STATE OF NEW YORK

DIVISION OF TAX APPEALS

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| In the Matter of the Petition | : | |
| of | : | |
| ALAIN E. AND BRIGITTE WERTHEIMER | : | DETERMINATION ON REMAND |
| 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. | : | DTA NO. 808770 |

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 of Taxation submitted its exhibits. Petitioners submitted no exhibits. The last date for filing of briefs was August 11, 1993. All briefs were filed within the prescribed date. Carroll R. Jenkins, Administrative Law Judge, rendered his determination dated October 21, 1993.

The Division of Taxation filed an exception to the determination of the Administrative Law Judge. In its decision dated January 12, 1995, the Tax Appeals Tribunal ("the Tribunal") rejected petitioners' arguments and granted the Division's exception. In doing so, the Tribunal noted thatMatter of McNulty v. New York State Tax Commn. (70 NY2d 789, 522 NYS2d 103) (hereinafter "McNulty") held that where a partner's distributive share of income is reported without regard to actual receipt, the only possible method of allocation under Tax Law § 654 is on a proportionate basis throughout the year. The Tribunal held that McNulty also applies to distributive share of partnership losses, and that since 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 their resident and nonresident return on a proportionate basis. The Tribunal remanded the matter to the Administrative Law Judge to address the following legal issue which was not addressed in the determination of October 21, 1993.

ISSUE

Whether the Court of Appeals decision in McNulty can be applied retroactively to the income tax return filed by petitioners for 1986.

FINDINGS OF FACT[1]

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. Petitioners' sole source of income was their distributive share of earnings of New York 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 ALLOCATED DISTRIBUTIONS | 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 |

[1]Any modifications to the facts made by the Tax Appeals Tribunal are incorporated herein.

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|---|---|---|---|
| Banyon Club Assoc., Ltd. | 59-2454066 | $ -0- | $ (179,289.00) |
| VV Associates-No.4 | 11-2600367 | $ -0- | $ (97,790.00) |
| Twin Towers Assoc. 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) |

Each of the above-referenced partnerships used the calendar year as their tax year for Federal and State income tax purposes, i.e., the tax year of each partnership ended December 31, 1986.

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.

The Court of Appeals decision in McNulty (supra) was issued on October 15, 1987. Petitioners' tax returns for 1986 were in-date stamped as received by the Division of Taxation ("Division") on October 15, 1987.

The 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 Commn. (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 Division argues that petitioners' distributive share of partnership losses, which had accrued and been distributed to them by the end of the partnerships' fiscal year, must, based on the Court of Appeals decision in McNulty, be prorated throughout the taxable year ending December 31, 1986.

Petitioners counter that they filed their 1986 income tax return a day prior to the

decision in McNulty and, therefore, the McNulty decision cannot be applied retroactively to that return.

CONCLUSIONS OF LAW

A. Tax Law former § 654(c)(2), 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. 20 NYCRR former 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 [hereinafter "the Former Regulation"].)

B. In Matter of McNulty v. New York State Tax Commn. (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 Tax Law § 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).

C. The Court of Appeals in McNulty v. State Tax Commn. (supra) stated:

> "Section 654 of the Tax Law, which establishes specialized reporting requirements for taxpayers who change resident 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 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 at 104; emphasis added).

D. The Tax Appeals Tribunal, in rejecting petitioners' arguments, contrues McNulty as holding that where a partner's distributive share of income is reported without regard to actual receipt, the only possible method of allocation under Tax Law § 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" (Matter of Wertheimer, Tax Appeals Tribunal, January 12, 1995).

Petitioner urges, however, that McNulty does not apply in this case because the Court of Appeals decision was not decided until October 15, 1987, a day after petitioner's 1986 return was mailed to the Division and the same day it was received by the Division. It must now be determined whether McNulty can be applied retroactively.

E. Petitioners rely, inter alia, on the decision in Chevron Oil Co. v. Huson (404 US 97,

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

30 L Ed 2d 296). In Chevron, the Supreme Court was faced with the issue of whether to apply its decision in Rodrigue v. Aetna Cas. & Sur. Co. (395 US 352, 23 L Ed 2d 360) to the plaintiffs in Chevron.

In Chevron, the plaintiff was injured while working on an artificial island drilling rig. Plaintiff instituted, in Federal District Court, a personal injury action some two years after the injury was sustained. The action was timely under the Federal law prevailing at the time. It would have been untimely under the applicable State law because Louisiana had a one-year statute of limitations for such actions. While the personal injury suit was pending, the United States Supreme Court, in Rodrigue v. Aetna Cas. & Sur. Co. (supra), determined that in suits of this type, the Federal law (i.e., the Death on the High Seas Act) was inapplicable and that its inapplicability removed any obstacle to the application of Louisiana law. Relying on this decision, the District Court in Chevron held that Louisiana's one-year statute of limitations on personal injury actions governed and barred the action.

