REPORT #628

TAX SECTION

New York State Bar Association

REPORT ON
NEW YORK TAXATION OP FOREIGN CORPORATE LIMITED PARTNERS

BY COMMITTEE ON INTERSTATE COMMERCE

September 19, 1989

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The Honorable James W, Wetzler
Commissioner of Taxation and Finance
W. Averell Harriman State Office Building Campus
Albany, New York 12227-0215

Dear Commissioner Wetzler:

Enclosed is a report by our Committee on Interstate Commerce on New York Taxation of Foreign Corporation Limited Partners. The draftsmen of this report are Robert E. Brown, Paul R. Comeau and Arthur R. Rosen.

The report concludes that the position set forth in advisory opinion TSB-A-88(5)C and similar pronouncements may and should be changed so that the policy and practical concerns behind the advisory opinion are dealt with by permitting partners, whether individual or corporate, general or limited, to elect to be taxed on their share of partnership income on a separate accounting basis where the partner has no other type of activity or interest subjecting it to taxation in New York.

Where a separate accounting election is validly made, one further consequence would be that - the ownership of the partnership interest would not taint other income which otherwise might qualify for the protections of Public Law 86-272, the U. S. Constitution or the State tax law. Partners not qualifying for the separate accounting election would have to file tax returns and pay tax under the normal tax rules.

The report also recommends that if the present corporate minimum franchise tax and other alternative bases of taxation are felt to be excessive burdens, a statutory change should be enacted to permit the Commissioner to waive the alternative bases taxation.

The report further recommends that in lieu of the above recommendations, New York should consider statutory changes to permit each partnership with foreign partners to withhold taxes (computed at the highest tax rate) for partners. The provision could permit each -foreign partner separately to elect or alternatively could permit the partnership to elect for all partners. The withholding would satisfy the tax liability and also relieve the partner of the burden of filing a tax return in New York if the partner was not otherwise subject to tax by New York. If the partner was otherwise subject, to tax by New York, the partner still would be required to file a tax return, with the withheld tax allowed as a credit against tax liability (and refunded if in excess of the actual tax liability).

Sincerely,

Wm. L. Burke
Chair

WLB/JAPP
Enclosure

cc (w/encl.): William F. Collins, Esq.
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NEW YORK STATE BAR ASSOCIATION

TAX SECTION

REPORT ON NEW YORK TAXATION OP FOREIGN CORPORATE LIMITED PARTNERS

BY COMMITTEE ON INTERSTATE COMMERCE[1/]

September 19, 1989

I. Background. On March 10, 1988, the New York state Department Of Taxation and Finance Technical Services Bureau issued TSB-A-88(5)C. This Advisory Opinion and other advisory opinions and bulletins by New York State and New York City indicate that a foreign corporation which is not otherwise subject to the corporate franchise tax will not become subject to the tax solely by virtue of becoming a limited partner in a limited partnership which is doing business in New York. See generally TSB-A-88(IQ)C; TSB-A-88(11)C; TSB-M-87(12)C? NYC PLR 67(6)C. The advisory opinions explicitly decline to follow a 1944 Appellate Division decision, a December 28, 1954 Opinion of the New York Attorney General and prior Tax Department policy (codified in a franchise tax regulation which has since been amended). See Chapman v. Browne, 268 AD 506, 48 NYS2d 598 (3rd

1/ This report was written by Robert E. Brown and Paul R. Comeau, cochairmen of the committee and committee member Arthur R. Rosen. Helpful comments were provided by Seymour S. Bernstein, Henry P. Bubel, william L. Burke, Peter C. Canellos, William M. Colby, Harvey P. Dale, Arthur A. Feder, Gordon D. Henderson, Philip T. Kaplan, Douglas W. Killip, Robert J. Levinsohn, James A. Levitan, Richard Q, Loengard, Jr., Stephen L. Millman, Stanley I. Rubenfeld, Michael L. Schler and David Watts.

Dept. 1944); 1954 Op. Atty. Gen'l 221; Tax Reg. §1-3.2(a)(5). For example, the regulation stated that if a partnership is doing business in New York State, all of its corporate partners would be considered doing business in the state and would be subject to the franchise tax imposed by Article 9-A. Chapman and the 1954 Opinion of the Attorney General state that this rule applies to both nonresident individuals and foreign corporate limited partners.

