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January 7, 2008

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Re: Comments on Proposed Amendments to Part 132 of
the Personal Income Tax Regulations

Dear Acting Commissioner Billet:

I am writing on behalf of the Tax Section of the New York State Bar Association to comment on the recent proposed amendments to Part 132 of the Personal Income Tax Regulations (the "proposed amendments").¹ In April 2005, the Tax Section submitted a report to the Commissioner of Taxation and Finance (Report No. 1084) regarding New York's nonresident income allocation requirements for certain employment-related compensation. Our April 2005 report noted discrepancies between the regulations, audit guidelines, and case law. The report also offered suggestions intended to bring clarity, consistency and simplicity to New York's allocation rules. In particular, the April 2005 report made recommendations regarding non-compete payments, termination pay, pensions, severance pay, stock option income, and the "reverse convenience" doctrine.

The proposed amendments seek to resolve many of the issues on which we commented in our April 2005 report. The proposed

¹ 20 NYCRR. Unless otherwise indicated, all "section" references are to the Personal Income Tax Regulations.

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amendments do not address the “reverse convenience” rule, stock options (which were addressed in 2006 regulations) or our recommendation that severance pay be allocated based on a days/days fraction rather than a compensation/compensation fraction. We stand by our prior comments and recommendations on these unaddressed issues, but will not restate them here and simply refer you to our April 2005 report. Rather, our comments in this letter are limited to what the proposed amendments do contain, and whether they accomplish the goals and recommendations set out in our April 2005 report. We will not address those amendments that primarily contain technical, grammatical or other minor revisions.

I. Section 132.1 - New York Adjusted Gross Income of a Nonresident Individual

Summary

The existing regulation addresses what is referred to as “New York adjusted gross income.” Under the Tax Law, New York adjusted gross income is a component of the “as if resident” tax calculation, specifically the denominator of the source fraction. It is noted, however, that the existing regulation actually appears to address the numerator of the source fraction (i.e., New York source income).

The proposed amendments would repeal existing section 132.1 and replace it with a new section titled “New York source income of a nonresident individual.” New section 132.1 describes the “as if resident” tax calculation methodology for nonresidents, as provided for in Tax Law § 601(e), i.e., “tax base” multiplied by “New York source fraction.” The proposed amendments also more specifically define New York source income of a nonresident individual for purposes of calculating the numerator of the New York source fraction. They do so by incorporating the language of Tax Law § 631(a)(1). In essence, the amendments to section 132.1 seek to bring the regulation into conformity with the applicable Tax Law provisions.

Comments

The Tax Section supports this proposed amendment. Since it seeks to track more closely the “as if resident” tax calculation methodology set out in the Tax Law, we suggest that it would be more accurate to refer to Tax Law §§ 601(e) and 631(a) in the heading for new section 132.1. As proposed, it currently reads: “Sec. 132.1. New York source income of a nonresident individual. (Tax Law, section 631).”

II. Section 132.2 - Income and Deductions from New York State Sources - General

Summary

The existing regulations provide that a nonresident individual’s items of income, gain, loss and deduction derived from or connected to New York sources are items attributable to (i) the ownership of any interest in real or tangible personal property in New York State, or (ii) a business, trade, profession or occupation (a “trade or business”) carried on in New York State.

The proposed amendments seek to bring the regulation into conformity with the Tax Law by incorporating the language of Tax Law §§ 631(b)(1)(C)-(E). These statutory provisions provide, generally, that the following are also deemed to have a New York source:

- Items attributable to the ownership of S corporation shares (where a New York S election is in place), to the extent provided for in Tax Law § 632.
- Winnings from a wager placed in a lottery conducted by the New York Division of Lottery (if the proceeds exceed \$5,000).
- Gains from the sale/disposition of stock in a cooperative housing corporation (if the proprietary leasehold is also transferred).

Comments

The Tax Section supports this proposed amendment.

III. Section 132.4 - Business, Trade, Profession or Occupation Carried On in New York State

Summary

The existing regulation reasserts the principle set forth in section 132.2 that New York source income includes items of income attributable to a trade or business carried on in New York. The existing regulation also (i) defines trade or business, (ii) states that income from the performance of personal services is New York source income only to the extent that the services were performed within the state (subject to the convenience of the employer doctrine in section 132.18), (iii) states that income attributable to the performance of personal services within the state will remain New York source income even if it is paid to a third party or is received in a taxable year after the year in which the services were performed, and (iv) provides an exclusion from taxation for pensions or other retirement benefits that qualify as an annuity as defined by the regulation.

