Petitioner Tocqueville Asset Management L.P. (TAM) filed a Petition for redetermination of a deficiency with the New York City (City) Tax Appeals Tribunal (Tribunal) on December 20, 2010. The Petition protested a September 22, 2010 Conciliation Decision issued by the City Department of Finance (Respondent) Conciliation Bureau with respect to a December 29, 2009 Notice of Determination (Notice) of a deficiency of New York City Unincorporated Business Tax (UBT) issued by Respondent for the 2005 tax year under Title 11, Chapter 5, of the City Administrative Code (Administrative Code). The Conciliation Decision sustained the Notice and discontinued the conciliation proceeding.

A hearing was held pursuant to section 1-12 of the Tribunal Rules of Practice and Procedure (Tribunal Rules) before the undersigned at One Centre Street, New York, New York, on November 18 and 19, 2013, where testimony was taken and exhibits were submitted. Petitioner and Respondent filed briefs, the last of which was filed on April 30, 2014. Petitioner was represented by Mark J. Hyland, Esq., Peter E. Pront, Esq., and Mandy DeRoche, Esq. of Seward & Kissel LLP. Respondent was represented by Frances Henn, Esq., and Amy Bassett, Esq., both Assistant Corporation Counsel with the City’s Law Department.
ISSUE

Whether the management fee paid by Petitioner to its corporate partner in 2005 is deductible for City UBT purposes to the extent that it represents compensation paid to the employees of that corporate partner who are also partners of Petitioner, Administrative Code § 507(3) and City UBT Regulations (19 RCNY) §§ 28-06(d)(1)(i)(B) and 28-06(d)(1)(ii)(B) and (D).

FINDINGS OF FACT

Petitioner, TAM, is a Delaware limited partnership formed in October, 1989. At all relevant times, it was an investment advisor registered with the Securities and Exchange Commission (SEC). TAM’s affairs were managed by Tocqueville Management Corporation (TMC), its sole general partner, a corporation formed in Delaware in 1989 which elected S corporation status. TMC was also a general partner of, and provided management services to, Tocqueville Securities L.P. (TSLP), a Delaware limited partnership formed in Delaware in 1990. TSLP is a broker-dealer registered with the SEC.

Consistent with the industry practice of separating regulated activity from non-regulated activity, TAM did not have employees. Instead, it acted solely through the employees of its general partner and management company, TMC, who were provided to it pursuant to TAM’s limited partnership agreement. Section 4.1 of the Amended and Restated Limited Partnership Agreement of TAM, dated January 1, 2005, provides that TMC, as general partner, “shall exclusively be responsible for, and shall have full and exclusive discretion with respect to, making all decisions concerning the management and operations of the business” of TAM.
TAM paid TMC an annual management fee for these services and allocated a specified percentage of its annual net profits to TMC. TMC’s management fee was computed based on the expenses it incurred in providing the management services to TAM and TSLP. The largest component of these expenses was compensation paid to TMC’s employees. (Tr at 158 and 161.) Management fees were allocated between TAM and TSLP based on their approximate relative gross receipts each year in order to reflect a proper allocation of expenses, as its accountants believed was required by the regulations of the SEC and the Financial Industry Regulatory Authority (FINRA) (Tr at 97-98, 204-210, and 229-243). TAM’s partners, including TMC, then received their pro rata shares of TAM’s income after payment of the management fee.

In order to reflect this financial reporting on its Federal, State, and City income tax returns, TMC did not report the management fee as income, and did not deduct associated expenses, including compensation paid to its employees. Instead, TAM reported the components of the management fee as deductions on the corresponding lines of its income tax returns, including the UBT return (Form NYC-204) for 2005 at issue here. It chose to do this so that the tax returns would conform to its financial reporting. Thus, although TAM had no employees, on its tax returns it deducted as salary and wages the portion of the management fee it paid for TMC’s employees. During all relevant years, TMC issued Forms W-2 and filed employment tax returns reflecting its payment of compensation to its employees.

