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Determination on Sale by S Corporation Explains Allocation Rules

By: Joseph Lipari

New York's Personal Income Tax applies to individuals who are nonresidents of the state. The Corporate Franchise Tax applies to corporations engaged in business both inside and outside the state. Like most states, New York provides a detailed set of rules to determine the portion of the income nonresidents and corporations earn that the state may tax. *Matter of Breitman*,[1] a recent Determination by an Administrative Law Judge of the Division of Tax Appeals, provides a useful explanation of many of the rules.

Steven Breitman, a New York nonresident, owned SEBCO, an S corporation that provided laundry facilities in apartment buildings. SEBCO leased space in buildings in which it installed, maintained, and serviced coin-operated washers and dryers. During the years at issue, SEBCO operated its business in over 4,000 locations over several states, including New York, New Jersey, and Pennsylvania.

A common group owned four of the Pennsylvania properties in which SEBCO leased space. SEBCO's leases for these spaces began in September 1997, with an initial term of ten years.[2] In 2004, the owners agreed to sell the four properties to a buyer who did not want to continue the arrangement with SEBCO. To complete the sale, the owners bought out SEBCO's leases for $500,000. The lease sale agreement between the owners and SEBCO provided that if the sale of the properties did not go through, the parties would cancel the sale and reinstate the leases. The sale did not include the equipment, which SEBCO removed. This was the first time SEBCO had sold any of its leasehold interests.

Since SEBCO was an S corporation that elected S treatment for New York tax purposes, SEBCO's income passed through to Breitman. Breitman reported the SEBCO income on Schedule E of his federal personal income tax return, Form 1040. However, on the ground that the leaseholds had no connection to New York, Breitman did not include the gain from the sale of the leaseholds in the income allocable to New York reported on his New York State nonresident tax return, Form IT-203.

Upon audit, the Tax Division determined that the gain from the sale of the leaseholds was attributable to SEBCO's business, and that a portion of the gain was apportionable to New York. After the Tax Division issued a Notice of Determination, Breitman and the Tax Division resolved some issues at a Conciliation Conference. The remaining issues became the subject of this Determination.

To understand the issue in this case, a refresher lesson in allocation and apportionment is helpful. Although individual residents of New York are taxable on 100 percent of their income, in general, nonresidents of New York are subject to tax only on income allocable to New York under the allocation rules of Tax Law section 631. Such income is characterized as "New York source income."[3] That section provides that nonresidents are taxable on income attributable to real or tangible personal property located in the state, or a business, trade, profession, or occupation carried on in the state.[4]

Separate provisions apply to shareholders of S corporations. Unlike many other states, shareholders of federal S Corporations doing business in New York may, generally, elect to treat the corporations either as New York S corporations (in which case the income would pass through to the shareholders of the corporation and be subject to the New York Personal Income Tax) or as New York C corporations (in which event the income would not pass through but instead would be taxable at the corporate level under either Tax Law Article 9-A, the Franchise Tax on Business Corporations, or Tax Law Article 32, the Franchise Tax on Banking Corporations). In part, the election reflects the understanding that although New York has nexus to tax corporations doing business in the state, it does not have nexus over nonresident shareholders of corporations. Thus, nonresident shareholders are given the option to avoid subjecting their corporations to corporate tax in

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New York by electing to subject themselves to New York Personal Income Tax on such income.[5] Consequently, under Tax Law section 631(b), nonresident shareholders of an S corporation that has elected to be a New York S corporation, include as New York source income the portion of the S corporation's income determined under Tax Law section 632. That section provides that in order to determine the amount of income the nonresident shareholder must include in his New York return, the S corporation must apportion its income under the rules applicable to corporations under Article 9-A or Article 32.

Unlike nonresident individuals who "allocate" their income inside and outside a particular state, corporations generally "apportion" their income among the states they do business using the state's prescribed apportionment formula. During the years at issue, New York provided for the commonly used three-factor formula under which the property, payroll, and receipts of the corporation from New York are divided by the property, payroll, and receipts of the corporation everywhere to determine the Business Allocation Percentage ("BAP") of the corporation.[6]

Although corporations taxable under Article 9-A separately apportion certain categories of investment income by means of an Investment Allocation Percentage ("IAP"), in this case SEBCO reported all of its income as business income allocable under the BAP. Although leaseholds are intangible assets, they are not investment assets for purposes of Article 9-A.[7]

During the years 2002 through 2005, SEBCO applied the three factor formula to compute its BAP which ranged from 37.28% to 43.12% over the four year period. The auditor's main adjustment was to apply the 2005 BAP to the gain on the sale of the leaseholds which resulted in an addition of $215,600 of gain from that reported by Breitman. Under the statute and regulations, the adjustments were clearly proper.

