

LiFITS memo*

New York State 2007 Tax Legislation Affecting Personal Service Corporations

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Summary

Under a new law, attorney-owners of personal service or S-corporations who are not residents of New York may be forced to pay New York state income tax using the law firm's New York state business-allocation factor. Chapter 60 of the Laws of 2007 (Senate 2110-C/Assembly 4310-C) provides that, where a personal service or S-corporation is a member or partner in a New York law firm, the New York state tax commissioner may treat the employee/owner of such corporation as having directly received a share of partnership profits sourced according to the apportionment rules applicable to the partnership. This discretionary authority to disregard a personal service or S-corporation may be invoked where it is determined that the effect of the formation or use of the personal service or S-corporation was to avoid or evade New York state or Yonkers personal income taxes. This tax law took effect January 1, 2007.

New York Treatment of Personal Service and S-corporations

Part K of Chapter 60 of the Laws of 2007 was signed into law by New York State Governor Eliot Spitzer on April 9, 2007 and amends the New York state tax law by adding Section 632-A. This new section states that where a personal service or S-corporation provides substantially all its services to another corporation or partnership and the effect of forming or using the corporation is the avoidance or evasion of New York taxes, the Commissioner of Taxation and Finance may allocate all income, deductions, credits, exclusions and other allowances between such personal service or S-corporations and its employee-owner. An employee-owner is defined as an employee of the personal service or S-corporation who owns more than 10 percent of the outstanding stock of such corporation. A personal service corporation is defined as a corporation whose principal activity is the performance of personal services and those services are substantially performed by an employee-owner. This tax law is effective for tax years beginning on or after January 1, 2007.

The New York State Department of Taxation and Finance (Department), Office of Tax Policy Analysis, (OTPA) in its analysis

of the legislation¹ indicated that it was aimed at nonresidents of New York who were avoiding "personal income taxation by having their New York sourced distributive share from a corporation or partnership paid to an out-of-state entity, which in turn expensed the income [as salary]..." The OTPA further indicated that the out-of-state entity generally pays a minimum tax to the state, while the individual avoids tax in New York because no services are performed in the state.

A final observation by the OTPA was that the legislation was modeled after Internal Revenue Code section 269A. However, it is significant to note that the OTPA failed to mention that the federal law may be invoked only at the formation of the personal service corporation or when used for the principal purpose of avoidance or evasion of tax, while the state provision merely requires that the effect of forming or using the corporation is the avoidance or evasion of tax, so intent is not relevant.

As written, the reallocation of income, deductions, credits, exclusions and other allowances between such personal service or S-corporations and its employee-owner is discretionary. However, at a recent public forum,² a Department spokesperson,

¹ Summary of Tax Provisions in SFY 2007-08 Budget (April 2007)

² Business Council of New York State 2007; Annual Conference on State Taxation (June 25-27, 2007)

when asked when the discretion would not be invoked, indicated that it would not be invoked in a situation where the corporation provided services to a number of corporations and partnerships. The implication of this comment is that it is likely that the Department will exercise this new authority in the law firm context where the member or partner is a personal service or S-corporation that provides services exclusively to a single law firm. In such instances, the employee-owner will be treated as receiving the partnership distributive share directly, and the income will be sourced based on the apportionment rules applicable to the firm.

If this new law is applied, many owners of personal service or S-corporations will be surprised. It remains to be seen if the state has the authority to ignore the corporate structure of an entity that is organized outside of New York and to treat what would otherwise be taxable wages in one state as a share of partnership profits taxable in another state.

Conclusion

This change in the New York state tax law may significantly impact personal service or S-corporation members or partners of New York law firms. We consistently work with clients to assist them with the application of recent law changes in New York. If we can assist you with any aspect of this new provision, please contact Stanley Kolodziejczak at (646) 471-3160 or Jonathan Robin at (646) 471 0509.

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