

## BUREAU OF LAW

## MEMORANDUM

*Income Tax Determinations*  
*A-2*  
*Pearlstone, William*

TO: **State Tax Commission**

FROM: **Francis V. Dow, Hearing Officer**

SUBJECT: **WILLIAM PEARLSTONE**

**In the Matter of the Application  
for Revision or Refund of Personal  
Income Taxes under Article 22 of  
the Tax Law for the Year 1960**

**In the Matter of the Petition for  
a Redetermination of a Deficiency  
or for Refund of Personal Income  
Taxes under Article 22 of the  
Tax Law for the Year 1962**

A formal hearing with reference to the above matters was held before me at 80 Centre Street, New York, New York on November 18, 1966. The appearances and the evidence produced were as shown in the stenographic minutes and exhibits submitted herewith.

The issue involved herein is whether the taxpayer, in computing his New York adjusted gross income, can modify his Federal adjusted gross income by deducting therefrom undistributed taxable income of a corporation which made an election under Subchapter S of the Internal Revenue Code.

The taxpayer filed a resident income tax return for the year 1960 in which he reported Federal adjusted gross income of \$10,803.17 which he modified by subtracting therefrom \$3,108.30 in computing New York adjusted gross income. The \$3,108.30 represented the taxpayer's share of undistributed taxable income of Nu-Rose Drug Company, Inc., a corporation which had made an election under Subchapter S of the Internal Revenue Code. The taxpayer filed a resident income tax return for the year 1962 in which he reported Federal adjusted gross income of \$11,003.16. The taxpayer modified his Federal adjusted gross income by subtracting \$1,403.71, undistributed taxable income of Nu-Rose Drug Company, Inc. in computing his 1962 New York adjusted gross income.

An assessment was issued against the taxpayer for the year 1960 (Assessment No. B-976818) on August 21, 1961 which assessed

additional personal income tax due in the amount of \$66.36 on the basis that the Tax Law contains no provision for a modification of Federal adjusted gross income by excluding taxable income of a Subchapter S corporation. A notice of deficiency and a statement of audit changes were issued for the year 1962 on July 12, 1963 (File No. 2-7906770) determining additional tax and interest due in the sum of \$82.40 on the basis that undistributed taxable income from a Subchapter S corporation is not a proper deduction from Federal adjusted gross income.

The taxpayer is a shareholder in Nu-Rose Drug Company, Inc., a small business corporation which elected not to be subject to the Federal income tax pursuant to the provisions of Subchapter S, sections 1371 et seq. of the Internal Revenue Code. The Nu-Rose Drug Company, Inc. filed its said election in 1960 which election has been in effect continuously since its initial filing. Nu-Rose Drug Company, Inc. filed New York franchise tax returns for 1960 and 1962 and reported its entire net income on such returns.

The taxpayer contends that the Legislature did not intend that resident New York taxpayers be taxed on undistributed taxable income of corporations which made elections under Subchapter S of the Internal Revenue Code and that an interpretation of the Tax Law holding such income taxable is unconstitutional, confiscatory, arbitrary and results in a duplication of tax.

Under the provisions of the Internal Revenue Code if Nu-Rose Drug Company, Inc. had not made an election under Subchapter S, its taxable income would be subject to the Federal income tax whether or not it was distributed to its shareholders. Such income when distributed to its shareholders is again taxable. If such income is not distributed, it is not taxable as income to the shareholders. The corporation by making an election under Subchapter S not to be subject to the income tax requires that its undistributed taxable income be reported by its shareholders and is taxable as income received whether or not it is distributed.

Section 612 of the Tax Law defines New York adjusted gross income of a resident as his Federal adjusted gross income with the modification specified under that section. Section 612 of the Tax Law makes no provision for the modification from Federal adjusted gross income by the amount of undistributed taxable income of a corporation which has made an election under Subchapter S of the Internal Revenue Code.

Article XVI, section 3 of the State Constitution provides that "Undistributed profits shall not be taxed." The record of the 1938 Constitutional Convention which added this clause to the Constitution indicates that the intent was merely to prohibit a tax similar to the Federal "surtax on undistributed profits" imposed by section 14 of the Revenue Act of 1936 which had aroused great opposition. The Federal surtax was imposed upon corporations and applied to undistributed income earned during the current year. This was in addition to the Federal income tax imposed on corporations on all earnings whether or not distributed.

Section 208, subdivision 9 of Article 9-A of the Tax Law defines entire net income of a business corporation as its total net income from all sources, which shall be presumably the same as the entire taxable income which such taxpayer would have been required to report if it had not made an election under Subchapter S of Chapter 1 of the Internal Revenue Code.

