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New York's Changes to Tax Policy Have Downsides for Nonresidents

By: Joseph Lipari and Debra Silverman Herman

New York has had a longstanding tradition of encouraging nonresident individuals to keep their money, securities and other intangible property in New York, and has maintained a tax policy in sync with this goal.[1] Under the New York Constitution, intangible personal property, such as stock and partnership interests, is deemed for tax purposes "to be located at the domicile of its owner," unless such intangible property is used in a New York trade or business (e.g. a liquor license or stock held as inventory by a dealer). Moreover, the State is barred from imposing any tax other than a tax "measured by income generally" (i.e. property tax) on intangible personal property.[2] Based on this provision, nonresident taxpayers have generally not been subject to Personal Income Tax on income earned from intangible assets, including the sale of stock or a partnership interest,[3] nor have intangibles of nonresident decedents been subject to New York Estate Tax.[4] In contrast, nonresidents are generally subject to tax on income derived from real and tangible personal property located in New York.

This article discusses two recent items that throw a monkey wrench into New York's historic tax policy. In both instances, the State is reclassifying the sale or ownership of an intangible property interest (stock or limited liability company interests) thereby treating it as if it were the sale or ownership of a real property interest. The first item is legislation enacted as a part of the 2009-2010 New York Executive Budget Bill that treats gain on the sale of interests in certain C corporations, limited liability companies and other entities classified as partnerships and S corporations, as New York source income for nonresident individuals, provided that 50 percent or more of the value of the total assets of the entity on the date of sale of the interest is real estate located in New York.[5] Since this provision is similar to the Federal FIRPTA provision[6] that applies when a nonresident alien sells an interest in an entity that owns real estate in the U.S. it is referred to as the "FIRPTA Provision."

The second item is a recent Advisory Opinion issued by the New York State Department of Taxation and Finance ("Department"), involving the issue of whether a nonresident decedent's interest in either an S corporation or a single member limited liability company owning real property in New York is subject to New York estate tax.[7] The Department concluded that the value of any New York real estate held by a nonresident decedent through an ownership interest in a single member limited liability company that has made an election under the Federal check-the-box regulations[8] to be disregarded for federal income tax purposes ("Disregarded SMLLC") will be subject to New York Estate Tax. A contrary ruling was reached with respect to real estate held by a nonresident decedent through an ownership interest in an S corporation.

Taxation of Nonresident Individuals

A nonresident individual is subject to tax only on New York source income, in contrast to a resident individual who is subject to tax on worldwide income. A nonresident has New York source income with respect to items of income, gain, loss and deduction attributable to (i) the ownership of any interest in real or tangible personal property located in New York, (ii) a business, trade, profession or occupation carried on in New York, (iii) certain lottery winnings, and (iv) gains from the sale, conveyance or other disposition of shares of stock in a cooperative housing corporation and the grant or transfer of the proprietary leasehold (the "Definition of New York Source Income").[9] Further, a nonresident's distributive share of partnership or S corporation income that is derived from or connected with New York sources produces New York source income.[10]

In contrast, income from intangibles is ordinarily taxable only by the state of the owner's domicile.[11] Most states, including New York, generally limit their taxes on income derived from intangibles to income from intangible

Joseph Lipari *and* ***Debra S. Herman*** *are partners in the law firm of Roberts and Holland LLP.*

personal property that is used in a business in a state or has acquired a business situs there. New York Tax Law Section 631(b)(2) invokes the business situs principle stating "income from intangible personal property, including annuities, dividends, interest, and gains from the disposition of intangible personal property, shall constitute income derived from New York sources only to the extent that such income is from property employed in a business, trade, profession, or occupation carried on in this state. Personal Income Tax Regulations Section 132.5 reiterates this rule.

