

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

TSB-A-98(13) I
Income Tax
November 5, 1998

STATE OF NEW YORK
COMMISSIONER OF TAXATION AND FINANCE

ADVISORY OPINION

PETITION NO. I980814B

On August 14, 1998, a Petition for Advisory Opinion was received from Christopher L. Doyle, Hodgson, Russ, Et. Al., 1800 One M&T Plaza, Buffalo, New York 14203-2391.

The issue raised by Petitioner, Christopher L. Doyle, is whether a nonresident individual, who is the sole general partner of a limited partnership whose only activity in New York is buying and selling options and other securities for its own account by trading under an Options Principal Member (an "OPM") of the American Stock Exchange ("AMEX"), must treat his distributive share of the partnership's income as New York source income for personal income tax purposes under Article 22 of the Tax Law.

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

A: The Amex

Taxpayer, an individual, is not a resident of New York. He is a general partner in a limited partnership ("LP") engaged as an OPM on the AMEX. The AMEX is a well established market on which both stocks and stock options are traded. Trading is accomplished by using an auction system. The main players in this system are the Intake Broker, the Specialist, the OPM and the Floor Broker.

A typical transaction starts with a customer who contacts an Intake Broker asking him to buy some stock options on (for example) XYZ stock. The Intake Broker handles the trade for a commission. The broker contacts a member on the floor of the AMEX and directs him to buy the options on the XYZ stock. This member, who receives a fee for the transaction, is called a Floor Broker. The Floor Broker goes to the location where the Specialist for XYZ stock options does business. OPM's have limited memberships which permit them to do nothing more than trade on their own accounts. If an OPM wants to buy (or sell) an XYZ option, he will congregate near the Specialist for the XYZ stock options.

B: Regular Members

The AMEX has authorized two different classes of memberships to conduct trading activities on the floor of the AMEX, a regular membership and an Options Principal Membership. Regular memberships afford members the widest range of possible activities. Only regular members may be Specialists. Regular membership is required if the member wishes to either trade or specialize in all the stocks (i.e. equity interests) listed on the AMEX. Finally, only regular members may be Floor Brokers or otherwise transact business with the public.

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The Specialist is responsible for both establishing and maintaining the prices at which the various options will trade. He does so by displaying the price he (or an OPM or a public customer if their price is higher) is willing to pay for a particular option. He will also display another, slightly higher price he (or an OPM or a public customer if their price is lower) will accept for selling it.

In the example, the Floor Broker will announce he is seeking to purchase options on XYZ stock, how many he wants and the price he is willing to pay. If the price is the Specialist's price, the Specialist will indicate how much of the transaction he will do. If the Specialist is unwilling to participate as a counter-party for the entire transaction, he will ask the OPMs if any of them wish to participate in the remaining portion of the transaction. The OPMs will then compete to participate in the portion of the transaction not taken by the Specialist. In many cases, the Specialist will decide which OPMs may participate in the transaction. If no OPM is willing to take part in the transaction, and if the price meets that posted by the Specialist, the Specialist is obligated to complete the trade for up to ten options contracts at the posted price. This obligation of the Specialist is explained in AMEX Rule 958A.

The Specialist, who must be a "regular" member (not an OPM) appointed to his position by the Exchange, must at all times be present and willing to buy or sell the options in which he specializes. He may not leave his post or refuse to post prices at which options can be bought and sold. If an offer to buy or sell is made, consistent with the prices he has posted, he must honor the offer.

Thus, it is the Specialist who is obligated to "make a market". He is required to post the prices at which various options will be bought or sold and has the responsibility to buy or sell them if no one else will. OPMs merely compete with each other to participate in the market created by the Specialist when they see fit to do so.

C: OPMs

According to AMEX Rule 958, an OPM is not required to do anything other than engage in a "course of dealings reasonably calculated to contribute to the maintenance of a fair and orderly market". At any time during the trading day, an OPM may leave the area where a particular option is traded and go to another area. He may leave the floor altogether if he chooses. If an offer to buy or sell options comes to the floor of the Exchange, an OPM is not obligated to participate in the transaction. That obligation belongs to the Specialist alone.

The Options Principal Membership, which was created in 1977, severely limits the kind of activity an OPM may conduct. Petitioner provides that the Offering Memorandum for Options Principal Memberships describes the privileges allowed this type of membership:

An options principal member may execute on the floor of the Exchange transactions in options initiated by him for his own account and may give orders in options for his own account to regular members of the

Exchange for execution. Such member may not execute agency transactions on the floor either for customers or for regular, associate or allied members of the Exchange or other options principal members, may not be registered as a specialist, may not execute on the Exchange any orders, whether as agent or principal, in stocks, warrants, bonds or other securities (except principal transactions in options) and may not accept orders from his member organization for execution. An options principal membership will not carry any of the privileges of regular membership except as described above and as otherwise specifically provided in the Constitution of the Exchange.

In short, although often referred to as "market makers", OPMS may do nothing but buy and sell options contracts for their own accounts and can only do so with other members of the Exchange.

Like other OPMS, LP's business activities are limited to buying and selling options (and the related underlying securities) for its own account.

Discussion

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 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

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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, Taxpayer is a general partner in a LP. The LP's business activities are limited to buying and selling options contracts for its own account, which is conducted by Taxpayer as an OPM on the AMEX. As an OPM, Taxpayer may buy and sell options contracts for the LP's own account, but he may not "execute agency transactions on the floor either for customers or for regular, associate or allied members of the Exchange or other options principal members, may not be registered as a specialist, may not execute on the Exchange any orders, whether as agent or principal, in stocks, warrants, bonds or other securities (except principal transactions in options) and may not accept orders from his member organization for execution."

Taxpayer may contribute to the maintenance of a fair and orderly market by trading for his own account, but he is not a "specialist" who is required to establish and maintain a fair and orderly market by executing orders as agent as well as principal. Therefore, as an OPM, Taxpayer is neither a "market maker" nor a dealer in options contracts, and, pursuant to section 631(d) of the Tax Law, Davidson, supra, and Singer, supra, LP is not carrying on a business, trade, profession or occupation in New York by buying and selling options contracts for its own account through Taxpayer, as an OPM on the AMEX. Accordingly, Taxpayer's distributive share of LP's income is not New York source income under section 631(a) of the Tax Law.

DATED: November 5, 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.