The New York unincorporated business tax manifests the intent to reach by tax those vocations which, if conducted in corporated form, would be the subject of taxation. If the business of Nu-Rose Drug Company, Inc. had not been incorporated, it would have been subject to the unincorporated business tax. The income from the business would be subject to the unincorporated business tax and it would also be taxable as income to the owners of the business under the personal income tax whether or not such income was distributed.

Here the undistributed taxable profits of Nu-Rose Drug Company, Inc. are not being subjected to an additional franchise tax. Since Article 9-A does not consider the election in computing franchise taxes the only result is to accelerate the payment by the shareholders of personal income tax on undistributed dividends as a result of the corporation making an election under Subchapter S of the Internal Revenue Code. If such income is distributed to the shareholders of the corporation, in a year subsequent to the current year, it will not be subject again to New York personal income tax. Such undistributed taxable income will not again be included in Federal adjusted gross income in any subsequent year. There is consequently one franchise tax and one income tax imposed on such undistributed earnings.

Even if the difference between Article 9-A and Article 22 treatment could be deemed the imposition of tax on undistributed profits in derogation of Article XVI, section 3 of the Constitution, Article XIX, section 22 as amended November 3, 1959 provides in part as follows:

"Notwithstanding the foregoing or any other provision of this constitution, the legislature, in any law imposing a tax or taxes on, in respect to or measured by income, may define the income on, in respect to or by which such tax or taxes are imposed or measured, by reference to any provision of the laws of the United States as the same may be or become effective at any time or from time to time, and may prescribe exceptions or modifications to any such provisions."

The Constitution there permits Federal conformity "Notwithstanding . . . any other provision of this constitution". This is supported by Matter of Garlin v. Murphy, et al., 51 Miss 2d 477 presently pending appeal where the court sustains the constitutionality of section 612 of the Tax Law taxing undistributed taxable income.

For the reasons stated above I recommend that the determinations of the State Tax Commission denying the taxpayer's application and petition in the above matters be substantially in the form submitted herewith.

/s/

FRANCIS V. DOW

HEARING OFFICER

FVB:lb  
Enc.

March 25, 1968

4-3-68

STATE OF NEW YORK  
STATE TAX COMMISSION

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IN THE MATTER OF THE PETITION :

OF :

WILLIAM PEARLSTONE :

FOR REDETERMINATION OF A DEFICIENCY OR :  
FOR REFUND OF PERSONAL INCOME TAXES :  
UNDER ARTICLE 22 OF THE TAX LAW FOR THE :  
YEAR 1962 :

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William Pearlstone, the taxpayer herein, having filed a petition for redetermination of a deficiency or for refund of personal income taxes under Article 22 of the Tax Law for the year 1962, and a hearing having been held in connection therewith at the office of the State Tax Commission, 80 Centre Street, New York, New York on November 18, 1966 before Francis V. Dow, Hearing Officer of the Department of Taxation and Finance, at which hearing the taxpayer's representative appeared and testified, and the record having been duly examined and considered,

The State Tax Commission hereby finds:

(1) That the taxpayer filed a resident New York income tax return for the year 1962 in which he reported Federal adjusted gross income of \$11,003.16; that he deducted from his Federal adjusted gross income \$1,403.71, his share of undistributed taxable income from Bu-Rose Drug Company, Inc., in computing his New York adjusted gross income.

(2) That a notice of deficiency and a statement of audit changes were issued for the year 1962 on July 12, 1963 (File No. 2-7906770) which determined additional income tax and interest due in the sum of \$82.40 on the basis that undistributed profit for a Subchapter S corporation is not a proper deduction from Federal adjusted gross income.

(3) That the Nu-Rose Drug Company, Inc. had elected to be subject to the provisions of Chapter 1, Subchapter S, sections 1371 through 1377 of the Internal Revenue Code, which election was in effect for the year 1962 which resulted in the inclusion of undistributed taxable income in the Federal and New York State adjusted gross income of the shareholders.

(4) That the taxpayer contended that the Legislature did not intend resident taxpayers to be taxed on their share of undistributed taxable income of corporations making an election under Subchapter S of the Internal Revenue Code, and that the interpretation of the New York Tax Law which subjects such income to personal income tax is unconstitutional, confiscatory, arbitrary and results in a duplication of tax.

Based upon the foregoing findings and all of the evidence presented herein, the State Tax Commission hereby

**DECIDES:**

(A) That the taxpayer's share of undistributed taxable income of the Nu-Rose Drug Company, Inc. was part of the taxpayer's Federal adjusted gross income; that New York State personal income tax was properly imposed on such income, pursuant to section 612 of the Tax Law, since such section provides that the New York adjusted gross income of a resident individual means his Federal adjusted gross income, as defined in the laws of the United States for the taxable year, with the modifications specified in that section; that section 612 of the Tax Law does not provide for any modifications permitting a subtraction of such income from the taxpayer's Federal adjusted gross income in computing his New York adjusted gross income; that section 612 of the Tax Law was enacted in accordance with the provisions of Article XII, section 22 of the New York State Constitution which provides that the Legislature, in any law imposing a tax on income, may define the income

on which the tax is imposed by reference to any provision of the laws of the United States; that the imposition of tax on such income does not violate any provision of the New York State Constitution.

