STATE OF NEW YORK

DIVISION OF TAX APPEALS

In the Matter of the Petition :

of :

ROBERT T. AND SUSAN M. GREIG :

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. :

DETERMINATION
DTA NO. 815529

Petitioners, Robert T. and Susan M. Greig, 38 Grace Court, Brooklyn, New York 11201, filed a petition 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.

On October 1, 1997 and October 3, 1997, respectively, petitioners, appearing by E. Parker Brown, II, Esq., and Gerald F. Stack, Esq., and the Division of Taxation, appearing by Steven U. Teitelbaum, Esq. (Craig Gallagher, Esq., of counsel), consented to have the matter determined on submission without a hearing. The Division of Taxation submitted documentary evidence on October 30, 1997 and a brief on December 15, 1997. Petitioners submitted their brief on November 10, 1997 and their reply brief on February 2, 1998, which date began the six-month period for the issuance of this determination. After review of the entire record, Thomas C. Sacca, Administrative Law Judge, renders the following determination.

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

Pursuant to the Tax Appeals Tribunal's Rules of Practice and Procedure § 3000.11, the parties have entered into a Stipulation of Facts, which has been incorporated in the following Findings of Fact. The Division of Taxation ("Division") had originally disallowed the foreign income exclusion claimed by petitioners on their 1992 return. The Division now concedes that petitioners are entitled to subtract the entire foreign income exclusion from gross income prior to allocating adjusted gross income to New York. Therefore, all references to this issue in the Stipulation of Facts have been eliminated from the Findings of Fact.

1. 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."

2. 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.

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[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 determination will pertain to Mr. Greig only, unless otherwise noted.

3. 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.

4. 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.

5. 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 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).

6. 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.

7. 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., 185 days ÷ 365 days) attributable to his period of nonresidence and approximately 49% attributable to his period of residence (July - December) (i.e., 180 days ÷ 365 days).

8. 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

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[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

1040 to arrive at a total amount of income from rents and partnerships allocated to New York of $896,311.00.

9. 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%
State Two Associates	802.00	0%
White Hall Venture Assoc.	0.00	100%

10. 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.

11. 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.

12. 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.

13. 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

14. 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.

CONCLUSIONS OF LAW

A. Tax Law former § 601(e), as applicable to the year 1992, provided, in relevant part, as follows:

> Nonresidents and part-year residents. (1) There is hereby imposed for each taxable year on the taxable income which is derived from sources in this state of every nonresident and part-year resident individual . . . which shall be equal to the tax computed under subsections (a) through (d) of this section, as the case may be, reduced by the credits permitted under subsections (b) and (c) of section six hundred six, as if such nonresident or part-year resident individual . . . were a resident, multiplied by a fraction, the numerator of which is such individual's . . . New York source income determined in accordance with part III of this article and the denominator of which is such individual's . . . federal adjusted gross income for the taxable year.

Therefore, the New York source fraction applicable to petitioner for 1992 was as follows:

New York source income of a part-year resident

Federal adjusted gross income for the taxable year

B. Tax Law former § 638, as applicable to the year 1992, provided for the New York source income of a part-year resident, in relevant part, as follows:

> (a) Individuals. The New York source income of a part-year resident individual shall be the sum of the following:
>
> (1) Federal adjusted gross income for the period of residence, computed as if his taxable year for federal income tax purposes were limited to the period of residence.
> (2) New York source income for the period of nonresidence determined in accordance with section six hundred thirty-one[6] as if his taxable year for federal income tax purposes were limited to the period of nonresidence.

Applying Tax Law former § 638 to the above, the New York source fraction becomes:

Federal AGI for resident period determined as if federal taxable year limited to resident period + NY source income for period of nonresidence determined as if federal taxable year limited to nonresident period
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[6] Tax Law former § 631 defined New York source income of a nonresident individual to include the net amount of income, gain, loss and deduction entering into the individual's federal adjusted gross income derived from or connected with New York sources, including the individual's distributive share of partnership income, gain, loss and deduction determined under Tax Law former § 632.

