STATE OF NEW YORK

TAX APPEALS TRIBUNAL

In the Matter of the Petition	:	
of	:	
ALAIN E. AND BRIGITTE WERTHEIMER	:	DECISION DTA No. 808770
for Redetermination of a Deficiency or for Refund of Personal Income Tax under Article 22 of the Tax Law and the Administrative Code of the City of New York for the Year 1986.	:	

The Division of Taxation filed an exception to the determination of the Administrative Law Judge issued on October 21, 1993 with respect to the petition of Alain E. and Brigitte Wertheimer, 1060 Fifth Avenue, Apartment 12B, New York, New York 10128. Petitioners appeared by Wilkie Farr & Gallagher (Peter W. Schmidt, Esq., of counsel). The Division of Taxation appeared by William F. Collins, Esq. (Michael J. Glannon, Esq., of counsel).

The Division of Taxation filed a brief in support of its exception and one in reply to petitioners' brief in opposition. The Division of Taxation filed a supplemental brief on the retroactive application of Matter of McNulty v. New York State Tax Commn. (70 NY2d 788, 522 NYS2d 103) and petitioners filed a response to the supplemental brief. Petitioners' response to the supplemental brief was received on July 18, 1994, which date began the six-month period for the issuance of this decision. The Division of Taxation's request for oral argument was withdrawn.

The Tax Appeals Tribunal renders the following decision per curiam.

ISSUE

Whether petitioners, New York residents from October 1, 1986 through December 31, 1986, were required to prorate their partnership losses between their 1986 New York nonresident return and New York resident return.

FINDINGS OF FACTS

We find the facts as determined by the Administrative Law Judge except for finding of fact "6" which has been modified. The Administrative Law Judge's findings of fact and the modified finding of fact are set forth below.

The parties entered into a Stipulation of Facts, dated June 29, 1993, which has been incorporated into the Findings of Facts below.

Alain E. Wertheimer and Brigitte Wertheimer, his wife, ("petitioners") were residents of the State of Connecticut for the period beginning January 1, 1986 through September 30, 1986.

Petitioners became residents of the State of New York on October 1, 1986 and remained residents of this State for the period through and including December 31, 1986.

Petitioner Alain E. Wertheimer was a limited partner in various partnerships. During calendar year 1986, income and losses were allocated to him, and cash distributions were made to him from these partnerships as follows:

NAME OF PARTNERSHIP	EIN #	CASH DISTRIBUTIONS	ALLOCATED INCOME/(LOSS)
Eagle 82 Bravo	73-1165526	$6,068.00	$ 4,381.00
Openheimer East Point Assoc.	13-3014211	$ -0-	$ 68,092.00
Buchanan 82 Drilling Program	74-2248314	$1,932.00	$ 509.00
Texoma Partners	23-2242495	$2,204.00	$ (14,146.00)
R & D Ltd. Partnership	06-1102454	$6,000.00	$ 79,526.00
Banyon Club Assoc., Ltd.	59-2454066	$ -0-	$ (179,289.00)
VV Associates-No.4 Twin Towers Assoc.	11-2600367	$ -0-	$ (97,790.00)
Ltd. Partnership of Albany	06-1076586	$ -0-	$ (860,873.00)
New Community Manor Associates Ltd.	22-2472107	$ -0-	$ (116,906.00)
Normandie Ltd. Partnership No. 35	54-1280147	$ -0-	$ (36,530.00)
Normandie Ltd. Partnership No. 39	54-1280149	$ -0-	$ (36,530.00)
Normandie Ltd. Partnership No. 46	62-1280153	$ -0-	$ (36,530.00)
Normandie Ltd. Partnership No. 48	62-1239579	$ -0-	$ (36,530.00)
Fairway Shores Assoc.	59-2416816	$ -0-	$ (15,758.00)

Limited Partnership			
1626 New York Assoc. Ltd.	04-2808184	$ -0-	$ (139,425.00)
1626 New York Assoc. Limited Partnership	04-2808184	$ -0-	$ (125,105.00)
TOTAL NET PARTNERSHIP LOSSES	$(1,542,904.00)		
M. Wythenhove Inc.-Sub S	13-3220707	$ -0-	$ 40,706.00
TOTAL LOSSES PER TAX RETURN			$(1,502,198.00)

At all relevant times, each of the above-referenced partnerships used the calendar year as their tax year for Federal and State income tax purposes.