(B) That the notice of deficiency and the statement of audit charges determining additional income tax and interest due in the sum of \$82.40 for the year 1962 are correct and do not include any tax or other charges which could not have been lawfully demanded and the taxpayer's petition for redetermination or refund of the deficiency for the year 1962 be and the same is hereby denied.

DATED: Albany, New York on this 25th day of April, 1968.

**STATE TAX COMMISSION**

/s/

JOSEPH H. MURPHY

**PRESIDENT**

/s/

A. BRUCE MANLEY

**COMMISSIONER**

/s/

SAMUEL E. LEPLER

**COMMISSIONER**

**STATE OF NEW YORK**  
**STATE TAX COMMISSION**

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**IN THE MATTER OF THE APPLICATION**

**OF**

**WILLIAM PEARLSTONE**

**FOR REVISION OR REFUND OF PERSONAL  
INCOME TAXES UNDER ARTICLE 22 OF THE  
TAX LAW FOR THE YEAR 1960**  
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William Pearlstone, the taxpayer herein, having filed an application for revision or refund of income taxes under Article 22 of the Tax Law for the year 1960, and a hearing having been held in connection therewith at the office of the State Tax Commission, 80 Centre Street, New York, New York on November 18, 1966 before Francis V. Dow, Hearing Officer of the Department of Taxation and Finance, at which hearing the taxpayer's representative appeared and testified, and the record having been duly examined and considered,

**The State Tax Commission hereby finds:**

(1) That the taxpayer filed a resident New York income tax return for the year 1960 in which he reported Federal adjusted gross income of \$10,805.17; that he deducted from his Federal adjusted gross income \$3,108.80, his share of undistributed taxable income from Nu-Rose Drug Company, Inc., in computing his New York adjusted gross income.

(2) That an assessment was issued for the year 1960 on August 21, 1961 (Assessment No. B 976818) which assessed additional income tax due in the amount of \$66.96 on the basis that the New York Tax Law contains no provision for modification of Federal adjusted gross income in computing New York adjusted gross income by deducting therefrom undistributed profits from a corporation which elected not to be subject to income tax pursuant to Chapter 1, Subchapter S of the Internal Revenue Code.



(3) That the Nu-Rose Drug Company, Inc. had elected to be subject to the provisions of Chapter 1, Subchapter S, sections 1371 through 1377 of the Internal Revenue Code, which election was in effect for the year 1960 which resulted in the inclusion of undistributed taxable income in the Federal and New York State adjusted gross income of the shareholders.

(4) That the taxpayer contended that the Legislature did not intend resident taxpayers to be taxed on their share of undistributed taxable income of corporations making an election under Subchapter S of the Internal Revenue Code, and that the interpretation of the New York Tax Law which subjects such income to personal income tax is unconstitutional, confiscatory, arbitrary and results in a duplication of tax.

Based upon the foregoing findings and all of the evidence presented herein, the State Tax Commission hereby

**DETERMINE;**

(A) That the taxpayer's share of undistributed taxable income of the Nu-Rose Drug Company, Inc. was part of the taxpayer's Federal adjusted gross income; that New York State personal income tax was properly imposed on such income, pursuant to section 612 of the Tax Law, since such section provides that the New York adjusted gross income of a resident individual means his Federal adjusted gross income, as defined in the laws of the United States for the taxable year, with the modifications specified in that section; that section 612 of the Tax Law does not provide for any modifications permitting a subtraction of such income from the taxpayer's Federal adjusted gross income in computing his New York adjusted gross income; that section 612 of the Tax Law was enacted in accordance with the provisions of Article III, section 22 of the New York State Constitution which provides that the Legislature, in any law imposing a tax on income, may define the income

on which the tax is imposed by reference to any provision of the laws of the United States; that the imposition of tax on such income does not violate any provision of the New York State Constitution.

(B) That the assessment for the year 1960 (Assessment No. B 975818) is affirmed; that such assessment together with interest and other statutory charges is correct and does not include any tax or other charges which are not lawfully due and owing; that the taxpayer's application for revision with respect to the assessment be and the same is hereby denied.

DATED: Albany, New York on this 25th day of April, 1968.

**STATE TAX COMMISSION**

/s/

JOSEPH H. MURPHY

**PRESIDENT**

/s/

A. BRUCE MANLEY

**COMMISSIONER**

/s/

SAMUEL E. LEPLER

**COMMISSIONER**