Before 2005, the year in issue, 29 of the 77 employees of TMC who rendered their services to TAM were shareholders in TMC. The two individuals who controlled TMC, Robert Kleinschmidt (Kleinschmidt) and François Sicart (Sicart), wanted to provide an
ownership interest to these employees so that their interests were aligned with TMC and TMC’s clients. They also wanted each shareholder’s ownership interest to be subject to change from year to year to reflect the employee’s services and value to TMC.

Both Kleinschmidt and James Kiriakos (Kiriakos), a certified public accountant employed at Pegg & Pegg, LLP, testified that TMC, as an S corporation, was required to reflect income to its shareholders based on their percentage ownership of its stock. They testified that it was cumbersome to make the annual adjustments of ownership of TMC stock because this required that TMC issue additional shares of TMC stock to reflect increases in ownership or redeem shares of stock to reflect decreases in ownership. TMC’s professionals were annually required to prepare documentation to reflect these changes.

They testified that to reduce this administrative burden, it was decided that beginning in 2005, the TMC employees who were shareholders of TMC (other than Kleinschmidt and Sicart) would cease to be shareholders of TMC and would become limited partners of TAM. Under this arrangement, rather than prepare the documentation required in prior years, only the schedule showing partners’ interests attached to the TAM limited partnership agreement needed to be amended. They testified that the economics of the 2005 structure were intended to be identical to the structure in 2004 and earlier years.

Before 2005, the profit from TAM flowed through its partner, TMC, to TMC’s shareholders. In 2005, each of these employee’s shares of the profits flowed directly to them as partners of TAM, rather than through TMC and then to them as shareholders of TMC. But the amount of profit for each partner remained approximately
the same as it had been when these individuals were shareholders of TMC. Kleinschmidt and Kiriakos testified that they did not perceive the structure as amended in 2005 to have any difference in income taxation for Federal, State or City purposes. The revised structure was viewed simply as a more efficient way to obtain the same economic results that were achieved in 2004 and prior years, and with the same tax consequences. Kleinschmidt testified, “There was an intent to change nothing.” (Tr at 88.) Petitioner’s witnesses’ testimony was credible on these points.

The Internal Revenue Service examined TMC’s Forms 1120S for 2008 and 2009, and accepted the returns as filed. Respondent examined TAM’s UBT return for 2000 and accepted it as filed.

I find that TAM, TMC, and TSLP, and the arrangements between and among them, were bona fide and had economic substance.

In preparing TAM’s 2005 UBT return, a deduction was taken for compensation paid to employees, including those who were partners of TAM. However, no deduction was taken for compensation paid to Kleinschmidt or Sicart, because they were officers of TMC, which was a corporate partner in TAM. Further, no deduction was taken for any amounts reported on a Schedule K-1 issued to an employee of TMC who was a partner in TAM. In this way, TAM deducted for UBT purposes only compensation for services paid to its partners, but did not deduct their share of profits from TAM’s operation, or any amounts paid to officers of TMC.

Respondent examined Petitioner’s 2005 UBT return and disallowed the deduction for salaries paid to partners in the amount of $10,778,701 and for the partner’s retirement plan in the amount of $274,753, which represents the amount attributable to
services performed by individuals who were partners in TAM. On December 29, 2009, Respondent issued a Notice of Determination of $435,938.12 in tax and $169,368.03 in interest computed to February 5, 2010, for a total of $605,306.15.

Petitioner timely requested a conference with Respondent’s Conciliation Bureau, and a conciliation conference was held. On August 3, 2010, the conferee issued a Proposed Resolution denying the deduction and sustaining the Notice. Petitioner disagreed in writing with the Proposed Resolution on August 16, 2010, and on September 22, 2010, the Director of Respondent’s Conciliation Bureau issued a Conciliation Decision discontinuing the conciliation proceedings. The Petition was timely filed on December 20, 2010. Respondent timely filed an answer dated February 24, 2011.

