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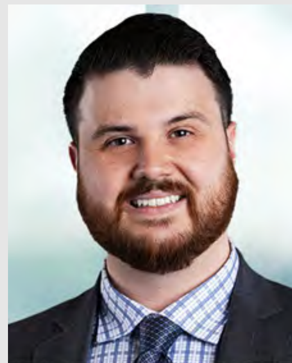
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In this installment of Noonan's Notes, Noonan and Tantillo discuss *Schreiber* and examine how the court's analysis could have an impact on the New York tax department's enforcement efforts in a different area, dealing with sales of partnership interests by nonresident taxpayers.

A couple decades ago, when one of us was a young state tax lawyer and the other was probably daydreaming in his second-grade class about his future life as a podcaster, the New York State Legislature passed sweeping economic development legislation designed to revive the local economies of several struggling or downtrodden areas throughout New York state.[1] Dubbed the Empire Zone Program, the legislation provided for substantial tax credits or tax-saving measures for individuals and companies that chose to operate their businesses within one of these so-called Empire Zones.[2] And perhaps not surprisingly, the new legislation spurred a couple decades of litigation as taxpayers, the New York tax department, and courts struggled to figure out how far some of these benefits extended.[3]

Since the program ended in 2010, the wave of litigation has ebbed. But we caught one more wave just recently, with a New York appellate court in *Matter of Schreiber* reviving an old battle on how far one of the more lucrative Empire Zone credits extended.[4] Apart from being another interesting (and perhaps the final) battle for the storied program, the case offers up an interesting statutory interpretation issue that could have an impact beyond an oddball tax credit. In this article, we'll break down *Schreiber* and examine how the court's analysis could have an impact on the tax department's enforcement efforts in a different area, dealing with sales of partnership interests by nonresident taxpayers.

The Schreiber QEZE Tax Reduction Credit Case

One of the benefits for taxpayers under the old Empire Zone Program was the availability of a "tax reduction credit" that essentially did what it said: It reduced the New York state taxes payable for qualifying taxpayers in Empire Zones. The specific issue in *Schreiber* arose in the context of S corporation shareholders who were also New

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[1] TSB-M-00-(4)I (Nov. 28, 2000); *see also* Robert D. Plattner, "New York Senate Republicans Propose Expansion of 'Empire Zones,'" *State Tax Today*, Mar. 1, 2001; TSB-M-01 (Jan. 16, 2001).

[2] The Empire Zone Program provided for three main benefits for businesses located within the zones: a sales and use tax exemption, a real property tax credit, and a tax reduction credit.

[3] For discussion of some of the cases, see Timothy P. Noonan and Christopher L. Doyle, "More Battles in New York's Empire Zones," *State Tax Notes*, July 19, 2010, p. 175.

[4] *Matter of Schreiber v. New York State Tax Appeals Tribunal*, 2023 N.Y. Slip Op. 06784 (N.Y. App. Div. 3d Dept.).

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York residents. The law provided that these taxpayers were entitled to a credit for the state tax paid on the flow-through portion of their S corporation income that was "allocated to the State."[5] For *resident* shareholders, though, arguably *all* their income is allocated to the state, because residents pay tax on all their income. But in several cases over the years, the tax department has asserted that even though those resident shareholders pay tax on 100 percent of their S corporation income, they get a corresponding credit only for the amount of that S corporation income that is properly apportionable to the state under the business allocation percentage (BAP) rules that apply to nonresident shareholders.[6] And if the S corporation had a significant amount of out-of-state sales, for instance, the New York resident shareholder's tax reduction credit would be minimal, even though they would have paid tax on 100 percent of their S corporation income as a resident of the state.

Taxpayers won several cases on this issue before the Tax Appeals Tribunal in 2016 issued its decision in *Matter of Purcell*, finding that the tax department's approach — to limit the credit to the amount of income allocated to New York under the BAP — was at least reasonable, and that decision was affirmed on appeal by the New York Appellate Division, Third Department.[7]

That seemed to settle the issue, but not for Herman Schreiber. In *Schreiber*, the issue before the court was whether it was rational for the tribunal to rely on *Purcell* to require the application of the BAP to determine what portion of the taxpayer's income was "allocated within the state" for purposes of calculating the taxpayer's qualified Empire Zone enterprise (QEZE) credit.