The advisory opinion provided relief for foreign corporations that are passive investors in limited partnerships. Advisory Opinion TSB-A-88(10)C, dated April 19, 1988, added another criterion, and indicated that the franchise tax would be imposed if the foreign corporate limited partner obtains a controlling interest in the limited partnership, in the June 12, 1989 issue of Tax Motes, a former Tax Department employee described the process which led to a reversal of Chapman and the 1954 Opinion of the Attorney General:

> A special computerized audit project had uncovered thousands of non-New York corporations which had never filed New York franchise tax returns, despite their status as limited partners in nationally syndicated partnerships headquartered in New York. Typically, the non filer might be a small, closely-held corporation which, having invested $5,000 for a limited partnership unit, could expect an annual distributive share of income of about $500. Lacking any other (even remote) New York connection, the corporation would usually owe "only" [the] $250 minimum franchise tax[2/]...Is it reasonable to expect such a corporation to pay New York at least half of its annual distributive share, plus interest and penalties, for each year of its investment?

2/ In 1989 the $250 minimum tax was increased to $350 for most corporations, and $450 or $800 for certain corporations.

Id. at page 1413. The advisory opinions grew out of an Opinion Of Counsel (TSB-M-87(12)C) which was issued on June 24, 1987, and which excluded from franchise taxation corporate limited partners with minority interests in SBC-registered partnerships, other corporate limited partners who were not covered by this Opinion sought an expansion to cover foreign corporate limited partners in unregistered partnerships.

These determinations have created uncertainty, and uncertainty could lead to opportunities for abuse. For example, foreign corporate limited partners with effective control of New York limited partnerships could avoid New York taxes on income attributable to substantial business activities conducted by the partnership in New York State. The taxes saved could greatly exceed the $350 minimum tax. In other instances, nonresident individuals who would be taxed as individual limited partners in limited partnerships conducting business in New York could escape New York taxation by setting up foreign “S” corporations (which do not elect “S” treatment in New York State) to own minority interests in the limited partnerships.

Recognizing potential revenue losses and abuses, we understand that the New York State Department of Taxation and Finance is reexamining the position taken in the advisory opinions, and is considering steps to limit their scope.

This report examines the legal and policy questions associated with the issues addressed by the advisory opinions.

II. Conclusion. To the extent constitutionally permissible; New York should tax all net income derived from businesses conducted in New York State. Public policy seems to dictate that if a partnership is doing business in New York State, all of the partnership's net income allocable to New York should be taxed by the state, irrespective of whether the income is allocated to domestic or foreign, individual or corporate, general or limited partners. where the taxpayer has no other type of activity or interest subjecting it to taxation in New York, the taxpayer should be permitted to adopt separate accounting concepts for this income, so that ownership of a limited partnership interest would not have to taint other business income which might qualify for the protections of Public Law 86-272, the United States Constitution or the Tax Law. Taxpayers not willing or able to elect such separate accounting would be treated as engaged in business in New York if the partnership were engaged in business in New York and in such event would be required to file tax returns and pay tax (including minimum corporate franchise tax) under the normal tax rules.

If the present corporate minimum franchise tax and other alternative bases of taxation are viewed as excessive burdens in these situations, the Division of Taxation should seek a statutory change to permit the Commissioner to waive the alternative bases of taxation.

In lieu of taxation of each foreign partner. New York should consider statutory changes to permit, each partnership with foreign partners to withhold taxes (computed at the highest tax rate) for each foreign partner who elects this form of taxation instead of “normal” taxation. Partners making this election would be relieved of the burden of filing franchise tax returns for their share of partnership income unless they were otherwise subject to tax by New York.

As a further alternative, New York could consider partnership level taxation of partner's allocated income at the highest corporate tax rate. Such a scheme, which would require statutory authorization, would avoid the question whether the partner's status in and of itself constituted doing business in New York. Foreign partners not otherwise doing business in New York (and individual partners not resident in New York) would be relieved of the obligation to file franchise tax returns and would have no New York tax liability.