The following changes are proposed to section 132.4:

1) As noted in V below, the proposed amendments would repeal section 132.10, which concerns nonresidents who purchase and sell property for their own account. Section 132.10 mimics Tax Law § 631(d) and is therefore redundant. As a conforming change, the proposed amendments replace the reference to section 132.10 in existing section 132.4 with a reference to Tax Law § 631(d).

2) In addressing the allocation of compensation for services performed both within and without New York State, the proposed amendments refer to the allocation rules in

sections 132.17, 132.18, 132.22 and 132.24. The proposed amendments remove the reference to section 132.16, which concerns rentals and gains from the sale or exchange of real property.

3) The proposed amendments repeal section 132.4(d)(1), which addresses "pensions or other retirement benefits constituting an annuity." They replace it with a new paragraph (1) providing that pension or retirement income will not be included in a nonresident's New York source income if (i) it is "retirement income" under 4 U.S.C. § 114 -- i.e., P.L. 104-95 as amended in 2006 by P.L. 109-264, or (ii) it constitutes an "annuity" as defined by the regulations. Pensions and other retirement benefits that meet the existing regulatory definition of an annuity will continue to be exempt from tax as well.

4) The proposed amendments redefine the term "compensation for personal services," which is taxable (if paid for past services performed in New York) when not exempt as "retirement income" or an "annuity." The following constitutes "compensation for personal services" under the proposed amendments: (i) amounts received in connection with the termination of employment, (ii) amounts received upon early retirement in consideration of past services rendered, (iii) amounts received that represent the cash value of any unused leave time, and (iv) amounts received upon retirement for consultation services.

5) The proposed amendments seek to incorporate the holdings of the Tax Appeals Tribunal in McSpadden and Colitti. Under the proposed amendments, "amounts that are received upon retirement that represent payments solely for the termination of a contractual right to future employment or a covenant not to compete" will not be considered compensation for personal services. The proposed amendments further provide: "The mere inclusion, however, of a covenant not to compete in an agreement made upon termination of employment or a provision that the right to certain compensation might be forfeited upon breach of such a covenant will not in itself determine whether or not amounts received pursuant to that agreement are compensation for personal services. The agreement must be considered in its entirety for a determination to be made as to the consideration given by the individual in exchange for amounts received pursuant to the agreement."

Comments

Each of the following comments regarding section 132.4 corresponds to the numbered "summary" paragraphs above:

1) We support this proposed change.

2) We suggest that the proposed amendments not remove the reference to section 132.16 in addressing the allocation of compensation for services performed both within and without New York State. Section 132.16 clarifies that gain or loss from the sale of real property is sourced based on the situs of the property and therefore is not subject to an allocation. Keeping the reference to section 132.16 may prevent taxpayers from concluding that they can

allocate gain/loss from the disposition of real property because they provided services with respect to the property both within and without New York. We also suggest that in addressing the allocation of compensation for services performed both within and without New York State, the proposed amendments include a reference to section 132.25. Section 132.25 provides for an alternative allocation methodology where the general allocation rules lead to unfair or inequitable results. Taxpayers who read the regulations should know that an alternative mechanism may be available if the other sections referred to do not fairly allocate their income.

3) We support this change, which brings New York's rules into conformity with the federal exclusion.

4) The proposed amendments provide that "compensation for personal services" must be included in New York source income "to the extent that the services were performed in New York State." "Compensation for personal services" is redefined to include "amounts received upon retirement for consultation services." It is not clear, therefore, whether the Department intends to tax compensation paid for future, post-retirement consulting services when such services are performed outside of New York. The wording of the proposed amendment could be construed as an attempt to tax such compensation if the retired consultant formerly performed services in New York. We assume the Department does not intend this outcome. We therefore suggest that the proposed amendments be modified to clarify that (subject to the convenience rule) no allocation is warranted to the extent that post-retirement consulting services are actually performed outside of New York.

5) The Tax Section commends the Department's effort to incorporate the *McSpadden* and *Colitti* exceptions into the regulations.

Regarding the *McSpadden* termination pay rule, the proposed amendments could be read to imply that the exception will not apply unless the income in question is paid to buy out a written employment contract. In *Brophy*, the ALJ held that a formal employment agreement (representing the requisite "right to future employment") need not be written. Rather, it could be established based on an understanding of the parties. We agree with the reasoning in *Brophy* and suggest that the phrase "contractual right to future employment" in line 138 of the proposed amendments be modified to read "contractual right, whether written or oral, to future employment," to clarify that the right need not take the form of a written employment agreement. Moreover, the proposed amendments do not address the question of whether a separate termination agreement is needed to trigger the *McSpadden* exception once a right to future employment is established. In *Davis*, the ALJ held that a separate termination agreement is not needed. We recommend that the proposed amendments incorporate this concept.

