STATE OF NEW YORK

TAX APPEALS TRIBUNAL

In the Matter of the Petition	:	
of	:	
ROBERT T. AND SUSAN M. GREIG	:	DECISION DTA NO. 815529
for Redetermination of a Deficiency or for Refund of New York State and New York City Income Taxes under Article 22 of the Tax Law and the New York City Administrative Code for the Year 1992.	:	

The Division of Taxation filed an exception to the determination of the Administrative Law Judge issued on July 30, 1998 with respect to the petition of Robert T. and Susan M. Greig, 38 Grace Court, Brooklyn, New York 11201. Petitioners appeared by E. Parker Brown, II, Esq. The Division of Taxation appeared by Terrence M. Boyle, Esq. (Kevin R. Law, Esq., of counsel).

The Division of Taxation filed a brief in support of its exception and a reply brief. Petitioners filed a brief in opposition. The Division of Taxation's request for oral argument was withdrawn.

After reviewing the entire record in this matter, the Tax Appeals Tribunal renders the following decision.

ISSUE

Whether petitioner Robert T. Greig may prorate his distributive share of partnership income between his resident and nonresident periods or whether he must include the entire distributive share in his resident period.

FINDINGS OF FACT

We find the facts as determined by the Administrative Law Judge. These facts are set forth below.

Petitioner Robert T. Greig[1] (hereinafter "petitioner"), was born in Hudson, New York, in 1945. He graduated from Cornell University in 1967 and from the University of Michigan Law School in 1970. He is a member of the bar of the States of Michigan and New York, as well as the bar of Japan, where he is designated a *Gaikokuho Jimu Bengoshi* or, roughly translated, a "foreign solicitor."

In 1973 petitioner joined the law firm of Cleary, Gottlieb, Steen & Hamilton (hereinafter "Cleary") as an associate in the firm's New York City office. On January 1, 1979, he became a partner in Cleary.

On August 1, 1982, at the behest of Cleary, petitioner and his family moved from New York City to Hong Kong. In July 1987, petitioner and his family moved from Hong Kong to Japan, where petitioner worked in Cleary's Tokyo office.

On July 4, 1992, petitioner and his family returned from Japan to New York City, and petitioner resumed work in Cleary's New York City office.

For the year petitioner left New York City, 1982, he filed an IT-201 Resident Income Tax Return and an IT-203 Nonresident Income Tax Return, as well as a NYC-203 City of New York Nonresident Earnings Tax Return, treating his distributive share of partnership income as 7/12

[1]As the treatment of the income of Robert T. Greig is the subject of this matter and the naming of Susan M. Greig on the notice of deficiency results from petitioners having filed a joint return, references to "petitioner" in this decision will pertain to Mr. Greig only, unless otherwise noted.

attributable to his period of residence in New York City (i.e., January - July) and 5/12 attributable to his period of nonresidence (i.e., August - December).

Petitioner treated the portion of his 1982 partnership distribution attributable to his period of residence as entirely New York source income, and he treated the portion of the partnership distribution attributable to his period of nonresidence as allocable to New York according to the New York allocation percentage determined by Cleary on its 1982 IT-204 Partnership Return.

For the year petitioner returned to New York City, 1992, petitioner filed an IT-203 Nonresident and Part-Year Resident Return, as well as a NYC-203 City of New York Nonresident Earnings Tax Return, treating his distributive share of partnership income as approximately 51% (i.e., 186 days ÷ 366 days) attributable to his period of nonresidence and approximately 49% attributable to his period of residence (July - December) (i.e., 180 days ÷ 366 days).

Petitioner, instead of treating 100% of the Cleary distribution as attributable to the resident period in the New York source fraction's numerator, apportioned approximately 51% to his nonresident period and approximately 49% to his resident period, based on the number of days he was in each such status in 1992. He then treated the nonresident portion as 48.139% allocable to New York according to the allocation determined by Cleary on its 1992 IT-204 Partnership Return. The resident portion of the distribution from Cleary was treated as entirely New York source income.