The case made its way to the Supreme Court where the issue before the Court was whether its decision in Rodrigue should be applied retroactively to the plaintiff in Chevron. The Court reviewed the factors considered in its cases dealing with the nonretroactivity question and concluded that the Louisiana one-year statute should not be applied retroactively since the Rodrigue case was a case of first impression which effectively overruled a long line of decisions to the effect that the State statute of limitations was not applicable. The Court summarized the criteria (hereinafter "Chevron criteria") for the nonretroactivity of judicial decisions as follows:

> "[f]irst, the decision to be applied nonretroactively must establish a new principle of law, either by overruling clear past precedent on which litigants may have relied [citation omitted] or by deciding an issue of first impression whose resolution was not clearly foreshadowed [citation omitted]. Second, it has been stressed that 'we must . . . weigh the merits and demerits in each case by looking to the prior history of the rule in question, its purpose and effect, and whether retrospective operation will further or retard its operation' [citation omitted]. Finally, we have weighed the inequity imposed by retroactive application, for '[w]here a decision of this Court could produce substantial inequitable results if applied retroactively, there is ample basis in our cases for avoiding the "injustice or hardship" by a holding of nonretroactivity' [citation omitted]" (Chevron Oil Co. v. Huson, supra, at 106-107, 30 L Ed 2d, at 306).

F. The Chevron analysis was adopted by the New York Court of Appeals in Gager v.

White (53 NY2d 475, 442 NYS2d 463, cert denied sub nom J. E. Guertin Co. v. Cachat, 454 US 1086). In Gager, the Court of Appeals stated:

> "where there has been such a sharp break in the continuity of law that its impact will 'wreak more havoc in society than society's interest in stability will tolerate' [citation omitted], it is now recognized that, when adherence to the traditional course [i.e., retroactive application of the decision] is strongly contraindicated by powerful factors, including strong elements of reliance on law superseded by the new pronouncement, a court may direct that it operate prospectively alone (Chevron Oil Co. v. Huson, 404 U.S. 97, 92 S.Ct. 349, 30 L.Ed.2d 296; Great Northern Ry. v. Sunburst Co., 287 U.S. 358, 53 S.Ct. 145, 77 L.Ed. 360)" (Gager v. White, supra, 442 NYS2d at 466).

G. "[C]onsonant with the common law's policy-laden assumptions, a change in decisional law usually will be applied retrospectively to all cases still in the normal litigating process . . ." (Gager v. White, supra, 442 NYS2d at 466). However, a court may direct that its decision operate prospectively alone where there has been such a sharp break in the continuity of law that the decision's impact would wreak havoc in society's interest in stability (see, Chevron Oil Co. v. Huson, 404 US 97, 30 L Ed 2d 296; Matter of McCann v. Scaduto, 71 NY2d 164, 524 NYS2d 398; Gager v. White, supra).

H. In McNulty, the Court of Appeals could have, but did not, expressly limit its decision to prospective application only. It was for that Court, not this forum, to set the intended parameters of its decision by expressly stating whether its decision was to be given only prospective application (cf., Matter of McCann v. Scaduta, supra, at 176, n. 3, 524 NYS2d at 403). Since the McNulty Court did not so limit its decision, the common-law rule obtains and the decision should be given both prospective and retroactive application. It should also be noted that at the time petitioners filed their returns for 1986, it was still an open tax year, since the tax reported was still subject to review and modification by the Division. For petitioners, 1986 remains an open tax year. Petitioners' tax liability for 1986 will not be fixed and final until a final decision in this matter has been rendered or the time for further appeals has expired. That being the case, the argument could be made that application of McNulty to petitioners' open tax year does not constitute a retroactive application.

I. Even if this forum (rather than the Court of Appeals) were to apply the Chevron

criteria to determine whether McNulty was to be given retroactive effect, it would not change the result here. First, there was no new principle of law adopted in McNulty overruling a long line of cases. The Court merely interpreted the "clear meaning" of an existing statute (Tax Law former § 654). True, it struck down the Division's regulation (20 NYCRR former 148.6), but it did so on the basis that the regulation was not in accord with that statute; and, second, while applying the McNulty holding to petitioners' 1986 return will result in their paying additional tax, there has been no showing that the application of the McNulty decision to petitioners would result in inequity, injustice or hardship to petitioners or to taxpayers generally.[3]

J. The petition of Alain E. and Brigitte Wertheimer is denied and the Notice of Deficiency issued March 16, 1989 is sustained.

DATED: Troy, New York
May 18, 1995

/s/ Carroll R. Jenkins
ADMINISTRATIVE LAW JUDGE

[3]The third criteria of Chevron dealt with whether retroactive application of the court's decision would tend to further the legislative purpose of the statute. That consideration is moot since section 654 was repealed effective January 1, 1988 (L 1987, ch 28, § 88).