Federal AGI for the taxable year

C. In 1990, the Regulations of the Division were amended with respect to the allocation of distributive shares of partnership income. The regulation, 20 NYCRR 154.6(a)(3)(i), provides as follows:

> (a) The distributive share of partnership income, gain, loss and deduction to be included in the numerator of the New York source fraction under section 601(e) of the Tax Law shall be determined as follows:
>
> (1) where the taxable year of the partnership ends during the period the individual . . . was a resident of New York State, the distributive share of partnership income, gain, loss and deduction included in Federal adjusted gross income shall be included in such numerator; or
>
> (2) where the taxable year of the partnership ends during the period the individual . . . was a nonresident of New York State, the distributive share of partnership income, gain, loss and deduction to be included in such numerator shall be only the portion of such items that are derived from or connected with New York sources that are included in Federal adjusted gross income.

Following the regulation cited above, the Division included 100% of petitioner's distributive share from the partnership, Cleary, in the numerator of the New York source fraction because the partnership's taxable year ended on December 31, 1992 when petitioner was a resident of the State of New York.

D. In support of his argument, petitioner relies on the decision of the Court of Appeals in ***Matter of McNulty v. New York State Tax Commission*** (70 NY2d 788, 522 NYS2d 103). In that case, 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 former § 654, taxpayers 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 taxpayers who moved in or out of the 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 (***id.***, 522 NYS2d at 103). Pursuant to the regulation, taxpayers were prohibited from prorating gains and losses between their resident and nonresident periods. As stated by the ***McNulty*** Court, the effect of this 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). The ***McNulty*** Court concluded that the regulation was an invalid exercise of the Tax Commission's authority and held that the taxpayers must be allowed to report their partnership distributions in a manner that "either reflects the actual date of receipt and expenditure or encompasses an annual amount distributed on a proportionate basis" (***id.***, 522 NYS2d at 104).

According to petitioner, Tax Law former § 654, applicable to the year 1979, was essentially the same as Tax Law former § 638, applicable to the year at issue. Tax Law former § 654(b) provided as follows:

> New York taxable income . . . as resident and nonresident. The New York taxable income . . . for the portion of the year during which he is a resident shall be determined, except as provided in subsection (c), under part II of this article [regarding residents] as if his taxable year for federal income tax purposes were limited to the period of his resident status. The New York taxable income . . . for the remaining portion of his taxable year during which he is a nonresident shall be determined, except as provided in subsection (c), under part III of this article [regarding nonresidents] as if his taxable year for federal income tax purposes were limited to the period of his nonresident status.

In addition, petitioner claims that the Division's former regulation at 20 NYCRR 148.6, applicable to the year 1979, was essentially the same as current 20 NYCRR 154.6(a)(3)(i), applicable to the year at issue. The former regulation provided as follows:

> Distributive share of member of partnership. Where an individual . . . is a member of a partnership and such individual . . . changes its [sic] resident status from resident to nonresident, or vice versa, the distributive share of partnership income, gain, loss and deduction of such individual . . . must be included in the computation of New York taxable income of such individual . . . 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 . . . for New York State personal income tax purposes must be determined according to the status of such individual . . . as a resident or nonresident at such time. The distributive share of income, gain, loss and deduction of such individual . . . is not prorated between the separate New York State resident and nonresident income tax returns required under this Part.

E. The Tax Appeals Tribunal applied the Court of Appeals decision in ***McNulty*** when it rendered its decision in ***Matter of Wertheimer*** (January 12, 1995). At the time the taxpayers in ***Wertheimer*** filed their 1986 personal income tax return, 20 NYCRR former 148.6 required taxpayers who moved into or out of the State during the tax year to treat partnership gains or losses as having occurred in "the portion of the taxable year in which or with which the taxable year of the partnership ends . . . ." In other words, the regulation prohibited taxpayers from prorating gains or losses between their resident and nonresident periods.

The Wertheimers became New York residents on October 1, 1986. Accordingly, they filed a nonresident return for the nine-month period from January 1, 1986 through September 30, 1986 and a resident return for the period from October 1, 1986 through December 31, 1986. Mr. Wertheimer was a limited partner in several limited partnerships all of which had a December 31st taxable year ending date. These partnerships generated large losses, resulting in an allocation to Mr. Wertheimer of losses in excess of $1.5 million. Following 20 NYCRR former 148.6, Mr. Wertheimer reported all of the losses on the resident return since he was a resident of New York on the last day of the partnership's taxable year.

Shortly after the return was filed by the Wertheimers, the Court of Appeals issued its decision in ***McNulty***. On audit, the Division, relying on ***McNulty***, prorated Mr. Wertheimer's distributive share of partnership losses between the resident and nonresident periods based on the number of months in each period. As a result, the Division allowed only 25% of the partnership losses to be taken on the resident return, i.e., 3/12 of the total losses representing the three months that the taxpayers were residents of New York State during 1986.