Specifically, petitioner's gross distributive share of income from Cleary for 1992 (exclusive of net real estate rental income) was $1,192,994.00. Petitioner reduced this amount by his unreimbursed expenses incurred in his capacity as a partner in Cleary (e.g., bar association

dues, professional publications, etc.) of $9,412.00. The resulting net amount was then allocated between the resident and nonresident periods as follows:

Item	Total Amount	Nonresident Period	Resident Period
Gross Cleary Distributive Share	$1,192,994.00	$606,276.00[2]	$586,718.00[3]
Less Expenses[4]	9,142.00	1,802.00	7,340.00
	$1,183,852.00	$604,474.00	$579,378.00

One hundred percent (100%) of the income allocated to the resident period was included in petitioner's New York source income. The income allocated to the nonresident period was multiplied by Cleary's New York allocation percentage (48.139%) and the resulting amount, $290,988.00[5] was included with the other items reported on Schedule E to petitioner's Form 1040 to arrive at a total amount of income from rents and partnerships allocated to New York of $896,311.00.

In addition to being a partner in Cleary, petitioner was also a partner in three other partnerships. Petitioner's distributive shares of partnership income from each of these partnerships and the portion of such income allocable to New York were as follows:

PARTNERSHIP	INCOME	ALLOCATION PERCENTAGE
Red Hook Cold Storage	$22,304.00	100%

[2] $1,192,994.00 x 186/366 = $606,276.00

[3] $1,192,994.00 x 180/366 = $586,718.00

[4] The unreimbursed professional expenses were allocated between the resident and nonresident periods based upon the period to which they related, as reflected in petitioner's records.

[5] $604,474.00 x .48139 = $290,988.00

State Two Associates	802.00	0%
White Hall Venture Assoc.	0.00	100%

Petitioner also owned certain real estate investments as shown on his Federal Schedule E. Income and loss from these investments were as follows:

PROPERTY	INCOME/<LOSS>
15 Willow Place, Brooklyn, NY	$8,195.00
Kelso, South Africa	<2,042.00>
38 Grace Court, Brooklyn, NY	<2,230.00>

As the two Brooklyn properties are located in New York, petitioner included 100% of the income or loss from these properties in computing his New York adjusted gross income. With respect to the South African property, petitioner deducted only the portion of the loss relating to the period of his residency in New York, i.e., approximately 49% of the total loss.

In 1996, the Division initiated an audit of petitioner's 1992 return. By Statement of Personal Income Tax Audit Changes dated August 15, 1996, the Division determined that "[as] to domicile, under the 548 day rule, taxpayers were deemed not domiciliaries of NY." However, with respect to the allocation of income phase of the audit, the Division determined that partnership income from Cleary was 100% taxable to New York. Also, the part-year New York City resident tax was deemed incorrect and therefore was adjusted. Lastly, the foreign income exclusion was disallowed.

Regarding the allocation of petitioner's distributive share of partnership income to New York State and City, the Division relied upon 20 NYCRR part 154 to support its view that if the partnership's taxable year ends during the period that petitioner was a resident of New York the

distributive share is to be included in its entirety in the numerator of the New York source fraction under Tax Law § 601(e)(3). Because Cleary's taxable year ended on December 31, 1992, the Division concluded that all of petitioner's distributive share of partnership income had to be included in the numerator of this fraction without any allocation to petitioner's nonresident period, with the result that 100% of the distributive share was deemed taxable by New York State and City.

On September 9, 1996, the Division issued to petitioner a Notice of Deficiency for the year 1992 assessing tax, interest and penalty as follows:

	TAX	INTEREST	PENALTY	AMOUNT DUE
New York State	$28,858.59	$ 8,022.46	$ 8,190.01	$ 45,071.06
New York City	43,002.46	11,954.35	12,427.54	67,384.35
Totals	$71,861.05	$19,976.81	$20,617.55	$112,455.41

Petitioner did not request a Conciliation Conference in the Bureau of Conciliation and Mediation Services, but, instead, filed a timely petition on November 26, 1996 directly with the Division of Tax Appeals. On February 26, 1997, the Division filed its answer to the petition.