It can be argued that the relationship between a limited partner and the State (i.e., the relationship between the partner and the partnership doing business in New York) may be so tenuous that the State lacks adequate constitutional or statutory jurisdiction to tax the partner.[3/] Traditional agency concepts would seem to negate this argument, and we have not found any cases which definitively address this apparent conflict. In recognition of possible statutory considerations and constitutional limitations, and in light of administrative concerns and the practical problems faced by relatively small foreign partners, a *de minimis* rule could be adopted for foreign partners who have an insubstantial connection with the partnership and the state and who derive minimal income from limited partnerships doing business in New York. Because of the difficulty of formulating and administering a rule based on quantitative exceptions, however, we believe that the other alternatives set forth above are better approaches to the question, particularly if, as proposed, regularly traded partnerships will now be taxed as corporations and their partners - general and limited - correspondingly treated as shareholders.[4/]

3/ For example, a foreign corporate limited partner without other New York contacts might ova a passive 1% interest in a partnership which owns only passive investments, such as a fixed stock portfolio or limited partnership interests in foreign an£ domestic limited partnerships. Would this partner have sufficient contact with New York to permit imposition of New York franchise taxes?

4/ The recent addition of Section 7704 of the Internal Revenue Code of 1986 has been adopted by New York with the passage of the 1989 Department Taxation and Finance Bill Mo. The Report on the Bill by the Tax Section's Committee on New York State Tax Matters supported that change.

Finally, whether or not New York resolves the differences in treatment between nonresident individuals and foreign corporate limited partners, New York should address the anomalous difference in tax treatment between foreign individuals and corporations trading for their own account. New York provides an exemption or exclusion for trading income for nonresident individuals, but does not provide a similar exclusion for trading income of foreign corporations, whether the favorable rule for individuals is motivated by constitutional considerations or by a desire to encourage investment and trading activity in New York by one who trades or invests for his or its own account, the same considerations that apply to individuals should apply to corporations. A full examination of the issue is beyond the scope of this report, but the difference in treatment exacerbates the disparity between the tax treatment of nonresident individual and foreign corporate limited partners.

III. Analysis. Partnerships are not separately taxed by New York State. Their income and losses pass through to the partners, and the partners are taxed as if they had received each individual item of income, loss or credit directly. Tax Reg.

54-6.5. This is true tor both limited and general partners, and is true for both corporate and noncorporate partners (although corporate partners normally allocate items differently than individuals). In the case of corporate partners, the income, losses or credits are reported on their New York State franchise tax returns.

Foreign corporations that are doing business in New York or that are otherwise taxable by New York file New York franchise tax returns and are taxed on income allocable to New York. Tax Law $209.1; Tax Reg, §1-3.2(a)(1). Except for the issue being addressed herein, if a foreign corporation is a partner in a partnership which is doing business in New York, the income from that partnership and from any other source is taxable to the extent allocable to New York sources. Tax Reg. §§1-3.2(a)(5) & 4-6.5.

The Advisory Opinions. The general rules described above were settled for many years, whether the foreign corporation vas a general or limited partner. The 1987 Opinion of Counsel and 1988 advisory opinions altered this tax treatment for certain foreign corporations that are limited partners and are not otherwise doing business or subject to the Article 9-A franchise tax. The advisory opinions noted that domestic or foreign corporations are subject to the franchise tax if they exercise a corporate franchise, do business, employ capital, own or lease property in a corporate or organized capacity, or maintain an office in New York State. They then asked whether a foreign corporation should be treated as meeting one of these tests simply because it is a limited partner in a partnership that meets one or more of the tests. They concluded that ownership of a limited partnership interest under these circumstances is not sufficient to justify taxation of the corporation's share of partnership income if the corporation has a minority interest in the partnership, is a limited partner, has a passive, inactive role in the partnership and has not acquired the partnership interest under circumstances whereby business carried on by the partnership in New York is integrally related to the regular business of the foreign corporation. According to the advisory opinions “the key to nontaxability is that the limited partnership holding be a passive, disinterested investment.”