The Administrative Law Judge's determination in ***Wertheimer*** held that ***McNulty*** did not mandate proration of partnership distributions between a partner's New York resident and nonresident returns. Rather, the Administrative Law Judge held that the taxpayers had the option to either prorate the income or loss or follow the rule of 20 NYCRR former 148.6. The Tax Appeal***s*** Tribunal reversed the determination of the Administrative Law Judge, and the case was remanded to the Administrative Law Judge to determine whether ***McNulty*** could be applied retroactively as was contended by the Division.[7]

F. The invalidated regulation was amended by the Division in an attempt to conform the regulation to the ***McNulty*** decision (***see***, 20 NYCRR former 148.6, amendment filed August 30, 1988, eff September 14, 1988, renum as 20 NYCRR 154.6). This amendment followed the Tax Reform and Reduction Act of 1987 (chapter 28 of the Laws of 1987) which brought about significant changes in the Tax Law. Among the changes was the repeal of Tax Law former § 654 (L 1987, ch 28, § 88) and its replacement with Tax Law former § 638. In repealing Tax Law former § 654, the Tax Reform and Reduction Act of 1987 repealed paragraphs (e) and (f), which required the proration of exemptions and deductions between the resident and nonresident

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[7]On remand, the Administrative Law Judge concluded that the Court of Appeals decision in ***McNulty*** should be applied retroactively. This conclusion was affirmed on different grounds by the Tax Appeals Tribunal in ***Matter of Wertheimer***, Tax Appeals Tribunal, March 14,1996).

returns. Proration of these items was not required in the year at issue as only one return was required to be filed by an individual who changed his resident status during the year. It is the position of the Division that the Court of Appeals, in ***McNulty***, invalidated 20 NYCRR 148.6 due to the mandatory prorations of exemptions and deductions found in the statute in contrast to the disallowance of proration of distributive shares of partnership income found in the regulation. According to the Division, the statute (Tax Law § 638) and the regulations (20 NYCRR 154.6) as they existed in the year at issue were consistent with each other and in accord with the ***McNulty*** decision. The amendment of 20 NYCRR 154.6 reflected a "reconsideration of the Court of Appeals decision in ***McNulty*** . . . in light of legislative changes with regard to the taxation of part-year residents enacted by the Tax Reform Act of 1987 (Chapter 28 of the Laws of 1987)."[8] The ***State Register*** further provides that:

> With the enactment of the Tax Reform and Reduction Act of 1987, where there is a change of residence, a single return for the taxable year is required, thus obviating prorations between returns. Therefore, where there is a change of residence, the amount of partnership items to be included in the numerator of the New York source fraction under section 601(e) of the Tax Law should be determined according to the status of the taxpayer as a resident or a nonresident at the time the taxable year of the partnership ends. This conforms with the federal principle contained in section 706 of the Internal Revenue Code that partnership items are recognized by a partner at the time the partnership taxable year ends.

G. A brief summary of the basic principles governing the taxation of income earned by a partnership under the Internal Revenue Code may be helpful in this matter. Although a partnership computes its net income, section 701 of the Internal Revenue Code provides that the

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[8]As detailed in the ***New York State Register***, May 16,1990, the objective of this change was to "enhance the administration of Article 22 of the Tax Law by clarifying the requirements regarding the determination of partnership and S corporation items to be reported where a partner or a shareholder of an S corporation changes resident status during the taxable year." Further, the ***State Register*** states that, "these amendments reflect a reconsideration of the Court of Appeals decision in ***McNulty v. State Tax Commission***, 70 NY2d 788, in light of legislative changes with regard to the taxation of part-year residents enacted by the Tax Reform and Reduction Act of 1987 (Chapter 28 of the Laws of 1987)."

partners are liable for the tax on the income. Pursuant to section 702 of the Internal Revenue Code, the tax is determined by each partner's reporting his distributive share of, *inter alia*, the partnership's income, gain and losses. Section 706(a) of the Code requires that each partner's distributive share of the income, gain and loss be included in that partner's taxable income for the taxable year of the partnership ending within or with the partner's tax year. A partner is required to report and pay tax on his distributive share of the net income of the partnership in this manner without regard to whether this amount was actually distributed or distributable to him in that year (***United States v. Basye***, 410 US 441, 35 L Ed 2d 412, ***reh denied*** 411 US 940, 36 L Ed 2d 402).

