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

TSB-A-88 (14) I
Income Tax
September 16, 1988

STATE OF NEW YORK
COMMISSIONER OF TAXATION AND FINANCE

ADVISORY OPINION PETITION NO. I880504A

On May 4, 1988, a Petition for Advisory Opinion was received from Douglas Condon of Trager, Glass & Co., CPA's, 1790 Broadway, New York, New York 10019.

The issue raised is how the tax on unearned income, under Article 22 of the Tax Law, is applied to an individual whose income is derived from an S corporation and from rental real property.

The facts are presented as examples:

Example 1: A taxpayer is the sole owner of an S corporation in which the taxpayer actively participates. The taxpayer draws no salary but takes distributions from the S corporation earnings. How are the S corporation profits, which pass through to the shareholder (taxpayer), treated for purposes of the tax on unearned income?

Example 2: The same facts as in Example 1 except that the taxpayer's ownership interest is less than 50 percent.

Example 3: The same facts as in Example 1 except that the taxpayer does not materially participate.

Example 4: The same facts as in Example 1 except that the taxpayer receives a salary from the S corporation.

Example 5: The taxpayer owns rental real property in which the taxpayer actively participates. The taxpayer had a net profit of $10,000 in 1987. How is this income treated for purposes of the tax on unearned income?

It is assumed that for purposes of Examples 1-5 the taxpayer is a resident individual, and that for purposes of Examples 1-4 the shareholders of the S corporation have made the election, pursuant to section 660 of the Tax Law, to treat the corporation as a New York S corporation.

Section 601(d)(1) of the Tax Law provides that, for taxable years beginning after 1986 and before 1989, the tax on certain unearned income is imposed on the New York unearned income of a resident individual who has New York adjusted gross income in excess of $100,000 (or $50,000 if married filing separately). Section 601(d)(4) provides that "New York unearned income" means New York adjusted gross income with certain adjustments. The New York adjusted gross income of a resident individual is the individual's federal adjusted gross income with the modifications required by section 612 of the Tax Law. An individual's federal adjusted gross income includes a shareholder's pro rata share of a S corporation's income, loss, deduction and reduction for taxes described in section 1366(f)(2) and (3) of the Internal Revenue Code. Section 601(d)(6) provides

for the adjustments decreasing New York adjusted gross income and states that:
there shall be subtracted from New York adjusted gross income:

(A) Earned income within the meaning of paragraph two of subsection (d) of section nine hundred eleven of the internal revenue code, except that the phrase "not in excess of thirty percent of his share of the net profits of such trade or business" shall not apply. . . .

(B) Earned income within the meaning of subparagraph (C) of paragraph two of subsection (c) of section four hundred one of the internal revenue code, including amounts (i) received as a pension or annuity which arises from an employer-employee relationship, (ii) paid or distributed out of an individual retirement plan or (iii) received as deferred compensation.

(C) Capital gain net income.

(D) Income in respect of alimony and separate maintenance payments.

(E) Any of the modifications required by subsection (b) of section six hundred twelve which are properly allocable to or chargeable against the adjustments determined under this paragraph and paragraph five of this subsection.

(F) A deduction for (i) interest on indebtedness incurred or continued to purchase or carry obligations or securities, (ii) ordinary and necessary expenses for (I) the production or collection of income or (II) the management, conservation or maintenance of property held for the production of income, and (iii) amortizable bond premium, to the extent such interest, expenses and premium are paid or incurred during the taxable year, are not deductible in determining New York adjusted gross income and are directly related to unearned income includible in New York adjusted gross income.

Section 401(c)(2)(C) of the Internal Revenue Code states:

(C) INCOME FROM DISPOSITION OF CERTAIN PROPERTY.-For purposes of this section, the term "earned income" includes gains (other than any gain which is treated under any provision of this chapter as gain from the sale or exchange of a capital asset) and net earnings derived from the sale or other disposition of, the transfer of any interest in, or the licensing of the use of property (other than good will) by an individual whose personal efforts created such property.

Section 911(d)(2) of the Internal Revenue Code states:

(2) EARNED INCOME. -

(A) **IN GENERAL. -** The term "earned income" means wages, salaries, or professional fees, and other amounts received as compensation for personal services actually rendered, but does not include that part of the compensation derived by the taxpayer for personal services rendered by him to a corporation which represents a distribution of earnings or profits rather than a reasonable allowance as compensation for the personal services actually rendered.

(B) TAXPAYER ENGAGED IN TRADE OR BUSINESS. - In the case of a taxpayer engaged in a trade or business in which both personal services and capital are material income-producing factors, under regulations prescribed by the Secretary, a reasonable allowance as compensation for the personal services rendered by the taxpayer, not in excess of 30 percent of his share of the net profits of such trade or business, shall be considered as earned income.