The facts in *Schreiber* were like those in *Purcell*: New York resident shareholders of an S corporation that did business in New York state sought a credit for tax on the flow-through portion of their S corporation income that was "allocated to the state." The business, a Manhattan-based photography company, calculated its QEZE credit based on all its taxable income, including income from sales that were shipped out of state. The tax department and tribunal, relying on *Purcell*, determined that the business's BAP needed to be applied to figure out the correct calculation of the QEZE credit, which significantly reduced the refund owed to the taxpayer. But unlike the S corporation in *Purcell*, which operated in New York and Virginia, the business in *Schreiber* did not have *any* out-of-state operations; the company's only location was in New York, and more specifically within an Empire Zone. The only reason it had a BAP less than 100 percent was because under the S corporation's BAP computation for sellers of tangible personal property, income gets allocated based on customer location.

The court found these distinctions significant enough to rule for the taxpayer. Most notably, the court stated that use of the BAP created an irrational result, noting that it made sense to reduce the QEZE in *Purcell* given the extent of that taxpayer's company's out-of-state activities, but not when a business was located only in New York. The court added that to restrict the QEZE credit to only sales with an end destination in New York would be contrary to the statutory purpose of the Empire Zone Program.

Fair enough. The distinction made by the court makes good sense, and it's refreshing to see that New York courts aren't just rubber-stamping Tax Appeals Tribunal decisions. But there is perhaps a broader impact here, given the court's holding that the tax department's attempt to use the BAP to determine income "allocated within New York" for purposes of the credit was simply at odds with the plain language of the statute, which makes no reference to using the BAP at all.

Impact on '1060 Cases'

New York's Tax on the Sale of Partnership Interests

That's where this otherwise oddball Empire Zone case gets interesting, because we're starting to see the tax department use the same rationale on an entirely different issue in the personal income tax area. Under a new statutory provision put in place by the Legislature in 2018, the tax

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[5] N.Y. Tax Law section 16(f)(2)(C).

[6] Noonan and Ariele R. Doolittle, "Empire Zone Litigation: Taking the 'Reduction' Out of the Tax Reduction Credit," *State Tax Notes*, Dec. 16, 2013, p. 665.

[7] *Matter of Purcell*, Tax Appeals Tribunal (Nov. 14, 2016); *aff'd*, *Matter of Purcell v. New York State Tax Appeals Tribunal*, 2018 N.Y. Slip Op. 08388 (N.Y. App. Div. 3d Dept.).

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department has the ability to characterize a nonresident's gain from the sale of a partnership — normally considered to be the nontaxable sale of an intangible asset by a nonresident — as New York-source income. Effective for any transaction after April 10, 2017, N.Y. Tax Law section 632(a)(1) provides that gain or loss recognized for federal income tax purposes by a nonresident partner on the sale or transfer of a partnership interest must be allocated to New York in a manner consistent with the applicable methods and rules for allocation under article 22 if the sale or transfer is subject to the provisions of IRC section 1060(a).

We'll get to the manner of allocation — which is the focus of our interest in this article — in a moment, but first a quick primer on IRC section 1060. Section 1060 contains special allocation rules for certain asset acquisitions. It requires that in an "applicable asset acquisition," the purchaser's basis in the acquired assets and the seller's consideration regarding the acquisition be allocated among the assets under the "residual method."[8] An applicable asset acquisition is defined as any transfer that involves a transfer of assets, which constitute a trade or business, *and* regarding that, the purchaser's basis in those assets is determined wholly by reference to the consideration paid for the assets.[9] So IRC section 1060 applies, for example, when partners in a partnership sell 100 percent of the partnership's interest to a third party.[10]

So under N.Y. Tax Law section 632(a)(1), if a nonresident is a partner in a partnership for which a sale of the membership interest is subject to the provisions of IRC section 1060, the 2018 legislation allows New York to tax the nonresident's income from the sale of that intangible asset even though income from the sale of intangible assets is not typically considered New York-source income.[11]

Allocation Rule by Fiat

But here's where we return to the topic at hand. Under the law, the gain from the sale of the partnership interest is supposed to be allocated to New York in a manner consistent with the applicable methods and rules for allocation under article 22. But that's all it says. There's nothing more in the law or regulations that specifies how the sourcing computation is to be done. Indeed, there are a lot of sourcing rules under article 22 that are set forth in N.Y. Tax Law section 631, but it's unclear from the law which sourcing rules apply to this specific type of transaction.

