

**THE CITY OF NEW YORK  
DEPARTMENT OF FINANCE**

**NOTICE OF RULEMAKING**

Pursuant to the power vested in me as Commissioner of Finance by sections 389(b) and 1043 of the New York New York City Charter and section 11-537(a) of the Administrative Code of the City of New York, I hereby promulgate the within amendments to the Rules Relating to the New York City Unincorporated Business Tax. These rules were published in proposed form on October 19, 2006. A hearing for public comment was held on November 20, 2006. In response to comments received, revisions were made to clarify subparagraph (i) of paragraph (1) of subdivision (d) of section 28-06, and subparagraph (iv) of paragraph (1) of subdivision (d) of section 28-06.

/s/ Martha E. Stark  
Commissioner of Finance

Note: Material to be deleted in [brackets]; New material is underlined.

## Amendments to Rules Relating to the New York City Unincorporated Business Tax

Section 1. Subparagraph (i) of paragraph (1) of subdivision (d) of section 28-06 of title 19 of the Compilation of the Rules of the City of New York is amended to read as follows:

(i) *General.*

(A) No deduction shall be allowed, except as provided in § 28-08 of these Regulations, for amounts paid or incurred to a proprietor or partner for services or for use of capital.

(B) In addition to all other amounts otherwise included, amounts paid or incurred to a proprietor or partner for services or for use of capital shall include any amount paid to any person if, and to the extent that, the payment was consideration for services or capital provided by a proprietor or partner.

[B](C) Examples:

*Example a:* A sole proprietor who does his own bookkeeping, billing and other administrative services may not deduct the cost of his time and skill in providing such services.

*Example b:* Salaries, commissions, consultant fees or professional fees paid to a general or limited partner for personal services rendered by the partner, either as an employee or an independent contractor of the unincorporated business, may not be deducted by the partnership.

*Example c:* Fixed annual payments made to retired partners under the terms of the partnership agreement, although deductible as “guaranteed payments” for Federal income tax purposes, may not be deducted.

*Example d:* Interest paid to a general or limited partner for monies contributed or loaned to the partnership may not be deducted by the partnership.

*Example e:* A sole proprietor may not claim a rental expense deduction for the use of real or personal property owned by him.

*Example f:* Partner A of Partnership ABC performs services for the partnership for which she is entitled to receive \$500,000. As part of a divorce settlement, Partner A instructs the partnership to pay this amount directly to her ex-spouse. The \$500,000 amount is considered to have been paid to Partner A for services and is not deductible.

§2. Paragraph (1) of subdivision (d) of section 28-06 of title 19 of such rules is amended by adding the following new subparagraph (iv):

(iv) Partner. For purposes of this paragraph (1) and subdivision (a) of section 28-08 of these Rules, a person will be considered a partner in an entity for any tax year for which that person meets the requirements of clause (A), (B,) (C) or (D) below. Any person who does not meet the requirements of at least one of such clauses will not be considered to be a partner in the entity.

(A) The entity files a Federal Form 1065, Schedule K-1, with respect to that person.

(B) The person is a party to the governing document of the entity (e.g., the partnership agreement);

(C) the person is liable for all or a portion of the debts or obligations of the entity;

(D) or the person has an interest in the capital or assets of the entity.

§3. Subparagraph (ii) of paragraph (1) of subdivision (d) of section 28-07 of such rules is amended to read as follows:

(ii) Payroll percentage. The percentage computed by dividing

(A) the total wages, salaries and other personal service compensation paid or incurred during the taxable year to employees in connection with the unincorporated business carried on within New York City, by

(B) the total of all wages, salaries and other personal service compensation paid or incurred during the taxable year to employees in connection with the unincorporated business carried on both within and without New York City.