With respect to the *Colitti* exception for non-compete payments, the proposed amendments contain strong language that the exception will not apply unless the income in question is paid "solely" for the non-compete covenant. The Tax Section is concerned that auditors may read this language as a license to deny *Colitti* treatment whenever a particular

dollar amount is not specifically assigned to a contractual non-compete provision. In our experience, there are circumstances in which it is clear from the agreement and the related facts taken as a whole that the taxpayer is receiving bargained-for consideration not to compete, even if the amount assigned to the non-compete is not stated on the face of the agreement. In these circumstances, we believe the taxpayer should, based on all relevant facts and circumstances surrounding the agreement, be permitted to establish a reasonable, arm's length allocation of value to the non-compete provision, to the same extent the taxpayer could do so for federal income tax purposes. We recommend that language permitting such an allocation be included in the proposed amendments so as to avoid creating a trap for the unwary. As written, the proposed amendments will inure primarily to the benefit of the sophisticated taxpayers who will simply break out the amount to be attributed to the non-compete provision. The hapless taxpayer who is the victim of careless draftsmanship should not be treated differently where it is clear that some value is attributable to the promise not to compete.

IV. Section 132.5 - Income from Intangible Personal Property

Summary

The existing regulation states the general rule that items of income, gain, loss and deduction attributable to intangible personal property do not have a New York source except to the extent that the intangible property itself was employed in a trade or business in New York. An example in the existing regulations clarifies that dividend income is not income derived from New York State sources when received by a nonresident taxpayer. The example states:

A, a resident of New Jersey, owns 100 percent of the stock of X Corporation, which operates a store in New York State. In 1980, the corporation pays A a salary of \$20,000, all of which was earned in New York State, and a dividend of \$2,000. A's income from New York State sources is his salary of \$20,000, since the dividend is not income derived from New York State sources and thus not taxable for New York State personal income tax purposes.

The proposed amendments repeal this dividend example.

The proposed amendments also add a new subsection (c) to address the Tax Law's rules for income and gains derived from the sale or disposition of co-op stock.

Comments

It is unclear to us why the proposed amendments remove the example addressing dividend payments. While subsection (a) of the existing regulation states that intangible income, "including annuities, dividends, [and] interest," do not have a New York source, we are concerned that removing the example may create some confusion as to New York's treatment of dividend income. Given the exception to the non-taxation of intangible income (i.e., that such

income is taxable if the intangible property is used in a trade or business in New York), some taxpayers may construe removal of the example as an indication that there is uncertainty whether and when dividend payments may be taxed. If the concern is that the \$2,000 dividend in the example might properly be characterized as compensation to the sole shareholder, we suggest retaining the example with an added statement that the compensation is arm's length and that the dividend payment is not disguised compensation.

We support new section 132.5(c), which brings the regulations into conformity with the Tax Law's rules for income and gains derived from the sale or disposition of co-op stock.

V. Section 132.6 - Income from Closed-Circuit and Cable Television Transmissions

Summary

The existing regulation addresses only the sourcing of income from closed-circuit and cable television transmissions.

The proposed amendments repeal this section and replace it with new section 132.6, entitled "Other income and deductions from New York State sources." New section 132.6 combines existing sections 132.6, 132.9 (Income, gain, loss or deduction with respect to the New York Insurance Exchange), and 132.10 (Purchase and sale for own account) by cross-referencing the relevant Tax Law sections, thereby bringing the regulations into conformity with the Tax Law.

Comments

We support this amendment.

VI. Sections 132.8 - Undistributed Taxable Income, Net Operating Loss, and Gain or Loss on Sale or Exchange of Stock with Respect to Electing Small Business Corporation

The proposed amendments repeal this section in its entirety. The existing regulation provides that, for a nonresident individual who is a shareholder of a corporation which is an electing small business corporation for Federal income tax purposes:

(a) undistributed taxable income of such corporation does not constitute income or gain derived from New York State sources;

(b) a net operating loss of such corporation does not constitute a loss or deduction derived from or connected with New York State sources; and

(c) any gain or loss realized or incurred on the sale or exchange by such individual of stock of a small business corporation (including a loss treated as ordinary under

section 1244 of the Internal Revenue Code) does not constitute a gain or loss derived from or connected with New York State sources.

