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

TSB-A-98(8)I
Income Tax
September 4, 1998

STATE OF NEW YORK
COMMISSIONER OF TAXATION AND FINANCE

ADVISORY OPINION PETITION NO. I980609A

On June 9, 1998, a Petition for Advisory Opinion was received from, MSD Capital, L.P., c/o McDermott, Will & Emery, 50 Rockefeller Plaza, New York, New York 10020.

The issue raised by Petitioner, MSD Capital L.P., is whether, based on the facts presented, the distributive share of income received (or deemed received) by M and the other M Interests from Portfolio LP, the Series G LLCs, the Series J LLCs, and Petitioner (1) would be considered New York source income for purposes of the New York State personal income tax and (2) would be considered net earnings from self-employment for purposes of the New York City Earnings Tax on Nonresidents.

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

Petitioner has been formed to facilitate the investment activities of M; his spouse, S; their relatives; and trusts formed by them primarily for the benefit of their relatives and charities (collectively, the "M Interests"). None of the M Interests is a resident of New York State. For various reasons, the M Interest investments will be made pursuant to the structure set forth below. The investments, virtually all of which will be securities and other financial instruments and some of which will be traded on public exchanges, will be managed in New York by two employees of Petitioner, G and J, who are both unrelated to any of the M Interests.

The planned structure envisions Petitioner having two partners: M, who would be the sole general partner, and T1, which would be the sole limited partner (T1, as a trust that would be solely funded by M and/or S, for the benefit of their descendants, would be an M Interest); M would contribute 1% of Petitioner's capital and T1 would contribute 99% of its capital; M's and T1's capital and income interests would reflect those same proportions. Petitioner, which would maintain its office in New York City, would employ G and J and such other staff as may be necessary to manage the investments of Portfolio LP, as described below. Petitioner's activities would be dedicated exclusively to (1) managing its own assets (which will consist of furniture, fixtures, and equipment and working capital) and the assets of Portfolio LP and (2) being a passive invester in the Series G and Series J LLCs (described below). None of the Series G LLCs, the Series J LLCs, or Portfolio LP will be a broker/dealer or "make a market" in any securities. All of these partnerships and LLCs will be treated as partnerships for federal income tax purposes.

The Series G LLCs and the Series J LLCs would each have Petitioner as its sole non-managing member and G (in the case of the Series G LLCs) or J (in the case of the Series J LLCs) as its sole managing member. (Under certain extraordinary circumstances, Petitioner may become a managing member.) Petitioner would contribute and have an interest in 87.5% of the capital of each of the Series LLCs, while the managing member would contribute and have an interest in the remaining 12.5% of the capital. Each of the two members of each

Series LLC would share in the income from the Series LLC proportionally with their respective capital investments, to a maximum amount equal to an objectively determinable floating rate return on their capital annually. Any income in excess of that would be shared, with the individual managing member (G or J) receiving 99% of such excess, and Petitioner receiving 1% of such excess. The sole activity of the Series G LLCs and the Series J LLCs would be the making, maintaining, and disposing of investments in securities and other financial instruments.

Portfolio LP would establish several separate funds (considered "series" under Delaware partnership law, which is the authority under which Portfolio LP would be formed). The exact amount and portion of the capital contribution of each partner may vary depending on the availability of assets; however, it is envisioned that (1) Petitioner would be the sole general partner in each fund, contributing 1% of the capital and receiving a 1% capital interest and a 20.8% interest in profits, and (2) other M Interests would be limited partners in each fund, collectively contributing 99% of the capital and receiving a 99% capital interest and a 79.2% interest in profits.

Discussion

Section 2 of the Tax Law provides the definition of certain terms used in the Tax Law, and was amended by Chapter 576 of the Laws of 1994 which added the following:

> 5. The term "limited liability company" means a domestic limited liability company or a foreign limited liability company, as defined in section one hundred two of the limited liability company law.
>
> 6. "Partnership and partner," unless the context requires otherwise, shall include, but shall not be limited to, a limited liability company and a member thereof, respectively.

An LLC that is treated as a partnership for federal income tax purposes, is treated as a partnership for New York State tax purposes. (See, Department of Taxation and Finance Memorandum, TSB-M-94(6)I and (8)C, October 25, 1994.) Accordingly, for New York State personal income tax purposes, the Series G LLCs and the Series J LLCs will be treated as partnerships.

Section 631(a) of the Tax Law provides that the New York source income of a nonresident individual includes the net amount of items of income, gain, loss and deduction entering into the individual's federal adjusted gross income derived from or connected with New York sources, including the individual's distributive share of partnership income, gain, loss and deduction, determined under section 632 of the Tax Law.