DETERMINATION OF THE ADMINISTRATIVE LAW JUDGE

In his determination, the Administrative Law Judge compared Tax Law former § 654 (in effect until December 31, 1987) with Tax Law former § 638 (applicable to tax year 1992) and the regulations enacted by the Division pertaining to each section. The Administrative Law Judge noted that the Court of Appeals, in ***Matter of McNulty v. New York State Tax Commn.*** (70 NY2d 788, 522 NYS2d 103), had invalidated the Division's regulation pertaining to Tax Law former § 654 (20 NYCRR former 148.6). That regulation required taxpayers who moved in or

out of New York 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. Taxpayers were prohibited from prorating gains and losses between their resident and nonresident periods. The Court concluded that this reporting methodology did not take into account when the income from the partnership was actually received. The Court found a clear legislative intent in Tax Law former § 654 that most forms of income, as well as exemptions and standard deductions, should be allocated between the taxpayer's resident and nonresident returns. Thus, the Court held that taxpayers had to be allowed to report partnership distributions in a manner that either reflected the date of receipt or encompassed a proportionate distribution.

The Administrative Law Judge rejected the Division's argument that ***McNulty*** concerned only the mismatching which would occur if exemptions and deductions were prorated between two returns as required by Tax Law former § 654(a) and partnership income was not handled in the same manner. The Division argued that the Tax Reform and Reduction Act of 1987 changed the reporting methodology by requiring a single return and obviating the need for proration between returns. In furtherance thereof, the Division also adopted a new regulation (20 NYCRR 154.6) concerning the reporting of partnership distributions. As a result, the Division argued that ***McNulty*** is no longer applicable and proration of partnership income should not be allowed in the numerator of the New York source fraction.

The Administrative Law Judge concluded that while the Tax Reform and Reduction Act of 1987 repealed paragraphs (e) and (f) of Tax Law former § 654, which required the proration of exemptions and deductions between the resident and nonresident returns, ***McNulty*** was concerned with the proper interpretation of the statutory language set forth in former section 654

of the Tax Law. The Administrative Law Judge concluded that there was nothing in ***McNulty*** which would limit its holding to situations where only mismatching of exemptions and deductions is present. The statutory scheme present in ***McNulty*** is similar to that found in the present matter and the statutory exceptions found in Tax Law § 637 and former § 638(c) indicate that it continued to be the intent of the Legislature that most forms of income should be allocated between petitioner's resident and nonresident periods to reflect the actual date of receipt or expenditure or encompass an annual amount distributed on a proportionate basis. Therefore, the taxpayers should be permitted to prorate the annual amount of the partnership distributions and allocate the amount proportionately between the resident and nonresident periods.

The Administrative Law Judge also rejected the Division's argument that its position conforms with the Federal principle embodied in section 706 of the Internal Revenue Code (hereinafter "Code") that partnership items are recognized by a partner at the time the partnership taxable year ends. The Administrative Law Judge reviewed principles of partnership taxation contained in the Code and concluded that section 706(a) of the Code does not mean that the partner's distributive share of the partnership's gain or loss was earned or sustained by the partner on the last day of the taxable year of the partnership ending with or within the partner's tax year. Rather, that language merely describes in which taxable year the partnership items should be included in the taxable income of a partner. Section 706(a) is compatible with the concept that the partner is deemed to have earned the income at the same date it is earned by the partnership. Under such circumstances, section 706(a) does not support the Division's position and, in fact, complements the position of petitioner that the partnership income received by petitioner be reported ratably throughout the year.

ARGUMENTS ON EXCEPTION

On exception, the Division urges the same position it advanced before the Administrative Law Judge; i.e., that the Court of Appeals decision in ***McNulty*** is inapplicable to the facts of this case and that the Division's regulation at 20 NYCRR 154.6 is a rational interpretation of the Tax Law and a valid exercise of the Commissioner's rule-making authority. Further, the Division argues that petitioners have not established reasonable cause for the abatement of penalties.

The Division states that a plain reading of Tax Law § 638, as it was in effect during 1992, demonstrates that the New York source income attributed to the resident period on the tax return of a part-year resident is to be determined by computing the New York adjusted gross income as if the individual's taxable year for Federal purposes were limited to the period of residence. Section 706(a) of the Code requires that a partner must include as part of his income his distributive share of partnership income of a partnership whose taxable year ends with or within his taxable year. Reading these sections together, argues the Division, if the partnership's taxable year ends during the period when the taxpayer is a resident of New York State, then the taxpayer's full distributive share of partnership income must be included in determining New York source income. The Division maintains that its regulation (20 NYCRR 154.6[a][3][i][*a*]) interprets this statutory requirement in a manner that reflects the clear import of the statutory language.