According to the advisory opinions, general notions of agency, whereby action of the general partner (as agent) are attributed to the limited partner (as principal) are not applicable in modern limited partnerships where the limited partners are purely passive, disinterested investors. Limited partnerships are creatures of statute, and purely passive limited partnership interests are more like preferred stock than true partnership interests. Consequently, activities undertaken by the general partner should not be attributed to passive limited partners, and absent this attribution, the foreign corporations which are not directly engaged in any of the activities described in Tex Law §209.1, are not doing business or otherwise subject to the franchise tax in New York and their share of income from the limited partnership cannot be taxed under Article 9-A.

This conclusion is inconsistent with a 1944 Appellate Division decision, the former general rule contained in a superceded published regulation and the 1954 Opinion of the New York Attorney General which concluded that a limited partner is doing business if a limited partnership is doing business. See Chapman v. Browne, supra; 1954 Opinions of the Attorney General 221, Tax Regulation §l-3.2(a)(5) read (prior to an amendment made to reflect the conclusions in the advisory opinions) as follows:

> “if a partnership is doing business, employing capital, owning or leasing property or maintaining an office in New York State, then all of its corporate partners are subject to the tax imposed by Article 9-A of the Tax Lav. The term partnership means a partnership, joint venture or other similar unincorporated entity.”

The advisory opinions distinguish these “precedents” by pointing out that they were based on limited authority and reflect neither modern economic reality nor modern thinking about the proper treatment of limited partnership interests. The regulation did not specifically mention limited partnership interests, and decisions in other contexts and other jurisdictions are used by the advisory opinion to support the favorable treatment.

Comparison with Tax Treatment of Individual Limited Partners. It is instructive to note that nonresident individual limited partners do not enjoy the favorable treatment provided by the advisory opinions to foreign corporate limited partners. Individuals are given relief in other ways. For example, Tax Law §631(d) provides that nonresidents are not taxed on income earned in New York from investments made for their own account. (See also, Behr, TSB-H-84(200)I). Further, a nonresident individual who owns preferred or common shares of a corporation doing business in New York is not taxed by New York on dividends received from the New York corporation. On the other hand, a nonresident individual is taxed on his distributive share of income received from a limited partnership that is doing business in New York. Compare Tax Reg. §131.5 & 134.1. But see Ausbrooks. infra.

Comparison with Tax Treatment of "S" Corporations. When New York State enacted legislation to permit an "S" election at the state level, it was unwilling to forego the taxes attributable to distributions to nonresident shareholders. Normally, a nonresident individual is not taxed by New York on income from intangibles, such as stock. Dividends are not taxable in most cases. See Tax Regulation Section 131.5. However, in the Lieb Advisory Opinion (TSB-A-B5-(5)-I) a nonresident shareholder of an electing New York "S" corporation received his share of investment income, and claimed that the income should not be taxed to him. The tax department noted that in exchange for an exemption from corporate franchise taxes, “S” corporation shareholders assume an obligation to individually pay tax on “S” corporation income, and must include a pro rata share of the corporation's income, even if the income would not be included in the nonresident's New York income if it was earned by the nonresident individually. Not only do they lose the ability to argue that all distributions by an “S” corporation represent income derived from intangibles, but they also lose the ability to argue that intangible income received by the “S” corporation should escape taxation at the individual level because of it's character as investment income.[5/] If the legislature looked at the foreign corporate limited partner question, it might reach the same conclusion.

Comparison with Tax Treatment of Other Entities. Foreign trusts and estates are taxed the same way as individuals. Tax Reg. §135.25. Foreign corporations that own a majority interest in a limited partnership or that are otherwise taxable by New York do not qualify for the relief provided by the advisory opinions. The advisory opinions imply that the limited partnership income moves from the excluded, passive investment category to the included taxable business income category.

[5/] It is important to note that the conclusion in the Lieb Advisory Opinion may be inconsistent with the statute (See Tax Law §§632 and 617).

Justification for Relief by the Advisory Opinions. What is the justification for this treatment? We believe it is primarily practical and administrative, although constitutional or statutory considerations may play a role.

Constitutional Tests.

