December 8, 2000

The Honorable Arthur J. Roth
NYS Department of Taxation and Finance
Office of Tax Operations
W.A. Harriman Campus, Building 9
Albany, NY 12227

Re: Proposed Repeal of the New York State Resident/Nonresident Partnership Allocation Regulations

Dear Commissioner Roth:

We are writing[1] in response to your letter requesting the Tax Section's comments on the proposed repeal of 20 NYCRR section 154.6. That regulation deals with the fairly common question of how an individual partner who changes his or her New York residency status during a partnership's taxable year ("P") should allocate his or her partnership income between the resident and nonresident periods.

There are at least four possible answers to this question:

1. P could allocate the partnership income/loss based on P's status as a resident or nonresident as of the close of the partnership's taxable year (the "end-of-year" method);

2. P could treat the partnership taxable year as closing on the date P's residency status changed (the "ruling off" method);

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[1] This letter was drafted by Maria Jones (co-chair of the Section's Committee on New York State Franchise and Income Taxes) and Carolyn Lee (a former Chair of the Section).

3. P could allocate the entire net income or loss for the partnership year based on the number of days or months in each of the resident and nonresident periods (the "pro rata" method); and

4. P could identify the resident and nonresident portions of the partnership income based on when P received distributions from the partnership (the "cash" method).

Currently the statute provides that, regardless of P's actual method of accounting, if P changes status from resident to nonresident (or from nonresident to resident), P is required to "accrue" to the period of residence (or nonresidence) "any items of income, gain [etc.] accruing prior to the change of status . . . ." Tax Law section 639(a) (b).

On its face, this statute would appear to support New York State's interpretation that P must use the end-of-year method (20 NYCRR §154.6(a)(3)(i)). This interpretation is consistent with basic concepts of tax accounting established under the federal income tax law that make clear that an accrual-method partner does not include partnership items in income until the last day of the partnership's taxable year. See Internal Revenue Code section 706(a).

In its recent decision in Matter of Robert T. and Susan M. Greig (TSB-D-99(21)I, September 16, 1999), however, the New York State Tax Appeals Tribunal determined that the regulation's required application of the end-of-year method was "not in harmony" with the statute. Regulation section 154.6 was held to be invalid "to the extent that it does not permit taxpayers to prorate the annual amount of their partnership distributions and allocate that amount proportionately between resident and nonresident periods. . . . " The Tribunal allowed the Greigs to use the pro rata method. In light of this decision, the Department has now proposed to repeal the existing regulation.

It must be noted that the Tribunal's decision in Greig is consistent with a 1987 decision of the New York Court of Appeals. McNulty v. NYS Tax Comm., 70 N.Y.2d 788. In considering the same fact pattern under a statute (former Tax Law section 654) identical in all material respects to the current section 639, the Court of Appeals concluded that P could not be required to apply the end-of-year method, and instead should be permitted to use one of the other three methods. In language that is difficult to parse, the Court of Appeals held that:

> Section 654 of the Tax Law, which establishes specialized reporting requirements for taxpayers who change residency status during the tax year, 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]). By requiring that annual partnership distributions be reported in their entirety on 1 of the 2 returns [resident or non resident] without regard either to when such distributions are received or to proration, rule 148.6 is inconsistent with this legislative policy. Even if, as the Commission contends, the State's policy of conformity with Federal tax laws militates in favor of treating partnership distributions for accounting purposes as having accrued on the last day of the partnership's fiscal year (see, 26 USC § 706; see also, Matter of Hunt v. State Tax Commn., 65 NY2d 13), consistency with the reporting approach expressed in Tax Law § 654 would nonetheless require that, for present purposes, taxpayers be permitted to prorate the annual amount of the partnership distributions and allocate that amount proportionately between the resident and nonresident returns.

Id. at 791(emphasis added).

The proper treatment of P has been further confused by the fact that the regulations have shifted between the pro rata method and the end-of-year method. The current regulations require a monthly proration for years prior to 1990, yet require the end-of-year method from 1990 forward, notwithstanding that there was no substantive change in the relevant allocation statute.