The Division alleges that the Administrative Law Judge incorrectly determined that the outcome in this case was controlled by the decision of the Court of Appeals in ***McNulty***. Contrary to the conclusion of the Administrative Law Judge, the Division argues that ***McNulty***

was decided to remedy the shortcomings of the reporting methodology prescribed by the Tax Law for part-year residents at that time, requiring a separate resident and nonresident return to be filed. According to the Division, the Court in ***McNulty*** simply held that if personal exemptions and standard deductions were required to be prorated between a resident and nonresident return, it was inconsistent to mandate that partnership items be relegated to one return or the other.

However, in 1987, the Tax Law was amended to provide for a single return for part-year residents. Since part-year residents were no longer required to prorate exemptions and deductions, the Division argues that the problem addressed by ***McNulty*** no longer existed. According to the Division, by its 1987 amendments to the Tax Law, the Legislature evinced an intent to have all partnership income included in the resident or nonresident portion of the taxpayer's income based on the taxpayer's status at the time when the partnership year ended.

The Division also asserts that the Administrative Law Judge erred in holding that a partner is deemed to earn income as it is earned by the partnership. The Division states that a partnership distributive share accrues when it is realized at the end of a partnership's fiscal year. Thus, the Division argues that its regulation (20 NYCRR 154.6[a][3][i]) is in harmony with principles of Federal taxation and must be adhered to. The Division maintains that a regulation which has a rational basis and is not unreasonable, arbitrary or capricious must be upheld, despite the fact that there may be another reasonable interpretation of the applicable statute. As the Division's regulation is consistent with the statute, and the Administrative Law Judge did not find it to be arbitrary, unreasonable or capricious, the Division emphasized that the regulation must be deferred to.

Finally, the Division claims that penalties must be upheld because petitioners' failure to pay the tax was due simply to a legal interpretation of their liability which differed from that of the Division. This is not a basis on which to abate penalty.

Petitioners, in opposition, state that the Administrative Law Judge correctly relied on ***McNulty*** and ***Matter of Wertheimer*** (Tax Appeals Tribunal, January 12, 1995) for his conclusion that a partner's distributive share of partnership income must be prorated between the resident and nonresident portions of the taxpayer's year for purposes of determining a part-year resident's tax liability allocable to New York. Petitioners argue that in analyzing Tax Law former § 654, the Court in ***McNulty*** found a clear legislative intent that most forms of income, as well as exemptions and standard deductions, should be allocated between the taxpayer's resident and non-resident returns to reflect either the actual date of receipt or an annual amount distributed proportionately. Petitioners assert that ***McNulty*** held that this method of reporting partnership distributions was required despite the Division's policy of conformity with Federal tax laws and treating partnership distributions as having accrued at the end of the partnership fiscal year.

Petitioners point out that this policy was argued successfully by the Division in ***Wertheimer*** and upheld by the Tax Appeals Tribunal. Although the Tax Law was amended in 1987, petitioners claim that the law subsequent to that date did not change the applicability of the ***McNulty*** concept. The Division's position, state petitioners, hinges on a narrow and improper reading of the ***McNulty*** decision. The legislative intent discerned in ***McNulty*** was that all income not specifically dealt with in a different manner by Tax Law former § 654 was to be prorated between the resident and nonresident periods. Nothing in the language of ***McNulty*** limits its applicability to situations where mismatching of exemptions and deductions with

income is present, as argued by the Division. Comparing Tax Law former § 654(b) (at issue in ***McNulty***) with Tax Law former § 638 (at issue in the present case) shows that the scheme for reporting income by a part-year resident by treating income as if it were earned in two separate tax "years" -- one as a resident and one as a nonresident -- remains the same. Thus, the Court of Appeals' decision should be given broad applicability to the present situation. Petitioners argue that the Administrative Law Judge's conclusion that the statutory scheme present in ***McNulty*** is similar to that found in the present matter and that it continued to be the intent of the Legislature that most forms of income should be allocated between a taxpayer's resident and nonresident periods.

Further, petitioners argue that the Administrative Law Judge correctly concluded that petitioners' position is consistent with the Code. Section 706 of the Code merely prescribes the taxable year in which partnership items must be included in the income of a partner, but does not determine when income was earned or a loss sustained. Partnership income, however, is deemed earned at the same time that it is earned by the partnership. Thus, conformity with principles of federal partnership taxation require that the partner be treated as having earned his pro rata share as it is earned by the partnership throughout the year.