The Tax Appeals Tribunal, in ***Wertheimer***, discussed the relationship of section 706(a) of the Internal Revenue Code, the Court of Appeals' decision in ***McNulty*** and the Tax Law and regulations as they existed at that time. The Tribunal stated that:

> Recognizing that the taxpayer's distributive share of partnership income did not indicate actual receipt of the income, the Court of Appeals in ***McNulty*** found the harm of regulation 148.6 to be that it compelled the taxpayer to report all of his partnership income on one of two returns "regardless of when the income was *actually received*" (***Matter of McNulty v. New York State Tax Commn.***, ***supra***, 522 NYS2d 103, 104, emphasis added). The Court concluded that this was inconsistent with section 654 which required an allocation that reflects "either the *actual date of receipt* and expenditure or encompasses an annual amount distributed on a proportionate basis" (***Matter of McNulty v. New York State Tax Commn.***, ***supra***, 522 NYS2d 103, 104, emphasis added). In our view, the holding of ***McNulty*** is that where a partner's distributive share of income is reported without regard to actual receipt, the only possible method of allocation under section 654 is on a proportionate basis throughout the year.

H. The Division contends that the ***McNulty*** Court was concerned only with the mismatching which would occur if exemptions and deductions were to be prorated between two returns and partnership income was not handled in the same manner. The Division reasons that

since two returns are no longer required under the current statutory scheme, ***McNulty*** is no longer applicable.

However, ***McNulty*** was concerned with the proper interpretation of the statutory language set forth in former section 654 of the Tax Law. In reviewing this language the Court of Appeals determined that "Section 654 . . . evinces a clear legislative intent that most forms of income, as well as exemptions and standard deductions, be allocated between the taxpayer's resident and nonresident returns. . . ." In support of this conclusion the Court cited former paragraphs (b), (e) and (f) of section 654 and compared these 2 paragraphs (c) and (i).

Former section 654(b)[9] set forth the general rule that in determining the income of an individual who changes his residency during the year, the year of change should be treated as two separate years - one encompassing the period of residence and one encompassing the period of nonresidence. This section is similar to former section 638 which was applicable during the year at issue..

Former section 654(c) and (i) set forth certain exceptions to the general rule. Specifically, former section 654(c) required that certain types of income be accrued to the period of residence or nonresidence regardless of the taxpayer's method of accounting. This concept was continued in the statutory scheme in former section 638(c). Likewise, former section 654(i) set forth a special rule concerning the proper tax treatment of lump sum distributions which is continued in section 637.

The Court of Appeals stated in ***McNulty*** that the intent of the Legislature in enacting former section 654 was that all income not specifically dealt with in a different manner by former

[9]Section 654(e) and (f) were concerned with the proration of personal exemptions and standard deductions and are not relevant under the current statutory scheme.

section 654 was to be prorated between the resident and nonresident periods. In support of its conclusion as to legislative intent, the Court cited paragraph (b) of former section 654 and contrasted it with paragraphs (c) and (i) of former section 654. The Court concluded that if proration was not the general rule the Legislature intended, there would be no reason to provide exceptions to this general rule in former section 654(c) and (i).

Although the mismatching of exemptions and deductions with income was present in ***McNulty***, there is nothing in the language of the Court of Appeals decision which would limit its holding to situations where only mismatching is present. Rather, the language used by the Court is sufficiently broad to apply to the present matter, inasmuch as former section 654 is similar to sections 637 and 638 as applicable to the year at issue. The Court stated that "section 654 . . . evinces a clear legislative intention that most forms of income . . . be allocated between the taxpayer's resident and nonresident returns . . .," and in light of the similarities between the sections of the Tax Law involved in the ***McNulty*** matter and those involved herein, such language is properly applicable to the matter at issue. 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.

I. The Division maintains that because a single return was required by the Tax Reform and Reduction Act of 1987, obviating the need for proration between returns, proration of partnership income should not be allowed in the numerator of the New York source fraction. The Division also states that its position "conforms with the Federal principle embodied in § 706 of the Internal Revenue Code that partnership items are recognized by a partner at the time the partnership taxable year ends." (Division's brief, page 6.)