We modify the Administrative Law Judge's finding of fact "6" to read as follows:

> Petitioners timely filed a New York State and City of New York Resident Income Tax Return and a New York State Nonresident Income Tax and City of New York Nonresident Earnings Tax Return for the year 1986, both filed under the status "married filing joint return." The resident income tax return filed by petitioners was for the period beginning October 1, 1986 through December 31, 1986 and all of the income and losses allocated by the partnerships to petitioner Alain Wertheimer were reported on this resident return. Petitioners' entitlement to claim such losses for the 1986 tax year is not in dispute.[1]

The Division of Taxation ("Division") issued a Statement of Audit Changes to petitioners on August 17, 1988. This statement advised petitioners that their tax was being recomputed as a result of errors on their 1986 income tax returns, and that additional income tax was being asserted in the amount of $169,988.00 plus interest. The statement explained further that petitioners were required to prorate their partnership losses, and appropriate New York additions to and subtractions from income because their 1986 income tax return covered less than a full year. The statement stated that the proration (set forth in the statement) was based on the number of months that petitioners were residents of New York State in 1986, i.e., three months.

[1]We modified the Administrative Law Judge's finding of fact "6" by adding the words "income and" to the second sentence of the fact to reflect additional details of the record.

Petitioners disputed the proposed assessment by letter dated September 8, 1988. The Division's letter in response, dated December 9, 1988, supplemented the explanation contained in the Statement of Audit Changes by stating that the 1987 Court of Appeals decision in Matter of McNulty v. New York State Tax Commission (supra) required that:

> "When a part-year New York resident return is filed due to a change of residence and the taxpayer is a member of a partnership or a shareholder of a New York S Corporation and [sic] distributive share should be prorated by months, over the entire tax year of the taxpayers . . . .
>
> "Your partnership (losses) and New York modifications have been prorated on an 3/12 basis. In the nonresident period New York nonresident partnership (loss) were not included as income.
>
> "New York State Regulation 148.6 is in the process of being revised." (Emphasis added.)

At the time this letter was written, the amendment to former regulation section 148.6 had not yet been finalized.

The Division issued a Notice of Deficiency to petitioners, dated March 16, 1989, asserting a tax deficiency of $169,988.00 plus interest for a total amount of $193,229.59.

OPINION

The Administrative Law Judge held that Matter of McNulty v. New York State Tax Commn. (supra) did not mandate proration of partnership distributions between a partner's New York resident and nonresident income tax returns, but invalidated 20 NYCRR 148.6 because it did not permit proration. The Administrative Law Judge stated:

> "[t]he Court was clear that the statute (Tax Law § 654[c][2], as construed by the Court) required that the taxpayer be permitted to allocate income, as well as exemptions and standard deductions, between the taxpayer's resident and nonresident returns in a manner that 'either reflects the actual date of receipt and expenditure or encompasses an annual amount distributed on a proportionate basis.'"

The Administrative Law Judge held that petitioners' 1986 income tax returns were consistent with: (1) Matter of McNulty v. New York State Tax Commn. (supra); (2) Tax Law § 654(c)(2); (3) the applicable court and administrative decisions; and (4) applicable tax return instructions at

the time of filing. Having concluded that McNulty did not invalidate petitioners' reporting method, the Administrative Law Judge deemed it unnecessary to address the issue of whether the holding in McNulty should be applied retroactively.

On exception, the Division asserts that the Administrative Law Judge erred in concluding that Matter of McNulty v. New York State Tax Commn. (supra) permitted proration rather than mandated proration when applying Tax Law former § 654 to petitioners' distributive share of partnership losses.

In response, petitioners assert that Matter of McNulty v. New York State Tax Commn. (supra) did not mandate proration, but permitted it. Petitioners argue that since the Court of Appeals made no mention of Matter of Kritzik v. Gallman (41 AD2d 994, 344 NYS2d 107), the case relied on by the lower court in sustaining the application of 20 NYCRR former 148.6, the holding in Matter of McNulty v. New York State Tax Commn. (supra) only invalidated 20 NYCRR 148.6 to the extent it did not permit proration of partnership income as a reporting option. Thus, petitioners assert that they had the choice of prorating their distributive share of partnership losses amongst the two returns or allocating all of their distributive share of partnership losses to either the resident or nonresident return depending upon when the loss was deemed to have accrued. In the alternative, petitioners argue that even if the Tax Appeals Tribunal holds that Matter of McNulty v. New York State Tax Commn. (supra) requires proration of partnership income or losses, the decision cannot be applied retroactively to them in this case.

We reverse the determination of the Administrative Law Judge for the reasons set forth below.