Petitioners assert that the Division's regulation (20 NYCRR 154.6[a][3][i]) is irrational and unreasonable. Petitioners point out that for tax years beginning prior to 1990 (including two years subsequent to the 1987 amendments to the Tax Law when relevant statutory language was precisely the same as that in effect for the instant year), proration of partnership income was actually mandated. The Division now argues against that same position in the present case.

Thus, deference to the Division's position as an administrative interpretation of legislative intent is not warranted.

Finally, petitioners maintain that in light of the regulatory confusion, the unjust attribution and the sound professional advice given to petitioners, imposition of penalty is not warranted in this case.

In reply, the Division emphasizes that in ***Wertheimer***, the Tax Appeals Tribunal concluded that ***McNulty*** was based on the entirety of Tax Law § 654, referring to subsections (b), (e) and (f) as authority for its conclusion that section 654 required 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 the rules for special accruals and lump sum distributions in Tax Law § 654(c) and (i). Since subsections (e) and (f) (requiring separate returns for the resident and non-resident portions of the tax year) are no longer part of the Tax Law, they no longer provide a basis for a legislative intent of proration. Additionally, the Division argues that petitioners have erroneously interpreted Federal principles of partnership taxation insofar as they relate to the time at which partnership income is deemed earned by a partner.

OPINION

The Administrative Law Judge, having determined the facts relevant to this case based on the record before him, has made a thorough analysis of the statutory and decisional law applicable thereto. We agree with the Administrative Law Judge that while the Legislature made substantive changes to the Tax Law in 1987 which thereafter required a part-year resident to file a single tax return rather than separate resident and nonresident returns, the scheme of allocating

income to the taxpayer's resident and nonresident periods for reporting a partner's distributive share of income, gain, loss and deductions from the partnership has remained essentially the same as it was prior to such legislative changes. Therefore, as the Administrative Law Judge concluded, the decision in ***McNulty*** continues to apply to this situation. For the reasons set forth in his determination, we rely on the analysis provided by the Administrative Law Judge and affirm his determination.

The Division of Tax Appeals has authority to rule on the validity of regulations promulgated by the Division of Taxation (***see***, Tax Law § 2006[7]). Generally, such regulations are properly upheld unless shown to be irrational and inconsistent with the statute (***Matter of Slattery Assocs. v. Tully***, 79 AD2d 761, 434 NYS2d 788, ***affd*** 54 NY2d 711, 442 NYS2d 978) or erroneous (***Matter of Koner v. Procaccino***, 39 NY2d 258, 383 NYS2d 295). On the other hand, the Division's regulations "are not entitled to such deference when, as here, the issue is one of pure statutory construction" (***Matter of Debevoise & Plimpton v. New York State Dept. of Taxation & Fin.***, 80 NY2d 657, 593 NYS2d 974, 977), for the Division has "no authority to create a rule out of harmony with the statute" (***Matter of Jones v. Berman***, 37 NY2d 42, 371 NYS2d 422, 429).

Relying on the Administrative Law Judge's analysis, we conclude that the Division's regulation 20 NYCRR 154.6(a)(3)(i) is not in harmony with the statute. Our conclusion is bolstered by the fact that the Division's regulation 20 NYCRR 154.6(a)(2)(i) requires that for tax years beginning in 1988 and 1989, the distributive share of partnership income, gain, loss and deductions included in the numerator of the New York source income fraction must be prorated between the resident and nonresident periods. However, for tax years beginning in 1990 and

thereafter, 20 NYCRR 154.6(a)(3)(i) allows no proration. Since the relevant portion of the statute on which these regulations is based (Tax Law former § 638) was identical for tax years 1988, 1989 and 1990, the Division has shown no rational basis for the differing treatment in reporting partnership distributions during that period. We conclude, therefore, that the Division's regulation 20 NYCRR 154.6(a)(3)(i) is 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.

Accordingly, it is ORDERED, ADJUDGED and DECREED that:

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

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

3. The petition of Robert T. and Susan M. Greig is granted; and

4. The Notice of Deficiency issued on September 9, 1996 is canceled.

DATED: Troy, New York
September 16, 1999

/s/Donald C. DeWitt
Donald C. DeWitt
President

/s/Carroll R. Jenkins
Carroll R. Jenkins
Commissioner

/s/Joseph W. Pinto, Jr.
Joseph W. Pinto, Jr.
Commissioner