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

TSB-M-89 (4)I
Income Tax
July 5, 1989

Note: This memorandum must be used in conjunction with TSB-M-82-(3)-I(Rev.) dated December 21, 1983, a copy of which is attached.

Taxation of Retired Shareholders of Professional Service Corporations

The Department has been asked to explain the proper method of computing the pension and annuity exclusion under section 612(c)(3-a) of the Tax Law for a retired shareholder of a professional service corporation who is also eligible for the subtraction modification under section 612(c)(12) of the Tax Law. In addition, inquiries have been made as to whether shareholders are entitled to the 612(c)(12) subtraction if they receive a distribution from an Individual Retirement Arrangement (IRA), Keogh Plan or other qualified plan, the principal of which is fully or partially composed of moneys rolled over from a professional service corporation pension plan. An explanation of these issues follows.

The pension and annuity exclusion for a retired shareholder of a professional service corporation who is also eligible for the 612(c)(12) subtraction is to be determined as follows:

1. Compute the amount of the 612(c)(12) subtraction for the year, using the applicable method explained in the attached TSB memorandum*.

2. The pension income reportable for federal tax purposes is then reduced by the 612(c)(12) subtraction.

3. The portion remaining, if any, up to a maximum of $20,000, is to be subtracted as the pension and annuity exclusion.

* The methods outlined in the TSB memorandum essentially parallel the methods under section 72 of the Internal Revenue Code (prior to the 1986 Tax Reform Act), which allowed employees receiving pensions to exclude any previously taxed contributions from federal adjusted gross income. Although the three-year rule under section 72(d) was repealed by the Tax Reform Act, New York State will continue to allow its use <u>only</u> for purposes of computing the 612(c)(12) subtraction.

Example: John Brown is age 62, retired and is to receive an annual payment from a professional service corporation pension plan of $20,000 for 20 years. Mr. Brown was previously taxed on $200,000 of the pension payments. Using the formula method in the attached TSB memorandum, the 612(c)(12) modification is $10,000 ($200,000/$400,000 x $20,000). The remaining portion of the pension distribution ($10,000) is to be subtracted as the pension and annuity exclusion.

A retired shareholder who receives a distribution from an IRA, Keogh or other qualified plan, the principal of which is fully or partially composed of moneys rolled over from a professional corporation pension plan, remains eligible for the 612(c)(12) subtraction. In this instance, the subtraction and, if the shareholder qualifies, the pension and annuity exclusion, are computed as follows:

1. Compute the amount of the qualified plan distribution attributable to the amount rolled over from the professional service corporation pension plan. The amount is determined using the rules for determining the previously taxed portion of distributions under section 72 of the Internal Revenue Code. This step is required only for the initial year of payment under the contract to determine whether the total amount previously taxed will be recovered in three years.

2. Then compute the section 612(c)(12) subtraction. Where the three-year rule applies, or where the payments constitute an annuity, the subtraction is to be computed using the guidelines in the attached TSB memorandum.

   Where the payments do not constitute an annuity, the subtraction is the amount that bears the same ratio to the amount distributed as (1) the aggregate amount added back, less an amount previously subtracted under 612(c)(12), bears to (2) the value of the contract. For purposes of this formula, all distributions from IRAs in any taxable year are treated as one distribution. In addition, the value of the contract is to be increased by any distributions during the calendar year, and income on the contract and the aggregate amount added back are to be computed as of the close of the calendar year in which the shareholder's taxable year begins.

3. The total distribution reported for federal purposes is then reduced by the 612(c)(12) subtraction.

4. The portion of the distribution remaining, if any, up to a maximum of $20,000, is to be subtracted as the pension and annuity exclusion.

Example: Mary Smith receives a distribution of $300,000 from a professional service corporation (PC) pension plan and rolls that amount into an IRA. Mary was previously taxed on $150,000 of the distribution. She subsequently retires at age 65 and will receive annual payments from the IRA of $50,000 for 20 years. Assuming that she made no nondeductible contributions to the IRA, the 612(c)(12) subtraction and the pension and annuity exclusion are computed as follows:

Annual distribution				$50,000
Amount rolled over from PC / Expected return under contract	=	$ 300,000 / $1,000,000	=	x .30
Amount of IRA distribution attributable to PC				$15,000

Since Mary will not recover the aggregate amount added back ($150,000) within three years and since the distribution constitutes an annuity, the formula method in the attached TSB memorandum must be used to figure the 612(c)(12) subtraction. Applying the formula, the subtraction is $7,500 ($150,000/$1,000,000 x $50,000). She may then subtract $20,000 of the remaining $42,500 as the pension and annuity exclusion.

Beneficiaries

The 612(c)(12) modification and, where the deceased shareholder would have qualified, the pension and annuity exclusion, may be taken by beneficiaries of deceased shareholders, and are computed using the same rules that would have applied to the shareholder.

New York State Department of Taxation and Finance
Taxpayer Services Division
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TSB-M-82- (3)-I (Rev.)
Income Tax
December 21, 1983

This Memorandum supersedes Memorandum numbered TSB-M-82-(3)-I dated April 27, 1982, <u>which should be destroyed.</u>

<u>Computation of Section 612(c)(12) Modification for Professional Service Corporation (P.C.) Shareholder</u>

Inquiries have been made concerning how a shareholder of a professional service corporation should compute the subtraction modification under section 612(c)(12) of the New York State Tax Law.

Under section 612(b)(7) of the New York State Tax Law, as amended by Chapters 358 and 1043 of the Laws of 1981, a shareholder of a professional service corporation is required to add to his federal adjusted gross income the excess of the amount deductible by the corporation as a contribution to certain employee plans for pensions, profit sharing, annuity and bond purchase, over the lesser of $15,000 or 15% of the earned income derived by such shareholder from such corporation.

Under section 612(c)(12) of the New York State Tax Law, a shareholder of a professional service corporation is permitted to subtract from federal adjusted gross income amounts necessary to prevent taxation of amounts previously included in income under section 612(b)(7) of the New York State Tax Law.

When the shareholder begins receiving retirement benefits, the section 612(c)(12) modification will be made in the following manner:

> If the total aggregate amount of the addback modification under section 612(b)(7) can be recovered in 3 years, the payments received by the shareholder can be subtracted from federal adjusted gross income until the entire aggregate amount of addback previously taxed is recovered.
>
> If the total aggregate amount of the addback modification under section 612(b)(7) cannot be recovered within 3 years, the following formula will be used:
>
> <u>Aggregate amount added back</u>   X
> Expected return under the contract
>
> The amount received under the contract   =
>
> The amount to beexcluded in arriving at New York adjusted gross income. (612(c)(12) modification)

Definition of terms:

1. Aggregate amount added back is the amount previously included in New York adjusted gross income because of the 612(b)(7) modification. This amount is reduced by any amounts which were previously subtracted from New York income under section 612(c)(12) prior to the use of the formula.

2. Expected return under the contract is computed as of the date payments commence and includes all amounts contributed plus amounts earned on the account (as defined under Internal Revenue Code section 72(c)(3)). This amount must be reduced by all amounts previously received under the contract prior to the use of the formula.

3. The amount received under the contract means the amounts received by the shareholder for the current taxable year.

4. The amount to be excluded in arriving at New York adjusted gross income is the section 612(c)(12) modification for the current taxable year.

The provisions of this memo also apply to section T46-112.0(c)(12) of the Administrative Code of the City of New York.

This memorandum should be used in conjunction with TSB-M-80-(8)-I, dated December 10, 1980.