STATEMENT OF POSITIONS

Petitioner asserts that there is no rule requiring denial of a deduction for compensation paid by a partnership to a corporate partner for the services of an employee of that corporate partner who is also a partner in the partnership. Petitioner interprets the regulations to say that two requirements must be met for the deduction for compensation to be denied. First, except in cases where there is assignment of income, the partnership must itself make the payment to the partner, and second, the payment must be for services rendered directly to the partnership by the partner. Petitioner argues that because the payment was made by TAM to TMC, and the partners rendered services to TMC, the payment is deductible. Petitioner further asserts that this situation falls within the exemption for compensation paid to employees of a
Respondent contends that the payments at issue are compensation for services rendered by partners and therefore not deductible. Respondent asserts that Petitioner’s interpretation requires the addition of words to the regulation. Respondent asserts that City UBT Regulation § 28-06(d)(1)(ii)(D) does not apply here because the employees of TMC were also partners in TAM, and that the terms of this regulation were not met because the payments at issue were not included in TMC’s gross income for federal income tax purposes.

CONCLUSIONS OF LAW

The issue here is whether the applicable statute and regulations permit Petitioner to deduct that portion of the management fee it paid to TMC that represents compensation for services rendered to Petitioner by TMC employees who are also Petitioner TAM’s partners. For the reasons discussed below, because the payments at issue were compensation for services provided by partners in TAM, the deduction is not permitted.

The provisions granting a deduction or exemption are to be construed in favor of the tax authorities, and the extent to which such a provision is allowed is a matter of legislative grace to which the taxpayer must prove entitlement. (Matter of Citrin Cooperman & Co., LLP v Tax Appeals Trib. of City of N.Y., 52 AD3d 228 [1st Dept 2008]; Matter of American Airlines, Inc., TAT (E)05-29(HO) [NYC Tax Appeals Tribunal, June 29, 2009]).
The UBT is imposed “on the unincorporated business taxable income of every unincorporated business wholly or partly carried on within the City.” Administrative Code § 11-503(a). Administrative Code § 11-505 provides that unincorporated business taxable income is the excess of unincorporated business gross income over its deductions. Subject to certain modifications, the unincorporated business deductions are the items of loss and deduction directly connected with or incurred in the conduct of the business which are allowable as a deduction for federal income tax purposes. Administrative Code § 11-507.

One such modification is provided by Administrative Code § 11-507(3), which denies the deduction for compensation paid to proprietors and partners. It provides that “No deduction shall be allowed (except as provided in section 11-509 of this chapter) for amounts paid or incurred to a proprietor or partner for services or for use of capital.”

Respondent promulgated UBT regulations in accordance with Administrative Code § 11-507(3). The three regulations at issue here are City UBT Regulations (19 RCNY) §§ 28-06(d)(1)(i)(B), 28-06(d)(1)(ii)(B) and 28-06(d)(1)(ii)(D).

City UBT Regulation § 28-06(d)(1)(i)(B) provides: “In addition to all other amounts otherwise included, amounts paid or incurred to a proprietor or partner for services or use of capital shall

1Administrative Code § 11-509(a) provides that “In computing unincorporated business taxable income, there shall be allowed (without allocation under § 11-508 of this chapter) deductions for reasonable compensation for taxable years beginning before January first, two thousand seven, not in excess of five thousand dollars... for personal services of... each partner actively engaged in the unincorporated business,” with the aggregate of such deductions limited to 20% of unincorporated business taxable income.
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."\(^2\)

City UBT Regulation § 28-06(d)(1)(ii)(B) provides in pertinent part that “amounts paid or incurred to a corporate partner for services provided the unincorporated business by the corporate partner’s officers shall not be allowed as a deduction under paragraph (1)(i) above.”

City UBT Regulation § 28-06(d)(1)(ii)(D) provides:

For purpose of paragraph (1)(i) of this subdivision (d), payments to partners for services do not include amounts paid or incurred by an unincorporated business to a partner of such business which reasonably represent the value of services provided the unincorporated business by the employees of such partner, and which, if not for the provisions of paragraph (1)(i) of this subdivision (d), would constitute allowable business deductions under § 28-06(a). The amounts paid or incurred for such employee services must be actually disbursed by the unincorporated business and included in that partner's gross income for Federal income tax purposes.

