STATE OF NEW YORK

DIVISION OF TAX APPEALS

In the Matter of the Petition	:	
of	:	
ALAIN E. and BRIGITTE WERTHEIMER	:	DETERMINATION 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.	:	

Petitioners, Alain E. and Brigitte Wertheimer, 1060 Fifth Avenue, Apartment 12B, New York, New York 10128, filed a petition 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.

Petitioners by their duly appointed attorney and representative, Willkie Farr & Gallagher (Peter W. Schmidt, Esq., of counsel), and the Division of Taxation by William F. Collins, Esq. (Michael J. Glannon, Esq., of counsel), signed a waiver of hearing and consented to have the matter determined based upon stipulated facts, documents and briefs. On June 15, 1993, the Division submitted its exhibits. Petitioners submitted no exhibits. Briefs were duly filed by the parties, the last, petitioners' reply letter-brief, being filed on August 11, 1993. After due consideration of the evidence and briefs filed herein, Carroll R. Jenkins, Administrative Law Judge, renders the following determination.

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 and New York resident income tax returns, orwhether all of such losses were properly includable on petitioners' New York resident tax return, where the Court of Appeals decision in McNulty v. State Tax Commission (70 NY2d 788, 522 NYS2d 103 [1987] [hereinafter "McNulty"]) was published on the same day as the tax returns in this case were in-

date stamped as received by the Division, and where the fiscal year of all of the partnerships ended on December 31, 1986.

FINDINGS OF FACT

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. Limited Partnership	59-2416816	$ -0-	$ (15,758.00)
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.

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 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.

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.

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 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.

SUMMARY OF THE PARTIES' POSITIONS

The dispute in this case is whether petitioners could properly report all partnership losses on their 1986 part-year resident return rather than prorating the losses between their resident and non-resident returns based on the number of months they resided in New York.

Petitioners argue that their 1986 income tax returns were:

> "consistent with the statute [Tax Law § 654(c)(2)], the regulations [20 NYCRR 148.6] interpreting such statute, the applicable court and administrative decisions, and tax return instructions operative at the time that they filed their New York tax returns . . ." (Petitioners' Brief, p. 2).

Petitioners are aware that on the day after they filed the subject tax returns, the Court of Appeals in McNulty v. State Tax Commission, (supra) struck down the Division's regulation (20 NYCRR 148.6) interpreting Tax Law § 654(c)(2) as being inconsistent with the legislative intent of the statute. As a result of McNulty, the Division amended Personal Income Tax

Regulation section 148.6 on September 14, 1988. Petitioners contend that the Division improperly applied this amended regulation retroactively to their tax returns filed almost a year prior to the amendment. Alternatively, petitioners urge that the McNulty decision was never intended to cover partnership losses and that the Division's position is inconsistent with the decision in McNulty.

CONCLUSIONS OF LAW

A. Tax Law former § 654(c)(2)[1], in effect for the 1986 tax year, provided, in part:

> "If an individual changes his status from nonresident to resident, he shall, regardless of his method of accounting, accrue for the portion of the taxable year prior to such change of status any items of income, gain, loss or deduction accruing prior to the change of status, other than items derived from or connected with New York sources, if not otherwise properly includible (whether or
>
> not because of an election to report on an installment basis) or allowable for federal income tax purposes for such portion of the taxable year or for a prior taxable year . . . ." (Emphasis added.)

The Division promulgated a regulation implementing the above provisions of Tax Law § 654(c)(2), which was construed by the Court in McNulty. Section 148.6 provided as follows:

> "Distributive share of member of partnership. Where 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 non-resident 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 resident and nonresident income tax returns required under this Part." (20 NYCRR former 148.6 [emphasis added] [hereinafter "the Former Regulation"].)

Section 148.6 was amended on September 14, 1988 as a result of the Court of Appeals decision in McNulty (supra).

B. A partnership gain or loss accrues when it is realized on the last day of the partnership's taxable year, i.e., December 31, 1986 (IRC § 706[a]; Matter of Kritzik v. Gallman, 41 AD2d 994, 344 NYS2d 107 [3d Dept 1973]). In this case, the last day of the 1986 taxable

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[1]Section 654 was repealed effective January 1, 1988 (L 1987, ch 28, § 88).

year for all of the partnerships was December 31st.

C. The Division denies that the assessment in this case is based on regulation 148.6, as amended in 1988, and contends instead that the assessment is based on the Court of Appeals decision in McNulty (Division's Brief, pp. 2-3). The Division further states that based on that decision, petitioners' distributive share of partnership losses, which had accrued and been distributed to them by December 31, 1986 (the end of the partnership's fiscal year), must be prorated throughout the taxable year ending December 31, 1986.

Petitioner counters that the proration in this case is inconsistent with the McNulty decision, noting in particular the Court's language that Tax Law § 654(c)(2) requires that allocations be made "in a manner that either reflects the actual date of receipt and expenditure or encompasses an annual amount distributed on a proportionate basis." (Emphasis added.)

D. The Division admits that the assessment was based on Tax Law § 654, as construed by the Court of Appeals decision in McNulty. If petitioners are correct that that the McNulty Court construed Tax Law § 654(c)(2) as giving taxpayers a choice in how they could report their partnership distributions, then the Division would have exceeded the statute in not permitting petitioners to report all of their losses on their resident return. In that event, petitioners must prevail. On the other hand, if it is determined that the McNulty rule stands for the proposition that a part-year resident taxpayer has no choice but to prorate his/her partnership distributions between his resident and nonresident returns, then we must go further and examine whether the McNulty rule can be applied retroactively.