The issue in this matter is not the time when partnership income is reported to the taxing authority but the time such income is deemed to be earned by the partners. The result of the Division's position is to give Internal Revenue Code § 706 a meaning beyond its purpose.

The basic rules under which partnership income or loss is computed, characterized and taxed to the partners are set forth in sections 701 through 704 and 706 of the Internal Revenue Code. These rules represent a blending of the aggregate (or conduit) and entity concepts of partnership taxation. The first concept is that a partnership is simply an aggregation of individuals, each of whom should be treated as the owner of a direct undivided interest in partnership assets and operations. The second concept is that a partnership is a separate entity, apart from its partners. Under this view, a partner has no direct interest in partnership assets or operations, but only an interest in the partnership entity separate and apart from its assets and operations. (McKee, Nelson & Whitmore, Federal Taxation of Partnerships and Partners, ¶ 1.02).

The Internal Revenue Code combines the aggregate and entity concepts in developing a comprehensive scheme for the taxation of partnerships (***see,*** Subchapter K, Part I). The aggregate concept predominates in those areas dealing with the taxation of partnership income to the partners and the general nonrecognition sections concerning contributions to and distributions from partnerships. Examples of the application of the aggregate concept include the requirement that partners take into account their "distributive shares" of partnership profit or loss, regardless of whether the partnership makes actual distributions to them (IRC § 702[a]), and the preservation of each item of partnership income, gain, loss, deduction or credit in the hands of the partners (IRC §§ 702[a], [b]). The entity approach predominates in the treatment of transfers of partnership interests as transfers of interests in a separate entity rather than in the assets of the partnership. Examples of the application of the entity concept include the requirement that a

partnership compute separately its “taxable income” (IRC § 703[a]), the provision for the filing of a separate partnership tax return (IRC § 6031) and the provision that a partnership have its own taxable year that, although usually coexisting with the taxable years of its partners, is nonetheless separate from their tax years (IRC § 706[a]). However, neither concept is exclusive to the areas in which they predominate and there is some crossover occurring by both concepts. (Mc Kee, Nelson & Whitmore, supra at ¶ 1.02[3]). The relationship between the entity concept applied in the determination of partnership income and the conduit principle applied to the taxation of that income was described by the United States Supreme Court in ***United States v. Basye**, **(supra)**,* as follows:

> For [the purpose of calculating partnership income], the partnership is regarded as an independently recognizable entity apart from the aggregate of its partners. Once its income is ascertained and reported, its existence may be disregarded since each partner must pay a tax on a portion of the total income as if the partnership were merely an agent or conduit through which the income passed.

Thus, the Internal Revenue Code provides a clearly defined separation between the treatment of a partnership as a separate entity for purposes of determining its income and the taxation of partnership income, once determined, to the partners under the conduit approach.

J. A partnership, as a tax-reporting entity, has its own taxable year separate from the taxable years of its partners. A partner includes his distributive share of partnership income on his return for his taxable year with or within which ends the partnership year during which the income was realized, in accordance with the partnership’s method of accounting (Internal Revenue Code § 706[a]). Prior to the enactment of the 1954 Code, a new partnership could adopt any taxable year without regard to the taxable years of its partners. As a result, many partnerships adopted taxable years designed to maximize the deferral of the payment of tax on partnership income by partners. Section 706(b)(1) of the 1986 Code severely circumscribes the

ability of a partnership to adopt or change to a taxable year that provides significant tax deferral. As a result, both the opportunity for deferral on partnership income and the danger of bunching more than twelve months of partnership income on a partner's return for a single year have been minimized. (McKee, Nelson & Whitmore, ***supra,*** at ¶ 9.01[1]).

K. It is a well-established concept that a partner is deemed to earn income as it is earned by the partnership (***see***, ***Richardson v. Commissioner,*** 693 F2d 1189***; Snell v. United States,*** 680 F2d 545, ***cert denied*** 459 US 989, 74 L Ed 2d 384; ***Williams v. United States,*** 680 F2d 382; ***Rodman v. Commissioner,*** 542 F2d 845; ***Marriot v. Commissioner***, 73 TC 1129; ***Moore v. Commissioner***, 70 TC 1024). Each of the above cases involved a similar factual pattern: a partner was admitted into the partnership late in the year and the partnership attempted to allocate to that partner a pro rata portion of the partnership income or loss for the entire year. In each case, the court rejected this attempt, relying on the assignment of income doctrine. As the court stated in ***Williams v. United States*** (***supra***):

> Under this doctrine, which is applicable to allocation of partnership income to partners [citations omitted], income is taxable only to the person who earns it . . . . Thus, the courts have recognized that partnership agreements allocating to a new partner a portion of partnership profits or losses attributable to the period prior to the partner's entry into the partnership violate the assignment of income doctrine.

