

New York State Department of Taxation and Finance
Taxpayer Services Division
Technical Services Bureau

TSB-A-99(3)I
Income Tax
June 25, 1999

STATE OF NEW YORK
COMMISSIONER OF TAXATION AND FINANCE

ADVISORY OPINION

PETITION NO. I990311B

On March 11, 1999, a Petition for Advisory Opinion was received from Robert Kaplan, CPA, LEF & Co. 70E Sunrise Highway, Valley Stream, New York 11582-0547.

The issue raised by Petitioner, Robert Kaplan, CPA, is how to source dividend income received from a subsidiary of a New York S corporation for a New York nonresident individual shareholder of the S corporation.

Petitioner submits the following facts as the basis for this Advisory Opinion.

A New York S corporation owns more than 50 percent of the capital stock in value and in voting power of an alien corporation operating outside of the United States. The alien corporation pays the S corporation a dividend. The dividend is treated as portfolio income on the nonresident shareholder's Schedule K-1. For purposes of Article 9-A of the Tax Law, the alien corporation has an issuer's allocation percentage of zero.

Discussion

Section 1366(a) of the Internal Revenue Code ("IRC") provides that

(1) ... In determining the tax under [Subchapter S] of a shareholder for the shareholder's taxable year in which the taxable year of the S corporation ends ... there shall be taken into account the shareholder's pro rata share of the corporation's –

(A) items of income (including tax-exempt income), loss, deduction, or credit the separate treatment of which could affect the liability for tax of any shareholder

....

Section 1366(b) of the IRC provides that the character of any item included in a shareholder's pro rata share under section 1366(a)(1) of the IRC shall be determined as if such item were realized directly from the source from which realized by the corporation, or incurred in the same manner as incurred by the corporation.

Section 1.1366-1(a)(2) of Proposed Treasury Regulations lists several items that each shareholder must take into account separately, and includes "[a]ny of the corporation's items of portfolio income or loss, and expenses related thereto, as defined under section 469 [of the IRC]."

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Section 1.469-2T(c)(3)(i) of the Temporary Treasury Regulations provides that portfolio income includes all gross income, other than income derived in the ordinary course of a trade or business (within the meaning of section 1.469-2T(c)(3)(ii)), that is attributable to –

(A) Interest ... annuities; royalties ... dividends of C corporation stock; and income (including dividends) from a real estate investment trust ... regulated investment company ... real estate mortgage investment conduit ... common trust fund ... controlled foreign corporation (within the meaning of section 957), qualified electing fund ... or cooperative

Section 957 of the IRC states that the term "controlled foreign corporation" means any foreign corporation if more than 50 percent of (1) the total combined voting power of all classes of stock of such corporation entitled to vote, or (2) the total value of the stock of such corporation, is owned (within the meaning of section 958(a)), or is considered as owned by applying the rules of ownership of section 958(b), by United States shareholders, on any day during the taxable year of such foreign corporation.

The dividend at issue in this case is a dividend from a controlled foreign corporation pursuant to section 957 of the IRC, that is treated as portfolio income pursuant to section 1.469-2T(c)(3)(i) of the Temporary Treasury Regulations. As such, it is a separately stated item pursuant to section 1.1366-1(a)(2) of Proposed Treasury Regulations that is reported as portfolio income by the S corporation on the shareholder's Schedule K-1, and is reported, by the shareholder, as dividend income on the shareholder's federal income tax return.

Section 601(e) of the Tax Law imposes a personal income tax for each taxable year on a nonresident individual's taxable income which is derived from sources in New York State. The tax is computed as if the individual were a resident, reduced by certain credits, and apportioned to New York by the New York source fraction, the numerator of which is the individual's New York source income and the denominator of which is the individual's New York adjusted gross income.

Section 631(a) of the Tax Law provides that the New York source income of a nonresident individual shall include the individual's pro rata share of New York S corporation income, loss and deduction derived from or connected with New York sources.

Section 632(a)(2) of the Tax Law provides that the New York source of a shareholder's pro rata share of New York S corporation items shall be determined under regulations of the Commissioner of Taxation and Finance consistent with the applicable methods and rules for allocation under Article 9-A of the Tax Law. Article 9-A of the Tax Law provides for separate allocations of business income and business capital, investment income and investment capital, and subsidiary capital. Part 4 of the Business Corporation Franchise Tax Regulations provides the applicable methods and rules for such allocations.

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Section 632(e)(2) of the Tax Law provides that the character of S corporation items for a nonresident shareholder shall, as under section 617(b) of the Tax Law, have the same character as for federal income tax purposes.

The New York State personal income tax treatment of items of income, gain, loss and deduction of a nonresident shareholder of a New York S corporation is explained in the New York State Department of Taxation and Finance Publication 35 (2/96) New York Tax Treatment of S Corporations and their Shareholders in Part VII.A. It provides that the source of S corporation items is made at the corporation level. It also provides that when computing a nonresident shareholder's New York source income, the S corporation's business allocation percentage, as determined under Article 9-A of the Tax Law, is applied to items of business income, and the S corporation's investment allocation percentage, as determined under Article 9-A of the Tax Law, is applied to items of investment income. However, it does not reference the allocation method to be applied to S corporation income from subsidiary capital.

Section 210.7 of Article 9-A of the Tax Law and section 4-10.1 of the regulations, provides that the portion of the subsidiary capital of a taxpayer to be allocated within New York State shall be determined by (a) multiplying the amount of its subsidiary capital invested in each subsidiary during the period covered by its report by the issuer's allocation percentage, as defined in section 210.3(b)(1) of the Tax Law, of each such subsidiary and (b) adding together the sums so obtained.

As explained in Publication 35, supra, the source of the dividend income, at issue in this case, is determined at the S corporation level. Since the dividend received by the S corporation is from its subsidiary, the dividend is treated as income from subsidiary capital for purposes of Article 9-A of the Tax Law. It is consistent with the prescribed methods for allocating business income and investment income, for such shareholder to allocate such subsidiary income by the method used to allocate subsidiary capital under section 210.7 of Article 9-A of the Tax Law, that is, by the issuer's allocation percentage of the subsidiary.

Accordingly, for purposes of section 632(a)(2) of the Tax Law, the portion of the nonresident shareholder's pro rata share of the dividend received by the S corporation from its foreign subsidiary, that is separately treated as portfolio income on the shareholder's Schedule K-1 and as dividend income on the shareholder's federal income tax return, that is derived from or connected with New York sources is determined by multiplying the shareholder's pro rata share of the dividend by the alien subsidiary's issuer's allocation percentage as determined under section 210.3(b)(1) of Article 9-A of the Tax Law. In this case, the alien subsidiary's issuer's allocation percentage is zero. Therefore, pursuant to section 631(a) of the Tax Law, no portion of the shareholder's pro rata share

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of the dividend is derived from or connected with New York sources, and for purposes of section 601(e) of the Tax Law, no portion of the dividend would be included in the numerator of the New York source fraction of the nonresident shareholder.

DATED: June 25, 1999

/s/
John W. Bartlett
Deputy Director
Technical Services Bureau

NOTE: The opinions expressed in Advisory Opinions are limited to the facts set forth therein.