Constitutional Limitations

Historically, limitations on New York's taxation of intangibles has not simply been a matter of legislative choice. Rather, they reflect long understood constitutional limitations on the state's ability to tax nonresidents. Article XVI, §3 of the New York Constitution mandates the limited tax treatment of intangibles owned by nonresidents:

> Moneys, credits, securities and other intangible personal property within the state not employed in carrying on any business therein by the owner shall be deemed to be located at the domicile of the owner for purposes of taxation, and, if held in trust, shall not be deemed to be located in this state for purposes of taxation because of the trustee being domiciled in this state, provided that if no other state has jurisdiction to subject such property held in trust to death taxation, it may be deemed property having a taxable situs within this state for purposes of death taxation. Intangible personal property shall not be taxed ad valorem nor shall any excise tax be levied solely because of the ownership or possession thereof, except that the income therefrom may be taken into consideration in computing any excise tax measured by income generally. Undistributed profits shall not be taxed.

In addition, the Due Process and Commerce Clauses of the United States Constitution have imposed limitations on the right of states to tax nonresidents on income from intangibles.

New York FIRPTA Provision

Part F-1 of the Budget Bill amends the Definition of New York Source Income in the Tax Law to define as "real property" located in New York an interest in a partnership, limited liability corporation, S corporation or non-publicly traded C corporation with one hundred or fewer shareholders (the "Entity") that owns real property located in New York if such real property has a fair market value that equals or exceeds fifty percent of all assets of the Entity on the date of sale of the nonresident's interest in the Entity. Only the assets that the Entity owned for at least two years before the date of sale of the Entity interest are used to determine the value of the Entity's assets, to avoid "stuffing" other assets into the entity prior to a sale. A significant and strange aspect of the legislation is the calculation of the amount of income sourced to New York, which is determined based on the relative values of the Entity's assets, rather than the amount of gain attributable to the New York real property. This means that the provision would tax gain on the sale of stock even in situations where there is no gain attributable to the New York real property held by the Entity (i.e. the gain derived from the individual's sale of stock is attributable to built-in gain on Massachusetts real property owned by the Entity).

As a result of this legislation, a nonresident will be required to determine the value of real property held by the Entity, even if he is not in a position to know or control the amount of such real property held by the Entity (i.e. the nonresident owns a small non-controlling interest in the Entity). The practical effect of this provision is that the Entity will now be required to track and disclose this information to nonresidents of New York to allow them to comply with the law. The nonresident individual will in many cases be subject to double tax on the gain from the sale of the Entity interest by virtue of the individual's home state taxing the income and disallowing any credit for taxes paid to New York. As discussed above, most states follow New York's historical rule and source the gain from the sale of an Entity interest to the individual's state of domicile.

The Memorandum in Support of this legislation indicates that it was necessary because a "nonresident can escape taxation [on the sale of an interest in real property located in New York] by placing the New York real property in an entity and then selling his or her interest in the entity," and that the provision "ensures that gain or loss on the direct or indirect sale of New York real property by a nonresident accomplished through the sale of an interest in an entity is subject to New York personal income tax."[12] However, the new law applies in many situations, not limited to these narrow set of facts.

Taxation of Nonresident Decedents

In the case of a nonresident of New York, the Estate Tax base is the value of any real property and tangible personal property having an actual situs in New York on the date of death.[13] In contrast, residents of New York are taxed on the full amount of their federal taxable estate, reduced by the value of real or tangible personal property having an actual situs outside New York.[14] For purposes of New York's Estate Tax, "residence" means only "domicile."[15]

Estate Tax Advisory Opinion

In an Advisory Opinion, the Department was asked to examine whether a nonresident decedent's interest in either a Florida corporation that elects to be treated as an S corporation under Internal Revenue Code section 1362(a) or a Disregarded SMLLC owning real property (a condominium) in New York on the date of death is subject to New York Estate Tax. The Department ruled that an interest in an S corporation is an intangible and is not included in the nonresident decedent's New York taxable estate, provided that the S corporation's separate corporate existence is bona fide (i.e. the corporation is not a mere sham or alter ego of its owner) under the criteria set forth by the U.S. Supreme Court in *Moline Properties v. Commissioner of Internal Revenue.*[16]

Specifically, the Department states "an interest in a corporation is considered intangible personal property" and "because stock in an S corporation is an intangible, that interest in property is not subject to the estate tax imposed on the estate of a nonresident decedent."[17] This characterization of an S corporation interest is, of course, at odds with the rationale of the FIRPTA Provision.

