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New York Proposed Regulations on Taxation of Corporate Partners and Sourcing of Income from Stock Options

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The New York State Department of Taxation and Finance ("Department") has recently issued proposed regulations regarding two issues that been the subject of much debate and controversy, especially during audits, for many years. The two issues are the taxation of corporate partners and the allocation and sourcing of income for individuals from stock options, restricted stock, and stock appreciation rights. What follows is a summary of the highlights of the proposed regulations.

I. Taxation of Corporate Partners

For some time, corporations owning interests in partnerships, joint ventures, or limited liability companies and doing business in New York have needed more clear guidance on the proper computation of tax under New York State State's General Business Corporation Franchise Tax. In response to repeated calls from auditors, taxpayers and practitioners, the Department has issued for comment, draft regulations aimed at providing comprehensive guidance for corporate partners.

Aggregate vs. Entity Method

Under the proposed regulations, corporations must compute tax under either the aggregate or entity method with respect to partnership interests owned by a corporation. Under the aggregate method, a corporate partner must take into account its distributive share of the partnership's assets, liabilities and items of receipts, income, gain, loss and deduction. In addition, the source and character of these items in the hands of the partnership are to be followed by the corporate partner. Under the entity method, the corporate partner's interest in the partnership is treated as an intangible asset.

The ability to use either the aggregate or entity method is not elective. The aggregate method is required if the taxpayer has the information necessary to utilize the aggregate method. The new rules create a presumption that the information necessary to calculate the tax utilizing the aggregate method is available to a corporate taxpayer if certain conditions are satisfied. For example, if the corporation is a general partner of the partnership, or if it conducts a unitary business with the partnership, the corporate partner is deemed to have the information and must utilize the aggregate method.

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Where none of the conditions are satisfied, corporate taxpayers are required to use the entity method.

While the aggregate method is the preferred method, the regulations do take into account the reality that corporate partners may not always have access to information with the level of detail necessary to calculate the tax under the aggregate method. Thus, the presumption of having access to the information is rebuttable.

The importance of determining which method to apply is heightened as a result of New York's taxing scheme. New York's calculation does not incorporate the common business versus non-business income scheme. New York is unique in that all capital (and income) of a corporation is divided into one of three categories: business, investment, or subsidiary. Income from business and investment capital is included in taxable income under New York's Entire Net Income base. In contrast, all dividends, interest and gains from subsidiary capital are excluded from taxable income. Therefore, determining whether an item of capital at the partnership level is either business or investment may significantly impact the tax liability of a corporate partner.

Subsidiary Capital

Except for the limited exception discussed below, partnership income is not treated as derived from subsidiary capital – even under the aggregate method. Under the aggregate method, the determination of whether an item is classified as either business or investment capital is made at the partnership level. Under the entity method, all income will be treated as from business capital. A discussion of the treatment of subsidiary capital follows.

Under the new rules, the aggregate method is not exactly aggregate when it comes to determining subsidiary capital. A subsidiary is defined as "a corporation over 50 percent of the voting stock of which is owned by the taxpayer."[1] The new rules state that stock held by a partnership cannot be treated as a "subsidiary" of a corporate partner because the stock is not directly held by the corporation. Thus, generally, a partnership's income generated by holding or disposing of stock is not treated as income from subsidiary capital and not excluded from taxable income.

The exception to this rule occurs where the corporate partner directly owns more than 50 percent of the corporation in which the partnership also holds stock. This is illustrated in the following example: Corporation X owns 60% of Corporation Y, which has 100 shares outstanding, and 80% of Partnership Z. Partnership Z owns 10% of Corporation Y. Due to the fact that Corporation X directly owns more than 50% of Corporation Y, Corporation X would include the proportionate part of the 10% of Corporation Y owned by Partnership Z (80% X 10% = 8 shares) in determining subsidiary capital. Thus, Corporation X would include 68 shares of Corporation Y in its subsidiary capital.

[1] N.Y.S. Reg. § 3-6.2(a).

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New Tax Form?