The bulk of the Determination was devoted to whether SEBCO could argue that the apportionment formula, as applied to it, was unconstitutional. The Determination set forth a detailed discussion of the major cases in this area, *Allied-Signal, Inc. v. Director, Division of Taxation*,[8] and *Matter of British Land (Maryland) Inc. v. Tax Appeals Tribunal*.[9] SEBCO argued that the imposition of the tax to the gain on the sale of the leaseholds was unconstitutional because the resulting tax "is out of all appropriate proportion to SEBCO's business in New York." SEBCO also argued that the sale of the leaseholds was "discrete and isolated."

The Determination explained that *Allied Signal* did not help SEBCO because the sale of the leasehold interests was not an unrelated business activity, and that SEBCO conducted a unitary business in which the Pennsylvania leaseholds were an integral part. The Determination noted:

> Presumably SEBCO's annual leasehold expense (i.e., rent) for the four properties was a business expense deduction taken by SEBCO. Further, presumably, the value (as opposed to the sale price) of the four leaseholds was included in SEBCO's "everywhere" portion of the property factor, at least for the years preceding the sale of such interests, and thus impacted the resulting BAP based allocation ratio for such years . . . . (Footnotes omitted.)

The Determination stated that it was thus "consistent" for the Division of Taxation to include the capital gain in income taxable under the allocation formula.

The discussion in the Determination of *British Land* was somewhat more involved. In that case, the New York Court of Appeals held that the application of the formula apportionment to the sale by the taxpayer of property in Maryland was unconstitutional. The ALJ noted that the Court of Appeals did not conclude generally that New York could not apply the apportionment formula to tax a portion of gain on the sale of out-of-state property. Rather the court concluded in that case that the gain calculated under the formula was "out of all appropriate proportion to the business transacted" in New York. Although not discussed in the Determination, the duration of ownership of the assorted properties influenced the New York Court of Appeal's decision in *British Land*. In *British Land* the corporation, through various subsidiaries, had held the property at issue in Maryland since 1973, and disposed of it in 1984. The corporation did not own any property in New York until 1982, nine years after acquiring the Maryland property. Thus, much of the appreciation in the Maryland property occurred before the corporation was subject to tax in New York. In *Breitman*, however, SEBCO was doing business in and out of New York for many years. The ALJ held that since SEBCO included the out-of-state properties in its calculation of the BAP in prior years, it was not improper for the Tax Division to impose the use of that formula on the sale of the Pennsylvania properties.

A surprising aspect of the Determination is that Breitman, the owner of the S corporation, represented himself *pro se*, yet according to the ALJ raised sophisticated, if unsuccessful constitutional arguments. Although one might suspect that Breitman received assistance from a tax practitioner who for one reason or another did not want to make a formal appearance, another option is that Breitman decided to learn, on his own initiative, state tax constitutional law. In the latter case, my sympathies go out to his friends and family.

[1] DTA No. 824268 (August 1, 2013).

[2] It appears likely that the leases provided for renewal options. The existence and terms of the options, if any, are not included in the Determination.

[3] Tax Law section 631(a).

[4] Tax Law sections 631(b)(1)(A), (B).

[5] The election is provided for in Tax Law section 660(a). Tax Law section 660(i) mandates a New York S election in the case of an S election in which more than 50 percent of the gross income of the corporation is investment income. This provision is meant to prevent resident shareholders of S corporations from deferring New York Personal Income Tax on their investment income by holding investment assets in an S corporation. It is likely that the Division of Taxation cannot constitutionally mandate this election constitutionally on the part of nonresidents.

[6] The Article 9-A apportionment rules are set forth in Tax Law section 210.3(a). Although, during the years at issue, corporations taxable under Article 9-A used a formula which double-weighted the receipts factor, the double weighting did not apply to S corporations. Tax Law section 210.3(a)(4)(i). For years after 2007, Article 9-A provides for a 100 percent receipts factor. Tax Law section 210.3(a)(10).

[7] Investment capital consists of stocks and corporate and government debt securities.

[8] 504 U.S. 768 (1992).

[9] 85 N.Y.2d 139 (1995).