The Department reached the opposite conclusion with respect to a Disregarded SMLLC interest, stating "if there is no [federal check-the-box] election, applicable to the date of death, to treat the SMLLC as if it were a corporation, the SMLLC would be disregarded for New York estate tax purposes, and the value of the condominium would be included in the nonresident decedent's New York gross estate."[18] This ruling ignores the fact that Disregarded SMLLCs are not nothings under state law, and posses most of the well-established characteristics of duly formed corporations, notwithstanding the Federal income tax rules (followed by the State)[19] that cause them to be disregarded. The Advisory Opinion does not address LLC's with more than one member which are characterized as partnerships for income tax purposes (unless the LLC elects to be taxed as a corporation) but it appears that such tax partnerships would still be viewed as intangibles for purposes of the Estate Tax.

Counter-Attack on New York's Tax Policy

It is expected that at least some sellers of Entity Interests affected by the new FIRPTA Provision and estates adversely affected by the decision reached by the Department in the Estate Tax Advisory Opinion will consider challenges under either the U.S. or New York State Constitutions. Since those challenges will likely take several years to work their ways through the courts, taxpayers and their advisors should review these provisions and their applicability.

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1 N.Y.S. Dep't of Tax'n & Fin., *New York's Tax Policy Relating to the Taxation of Intangible Personal Property of Nonresidents*, TSB-M-92 (3)I, (1)M, Oct. 9, 1992 [hereinafter Intangible Tax Policy].

2 Article XVI, §3 of the New York Constitution. See infra, provision quoted in its entirety in the text of the article.

3 *See* N.Y.S. Dep't of Tax'n & Fin., *New York Tax Treatment of Gains and Losses From the Sale by a Nonresident or Part-Year Resident of an Interest in a New York Partnership* , TSB-M-92 (2)I, Aug. 21, 1992. In contrast to the above rule, a partner's distributive share of partnership income, gain, loss or deduction that is derived from or connected with New York sources is constitutionally subject to New York tax.

4 Intangible Tax Policy, supra note 1, at p.3.

5 See S. 57-B, A 157-B, Part F-1.

6 IRC § 897(c)(1)(A)(ii). FIRPTA itself is not a taxing provision, but rather serves to characterize the gain or loss on a disposition of a U.S. real property interest as effectively connected with the conduct of a trade or business within the United States, thereby making the gain subject to Federal income tax.

7 N.Y.S. Dep't of Tax'n & Fin., TSB-A-08(1)M, Oct. 24, 2008 [hereinafter TSB-A-08(1)M].

8 Treas. Reg. §§301.7701-2(a), - 2(c)(2), -3(a) and -3(b)(1)(ii).

9 N.Y. Tax Law §631(b).

10 N.Y. Tax Law §631(a).

11 "Domicile" is defined in the New York State regulations as "in general . . . the place which an individual intends to be such individual's permanent home -- the place to which such individual intends to return whenever such individual may be absent." N.Y.C.R.R. §105.20(d).

12 *See* 2009-10 New York State Executive Budget, Revenue Article VII Legislation, Memorandum in Support available at http://publications.budget.state.ny.us/eBudget

13 N.Y. Tax Law §960.

14 N.Y.Tax Law §954(a)(1).

15 Under the Personal Income Tax, an individual may be a statutory resident of New York if the individual maintains a permanent place of abode in the state and is physically present in New York in excess of 183 days. N.Y. Tax Law §605(b)(1)(B).

16 319 U.S. 436 (1943).

17 TSB-A-08(1)M, supra note 7.

18 Id.

19 See generally N.Y.S. Dept of Tax'n & Fin., *Important Notice - New York Tax Status of Limited Liability Companies and Partnerships*, TSB-M-94(b)I, Oct. 25, 1994.