(C) For purposes of this subparagraph (ii), employees within New York City include all employees regularly connected with or working out of an office or place of business of the taxpayer within New York City, irrespective of where the services of such employees were performed. However, if the taxpayer establishes to the satisfaction of the Commissioner of Finance that, because of the fact that a substantial part of its payroll was paid to employees attached to a New York City office who performed a substantial part of their services outside New York City, the computation of the payroll factor according to the general rule stated above would not produce an equitable result, the Commissioner of Finance may, in his or her discretion, permit the payroll factor to be computed on the basis of the amount of compensation paid for services actually rendered within and without the City. Moreover, wherever it appears that, because a substantial part of the taxpayer's payroll was paid to employees attached to offices outside the City who performed a substantial part of their services within the City, the computation of the payroll factor according to the general rule would not properly reflect the amount of the taxpayer's business done within New

York City by its employees, the Commissioner of Finance may require the payroll factor to be computed on the basis of the amount of compensation paid for services performed within and without the City. In any case, where the payroll factor is permitted or required to be computed on the basis of the amount of compensation paid for services performed within and without the City, the amount treated as compensation for services performed within the City will be deemed to be:

- (a) in the case of an employee whose compensation depended directly on the volume of business secured by him or her, such as a salesman on a commission basis, the amount received by him by her for the business attributable to his or her efforts within New York City;
- (b) in the case of an employee whose compensation depended on other results achieved, the proportion of the total compensation which the value of his or her services within New York City bears to the value of all his or her services; and
- (c) in the case of an employee compensated on a time basis, the proportion of the total amount received by him or her which the working time employed within New York City bears to the total working time.

§4. Clause (A) of subparagraph (ii) of paragraph 2 of subdivision (d) of section 28-07 of Title 19 of the Rules of the City of New York is amended by adding a new subclause (8) to read as follows:

(8) A business that engages in pre-production activities, but not in the creation of the final product, will be considered to be engaged in manufacturing only if the pre-production activities are extensive and constitute an integral part of the manufacturing process.

§ 5. Subparagraph (iv) of paragraph 2 of subdivision (d) of such section 28-07 is amended by adding new example (14) to read as follows:

(14) Partnership X produces and sells apparel. X maintains a large staff including designers, graphic artists, pattern makers, computer operators, cutters, sewers and drapers. X's staff develops original ideas for garments, produces illustrations with the aid of computer systems, and selects certain of these ideas to be converted into finished samples. The creation of the samples involves selection of fabrics, cutting, sewing, testing of fabric quality and color and fitting the prototype garments. X then uses the computer systems to make style patterns, which it transfers electronically along with detailed instructions to third-party contractors to whom it also specifies or furnishes the fabrics and other raw materials used to produce the garments. The contractors, whose

operations are overseen by X's employees, assemble the garments using the patterns and materials supplied by X. X then sells the garments to its wholesale customers.

X's extensive pre-production activities are considered an integral part of the manufacturing process. As a result X is considered to be engaged in the manufacture and sale of tangible personal property. If more than 50% of Partnership X's receipts are from the sale of garments produced as described above, X will be considered a manufacturing business.

§6. Subdivision (a) of section 28-08 of such Rules is amended to add a new paragraph (3) to read as follows:

(3) For purposes of this subdivision, a person will be considered a partner of an entity if that person would be considered to be a partner under section 28-06(d)(1)(iv) of these Rules.

§7. Sections 1, 4 and 5 of these amendments shall apply to all open years. Sections 2, 3 and 6 of these amendments shall apply to taxable years commencing on or after the thirtieth day after publication of these amendments in the City Record.

## **BASIS AND PURPOSE OF AMENDMENTS**

Sections 1, 2, 3 and 6 of these amendments affect the portion of the Rules Relating to the New York City Unincorporated Business Tax governing the allocation of unincorporated business income, and also provide guidance to taxpayers concerning provisions related to payments made to a partner, including when a person, including an individual or entity, will be treated as a partner of a taxpayer. They also make clear that when taxpayers make payments to other parties, those payments may be considered to have been made to a partner if the payment was consideration for services or capital of the partner. This reflects the Department's general intent that the tax principles of assignment of income as established in Lucas v. Earl, 281 U.S. 111 (1930), and other cases, will be followed in making that determination. Additionally, the amendments conform the treatment of employees' wages for purposes of the payroll percentage component of the formula allocation method to the treatment afforded for purposes of the payroll allocation factor under the New York City General Corporation Tax.

Sections 4 and 5 of these amendments affect the portion of the Rules Relating to the New York City Unincorporated Business Tax governing the definition of "manufacturing businesses" for purposes of the election to double-weight the receipts factor of the business allocation percentage. These amendments clarify that extensive preproduction activities that are an integral part of the manufacturing process will qualify as manufacturing activities regardless of a sole proprietorship's or an entity's line of business. Prior to these amendments the rules contained only an example illustrating this principle in the context of a publishing business.