The proper interstate commerce and due process constitutional teat is enunciated by Complete Auto Transit v. Brady, 430 U.S. 274(1977). According to the United States Supreme Court, state taxation of corporations is constitutional if (i) there is sufficient nexus between the corporation and the state, (ii) the tax does not discriminate against interstate commerce, (iii) the tax is fairly apportioned and (iv) the tax is fairly related to services provided by the state. Matter of Knapp, 413 N.Y.S. 237 (1979) indicates that nexus exists if there is an appreciable connection between the partners and the state, plus a substantial connection between the income sought to be taxed and New York state. See also Weil v. Chu, 120 A.D. 2d 781, 501 N.Y.S. 2d 515 (3d Dept. 1986). It would appear that the Latter Knapp and the last three Complete Auto Transit tests are clearly met in any situation where the business is being conducted in New York State, a person who owns a capital and income interest in the business is receiving a share of that income, and New York State is taxing that income. The tax does not descriminate against interstate commerce because it applies only to income from new zone sources fairly related to services provided by New York. See Knapp, supra.

The remaining relevant "nexus" test is whether a corporate limited partner has an appreciable connection with the state through its relationship with the partnership. To determine whether the relationship exists, it is necessary to review principles of agency and partnership lav.

The advisory opinions discuss agency and limited partnership decisions which have applied constitutional tests in other contexts. For purposes of long arm statutes, in recognizing the limitations of the due process clause of the fourteenth amendment, courts have held that limited partners are not transacting business in New York, even though the partnership may be transacting business in the state. See Lynn v. Cohen, 359 F. Supp 565 (SDNY 1973). Although the general partners are conducting business in the state, they are not true agents of the limited partners for purposes of granting in personum jurisdiction over the limited partners, because the limited partners, as prinicipals, do not exercise dominion and control over the general partners as agents. These cases are construing the "agency" concept for purposes of Section 302(a), the long arm statute. See CPLR §302(a) Other cases regarding federal diversity

Jurisdiction and the role of the general partner as general agent for the limited partners also deal with situations which may or may not apply when determining the state's power to tax. Although a general partner may not be the general agent of the limited partner, it is the agent or manager acting on behalf of all limited and general partners for purposes of conducting the business of the partnership. See generally 16 N.Y. Jun. 2d §§1548, 1377 & 1378[6/]. The limited partners, through the partnership agreement, permit the general partner to conduct and manage the business for the benefit of all partners. Through this designee or "agent" they are conducting a business in the state and derive benefits, including income distributions, from that business. Accordingly, this structured, carefully-defined agency relationship may bring all partners who derive New York income from the partnership within the reach of New York's tax law. This is illustrated by the Lynn case, which is one of the principal cases sited in the advisory opinions. This case involved in personam jurisdiction over an individual limited partner. The

[6/] A general partner in a limited partnership has the same rights, duties, powers and liabilities as a partner in an ordinary partnership, but cannot bind a limited partner beyond the letter's investment in the firm and cannot act in contravention of the limited partnership certificate. 16 N.Y. Jur. 51548. The general partners manage the entire property and business of the limited partnership. Id, at §1546 fn. 94. General partners are general agents for the group for purposes of the business, although they may not be general agents for other purposes. See generally id. at §1378.

federal district court concluded that New York lacked in personam jurisdiction. However, it is clear that the New York State Department of Taxation and Finance takes the position that it can impose personal income taxes on the partnership income, despite the state's inability to claim jurisdiction over the individual for long arm statute purposes. The Division of Taxation would not view Lynn as a constitutional impediment to taxation of the individual. In a factually parallel situation, the federal government does hot encounter a constitutional problem when it taxes foreign corporations which are limited partners in partnerships conducting business in the united States (although different constitutional considerations apply with respect to the federal government and foreign commerce). See Code §975(1); Rev. Rul. 85-60, 1985-1 CB 187; Vitale, 72 T.C. 386 (1979). (See also New York's real estate gains tax, which imposes the tax on a foreign shareholder who transfers a minority interest in a corporation which owns sufficient real estate to justify imposition of the real estate gains tax).