Never fear, your tax department is here. In an informational publication issued after the law change, the tax department instructed taxpayers to use the BAP of the selling partnership in the year of sale to determine the amount of gain derived from New York sources.[12] But is the use of BAP the right approach? A closer examination of the law leads us to believe that it may not be.

First, neither the statute nor regulation directs a taxpayer to use the entity's BAP when allocating gain from the sale of assets by a partnership. Technical memoranda (TSB-Ms) are not law, and the tax department cannot use a TSB-M to set a new rule. It needs a law or regulation to do that.[13] So at a minimum, if there is a situation similar to *Schreiber* in which the BAP overestimates the amount of New York activity (which often happens with New York's arcane three-factor partnership apportionment test), then *Schreiber* should give support for an argument that the use of the BAP is improper, and that some other more rational method is allowed.

But more broadly, in this context, why would we, as a rule, use the entity's BAP to determine the allocation of the gain from the sale of all the partnership assets? N.Y. Tax Law section 632 appears to suggest that for allocation purposes, we treat a sale of a partnership interest subject to IRC section 1060 as a deemed asset sale. That should mean, for tax purposes, that the partners

[8] *See* IRC section 1060(a).

[9] *See* IRC section 1060(c).

[10] *See* IRC section 1060; TSB-M-18(2).

[11] Is it constitutional to tax a nonresident on the sale of an intangible asset like a partnership interest? That's a question for another day (or article). But an Ohio case we covered back in 2016 might suggest New York has a constitutional problem on its hands. Noonan and Joshua K. Lawrence, "Could Ohio's Latest Due Process Case Spell Trouble for New York?" *State Tax Notes*, July 11, 2016, p. 117.

[12] *See* TSB-M-18(2).

[13] *See Matter of Stuckless*, DTA No. 819319 (N.Y. Tax App. Trib. Aug. 17, 2006) (citing *Lorillard Tobacco Co. v. Roth*, 786 N.E.2d 7 (N.Y. 2003) (explaining that a TSB-M serves an advisory purpose, and it lacks the precision of determinations generated through more formal department action)).

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are treated as selling their share of each of the partnership assets. Indeed, when a partnership sells assets and generates capital gain income, it is not reported and allocated on a partner's federal Schedule E; instead, the partner's share of the gain from the sale of the asset is reported on Schedule D. So it would follow logically, despite the instructions in the nonbinding TSB-M, that the gain should be allocated on an asset-by-asset basis.

That brings us back to N.Y. Tax Law section 631, which tells us that items of income attributable to a business carried on in New York are New York sourced, and all other items are not. Therefore, the analysis of the source of the income from these IRC section 1060 transactions must include a determination of whether the deemed assets sold are in fact used in a New York trade or business. So on the one hand, this analysis is easy; obviously, any gain from tangible assets used by the business in New York will be allocated to New York. But what about the gain from intangible assets, such as goodwill, which are often the largest piece of these transactions?

A Good Way to Allocate Goodwill?

N.Y. Tax Law section 631(b)(2) provides that income from intangible personal property will constitute income derived from New York sources "*only* to the extent that such income is from property *employed in* a business, trade, profession, or occupation carried on in this state."[14] So herein lies the biggest issue for most of these IRC section 1060 transactions, since often the largest portion of the gain is tied to the seller's goodwill.

The tax department's position, both in these section 1060 cases and more generally, is that goodwill is one of those assets that is indeed employed in a New York trade or business, at least to the extent that the trade or business operates in New York. But importantly, there is no statute, regulation, case, or ruling in the New York personal income tax area addressing whether goodwill — personal or corporate — is an intangible "employed" in the business to which it relates.[15] Indeed, the department's own Nonresident Allocation Guidelines acknowledge bluntly that "unfortunately there is not much guidance" on when an intangible, in general, is "employed in" a trade or business in New York.[16]

Yet the guidance outlined below that *is* available, both from a federal and New York standpoint, supports the notion that self-created goodwill — while it may factor in the overall *value* of a company in the case of a sale — is not "employed in" the underlying business's operations. Rather, the goodwill of a business — something that is *developed* over the course of the business's operation and by the success of the business — is a concept that, for federal tax and accounting purposes, becomes relevant only when the business is *sold* and regarding the *acquirer's* subsequent business.

