NEW YORK CITY TAX APPEALS TRIBUNAL
ADMINISTRATIVE LAW JUDGE DIVISION

In the Matter of the Petition of CITRIN COOPERMAN & COMPANY, LLP	**DETERMINATION** **TAT(H) 01-17(UB)**

Hauben, D.C.A.L.J.:

Petitioner, Citrin Cooperman & Company LLP, filed a Petition with the New York City ("City") Tax Appeals Tribunal ("Tribunal") requesting redetermination of a deficiency of City Unincorporated Business Tax ("UBT") under Chapter 5 of Title 11 of the Administrative Code of the City (the "Code") for the period beginning January 1, 1996 and ending December 31, 1997 (the "Tax Years").

A hearing was held before the undersigned on July 25, 2005 and August 16, 2005. The parties submitted Briefs and Reply Briefs, the last of which was submitted on January 25, 2006. Petitioner appeared by Nathaniel Gore, Esq., and John K. Crossman, Esq., of Zukerman Gore & Brandeis, LLP. The City appeared by George P. Lynch, Esq., Assistant Corporation Counsel. Robert J. Firestone, Esq., Senior Counsel of the City's Law Department, participated on the briefs.

ISSUE

Whether certain payments to Petitioner's retired partners and to a partner were payments for services or for the use of capital that are required to be added back to Petitioner's Unincorporated Business Taxable Income ("UBTI") under Code §11-507(3).

FINDINGS OF FACT

1. Petitioner, Citrin Cooperman & Company, LLP (the "Firm"), certified public accountants, is a New York registered limited liability partnership which was engaged in business in the City during the Tax Years.

2. Petitioner timely filed a UBT return for each of the Tax Years and paid the tax reported thereon.

3. For purposes of calculating its UBT liability in each of the Tax Years, Petitioner deducted payments (the "Payments") to retired partners Norman Michaels ("Michaels"), Melvin Feldman ("Feldman") and payments to special partner Al Horowitz ("Horowitz") (collectively, the "Retired Partners"). Petitioner deducted $63,405 and $117,056 for payments made to Michaels in 1996 and 1997, respectively;[1] $35,000 for payments made to Feldman in 1997;[2] and $150,000 for payments made to Horowitz in 1997. Petitioner provided the Retired Partners with federal Schedules K-1 which reported these payments as guaranteed payments.

4. During the Tax Years, Petitioner operated under a written partnership agreement dated February 1, 1989, as amended as of

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[1] Petitioner made semi-monthly payments to Michaels of $5,593.68, of which $716.31 represented a return of his cash basis capital account and $4,877.37 represented a payment to him as a retired partner. Of the $63,405 paid to Michaels in 1996, $55,796 represented "past service compensation" and $7,609 represented unrealized receivables. Of the $117,056 paid to Michaels in 1997, $103,009 represented "past service compensation" and $14,047 represented unrealized receivables. Petitioner is only protesting the add-backs for "past service compensation."

[2] By Letter Agreement dated November 4, 1994, payments to Feldman as a retired partner were paid at the rate of $8,750 per month, of which $5,591.25 represented "past service compensation" and $3,158.75 represented unrealized receivables. Petitioner is only protesting the add-backs for "past service compensation" totaling $21,980.

February 7, 1992, February 1, 1993 and January 1, 1997 (the "Partnership Agreement") that requires all partners to devote full time and attention to the affairs of the Firm, including the performance of services.

5. A Partner of the Firm may retire any time at or after age 62. Giving notice of retirement to the Firm automatically creates a liability of the Firm to the retiring partner under the Partnership Agreement. Upon retirement, a partner is entitled to receive from the Firm his capital and loan accounts, his share of undistributed net taxable income (to the effective date of his retirement), and compensation for past services.

6. Section 14 of the Partnership Agreement is entitled "Past Service Compensation." Section 14.1 of the Partnership Agreement provides, in pertinent part:

> There shall be paid only to equity owning Partners **as a further compensation for prior services to the Partnership** of a [retired] equity owning Partner an amount computed [there follows provisions by which the retired partner will receive 93 monthly payments, the total of which will approximate 125% of Petitioner's average annual client collections (based on the last two year's collections) multiplied by the retiring partner's equity percentage]. [Emphasis added.]