Statutory Tests. The result of the advisory opinions appears not to be required by the New York tax law or regulations. The regulations state that, in general, all partners are exercising the privileges which justify franchise taxation if the partnership is exercising these privileges. Arguably, a foreign corporation which chooses to participate in a venture as a limited partner accepts the consequences of that choice, including both the benefits and the detriments. The benefits include characterization of the income as if it was received directly by the partner. The limited partner has invested in an entity which is not separately taxable, but which is subject to a separate and distinct set of tax rules which call for “flow through” treatment, and one of the consequences is state taxation of that income.

The current statutory scheme gives the tax department some latitude in determining whether a foreign corporation is taxable. Regulation Section 1-3.2(a)(5) states a general rule whereby all partners are doing business in the state if the partnership is doing business in the state. However, Regulation Section 1-3.2(b)(2) states that the “doing business” determination and other tests of the statute must be resolved by examining the facts and circumstances of each case. Pacts and circumstances which are listed in the regulation and which have been cited by numerous courts include the nature, continuity, frequency and regularity of the activities of the corporation in New York State and the purposes for which the corporation was organized in this context, it appears that the Department of Taxation and Finance had the power to reach the conclusions contained in the advisory opinions. However, the Tax Department could have reached the opposite conclusion, imposing taxes on all Hew York source limited partnership income received by a foreign corporate limited partner.

Viewed in this context, the advisory opinions represent a practical solution which attempts to balance constitutional, revenue, and administrative concerns for both New York state and foreign corporations.

Extension of Opinions to Other Taxpayers. It is appropriate to ask whether New York should extend this treatment to nonresident individuals, trust and estates. See generally Tax Law §5632(c) and 634(b)(2), which give the Division of Taxation some latitude in modifying the general rules applicable to the income of nonresident individuals, estates and trusts. Presumably, the same legal and practical considerations are applicable.[7/] Perhaps the minimal income problem, whereby a foreign corporation with minimal limited partnership income is subjected to relatively high corporate minimum taxes, is addressed through the standard deduction allowed to nonresident individuals and the New York exemption for nonresident

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[7/] Foreign corporate limited partners also have a problem under Public Law 86-272 (15 USCA §§381-384). That section provides a corporate income or franchise tax exemption if the activities of the corporation are limited to solicitation. See generally Tax Reg. §1-3.2 (a)(3). If a foreign corporate limited partner is "doing business" in New York because the limited partnership is doing business, this imputed activity might create risks for the foreign corporation under Public Law 86-272. Unrelated sales income might fall within New York's tax net. Since individuals, estates and trusts do not have this concern, special relief (perhaps in the form of a separate accounting for partnership income) might be appropriate for foreign corporations. See Weil v. Chu, supra, which refers to the "direct accounting" method of allocating income as the preferred method of allocating New York income.

individuals, estates and trusts. If a nonresident foreign corporation is doing business or exercising any of the other privileges which justify taxation by New York, it is subject to the corporate minimum tax, even if it has a loss. Nonresident individuals and nonresident estates and trusts are not subject to a “privilege” tax, such as the franchise tax. Instead, they pay taxes based upon income, and they have the benefit of standard deductions or exemptions to prevent imposition of tax requirements when income from New York sources is nonexistent or minimal. However, limitations which permit the standard deduction and exemptions for nonresidents based upon the proportion of New York income to total income have the effect of reducing the ability of the standard deduction and exemptions to shield low levels of income, and 1987 tax legislation which taxes the New York source income at the highest rate applicable to the total income of the nonresident could lead to tax liability and burdensome complexity where relatively low levels of limited partnership income are involved. Consequently, if the Tax Department decides to perpetuate the tax relief provided for foreign corporate limited partners, it may wish to consider extending this relief to nonresident individuals and estates and trusts.