As the facts indicate, the dispute arose as a result of the Court of Appeals decision in Matter of McNulty v. New York State Tax Commn. (supra). In McNulty, the taxpayers were residents of New York from January through August of 1979 and nonresidents the remainder of 1979. Their sole source of income was their distributive share of earnings of a New York

partnership. The taxpayers filed their resident and nonresident returns prorating the partnership income between the returns. The former State Tax Commission recomputed their tax liability allocating all of the partnership income to the nonresident return in accordance with 20 NYCRR former 148.6. 20 NYCRR former 148.6 provided:

> [w]here an individual or a trust is a member of a partnership and such individual or trust changes its resident status from resident to nonresident, or vice versa, the distributive share of partnership income, gain, loss and deduction of such individual or trust must be included in the computation of New York taxable income of such individual or trust for the portion of the taxable year in which or with which the taxable year of the partnership ends, and treatment of the distributive share of such individual or trust for New York State personal income tax purposes must be determined according to the status of such individual or trust as a resident or nonresident at such time. The distributive share of income, gain, loss and deduction of such individual or trust is not prorated between the separate New York State resident and nonresident income tax returns required under this Part.

In effect, this regulation required taxpayers who change residency during a taxable year to allocate all of their distributive share of partnership income, gain or loss in the portion of the taxable year in which the partnership's tax year ended. Thus, partnership income, gains or losses were allocated entirely to either the resident or nonresident return depending on when the taxable year of the partnership ended. Because exemptions and deductions were required to be prorated between the resident and nonresident returns, the taxpayers were deprived of a portion of the exemptions and deductions to offset their partnership income. The Court of Appeals held that the regulation was an "invalid exercise of the Tax Commission's authority" (Matter of McNulty v. New York State Tax Commn., supra, 522 NYS2d 103, 104). The Court stated that Tax Law former § 654:

> "evinces a clear legislative intention that most forms of income, as well as exemptions and standard deductions, be allocated between the taxpayer's resident and nonresident returns in a manner that either reflects the actual date of receipt and expenditure or encompasses an annual amount distributed on a proportionate basis (see Tax Law § 654[b], [e], [f]; cf. § 654[c], [i] [governing 'special accruals' and 'lump sum' distributions])" (Matter of McNulty v. New York State Tax Commn., supra, 522 NYS2d 103, 104).

The court further stated that:

> "[b]y requiring that annual partnership distributions be reported in their entirety on 1 of 2 returns without regard either to when such distributions are received or to proration, rule 148.6 is inconsistent with this legislative policy" (Matter of McNulty v. New York State Tax Commn., supra, 522 NYS2d 103, 104).

We conclude that the Administrative Law Judge erroneously concluded that petitioners':

> "income tax returns were also consistent with the Court of Appeals decision in McNulty, since the partnership losses were allocated on petitioners' returns in a manner that reflected the actual date of receipt or accrual of the loss, i.e., December 31, 1986" (Determination, conclusion of law "I").

We believe that this case requires a brief summary of the basic principles governing the taxation of income earned by a partnership under the Internal Revenue Code. Although a partnership computes its net income, section 701 of the Internal Revenue Code provides that the partners are liable for the tax on the income. Pursuant to section 702 of the Internal Revenue Code, the tax is determined by each partner reporting his distributive share of, inter alia, the partnership's income, gain and losses. Section 706(a) of the Code 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. 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 (United States v. Basye, 410 US 441, reh denied 411 US 940).

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. Similarly, we conclude that because Mr. Wertheimer's distributive shares of losses were reported by petitioners without regard to the actual date of receipt and expenditure, the distributive shares of the losses must be allocated between the resident and nonresident return on a proportionate basis.

It is obvious from the foregoing conclusion that we believe the Administrative Law Judge erred when he stated that petitioners' 1986 income tax returns were consistent with the McNulty decision because "the partnership losses were allocated on petitioners' returns in a manner that reflected the actual date of receipt or accrual of the loss . . . ." (Determination, conclusion of law "H"). The error of this statement is that it appears to equate the actual date of receipt to the date the loss accrued. This premise is inconsistent with the Court of Appeals' holding which rejected the accrual date as a method of allocating the distributive share of partnership income because this method did not reflect the actual date of receipt of the income.

We also see no basis for petitioners' position that McNulty applies only for purposes of allocating the distributive share of partnership income and not of losses. First, this is inconsistent with the language of the decision:

> "[b]y requiring that annual partnership distributions be reported in their entirety on 1 of the 2 returns without regard either to when such distributions are received or to proration, rule 148.6 is inconsitent with this legislative policy" (Matter of McNulty v. New York State Tax Commn., supra, 522 NYS2d 103, 104).

This language is general both when addressing the distributive shares and the error of the regulation.

Second, the rule suggested by petitioners, that the distributive share of partnership income must be allocated on a proportionate basis throughout the year but that losses may be allocated entirely to one return according to the date the losses accrued, is not logical. The illogic of

petitioners' theory is evidenced by its application to the instant facts. Because Mr. Wertheimer had a distributive share of income from some partnerships and a distributive share of losses from others, petitioners' proposed rule would prorate the income between the resident and nonresident returns but would allocate the losses entirely to one return. The principles set forth above with respect to the taxation of partnership income apply both to partnership income and losses and we can see no reason why the distributive share of income and losses should be allocated under different methods.