E. Based on the evidence, including the admissions of the Division, I conclude that the Notice of Deficiency was based on the McNulty decision alone and not on the amended regulation issued subsequent to that decision (see, Findings of Fact "7" and "8"); therefore, this analysis will focus on the McNulty holding.

F. In Matter of McNulty v. New York State Tax Commission (supra) 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 section 654 they 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 that taxpayers, who move in or out of the State during the tax year, treat partnership gains or losses as having all accrued in the "portion of the taxable year" in which the partnership's own tax year ends.

As noted by the McNulty Court,[2] the effect of this former 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).

Therefore, the application of former regulation 148.6 in the McNulty case resulted in the taxpayers, whose sole source of income consisted of the partnership distribution, reporting all their income on their nonresident tax return and no income on their resident return. Consequently, because their personal exemptions and deductions had to be prorated and allocated between the taxpayers' resident and nonresident returns, the taxpayers were deprived of the beneficial use of the exemptions and deductions reported on the resident return because there was no income against which they could be applied. The Court used the following computations to illustrate the effect of 20 NYCRR former 148.6:

Computation Without Application of Regulation 148.6

	(Jan.-Aug.) Resident	(Sept.-Dec.) Nonresident
Total N.Y. Income	$26,667.00	$13,333.00
N.Y. Deductions	(8,340.00)	(4,170.00)
N.Y. Exemptions	(1,867.00)	(933.00)
	$16,460.00	$ 8,230.00

TOTAL TAXABLE INCOME: $24,690.00

Computation Under Regulation 148.6

[2]Wherever the term "McNulty Court" is used, the term refers to the Court of Appeals.

	(Jan.-Aug.) Resident	(Sept.-Dec.) Nonresident
Total N.Y. Income	$ -0-	$40,000.00
N.Y. Deductions	(8,340.00)	(4,170.00)
N.Y. Exemptions	(1,867.00)	(933.00)
	$ -0-	$34,897.00

TOTAL TAXABLE INCOME: $34,897.00

The Court in McNulty held that Tax Law § 654(c)(2) required the allocation of "partnership distributions" of items of income, deductions and exemptions between the 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" (hereinafter "the McNulty rule") (id., 522 NYS2d at 104 [emphasis added]).

G. Petitioners urge that the Court in McNulty did not intend that its use of the term "partnership distributions" in its decision should include a partner's distributive share of losses. Petitioners' argument is not persuasive. By their terms, both Tax Law § 654(c)(2) and former regulation section 148.6, as construed by the Court in that case, made provision for the treatment on part-year returns for items of "income, gain, loss or deduction". While the McNulty Court did not specifically address the situation where the partnership's annual distribution consists of losses, it would be incongruous to interpret that decision, in construing Tax Law § 654(c)(2), as applying only to partnership distributions of income and gains. In other cases construing this provision (prior to McNulty) it is clear that the State Tax Commission and the Appellate Division considered a partnership's distributions as including not just income and gains, but also losses (Matter of Palmquist, State Tax Commn., April 28, 1986; Matter of Kritzik v. Gallman, 41 AD2d 994, 344 NYS2d 107 [3d Dept 1973]). There is no language in McNulty that would lead one to conclude that it did not also apply to partnership losses.

H. The McNulty Court held that the regulation (section 148.6) was an invalid exercise of the Tax Commission's authority because requiring annual partnership distributions to be reported in their entirety on one of the two returns "without regard either to when such

distributions are received or to proration . . . is inconsistent with [the] legislative policy [of section 654 of the Tax Law]" (id., 522 NYS2d at 104 [emphasis added]). With respect to the statute's legislative policy, the McNulty Court stated that section 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]." (Id., 522 NYS2d at 104 [emphasis added].)

It is important to note here that the above-referenced language of the McNulty Court did not, contrary to the Division's argument, mandate proration. The Court invalidated former section 148.6 because it did not permit proration as an option. The Court was clear that the statute (Tax Law § 654[c][2], as construed by the Court) required that a 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." In other words, Tax Law § 654, as construed by the McNulty Court, gave taxpayers a choice of options that was not available under former regulation section 148.6. The Court did not mandate proration, it merely struck down former section 148.6, because it did not comport with this element of the statute which it purported to interpret.

I. Petitioners argue that their 1986 income tax returns were:

> "consistent with the statute [Tax Law § 654(c)(2)], the regulations [20 NYCRR 148.6] interpreting such statute, the applicable court and administrative decisions, and tax return instructions operative at the time they filed their New York tax returns . . . ."

That is true. Their 1986 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. There is no need to decide whether section 148.6 of the regulations, as amended in 1988, like its predecessor provision, is contrary to the statute and in excess of the Division's authority, since the tax asserted here was not based on that provision.

J. Inasmuch as it has been determined that the Division has misconstrued the Court's decision in McNulty and Conclusion of Law "I" resolves the issue in favor of petitioners, it is not necessary to address petitioners' argument concerning the retroactive application of the rule enunciated by the Court in McNulty.

K. The petition of Alain E. and Brigitte Wertheimer is granted and the Notice of Deficiency issued March 16, 1989 is cancelled.

DATED: Troy, New York
October 21, 1993

/s/ Carroll R. Jenkins
ADMINISTRATIVE LAW JUDGE