7. Michaels, who had been a partner in Michaels, Sesholtz & Associates, ("MSA"), an accounting firm, was admitted as a partner in Petitioner as of February 7, 1992, pursuant to an Agreement between him and Petitioner (the "Admission Agreement")[3] which

[3] The Admissions Agreement is between Petitioner, MSA, Richard Sesholtz, Michaels and Maria Yoss.

contained provisions that modified the Partnership Agreement with respect to payments to be made to Michaels when he retired.

8. The payments to Michaels in 1996 and 1997[4] were made pursuant to Section 6 of the Admission Agreement, which provides in pertinent part, as follows:

> (A) . . the Partnership shall be obligated to . . . pay [Michaels, 93 monthly payments, the total of which will approximate 125% of Petitioner's average annual client collections (based on the last two year's client collections) multiplied by Michaels equity percentage] **as further compensation for prior services to the Partnership** "Past Service Compensation" . . ..[Emphasis added.]

9. The rights and obligations of Feldman and Petitioner (with certain exceptions not relevant here) are governed by a prior partnership agreement dated January 1, 1983 (the "Prior Agreement").[5] Feldman retired effective August 31, 1997. Pursuant to the Prior Agreement, upon retirement, Feldman received from Petitioner his capital and loan accounts and his share of undistributed taxable income to the effective date of his retirement. Feldman also was entitled to compensation for past services,[6] as provided in the Prior Agreement.

10. Section 13.3 of the Prior Agreement provided in pertinent part:

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[4] *See*, Finding of Fact 3, *supra*, and Footnote 1, *supra.*

[5] Sec. 2.5 of the Partnership Agreement.

[6] *See*, Finding of Fact 3, *supra*, and Footnote 2, *supra*.

> There shall be paid only to equity owning Partners **as a further compensation for prior services to the Partnership** of such [retired] equity owning Partner [84 monthly payments, the total of which will approximate 150% of Petitioner's average annual client collections (based on the last two year's collections) multiplied by the retiring partner's equity percentage]. [Emphasis added.]

11. Pursuant to an agreement between Petitioner, Horowitz and each of Petitioner's other partners, dated December 12, 1996 (the "Special Partner Agreement"), Horowitz (who had been a partner in Robbins, Greene, Horowitz, Lester & Co., LLP ("RGH")), became a special partner of Petitioner.[7] Under the Special Partner Agreement, Petitioner paid Horowitz $150,000 in 1997 and provided him with an office.[8]

12. Pursuant to the Special Partner Agreement, Horowitz was also entitled to receive a $150,000 payment from Petitioner in 1998.[9] Horowitz was to retire as a special partner of the Firm

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[7] Section 2.04 of the Special Partner Agreement provides as follows:

> As a special partner of the Company Horowitz' rights and obligations are determined solely pursuant to the terms of this Agreement. Horowitz is not a party to the Partnership Agreement and shall not be subject to the obligations or entitled to receive the benefits created under the Partnership Agreement except for rights pursuant to Paragraph 2.01(c). . . with respect to payments from departing RG Partners. Among other things, Horowitz shall not have an Equity Percentage, a Profit/Loss Percentage or a capital account, shall not be required to make any capital contribution to the Company, and shall not share in the profits of the Company. Horowitz shall not be entitled to vote as a partner of the company.

Petitioner never asserted that due to the nature of Horowitz' relationship with the Firm, he was not a partner of the Firm for UBT purposes.

[8] At the same time, Petitioner entered into an agreement with other partners of RGH, whereby those other partners of RGH became partners of Petitioner.

[9] Section 2.01(a) of the Special Partner Agreement provided that "Horowitz shall be a special partner of the company during the Adjustment Period [1997 and 1998]. During the Adjustment Period [Petitioner] shall pay to Horowitz the

effective January 1, 1999 and under Paragraph 2.01(b) of the Special Partner Agreement, receive payments from Petitioner ". . . **[a]s compensation for Horowitz' past services to the Company . . .** Horowitz and the Company shall both treat these payments as ordinary income to Horowitz and deductible by the Company." [Emphasis added.]

13. Under the Special Partner Agreement, during 1997 and 1998, Horowitz was to introduce RGH clients to Petitioner and use reasonable efforts to cause the RGH clients to become clients of Petitioner. Petitioner was to cooperate with Horowitz in the performance of his services to facilitate the transfer of RGH clients to Petitioner.