Administrative and court decisions analyze UBT transactions by considering their economic substance. The Appellate Division, First Department, wrote in Guttmann Picture Frame Assoc. v O’Cleireacain, 209 AD2d 340 (1st Dept 1994), “Tax legislation should be implemented in a manner that gives effect to the economic substance of the transaction [citation omitted] and the taxing

\(^2\)This section was added by amendment in January 2007. The City Rec, January 24, 2007 at 225. Its history indicates that it was enacted to “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.” The provision applies to all open years, and thus applies to 2005, the year at issue.
authority may not be required to acquiesce in the taxpayers’
election of a form for doing business but rather may look to the
reality of the tax event and sustain or disregard the effect of the
fiction in order to best serve the purposes of the tax statute
[citation omitted].”

In Matter of AGS Specialist Partners (TAT (E) 2000-10 (UB)
[NYC Tax Appeals Tribunal, May 21, 2003]), the Tribunal considered
the economic substance of the transaction. The taxpayer paid
compensation to the officers of its corporate partners, for
services that were required to be performed by the corporate
partners. The Tribunal held that the deduction was appropriately
disallowed. How that payment was made was not considered relevant.
The Tribunal wrote, “We do not consider it material for purposes of
our analysis whether the payments are made to the corporation or
the corporate officers or whether the corporate officers are
treated as employees by the unincorporated business.”

The Tribunal analyzed the economic substance of another
transaction in Matter of Horowitz (TAT (E) 99-3 (UB) [September 1,
2005], affd, 41 AD3d 101 [1st Dept 2007], lv denied, 10 NY3d 710
[2008]) and held that, “The payments at issue while made to third
parties were made by the unincorporated business for the benefit of
the proprietor and were remuneration for services rendered by the
proprietor to his unincorporated business. Hence, the economic
substance of these transactions requires the disallowance of these
deductions.”

The compensation at issue was paid by TAM to its corporate
general partner for services rendered by that partner’s employees
who were partners in TAM. City UBT Regulation § 28-06(d)(1)(i)(B)
requires an addback for “any amount paid to any person if, and to
the extent that, the payment was in consideration for services . . . provided by . . . a partner.” Because the payments at issue were for services performed by TAM’s partners, Administrative Code § 507(3) and City UBT Regulation § 28-06(d)(1)(i)(B) do not permit this deduction.

Petitioner relies on statements in the January 24, 2007 City Record to attempt to limit the applicability of § 28-06(d)(1)(i)(B) to assignment of income situations. As a general rule, a regulation, like a statute, is to be interpreted according to its plain language. (Matter of Cortland-Clinton, Inc. v New York State Dept of Health, 59 AD2d 228 [4th Dept 1977].) “It is fundamental that a court, in interpreting a statute, should attempt to effectuate the intent of the Legislature [citation omitted] and where the statutory language is clear and unambiguous, the court should construe it so as to give effect to the plain meaning of the words used [citation omitted].” (Patrolmen’s Benevolent Assn. of City of N.Y. v City of New York, 41 NY2d 205, 208 [1976]). Indeed, “the clearest indicator of legislative intent is the statutory text.” (Roberts v Tishman Speyer Props., L.P., 62 AD3d 71 [1st Dept 2009].)

Although some of the language in the City Record indicates that assignment of income was a consideration in its promulgation, the broad language of this regulation goes beyond assignment of income cases and covers situations such as the one at issue.

Petitioner’s interpretation of the statute and regulation would permit taxpayers to reduce or avoid UBT by simply establishing a corporate partner and making the taxpayer’s partners employees of that corporate partner. Had that corporate partner not been formed, the deduction for payments to the partners would
be disallowed. These payments cannot become deductible by making the partners employees of a corporate partner.\textsuperscript{3} The history leading to the 2005 structure to explain how that structure came about is not relevant in making this determination. Petitioner’s motives were blameless, but the 2005 restructuring created a situation where the deduction for compensation paid to the corporate employees was lost once they became partners of TAM.\textsuperscript{4}

Petitioner argues that this case falls within the provisions of Regulation §28-06(d)(1)(ii)(D) (the D Exception).\textsuperscript{5} The D Exception provides that, for purposes of §28-06(d)(1)(i), payments to partners for services do not include amounts “which reasonably represent the value of services provided the unincorporated business by the employees of such partner . . . .” The D exception requires that such amounts “must be actually disbursed by the unincorporated business and included in that partner’s gross income for Federal income tax purposes.”

