnership income did not indicate actual receipt of the income, the Court of Appeals in ***McNulty*** found the harm of regulation 148.6 to be that it compelled the taxpayer to report all of his partnership income on one of two returns "regardless of when the income was *actually received*" (***Matter of McNulty v. New York State Tax Commn.***, ***supra***, 522 NYS2d 103, 104, emphasis added). The Court concluded that this was

> inconsistent with section 654 which required an allocation that reflects "either the *actual date of receipt* and expenditure or encompasses an annual amount distributed on a proportionate basis" (***Matter of McNulty v. New York State Tax Commn.***, ***supra***, 522 NYS2d 103, 104, emphasis added). In our view, the holding of ***McNulty*** is that where a partner's distributive share of income is reported without regard to actual receipt, the only possible method of allocation under section 654 is on a proportionate basis throughout the year.

On remand, the Administrative Law Judge concluded that the Court of Appeals decision in ***McNulty*** should be applied retroactively. This conclusion was affirmed on different grounds by the Tax Appeals Tribunal in ***Matter of Wertheimer*** (Tax Appeals Tribunal, March 14,1996).

D. In ***Montgomerie v. Tax Appeals Tribunal*** (***supra***), the taxpayer, a partner in a New York law firm who moved out of New York State toward the end of the tax year, argued that his share of the partnership income should be included entirely in his nonresident period, consistent with 20 NYCRR former 148.6. The Tax Appeals Tribunal and the Appellate Division, Third Department, disagreed with the taxpayer, requiring the partnership income be prorated between the taxpayer's resident and nonresident periods. The Court, relying on ***McNulty***, stated that:

> Tax Law former § 654 "evinces a clear legislative intention that most forms of income . . . be allocated between the taxpayer's resident and nonresident return in a manner that either reflects the actual date of receipt and expenditure or encompasses an annual amount distributed on a proportionate basis (citations omitted).

E. The final case relied on by the parties in support of their respective positions is the Tax Appeals Tribunal's decision in ***Matter of Greig*** (***supra***), where the Tribunal affirmed the determination of the Administrative Law Judge. The taxpayer in ***Greig*** was a partner in a New York law firm who had moved into New York during the tax year in issue. Instead of reporting his partnership income pursuant to 20 NYCRR 154.6, which requires a partner who had changed residency status to New York during the taxable year to include all of the distributive share of partnership income in the residency period, without any allocation to the nonresident period, the

taxpayer allocated his partnership income on a pro-rata basis between the two periods. The Tax Appeals Tribunal relied on the analysis provided by the Administrative Law Judge in affirming his determination, in which he stated that:

> [T]axpayers must be allowed to report their partnership distributions in a manner that either reflects the actual date of receipt and expenditure or encompasses an annual amount distributed on a proportionate basis (***citing McNulty*** [***supra***]).

F. The language of the courts and the Tax Appeals Tribunal in the above discussed cases clearly indicate that partners and shareholders of Subchapter S corporations have the option of *either* reporting their distributions in a way which reflects the actual date of receipt *or* on a proportionate basis that allocates the income throughout the year. Contrary to the position taken by the Division, in none of the cases is there a preference proclaimed for reporting distributions of income by either using the actual date of receipt or allocating the distributions on a prorated basis. In fact, in ***Wertheimer***, the Tribunal seemed to indicate that reporting on the actual receipt basis would be preferable, when it stated that "[i]n our view, the holding of ***McNulty*** is that where a partner's distributive share of income is reported *without regard to actual receipt*, the only possible method of allocation under section 654 is on a proportionate basis throughout the year." Therefore, it is determined that pursuant to the decisions discussed above, a partner or shareholder of a Subchapter S corporation who changes his resident status during the year in issue may report his distributions of income or loss in a manner that either reflects the actual date of receipt and expenditure or be allocated on a prorated basis between the resident and nonresident periods.

G. The character of any item included in an S corporation shareholder's pro rata share shall be determined as if such item was realized directly from the source from which realized by the corporation (Tax Law § 617[b]; Internal Revenue Code § 1366[b]). There is no dispute that

the character of the asset sale by International Zinc resulted in a capital gain by the corporation and therefore a capital gain for petitioner. Where an individual changes resident status during the taxable year, capital gains are to be computed separately for the resident and nonresident periods. The capital gain to be reported for the period of nonresidence includes only those capital gains reported for Federal income tax purposes which are derived from or connected with New York State sources during the nonresident period.

The Court of Appeals, in ***Matter of Ausbrooks v. Chu*** (66 NY2d 281, 496 NYS2d 969), provided the following guidance in addressing the issue of whether a business, occupation or profession was being conducted in New York State when it stated that:

> In determining whether an enterprise is carrying on business in New York State, . . . certain objective factors must be weighed, including: (1) whether the business is "systematically and regularly carried on" in New York (20 NYCRR 131.4[a][2]); [and] (2) whether activities within the State in connection with the business are conducted in this State with a "fair measure of permanency and continuity" (20 NYCRR 131.4[a][2]). . . . In sum, an enterprise is carrying on business in New York, for tax purposes, where there exists a reasonably systematic and continuous transactional nexus between this State and the enterprise.