Comments

Unlike other sections that would be repealed by the proposed amendments, the proposed repeal of section 132.8 is absolute. Its provisions have not been moved to a different section, consolidated, etc. The existing regulation refers to an “electing small business corporation,” which is not a concept under current federal law, though it was a term used in Internal Revenue Code to describe an electing S corporation prior the Subchapter S Revision Act of 1982. We agree that the existing regulation is, at best, out of date. However, rather than repealing it, to the extent the regulation is intended to address S corporations, we suggest that it be amended to specify how nonresidents should determine the New York source portion, if any, of (i) S corporation flow-through income (which should be subject to tax based on the allocation rules provided in Tax Law § 132), (ii) distributions from S corporations, and (iii) gain or loss from the sale of S corporation shares.

VII. Other Comments

We also offer the following comments regarding the proposed amendments:

1) In various places, the proposed amendments refer to co-op sales, which are now generally taxable under the Tax Law. The draft regulations, however, appear to link the New York source income derived from such sales to the taxability of the transaction under Article 31 of the Tax Law. Since income derived from the sale of a co-op located in New York should still be New York source income even if there happens to be an exemption from the transfer tax under Article 31, we suggest that the draft regulations not define New York source for co-op sales by reference to taxability under Article 31.

2) In various places (for example lines 120 et. seq.), the proposed amendments speak in terms of “retirement from service” when addressing deferred compensation, pensions, annuities, etc. These types of issues arise not only when an individual is “retiring” (in the classic sense), but also when the individual simply changes jobs. We recommend that the proposed amendments be amended, where necessary, to make it clear that the rules applicable to post-retirement income also apply upon one’s termination of, or separation from, employment.

3) The example at lines 229-242 of the proposed amendments, which appears to be in the existing regulations, refers to gain from the sale of rental property as being capital. Since depreciable property is technically not a capital asset, the example is not correct in referring to the gain as “capital”, unless the rented property is bare land.

4) The example under section 132.20, which appears at lines 492-515 of the proposed amendments, has been amended to state that the \$100,000 payment in question is not

“retirement income” as described in 4 U.S.C. § 114. We suggest that the proposed amendments be modified to explain why the payment does not qualify as an exempt “federal annuity”.

5) The proposed amendments would revise section 132.7 by adding “passive losses” to the regulation’s existing treatment of capital losses and net operating losses. We agree with this proposed change, but note that Code § 469 is not the only federal Code provision whereby losses may be realized but not recognized. For example, losses may be limited by the at risk rules of Code § 704(d). We question, therefore, why the draft regulations address only passive losses. By doing so, an implication may be created that New York intends to treat passive losses differently than other suspended losses. We do not believe there should be a difference in treatment and suggest that the proposed amendments be revised to clarify this issue. Additionally, it is theoretically possible to have passive losses that are not in federal AGI (i.e., they are “below the line”). We suggest that the proposed amendments clarify that the sourcing rules not depend upon the above-the-line or below-the-line status of the losses.

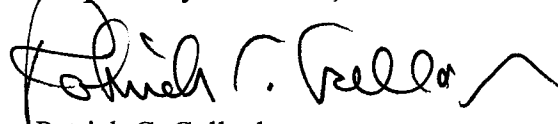
6) Existing section 132.7(a) permits certain deductions for capital losses, passive activity losses, and net operating losses only to the extent that they relate “solely” to items of income, gain, loss or deduction derived from or connected to New York sources. For a multi-state business, there will be an apportionment of overall net income, based on apportionment factors. In such cases, we assume that a determination as to whether the “solely” requirement is met should be made after an apportionment of overall net income has been made.

7) Existing section 132.7(c)(2)(i) provides that a net operating loss from a nonresident year cannot be carried back or forward to a taxable year in which the nonresident individual was or is a resident of New York. Assuming that the NOL relates to a New York business, we question whether a resident should be precluded from claiming the NOL against the income of that same business. Currently, we are not aware of any provision in the Tax Law that would prevent the NOL from being carried back or forward to a resident year.

* * * * *

Thank you for giving us the opportunity to review the proposed amendments to Section 132 of the regulations. We appreciate your consideration of our comments. Please let us know if you would like to discuss the proposed amendments or our comments further or if we can assist you in any other way.

Respectfully submitted,



Patrick C. Gallagher

cc: Robert Megna
Commissioner-Elect
NYS Department of Taxation and Finance

John W. Bartlett
Chief of Regulations
NYS Department of Taxation and Finance