Section 632(a)(1) of the Tax Law provides that "[i]n determining New York source income of a nonresident partner of any partnership, there shall be included only the portion derived from or connected with New York sources of such partner's distributive share of items of partnership income, gain, loss and deduction entering into the individual's federal adjusted gross income. The determination of such portion shall be consistent with section 631 of the Tax Law.

Section 631(b) of the Tax Law provides that items of income, gain, loss and deduction derived from or connected with New York sources include those items attributable to a business, trade, profession or occupation carried in New York State. However, section 631(d) of the Tax Law provides that a nonresident, other than a dealer holding property primarily for sale to customers in the ordinary course of the individual's trade or business, shall not be deemed to carry on a business, trade, profession or occupation in this state solely by reason of the purchase and sale of property or the purchase, sale or writing of stock option contracts, or both, for the individual's own account.

In Kenneth S. Davidson Partners, Adv Op Comm T&F, June 28, 1988, TSB-A-88(11)I, it was held that the purchase and sale by the partnership of options on indexes, foreign currencies, debt obligations and futures contracts and the exercise, closing out or expiration of such options solely for its own account did not constitute the carrying on of a business, trade, profession or occupation in New York State. However, the opinion noted that the partnership would not be considered to be solely trading for its own account if it engaged in certain other activities such as market making activities.

In Paul E. Singer, Adv Op Comm T&F, June 4, 1992, TSB-A-92(2)I, a partnership with its principal office in New York engaged in trading securities for its own account. It had two general partners, one was a nonresident individual and the other was a limited partnership. The opinion held that the partnership was not carrying on a trade or business in New York because it was engaged solely in trading for its own account, thus the income attributable to the partnership was not New York source income, and this did not change despite the existence of a tiered partnership arrangement, where the partnership's income is funneled through the limited partnership before its ultimate distribution, or deemed distribution to the individual.

In this case, pursuant to sections 631 and 632 of the Tax Law and following the Davidson, supra, and Singer, supra, opinions, the activities of Petitioner, Portfolio LP, the Series G LLCs and Series J LLCs constitute trading for their own accounts. Accordingly, the distributive share of income that M or any of the other M Interests receive, or are deemed to receive, from Portfolio LP (whether directly or indirectly through Petitioner), from the Series G LLCs and Series J LLCs (indirectly through Petitioner), and/or from Petitioner is not deemed to be attributable to a trade or business carried on in New York State. Therefore, M and the other M Interests will not have New York source income from these activities under section 631 of the Tax Law.

The New York City Earnings Tax on Nonresidents is authorized under Article 30 of the Tax Law, and is administered by New York State. Section 11-1902 of the Administrative Code for the City of New York ("Admin. Code") imposes the tax on wages earned and net earnings from self-employment, within the City, of nonresident individuals, estates and trusts. Net earnings from self-employment is defined, in section 11-1901(f) of the Admin. Code, to be the same as net earnings from self-employment as defined in section 1402(a) of the Internal Revenue Code ("IRC"), with some variations not relevant herein. A trust shall be deemed to have net earnings from self-employment determined in the same manner as if it were an individual subject to the tax on self-employment income.

Section 1402(a) of the IRC defines net earnings from self-employment as:

> gross income derived by an individual from any trade or business carried on by such individual, less the deductions allowed by this subtitle which are attributable to such trade or business, plus his distributive share (whether or not distributed) of income or loss described in section 702(a)(8) from any trade or business carried on by a partnership of which he is a member; except that in computing such gross income and deductions and such distributive share of partnership ordinary income or loss --
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> ...
>
> (2) there shall be excluded dividends on any share of stock, and interest on any bond, debenture, note, or certificate, or other evidence of indebtedness ... unless such dividends and interest are received in the course of a trade or business as a dealer in stock or securities;
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> (3) there shall be excluded any gain or loss —
>
> (A) which is considered as gain or loss from the sale or exchange of a capital asset;
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> ...
>
> (13) there shall be excluded the distributive share of any item of income or loss of a limited partner, as such, other than guaranteed payments described in section 707(c) to that partner for services actually rendered to or on behalf of the partnership to the extent that those payments are established to be in the nature of remuneration for those services.

In this case, the distributive share of income that M or any of the other M Interests receive, or are deemed to receive, from Portfolio LP (whether directly or indirectly through Petitioner), from the Series G LLCs and Series J LLCs (indirectly through Petitioner), and/or from Petitioner, would not be considered net earnings from self-employment for purposes of the New York City Earnings Tax on Nonresidents.

DATED: September 4, 1998

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

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