Eliminating or Restricting the Relief of the Advisory Opinions. Although New York has the power to provide the relief described in the advisory opinions, it may also have the power to withdraw or restrict that relief. Cases such as Consolidated Edison of Hew York, 24 N.Y, 2D 114 (1969), have recognized that the Tax Department’s power to interpret the law also Includes the power to change interpretations from time to time. At present, only one precedential determination has been issued by the Department, and that consists of the 1987 Opinion of Counsel. According to Tax Regulation Section 900.2(a)(1), an Opinion of Counsel such as TSB-M-87(12)(C) is an official opinion interpreting the applicability of the Tax Law to a general situation, circumstance or set of facts. These Opinions normally have wide application, and all bureaus and divisions of the Division of Taxation must follow these Opinions where the factual situations are the same. The 1987 Opinion of Counsel is fairly narrow because it deals with limited partnership interests issued pursuant to a public offering under the federal securities act. The 1988 advisory opinions cover more typical limited partnerships, which are not registered. However, Regulation Section 901.1 et. seg. state that an advisory opinion is limited to the facts specified in the petition and will be binding only with respect to the person to whom the advisory opinion is rendered. The regulations also state that the Division of Taxation may modify a previously issued advisory opinion on a prospective basis. See also Tax Law §171 twenty-fourth.

IV. Alternative Approaches. The Division of Taxation has several choices. It may:

- continue to rule upon the tax status of limited partners on a case by case basis by issuing additional advisory opinions;

- revert to historic treatment of partnerships, subjecting limited partners to franchise taxation in all instances, (in which event P.L. 86-272 concerns could be addressed by requiring separate accounting for the passive limited partnership income);

- create a general rule through regulations, and expand or contract the general rule to cover foreign corporations, individuals, States and trusts, or others;

- establish safe harbors, either through regulations or by practice; or

- seek a statutory change to provide clearly-authorized rules.

Bach of the alternatives will be discussed separately, but we believe the better course involves a combination of making some administrative changes and some legislative changes.

Case by Case Advisory Opinions. The Division of Taxation can continue its current practice, issuing determinations to particular limited partners in the form of advisory opinions, and issuing opinions of counsel to cover situations with wider applicability. The principal advantage is the ability to review the facts and circumstances of each situation individually, weeding out abuse and granting relief where appropriate. The principal disadvantage, of course, is the administrative burden, coupled with uncertainty for taxpayers who do not obtain determinations. There is also the possibility of inconsistency as personnel changes or other factors lead to different conclusions in factually similar situations. We find these considerations compelling reasons for not continuing this approach. Furthermore, it appears that the Division of Taxation is not completely satisfied with outstanding determinations, and may wish to provide clarification which will prevent a misapplication of the principles which surface In the current opinions.

<u>Create a General Rule</u>. Another alternative would entail creation of a general rule through regulations. The new “general” rule could provide relief subject to whatever limitations are deemed appropriate. Any such rule also could be extended to foreign individuals, estates and trusts which own limited partnership interests.

A rule which exempted all non-New York limited partners, however, would obviously go well beyond the problem giving rise to the immediate concern and would unnecessarily do violence to the basic principle that New York should tax all of the income allocable to New York of a partnership doing business in New York. Attempting to specify appropriate limitations for a “general” relief rule focusing on the partner would pose essentially the same considerations and concerns discussed below under “Safe Harbors.”

By contract, further attention to a rule focusing upon the partnership itself, rather than the partners, would be helpful in dealing with at least one part of the problem. One of the areas of growth has been limited partnerships set up to invest in stock of securities of one or more other companies. Uncertainty continues to exist as to when partnerships of this type are “doing business” in New York. We believe that it would b« an appropriatte and desirable exercise of the Division's regulatory power to promulgate rules clarifying what may be done without the partnership (and derivatively the partners) being treated as “doing business” in New York.

Safe Harbors. Regulations or future advisory opinions or opinions of counsel could establish safe harbors based upon the size of the investment (e.g., less than $5,000 invested), the amount of income generated (e.g., less than $1,000), the ownership percentage (e.g., 5% or less of the limited partnership), and so forth. A possible variation would be to formulate any such limitations as a favorable presumption rebuttable by the Division of Taxation.

The 1989 advisory opinions already allude to a narrowly-defined class of qualifying limited partners, and recent cases such as Ausbrooks, 66 N.Y. 2d 281 (1985), have examined similar factors in determining the tax status of foreign limited partners. In Ausbrooks, for example, a nonresident individual vas a limited partner in a New York partnership, and that partnership was a limited partner in other partnerships. The Court pierced the various layers and concluded that the limited partner vas a passive investor in a partnership which itself was a passive investor in out-of-state real estate and other ventures.