Finally, the recent Tribunal decisions have not definitively addressed whether P is permitted, if not required, to use the end-of-year method. In Matter of Bruce M. and Claire Montgomerie (DTA No. 812425, August 24, 2000), the Tribunal indicated that it would require P to use the pro rata method. However, that statement was merely dicta, given the Tribunal's decision that that taxpayer had failed to satisfy his burden of proof. Moreover, in that case the year at issue was 1986, and the applicable regulation was the same regulation that was invalidated in McNulty; the decision's relevance to years covered by the post-1990 regulation is unclear.

At this point, therefore, the law is in a state of profound confusion.

1. As a substantive matter, it is not clear that McNulty and Greig represent a proper interpretation of the concept of "accrual."

2. The cases thus far have held only that P cannot be required to use the end-of year method; they have not specifically held that P is prohibited from using that method. Certainly the cases have not addressed the treatment of a P who followed the end-of-year method based on the regulations in effect for 1990 and following years. Ps who used the end-of-year method in preparing their returns therefore have arguments that they are entitled to use that method under the statute, and/or that the Department is precluded from challenging their reliance on the regulation.

3. Taxpayers who prefer the pro rata method clearly have support for that position under McNulty and Greig.

4. The pro rata method has the potential to result in the taxation of extra-territorial income if income properly identified with a nonresident period is allocated into the resident period and subjected to tax. Ps in such a situation may therefore argue for the ruling off method, based on constitutional principles and the McNulty court's reference to "receipt of income and expense."

5. Finally, Ps for whom the timing of distributions results in favorable tax treatment may cite the McNulty references to the "actual date of receipt" and "when such distributions are received" as support for the application of the cash method.

One thing is certain--there is sufficient confusion to support any number of interpretations. And given the amount of litigation already engendered by this issue, it seems likely this issue will not easily be laid to rest.

We understand that you have proposed the repeal of section 154.6 (which specifies the end-of-year method) because you believe that the Tribunal has invalidated that regulation by its decision in Greig. Repealing the regulation at this time serves the administrative purpose of ensuring that it will not be included in the regulations being published for the 2001 filing season and we agree, that for this reason, you should go forward with your proposal to repeal the regulation at this time. However, without also promulgating regulations that specify the required treatment in lieu of the end of year method, the repeal of the existing regulation simply invites more confusion. Thus, we recommend that repeal of the regulation be followed promptly by the promulgation of a new regulation that specifies the method that should be followed in the future.

On a going forward basis we believe the best choice of method is a daily pro rata method (for example the daily pro rata method used in TSB-M-00(1)I). The pro rata method is simple to apply, and as a practical matter many Ps will not desire the refinements inherent in the ruling off method, nor will they want to bear the additional accounting costs this method entails. A daily proration of partnership income achieves a common sense result, similar in many cases to the results applicable to sole proprietors and employees. However, in addition, we propose that partnerships be permitted to make an irrevocable election to use the ruling off method in lieu of the pro rata method. Partnerships making the election would be required to undertake to supply to partners the information necessary to apply the ruling off method. Furthermore, such an election would be binding on all the partners and could be revoked only with the permission of the Commissioner. While it seems unlikely that many partnerships will choose the ruling off method, we believe it is fair to permit this method with these restrictions. Further,

because of the potential unconstitutionality of the pro rata method in some circumstances, we believe it is essential to provide the ruling off method as an alternate method, at least where necessary to avoid the taxation of extraterritorial income and perhaps to allow for other methods at the Commissioner's discretion (subject to some identifiable criteria) when necessary to prevent distortion.

Ideally, this issue should be resolved legislatively. We question whether any regulatory interpretation will resolve this issue, given the likelihood that Ps for whom one of the other methods is beneficial will continue to take, and defend, their desired position(s). We wish to emphasize that in the absence of such legislation it is likely this debate will continue for years. It also is possible that taxpayers' positions will result in situations in which multiple methods are used by Ps under the existing statute, presenting numerous opportunities for whipsaw (both among different Ps, and in the treatment the same P applies in different years or to different partnerships in the same year). Such a situation, while replete with planning opportunities, would be most undesirable from a tax policy perspective. We suggest that the Department propose specific legislation that will, at least on a prospective basis, resolve this issue.

We are, as always, available to work with the Department on drafting and supporting a new regulation or legislation.

Sincerely,

Robert H. Scarborough