

Amendments to the Treatment of Certain S Corporation Income by Nonresident Taxpayers

Chapter 57 of the Laws of 2010 amended the treatment of certain income by nonresident individuals who are shareholders of an S corporation. This memorandum discusses the amendments and their effective dates.

Income from installment obligations under IRC section 453(h)(1)(A)

If a nonresident is a shareholder in an S corporation that has made the election to be a New York S corporation, and the S corporation has distributed an installment obligation under IRC section 453(h)(1)(A) to the shareholders, any gain recognized on the receipt of payments from the installment obligation for federal income tax purposes will be treated as New York source income. The amount of the gain to be included in New York source income is determined using the applicable allocation percentage under Article 9-A (franchise tax on business corporations) or Article 32 (franchise tax on banking corporations) of the New York State Tax Law in effect for the year the assets were sold.

Generally, this amendment applies to taxable years beginning on or after January 1, 2007. However, it will also apply to any other taxable years where the statute of limitations for issuing an assessment remains open because the taxpayer for that year:

- failed to file a return,
- failed to report federal changes,
- filed a false or fraudulent return with the intent to evade tax, or
- substantially omitted income under section 683(d) of the Tax Law.

In addition, this amendment applies to installment payments received in any tax year described above even if the payments are attributable to an installment obligation entered into prior to that year.

A taxpayer who is affected by this amendment for any prior year described above must file an amended return for any of the years affected if a return was previously filed for that year, or must file an original return if no return was filed for the prior year. Taxpayers amending returns or filing original returns will not be assessed penalties for any underpayment of tax attributable to this amendment.

(Tax Law section 632(a)(2))

Income from an election under IRC section 338(h)(10)

If a nonresident is a shareholder in an S corporation that has made the election to be a New York S corporation, and the S corporation has made an election under IRC

section 338(h)(10), then any gain recognized on the deemed asset sale for federal income tax purposes will be treated as New York source income. The amount of the gain to be included in New York source income is determined using the applicable allocation percentage under Article 9-A or Article 32 of the New York State Tax Law in effect for the year that the section 338(h)(10) election was made.

In addition, when a nonresident shareholder exchanges his or her S corporation stock as part of the deemed liquidation, the new law provides that any gain or loss recognized on the stock sale for federal income purposes will be treated as the disposition of an intangible asset for New York State purposes and will not increase or offset any gain recognized on the deemed asset sale as a result of the section 338(h)(10) election. Therefore, the gain or loss from the deemed liquidation of S corporation stock is not included in New York source income.

Generally, this amendment applies to taxable years beginning on or after January 1, 2007. However, it will also apply to any other taxable years where the statute of limitations for issuing an assessment remains open because the taxpayer for that year:

- failed to file a return,
- failed to report federal changes,
- filed a false or fraudulent return with the intent to evade tax, or
- substantially omitted income under section 683(d) of the Tax Law.

A taxpayer who is affected by this amendment for any prior year described above must file an amended return for any of the years affected if a return was previously filed for that year, or must file an original return if no return was filed for the prior year. Taxpayers amending returns or filing original returns will not be assessed penalties for any underpayment of tax attributable to this amendment.

(Tax Law section 632(a)(2))

Income from an installment sale contract

If a nonresident is a shareholder in an S corporation that has made the election to be a New York S corporation, and that S corporation terminates its taxable status in New York, any income or gain recognized on the receipt of payments from an installment sale contract entered into when the S corporation was subject to tax in New York will be treated as New York source income. The amount of the income or gain to be included in New York source income is determined using the applicable allocation percentage under Article 9-A or Article 32 of the New York State Tax Law in effect for the year that the S corporation sold the assets that gave rise to the installment sale contract.

This amendment is applicable to installment payments received in taxable years beginning on or after January 1, 2010, even if the payments are attributable to an installment sale contract entered into prior to 2010.

(Tax Law section 631(b)(1)(E-1))

2010 estimated tax

As a result of the amendments, a taxpayer's 2010 estimated income tax may be underpaid or a taxpayer may be required to begin making estimated tax payments. To avoid the penalty for underpayment of estimated tax for tax year 2010, the total amount of estimated tax and withholding tax paid must be:

- at least 90% (66 2/3% for farmers and fishermen) of the amount of income tax due as shown on the taxpayer's return for 2010; **or**
- 100% of the tax shown on the taxpayer's return for 2009 (110% of that amount if he or she is not a farmer or a fisherman and his or her New York adjusted gross income shown on that return is more than \$150,000 or, if married filing separately for 2010, more than \$75,000). To qualify for this provision, the taxpayer must have filed a return for 2009, and it must have been for a full 12-month year.

No penalty will apply to any shortage in a taxpayer's April 15, 2010, or June 15, 2010, estimated tax payments that are attributable to this amendment, provided the taxpayer includes any shortfall in his or her September 15, 2010, payment, or the taxpayer begins making estimated tax payments by September 15, 2010.

NOTE: A TSB-M is an informational statement of existing department policies or of changes to the law, regulations, or department policies. It is accurate on the date issued. Subsequent changes in the law or regulations, judicial decisions, Tax Appeals Tribunal decisions, or changes in department policies could affect the validity of the information presented in a TSB-M.