The income or losses in question were not generated by Mew York activities or enterprises. The Court refused to permit deductions of losses by the nonresident individual limited partner against New York source income on his nonresident personal income tax return. However, safe harbors based upon economic criteria such as the income level of or the amount invested by limited partners may be difficult to justify legally, since the amount of income has never been a factor in determining whether a state has jurisdiction to tax a foreign corporation. in addition, any such limitations (at least those based on quantitative threshholds) raises the specter of a limited partner flipping in and out of New York taxation from year to year with all the complexity and compliance and audit issues that could entail. Moreover, policy considerations on minimum tax levels would also impact the appropriate level for any such limits. (New York recently increased its minimum tax and imposes that tax on domestic or foreign corporations that do not have sufficient income or capital to justify a higher level of taxation.)

If the safe harbors are based on agency concepts, and focus on the passive role of the limited partner, New York may have difficulty policing the limited partner’s level of activity. Limited partners are not usually involved in managing the partnership, but nay participate in management if they are willing to give up their limited liability. See 16 N.Y. Jur, 2d §1546. Certain states such as Delaware permit the formation of limited partnerships which give the limited partners greater managerial power than limited partners in a partnership formed under the New York lav. Other states such as Wyoming and Florida have limited liability companies which are taxed as partnerships. Because of these differences, any safe harbors based on limited partner status would need to consider whether to limit the relief to partners who would qualify as limited partners under the New York Limited Partnership Law.

Statutory Clarification. Instead of or in addition to regulations or advisory opinions, the Division of Taxation could seek clarification from the legislature in the form of statutory safe harbors. Although statutory clarification might be desirable, it is not required. Statutory changes cannot be accomplished as quickly as regulatory changes, and the legislative climate may not permit a statutory change which excludes from taxation a group of foreign corporations who have been subject to the tax since the 1944 Chapman decision and the 1354 Opinion of the Attorney General.

As stated in our Conclusions, we believe the preferable administrative alternative is taxation of foreign corporate limited partners according to the general rule contained in the regulations and the position adopted by the Attorney General in 1954, to the extent constitutionally permissible. From a policy standpoint, it is difficult to question the propriety of a tax scheme which requires at least one level of New York. State taxation on each dollar of business income earned in New York State, where the normal rules would result in an overreaching or excessive burden, we believe that an election should permit the New York income of foreign partners, whether or not corporate and whether or not limited partners, to be determined by applying the principles of separate accounting. Accordingly, only the New York income (determined by using the partnership’s allocation factors) would be subject to tax in such case. The tax treatment of other income of the corporation, such as income which would otherwise qualify for constitutional or P.L. 86-272 protection then would not be affected by the corporation's ownership of the limited partnership interest.

We also believe however that two further steps, that would involve statutory changes, should be considered and adopted. One change would be to permit the Division to waive by regulations the alternative bases of taxation, including the minimum franchise tax, where taxation on the basis of separate accounting was elected and no New York tax return would otherwise be due. This could be used to relieve the financial burden on those corporations having relatively small taxable income to report to Hew York as o result of an investment in a partnership. The concept raises theoretical questions of the appropriateness of a minimum franchise tax and the same kind of issues discussed above under "Safe Harbors" on suitable limitations if the minimum tax is not eliminated entirely. But when coupled with a separate accounting requirement, it has the practical benefit of targeting the relief to those cases where the State is realizing the relatively little revenue (given apparent compliance levels and the costs of stricter enforcement) while preserving the State's right to compel compliance and tax when the benefits of the New York activity are more meaningful.

A second statutory change that should be considered would be to permit foreign partners, corporate and individual, to have their tax liability satisfied through withholding at the partnership level at the highest statutory rate on that portion of the partner's net partnership income taxable by Mew York on a separate accounting basis. Such an approach, which has been adopted by other states, would result in an appropriate tax to New York while the partner making the election would be relieved of the burden of filing a New York return or paying tax on any other New York source income unless the partner otherwise were subject to New York tax. As a variation on this approach, the election could be required to be made by the partnership for all partners. The partnership election and tax payment by the partnership again would satisfy the partner's filing obligation and tax liability to New York unless the partner was otherwise subject to tax in New York (in which event the withheld tax would become a credit against the normal New York State tax liability).