This would not have been the result if the income was determined to be earned on the last day of the partnership year, a conclusion necessary to achieve both the results requested by the taxpayers in the above-cited cases as well as the result put forth by the Division in the present matter.

L. Section 706 of the Internal Revenue Code is consistent with the assignment of income doctrine and the principle that a partner earns income as it is earned by the partnership. The language of 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. That language merely describes in which taxable year the partnership items should be included in the taxable income of a partner (Rev Rul 77-311, 1977-2 C.B. 218; Rev Rul 77-310, 1977-2 C.B. 217). This principle was further developed in Rev Rul 94-40, 1994-1 C.B. 274, which held that a Real Estate Investment Trust ("REIT") had to take into account its share of a partnership's income ratably throughout the year for purposes of determining the REIT's required distribution under IRC § 4981, as opposed to deeming all of the income earned on the last day of the partnership's year.

M. The principle that the income of the partnership is not deemed earned on the last day of the partnership taxable year, but rather is treated as earned ratably throughout the year, is recognized elsewhere in the Internal Revenue Code, most notably in section 6654 dealing with penalties imposed for failure to make estimated tax payments. In determining whether a taxpayer qualifies for an exception to these penalties, section 6654(d)(2) authorizes a taxpayer to gear his installment payment to his taxable income for the months in the taxable year ending before the month in which the installment of estimated tax is required to be paid. The Internal Revenue Service's Treasury Regulation § 1.6654-2(d)(2)(ii)(B), following the concept of income being earned ratably throughout the year, provides, in relevant part, as follows:

> In determining a partner's taxable income . . . for the months in his taxable year which precede the month in which the installment date falls, the partner shall take into account items set forth in section 702 . . . to the extent such items are attributable to months in such partnership taxable year which precede the month in which the installment date falls.

The approach taken in the regulation was followed in ***Stewart v. United States***, (263 F Supp 451). In that case, a partner in an investment banking firm put forth the position that no estimated tax was due on partnership income until the conclusion of the partnership year, i.e., that the income was not earned until the end of the year. The court rejected this contention,

holding that the accrued income of the partnership for the months preceding the due date of an estimated tax payment is "certainly taxable income for purposes of a partner's estimated payments regardless of when the taxable year of the partnership ends" (***id.,*** at 456). In addition, New York State follows the Federal rule that partnership income is deemed earned ratably throughout the year for purposes of computing estimated tax payments (***see***, 20 NYCRR 185.3[j]).

N. Contrary to the Division's position, section 706(a) does not determine the date on which partnership income is deemed earned, only when such income is to be reported. The purpose of section 706 was to address the problem of partners deferring the payment of tax on partnership income. In contrast, former section 638 as applicable to the year at issue and former section 654 were concerned with the period in which a partner had earned partnership income. 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) is not supportable of 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.

As previously discussed, the statutory scheme present in ***McNulty*** is similar to that found in the present matter. 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 be allocated between petitioner's resident and nonresident periods "in a manner that either reflects the actual date of receipt or expenditure or encompasses an annual amount distributed on a proportionate basis" (***Matter of McNulty v. New York State Tax Commn., supra).*** By requiring that annual partnership distributions be reported in their entirety during one of two

periods, without regard to either when the distributions are received or to proration, 20 NYCRR 154.6(a)(3)(i) is inconsistent with this legislative policy (***Matter of McNulty v. New York State Tax Commn., supra).*** Even if, as the Division contends**,** the State policy conforms to the Federal policy as provided in section 706(a) of the Internal Revenue Code, consistency with the reporting approach provided in Tax Law former § 638 requires that petitioner be permitted to prorate the annual amount of the partnership distributions and allocate that amount proportionately between the resident and nonresident periods.

O. The petition of Robert T. and Susan M. Greig is granted and the Notice of Deficiency issued on September 9, 1996 to petitioners is canceled.

DATED: Troy, New York
July 30, 1998

/s/ *Thomas C. Sacca*
ADMINISTRATIVE LAW JUDGE