The Internal Revenue Code definition of "earned income" is substantially similar to the personal income tax definition of "New York personal service income" that was contained in section 603-A of the Tax Law, prior to that section's repeal in 1987. Therefore, herein it is appropriate to apply precedent set under such section 603-A.

Section 603-A of the Tax Law provided for a maximum tax rate on New York personal service income. Section 603-A(b)(1) defined "New York personal service income", in part, as:

> wages, salaries, or professional fees, and other amounts received as compensation for personal services actually rendered, but does not include that part of the compensation derived by the taxpayer for personal services rendered by him to a corporation which represents a distribution of earnings or profits rather than a reasonable allowance as compensation for the personal services actually rendered. In the case of a taxpayer engaged in a trade or business in which both personal services and capital are material income producing factors**..**, a reasonable allowance as compensation for the personal services rendered by the taxpayer shall be considered as earned income**. . . .**

The personal income tax regulations of the State Tax Commission provided that "[w]here an individual performs personal services for a corporation (including an S corporation), personal service income generally is only the portion of income received from the corporation that represents a reasonable allowance for salaries and other compensation for personal services actually rendered." 20 NYCRR 100.4(c)(1)(iii). (Emphasis supplied).

The personal income tax regulations also provided that "[w]here an individual is engaged in an unincorporated trade or business in which both personal services and capital are material income-producing factors, a reasonable allowance as compensation for the personal services actually rendered is personal service income from the trade or business." 20 NYCRR 100.4(c)(1)(v). However, such allowance cannot be more than the net profits of the business.

The personal income tax regulations do not specify any test to determine the portion of income received from a corporation or an unincorporated trade or business that represents a reasonable allowance for salaries and other compensation for personal services actually rendered. Nor do the regulations contain any provisions restricting "New York personal service income" to amounts reported on W-2 forms.

However, section 617(b) of the Tax Law provides that each item of S corporation income, gain, loss or deduction shall have the same character for a shareholder under Article 22 as for federal income tax purposes. In addition, where an item is not characterized for federal income tax purposes, it shall have the same character for a shareholder as if realized directly from the source from which realized by the S corporation or incurred in the same manner as incurred by the S corporation. Therefore, earned income cannot include items of income or gain that would be characterized as unearned income if realized by the taxpayer directly from the source from which realized by the S corporation.

The determination of what represents a reasonable allowance for salaries and other compensation for personal services actually rendered is a factual question which must be answered on a case by case basis based upon a careful review of the relevant facts and circumstances of each case. Factors which may be taken into account in arriving at a reasonable allowance include: the nature, extent and scope of the taxpayer's work, the taxpayer's qualifications, the size and complexities of the trade or business, a comparison of the taxpayer's compensation to the compensation of other employees, a comparison of the taxpayer's income from the corporation to the income of other shareholders of the corporation and the prevailing rates of compensation for comparable positions in comparable companies. However, the above list is not intended to be an exhaustive list. Zalman C. and Elaine K. Bernstein, Advisory Opinion of the Commissioner of Taxation and Finance, December 15, 1987, TSB-A-87(10)I.

It should be noted that the burden of proving that income received represents a reasonable allowance for compensation for personal services actually rendered falls upon the taxpayer. Antonio and Frances Coppola, Joseph and Marie Coppola, Decision of the State Tax Commission, February 18, 1986, TSB-H-86(44)I; Migliore v. Commissioner, 36 TCM 1004 (1977) (applying the provisions of former Internal Revenue Code section 1348 relating to the definition of"earned income" which is substantially the same as section 603-A of the Tax Law); Paula Construction, Co. v. Commissioner, 58 T.C. 1055 (1972).

Accordingly, with respect to Examples 1 through 5, New York unearned income includes the income from both the S corporation and the rental real property that is included in New York adjusted gross income, decreased by the adjustments required by section 601(d)(6).

In particular, New York adjusted gross income is decreased by earned income which includes income from wages, salaries, professional fees or other amounts received as compensation for personal services, if such amounts represent a reasonable allowance for personal services actually rendered. Such earned income is not restricted to an amount designated as salary and reported on a W-2 form.- However, the taxpayer bears the burden of proving that any amount of income from the S corporation included on the taxpayer's K-1 form or from the rental of real property is earned income. Inasmuch as any such proof will entail a question of fact, a determination of what constitutes earned income cannot be made within the context of an advisory opinion.

Finally, it is noted that for purposes of the tax on unearned income, earned income is not determined by reference to the passive activity rules established pursuant to Internal Revenue Code Section 469.

DATED: September 16, 1988

s/FRANK J. PUCCIA
Director
Technical Services Bureau

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