Finally, we disagree with petitioners' depiction of the facts of McNulty. Petitioners state that:

> "[i]n McNulty, the Court of Appeals ruled that the taxpayers could prorate their cash income. The Court in McNulty created a limited exception to the general accrual rule of partnership income by 'permitting' the taxpayers in that case to prorate their partnership cash income. However, the Court did not overturn the general rule that partnership losses (which are non-cash allocations) accrue on the last day of the partnership's taxable year . . . .
>
> "The Court permitted the McNultys to prorate their partnership cash receipts since those receipts were received at various time throughout the year" (Petitioners' brief on exception, p. 8).

We do not see in the Court of Appeals decision in McNulty, nor in the underlying State Tax Commission (Matter of McNulty, State Tax Commn., July 31, 1984) and Appellate Division decisions (Matter of McNulty v. New York State Tax Commn., 118 AD2d 1041, 500 NYS2d 415), any indication that the facts involved cash receipts. Instead, the three decisions state that the facts involved a distributive share of partnership earnings. Thus, we find no basis for petitioners' interpretation of McNulty as applying only to cash receipts from a partnership. Further, we do not understand how cash receipts would be relevant because, as described earlier, the partners pay tax on their distributive share of income without regard to actual distributions made to them.

For purposes of clarity, we also express our disagreement with the Administrative Law Judge's conclusion that

> "the Court in McNulty held that Tax Law § 654(c)(2) required th allocation of 'partnership distributions' of items of income, deductions and exemptions . . . " (Determination, conclusion of law "F").

Our understanding of McNulty is that the decision was based on the entirety of section 654, not on 654(c). As indicated in the quote set forth above, the decision refers directly to section 654(b), (e), and (f) as authority for its conclusion that section 654 requires that most forms of income, as well as exemptions and standard deductions, be allocated based on the actual date of receipt or on a proportionate basis, and contrasts this rule with that provided by section 654(c) and (i) for special accruals and lump sum distributions (Matter of McNulty v. New York State Tax Commn., 70 NY2d 788, 522 NYS2d 103). Section 654(c)(2) sets forth a special accrual rule for amounts that accrued prior to a change in resident status but were not otherwise properly includible or allowable for Federal income tax purposes. The distributive shares of partnership income, gain and loss would not be items that had accrued but were not allowable or includible for Federal income tax purposes and, thus, would not be under the special accrual rule of section 654(c)(2).

In light of our decision above, this matter must be remanded to the Administrative Law Judge for a determination on the issue of retroactivity that was not addressed by the Administrative Law Judge. We make this remand because petitioners have a right to an administrative determination on the issues raised before the Administrative Law Judge (Matter of Riehm v. Tax Appeals Tribunal, 179 AD2d 970, 579 NYS2d 228, lv denied 79 NY2d 759, 584 NYS2d 447) and we believe that this determination should be rendered first by the Administrative Law Judge (Matter of United State Life Ins. Co. in the City of New York, Tax Appeals Tribunal, March 24, 1994).

Petitioners urge us to rule on the retroactivity issue and argue that "[r]emanding a strictly legal issue serves no obvious purpose and would not be in the best interests of the parties in this case" (Letter of March 1, 1994). We disagree. A decision by the Administrative Law Judge on

this, or any, legal issue gives the losing party another opportunity to argue the issue in the administrative forum. This additional level of argument allows the further development of the issue and, thus, enhances the background for our resolution, if necessary, of the case. We think that this result is in all of the parties' best interest.

We direct the Administrative Law Judge to issue his determination as expeditiously as possible without further briefs or hearings. If either of the parties disagree with the Administrative Law Judge's determination on remand, the party may obtain review of the determination by filing a timely exception to the determination on remand. If no exception is filed to the determination on remand, this decision shall become final for purposes of section 2016 of the Tax Law after the period for filing an exception to the determination on remand has expired.

Accordingly, it is ORDERED, ADJUDGED and DECREED that:

1. The exception of the Division of Taxation is granted;

2. The determination of the Administrative Law Judge is reversed;

3. The petition of Alain E. and Brigitte Wertheimer is denied to the extent that Matter of McNulty v. New York State Tax Commn. (70 NY2d 789, 522 NYS2d 103) is held to apply to the distributive share of partnership losses; and

4. This matter is remanded to the Administrative Law Judge for a determination on whether the result in paragraph "3" applies to the return filed by petitioners for 1986.

DATED: Troy, New York
January 12, 1995

/s/John P. Dugan
John P. Dugan
President

/s/Francis R. Koenig
Francis R. Koenig
Commissioner