Petitioner established his domicile in Florida prior to the sale by International Zinc which gave rise to the capital gain. Thus, at the time that the capital gain arose, petitioner was a nonresident of New York. Once he established Florida residency, he had no personal nexus to the State of New York. There is no evidence in the record that petitioner, while a nonresident, was conducting any business in New York. As there did not exist a systematic and continuous transactional nexus between this State and petitioner, it cannot be found that petitioner was carrying on a business in New York State with regard to the capital gain earned by International Zinc and therefore, most of the capital gain realized on the sale is not subject to personal income tax. The only connection established in the record is International Zinc's business allocation

percentage, as modified on audit. It is this percentage of the capital gain which petitioner is required to report to New York State. Furthermore, the Division's own regulations provide that where an individual changes resident status during the taxable year, capital gains are to be computed separately for the resident and nonresident periods. In addition, the regulations provide that the capital gain to be reported for the period of nonresidence includes only those capital gains reported for Federal income tax purposes which are derived from or connected with New York State sources during the nonresident period. As it has been established that the capital gains realized on the sale of International Zinc's assets was not derived from or connected with New York State sources during the nonresident period, except to the extent of the corporation's business allocation percentage, and the Tax Law and the regulations do not provide that a shareholder of an S corporation who changes residence status during the taxable year is to be treated any differently than any other taxpayer involved in a change of residency to another state, petitioner is not required to include the capital gain in his computation of New York income except to the extent of International Zinc's business allocation percentage.

H. In response to the ***Greig*** decision, the Division issued Technical Services Bureau Memorandum TSB-M-00(1) on February 23, 2000. The TSB-M articulates the Division's policy on "the manner in which a partner of a partnership or shareholder of a New York S corporation reports his or her share of the income, gain, loss and deduction of the partnership or New York S corporation where the partner or shareholder changes residence status during the year." The memorandum states that the Division's policy is that the amount of partnership or 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. This is accomplished by first multiplying the individual's distributive or pro rata share of income, gain, loss and

deduction for Federal income tax purposes for the tax year by a fraction, the numerator of which is the number of days in the individual's tax year that the individual was a resident of New York State and the denominator of which is the total number of days in the individual's tax year. The second calculation in the formula is similar to the first except that the numerator is the number of days in the individual's tax year that the individual was a nonresident of New York State and the result is multiplied by the partnership's or New York S corporation's New York allocation percentage for the year. Finally, the two amounts computed are combined and included in New York source income. The same steps are used to determine the amount of the distributive or pro rata share of New York addition and subtraction modifications from the partnership or New York S corporation to be included in New York source income. It is the position of the Division that this memorandum provides the basis by which it can require petitioner to prorate the capital gain between his resident and nonresident periods.

I. The Division's memorandum properly addresses the factual circumstances found in ***McNulty v. State Tax Commission*** (***supra***); ***Matter of Montgomerie v. Tax Appeals Tribunal*** (***supra***); ***Matter of Greig*** (***supra***); and ***Matter of Wertheimer*** (***supra***). Each of these cases involved a partner who had changed his resident status during the year at issue, and the question concerned the treatment of his partnership distribution. The income of a partnership is not deemed earned on the last day of the partnership taxable year, but rather is treated as earned ratably throughout the year (***Williams v. United States,*** 680 F2d 382). It is also a well-established concept that a partner is deemed to earn income as it is earned by the partnership (***see***, ***Richardson v. Commissioner,*** 693 F2d 1189***; Snell v. United States,*** 680 F2d 545, ***cert denied*** 459 US 989, 74 L Ed 2d 384; ***Williams v. United States,*** 680 F2d 382; ***Rodman v. Commissioner,*** 542 F2d 845; ***Marriott v. Commissioner***, 73 TC 1129; ***Moore v. Commissioner***,

70 TC 1024). Absent a direct accounting for each item of partnership income and expenditure, the memorandum is consistent with the decision of the courts and Tax Appeals Tribunal as well as sections 631, 632 and 638 of the Tax Law in requiring the proration of items earned or incurred by the partnership or New York S corporation between the taxpayer's resident and nonresident period. In addition, absent a direct accounting of each item of partnership or New York S corporation income and expenditure, and considering that such items are earned and incurred throughout the year, prorating the items between the resident and nonresident periods of the partner or shareholder most accurately reflects when the items were earned or incurred.

However, the memorandum does not address the situation contained in the present matter where the items of income have an actual date of receipt. As previously discussed, the courts and Tax Appeals Tribunal provided two alternatives for allocating items of income and expenditure earned by a partner or shareholder of a New York S corporation who changes residence during the year at issue; either the actual date of receipt or a proration between the periods of residence and nonresidence. In the matter at hand, there are two items of income which were passed through by the New York S corporation to petitioner which were adjusted by the Division on audit: interest income and the capital gain. It is interesting to note that the Division, in allocating the interest income between the resident and nonresident periods, used the actual date that the interest income was earned in determining which period to include such income. This action by the Division is not only inconsistent with the policy established in Technical Services Bureau Memorandum TSB-M-00(1) but indicates that allocating based on a pro rata determination is not the only acceptable method of reporting partnership and New York S corporation income and expenditures, as the Division seems to be arguing in this matter. Requiring petitioner to allocate the capital gain on a pro rata basis is not only inconsistent with

the statutes, case law and regulations, but is inconsistent with the direct accounting method employed by the Division on audit in allocating the interest income.

J. The petition of Gregg and Stephanie Falberg is granted, and the Division of Taxation is directed to modify the Notice of Deficiency dated December 26, 2000 consistent with the Conclusions of Law.

Dated: Troy, New York
October 9, 2003

/s/ Thomas C. Sacca
ADMINISTRATIVE LAW JUDGE