Indeed, the first question in this analysis must be whether the intangible asset itself is *employed in* the trade or business. Numerous rulings, and even the department's own written guidance, clarify that a business-related intangible is not automatically deemed employed *itself* in a New York business merely because it relates or can be tied to an underlying business.[17] The simplest case in point is the treatment of a partnership interest in a New York partnership or limited liability company owned by a nonresident. Thus, for example, based on case law and the department's guidance, if a nonresident taxpayer sold a membership interest in an entity, there would be no allocation to New York, since an interest in a New York partnership is generally treated as an intangible that *is not employed* in the underlying partnership's business. That is true even though

[14] N.Y. Tax Law section 631(b)(2) (emphasis added).

[15] For what it's worth, there is now a regulation in the corporate tax area that does address this question, providing that goodwill is sourced based on an average of the corporation's BAP for the previous three years. N.Y. Comp. Codes R. & Regs. section 4-1.6.

[16] New York Nonresident Allocation Guidelines, at 49.

[17] *See, e.g.*, *Epstein v. State Tax Commission*, 89 A.D.2d 256 (3d Dept. 1982).

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the intangible property is what allows the partner to participate in the partnership's business carried on in New York.[18]

But what about goodwill? By definition, goodwill is a valuation of *future* earning potential rather than an asset used in or by the business. For example, the U.S. Treasury regulations define goodwill as "the value of a trade or business attributable to the *expectancy* of *continued* customer patronage."[19] Similarly, the Financial Accounting Standards Board discusses goodwill exclusively in the context of the sale or combination of a business, defining it as "an asset representing the *future* economic benefits arising from other assets acquired in a business combination."[20] The U.S. Tax Court has similarly regarded goodwill as the excess value or "earning power" over and above the assets actually *used* in the business.[21]

These characterizations all acknowledge goodwill as a value placed on a business in the context of it being *acquired*. The fact that a successful business, through its operations, may create value via an expectation of return patronage of customers, or may induce other customers to patronize the business, does not mean the business has been at the same time *using* that intangible goodwill in its operations; it is merely a value placed on a business based on the expectancy of continued business — a value in excess of the business's actual identifiable assets. And notably, self-created goodwill — that is, goodwill developed by the operations of an existing business — is not something an existing company or individual can claim as an asset for amortization, depreciation, or related purposes.[22] It becomes an amortizable asset to an acquirer only in the context of and after a sale of the business.

Thus, the weight of authority on the nature and definition of goodwill makes it even clearer that goodwill is an intangible representing *future* economic benefits whose value arises in the context of a sale of a business — not an intangible employed by the business.

Though there is more to discuss on this topic, this fundamental assumption that goodwill should not be allocated to New York because it is an intangible not used in a trade or business brings us back to the essential point: The use of an entity's BAP is the wrong way to allocate gain in these section 1060 cases — and this is not only because it can often create a distortive and irrational result for taxpayers. The lesson from *Schreiber* is also that in the absence of express statutory or regulatory instruction, the tax department is not able to force the use of a BAP to determine how income gets "allocated to New York." And with that important concept in place, taxpayers should be armed with another tool to combat the tax department's continued and aggressive enforcement of these section 1060 cases. ■

[18] This was not always the department's position. In TSB-M-92(2)I (Aug. 21, 1992), the department acknowledged that it had previously taken a position that a partnership interest in a New York partnership must be "employed in" either the partnership's business or by the partner in a New York trade or business. But the TSB-M confirmed that the department had changed its position, acknowledging that a partnership interest itself would generally not be deemed "employed" in a trade or business, "regardless of the type of activity . . . that the partnership engaged in," and even though the interest allowed its holder to participate in the earnings of the business.

[19] Treas. reg. section 1.197-2(b)(1) (emphasis added).

[20] FASB Accounting Standards Codification of 2009, ASC 805-30 (emphasis added).

[21] *See Staab v. Commissioner*, 20 T.C. 834 (1953).

[22] *See* IRC section 197(c)(2)(B).

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