A reading of the D Exception together with the other provisions of §28-06 (d)(1)(i) and (ii) indicates that the D Exception operates only where the employees are not themselves partners in the partnership. City UBT Regulations §§ 28-06(d)(ii)(A), (B), and (C) state respectively that the deduction is not permitted for compensation paid to (1) a partner in the

\textsuperscript{3}As noted, no suggestion is made that Petitioner used the structure at issue here to seek to minimize or avoid tax; the uncontroverted testimony is to the contrary.

\textsuperscript{4}Petitioner offers Finance Letter Ruling FLR-(28)-UB-4/86 (April 7, 1986) and Matter of Zaks (TAT(H)93-130(UB) [NYC Tax Appeals Tribunal, May 31, 1994]) in support of its position. Neither is precedent here. (19 RCNY § 16-05(a) and City Charter § 168.d; Tribunal Rules(20 RCNY) § 1-12(e)(2)). Further, they were decided before §28-06(d)(1)(i)(B) was enacted and both are premised on the recipient including the compensation in income, which did not occur here.

\textsuperscript{5}The parties have referred to this as the “D Exception” and that terminology will be followed here.
unincorporated business, (2) an officer of a corporate partner in the unincorporated business (regardless of whether that officer is also an employee of the corporate partner), or (3) a partner in a partnership that is a partner in the unincorporated business. The only deduction that is permitted is for a payment for the services of an employee of a partner. The D Exception is an exception to the general rule that a payment for a partner’s services is not deductible. It operates only where the employee is not a partner. It does not resurrect the deduction denied by § 28-06(d)(1)(i)(B) to make payments to a partner deductible.⁶

Petitioner argues that the D Exception should be interpreted to deny the deduction only in cases where (1) except in the limited “assignment of income circumstances” articulated in § 28-06(d)(1)(i)(B), the partnership itself makes a payment to the partner, and (2) the payment must be in consideration for services rendered directly to the partnership.⁷ As discussed above, the broad language of § 28-06(d)(1)(i)(B) does not indicate an intent to limit its application to assignment of income situations. Further, the limitations Petitioner seeks to impose on the D Exception are not present in the language of the regulation and require that § 28-06(d)(1)(i)(B) be ignored. To insert these words in seeking to interpret the D Exception would be an act of amendment rather than interpretation. (Miller Tabak Hirsch & Co., TAT(E)94-173(UB) [NYC Tax Appeals Tribunal, March 30, 1999]).

⁶The same conclusion was reached in Matter of Weeks-Lerman Group, LLC (TAT(H)05-54(UB)[NYC Tax Appeals Tribunal, June 10, 2008]). Although this administrative law judge determination is not binding here (City Charter § 168.d; Tribunal Rules (20 RCNY) §1-12(e)(2)), it interprets the regulations to hold that “payments to employees of partners who are not also partners or proprietors are deductible business expenses.” (Emphasis in original.)

⁷Note that as reported, TAM did not deduct the payment of management fee to TMC, but instead treated the component parts of that fee as if they were paid directly by TAM. The result is that, according to the UBT return, TAM made the payments directly to its limited partners.
In *Miller Tabak*, the taxpayer contended that a deduction should be allowed for payments to employees who were also partners in the petitioner, arguing that the phrase “payments to partners” in Administrative Code § 11-507(3) did not include payments to partners who were also employees. In discussing the issue, the Tribunal stated “Petitioner interprets the phrase to mean ‘payments to partners in their capacity as partners’ and not payments to individuals who happen to be partners but are not acting in that capacity.”