According to the Regulatory Impact Statement issued by the Department regarding the new rules, the form by which partnerships should furnish information to corporate partners is currently in development. The main goal of the form is to provide corporate partners with the necessary details to facilitate computation of the corporate partner's tax liability. One issue that the Department will face is determining the due date for providing the form to a corporate partner. A partnership may not have the information required to be provided to a corporate partner in time for a corporate partner's normal due date. Accordingly, the new rules may cause more corporations to file extension requests. Partnerships that are required to file a return in New York should watch for guidance on the new form.

Effective Date

The new rules are intended to be effective for taxable years beginning on or after January 1, 2007.

II. Sourcing Income from Stock Options, Restricted Stock, and Stock Appreciation Rights

The decision of the New York State Tax Appeals Tribunal ("Tribunal") in *Matter of Stuckless*, DTA No. 819319 (August 17, 2006), was the main catalyst for the issuance of new rules regarding the sourcing of employee deferred compensation in the form of stock options, restricted stock and stock appreciation rights. The *Stuckless* decision called into question the precedential value of the Department's administrative guidance on the issue. From 1995 until the *Stuckless* decision, TSB-M-95(3)I was the leading authority in this area. The *Stuckless* decision led to legislation requiring the issuance of regulations in this area within 180 days from the passage of the most recent state budget bill.

The Stuckless Decision

The taxpayer in *Stuckless* was granted incentive stock options ("ISO") by his employer, Microsoft Corporation, in various amounts during 1991 and 1992. The taxpayer was a resident of New York at the time he was granted the ISOs by Microsoft. On September 1, 1996, the taxpayer moved to Washington State and continued his employment with Microsoft. While a resident of Washington, during 1997 and 1998, the taxpayer exercised the stock options granted to him in 1991 and 1992. The taxpayer moved back to New York in July of 1998.

The Department audited the taxpayer for the years 1997 and 1998. The taxpayer did not file a New York State personal income tax return for 1997 and filed a Nonresident and Part-Year Resident Income Tax Return for 1998.

Under TSB-M-95(3)I, the taxpayer was required to allocate a portion of the option income based on a fraction, the numerator of which is the total days worked in New

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York during the compensable period (*i.e.*, the date of grant to the date of exercise) and the denominator of which is the total number of work days during the compensable period.

With respect to 1997, the taxpayer's position was that, as a nonresident, none of the income received as a result of exercising the ISO was New York source income. On the return filed for 1998, the taxpayer did not source any income from options exercised prior to changing residency from Washington to New York. In contrast, the Department's position was that a portion of the ISO income should have been sourced to New York under the methodology set forth in TSB-M-95(3)I.

The Tribunal rejected the Department's assertion that the rules in the TSB should be followed and given deference by the Tribunal. The Tribunal, after analyzing the applicable regulations, found in favor of the taxpayer and canceled the assessment. According to the Tribunal, if the Department desired to depart from the existing regulations, such departure should be effected through legislation or regulation.

Regulatory Allocation Period

Certain rules have changed for determining the period over which deferred stock-based compensation is allocated. The allocation period is no longer simply the period from the "date of grant" to the "date of excersise" as set forth in TSB-M-95(3)I. Under the new regulation, the "applicable allocation period" for determining New York source income related to (i) statutory stock options, (ii) nonstatutory stock options with no readily ascertainable value at the time of grant, and (iii) stock appreciation rights, is from the date of grant to the vesting date. If the taxpayer is vested in the option at the time of grant, the income is sourced the same as regular, non-stock based remuneration (*i.e.*, regular wages) during the year of grant.

For nonstatutory stock options that have a readily ascertainable value, the regular, non-stock based remuneration during the taxable year the option was granted.

In the case of restricted stock, the allocation period is from the date the stock was received until the date the stock is substantially vested (*i.e.,* until the stock is transferable or not subject to a substantial risk of forfeiture). However, for dividends paid on restricted stock, the income is sourced the same as regular, non-stock based remuneration during the year that such dividends were received.

Impact on Employers

Employers are required to apply the new rules with respect to withholding on income from stock options, restricted stock and stock appreciation rights. Accordingly, it is advisable to apprise payroll departments of the new rules. The Department has been aggressively auditing employers since the issuance of Withholding Tax Field Audit Guidelines in April of 2005.

Effective Date

The new sourcing rules are intended to be effective for taxable years beginning on or after January 1, 2006.■

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