The Tribunal rejected this distinction, and held that “the focus should be on whether the [i]ndividuals are partners and, once it is determined that the [i]ndividuals are partners, no payment made to the [i]ndividuals ‘for services or for the use of capital’ (in whatever capacity) is deductible.” The Tribunal added that it is “not the function of this forum to ‘add words to a statute which has a rational meaning as written’,” quoting *Richmond Constructors v Tishelman* (61 NY2d 1 [1983], rearg denied, 61 NY2d 905 [1984]).

The only difference between *Miller Tabak* and this case is that in *Miller Tabak* the compensation was paid to partners who were employees of the partnership and here the compensation was paid to partners who were employees of the corporate general partner. *Miller Tabak* made clear that once it is determined that payment is to a partner, the payment for services “in whatever capacity” is not deductible. Further, *Matter of Horowitz* made clear that, consistent with § 28-06(d)(1)(i)(B), the payment need not be made to the partner, but may be made to anyone.

Even if these issues could be overlooked, the D Exception requires that the amount to be deducted “be actually disbursed by the unincorporated business and included in the partner’s gross
income for federal income tax purposes.” Petitioner concedes that this did not happen. TMC did not report the management fee as income and TAM took a deduction as if it had paid the employees. Thus, although the amount was “actually disbursed,” it was not “actually . . . included in the partner’s gross income.”

Petitioner offers three arguments to justify this noncompliance. Petitioner argues first that it did not deduct the payment to TMC but instead had TAM take the deduction as if it had directly paid the partners so that its tax returns would conform to its financial reporting. It argues second that the same tax effect occurred by having TAM take the deduction instead of having TMC report the income from the receipt of the management fee and then having TMC take the deduction. It argues third that there is federal case law to support the view that “included” is synonymous with “includible” in interpreting Internal Revenue Code § 83(h).

None of these arguments succeeds. First, the reasons for TAM’s reporting position are not relevant. The regulation provides no exceptions for industry practice or otherwise. Second, TAM’s reporting may have resulted in the same overall tax effect, but, again, the regulation is not concerned with this.

Third, case law interpreting an Internal Revenue Code provision is not relevant here because other than using the word “included,” the City and Federal provisions have little in common.\footnote{Internal Revenue Code § 83(h) permits a deduction in an amount “included under subsection (a), (b), or (d)(2) in the gross income of the person who performed such services.” The Federal Circuit held in Robinson v. United States, 335 F3d 1365 (Fed. Cir. 2003) that the deduction was permitted to the employer in the amount that was includible in the employee’s wages, regardless of whether it was actually reported. The Tax Court held to the contrary in Venture Funding, Ltd. v Commr of Internal Revenue, 110 TC 236 (1998), affd, 198 F.3d 248 (6th Cir. 1999).}
The D Exception requires that the amount to be deducted be “actually disbursed . . . and included in that partner’s gross income for Federal income tax purposes.” “Actually” modifies both “disbursed” and “included.” It strains the regulation beyond reason to interpret it, as Petitioner urges, to mean “actually disbursed” by the payor and but merely includible in the payee’s gross income even if it is not actually included. Finally, as noted above, deductions and exemptions are to be strictly construed against the taxpayer, and it is apparent that the requirements of the D Exception were not met, so this provision is unavailable.

In sum, City UBT Regulation § 28-06(d)(1)(i)(B) governs this case. This regulation denies the deduction for compensation for services performed by a partner. Because the compensation at issue was paid for the services of partners, the deduction is not allowed. The D Exception does not apply where the employees of a partner in the unincorporated business are themselves partners in that unincorporated business, and in any event its requirements were not met here.

ACCORDINGLY, IT IS CONCLUDED THAT the payments to employees of TMC who were also limited partners of TAM are subject to Administrative Code § 11-507 and City UBT Regulation §§ 28-06(d)(i) and (ii) and may not be deducted. The Petition is denied and the Notice of Determination dated December 29, 2009 is sustained.

Dated: June 17, 2014
New York, New York

David Bunning
Administrative Law Judge