14. Petitioner and Respondent stipulated that the payments to Horowitz in 1997 "represented a draw against future past service compensation as finally calculated and payable to Horowitz over a ten (10) year period" ("Draw"). Accordingly, the Draw was an advance payment against the amount that Horowitz would be entitled to upon his retirement from Petitioner for past services.[10]

15. The total of the amounts of compensation for past services that Petitioner was obligated to pay to Horowitz is based on a formula amount. The base formula amount is equal to 50% of the average annual collections of petitioner over a two year period commencing January 1, 1997 attributable to the clients and referrals of RGH. All that had to happen for Horowitz to receive payments under the Special Partner Agreement was for the clients of RGH to become Petitioner's clients.

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annual Draw of $150,000. . ."

[10] Payments for past services began in 1999, with Horowitz receiving a draw against such amounts in 1997 and 1998.

16. Robert N. Stanton testified as an expert witness on the valuation of accounting firms for purchase, sale or merger. Mr. Stanton testified that an equity partner's interest in an accounting firm has a value that generally is based on the value of the firm's clients, which in turn is based on the value of the fees generated from those clients. He further testified that the clients that an equity partner has serviced generally stay with the firm when that partner retires and that the value of accounting practices ranges between 100% to 150% of annual fees.

17. Mr. Stanton also was involved as a consultant with respect to the merger of MSA into Petitioner in 1992, as well as the transactions involving Horowitz and the RGH partners. With respect to Horowitz, Mr. Stanton testified that Horowitz had a 50% equity interest in RGH and that Horowitz wanted to retire but that he also wanted his partners to be part of an ongoing firm and not feel that he was abandoning them. So, while he wanted to sell his share of RGH and retire, Horowitz agreed to have RGH merge into Petitioner followed by his withdrawal after a two-year adjustment period pursuant to the provisions in the Special Partner Agreement under which he received advance payments for past service for the first two years and would receive payments for the balance due him for past service over the next eight years.

18. Niles Citrin, a partner in Petitioner, testified that Petitioner's partners took IRC §736 into account when drafting the Partnership Agreement, the Prior Agreement, the Admission Agreement and the Special Partner Agreement (collectively, the "Agreements"). As allowed under federal law, Petitioner's partners and incoming partners, negotiated and agreed between themselves as to the tax treatment of payments to departing partners both to the Firm and to its partners. The partners negotiated and agreed that such

payments would be ordinary income to the partners and deductible by the Firm. Petitioner and its partners, in consultation with their attorneys, specifically avoided attributing any of the payments to goodwill so as to avoid having the payments treated as being for a capital asset and to insure a deduction for the Partnership.

19. Respondent issued a Notice of Determination to Petitioner dated April 12, 2000 asserting a UBT deficiency for the Tax Years. The deficiency asserted for 1996 is in the principal amount of $2,536, plus interest of $724.74, for a total deficiency of $3,260.74. The deficiency asserted for 1997 is in the principal amount of $27,250, plus interest of $4,784.97, for a total deficiency of $32,034.97.[11] The deficiency for 1996 is based on Respondent's adding back to Petitioner's taxable income as reported, payments to partners of $63,405. The deficiency for 1997 is based on Respondent's adding back to Petitioner's taxable income as reported, payments to partners of $283,933 and increasing Petitioner's allocation of income to the City by $397,335. Petitioner does not dispute the allocation percentage used by Respondent for 1997. Petitioner also does not protest the portion of the deficiency attributable to the add-back of amounts paid to Michaels and Feldman that were for unrealized receivables, as noted in Footnotes 1 and 2, *supra*.

STATEMENT OF POSITIONS

Petitioner contends that the Payments were not for services. Rather, Petitioner argues, with respect to Michaels and Feldman, the payments were for the purchase of their interests in the goodwill of the Firm based on a formula which takes into account

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[11] The total deficiency for the Tax Years, including interest calculated to April 30, 2000, is $35,295.71.

the value of the Firm's clients. With respect to Horowitz, Petitioner argues that the form of the transactions with Horowitz and RGH, structured as a merger of Petitioner and RGH followed by the withdrawal of Horowitz, should be disregarded. Instead, Petitioner asserts the transaction should be treated for UBT purposes as a sale by Horowitz of his interest in RGH to Petitioner with the result being that Petitioner's payments to Horowitz are not subject to the UBT add-back modification.

Respondent contends that the Payments were for prior services as stated in the Agreements and thus must be added back for UBT purposes.

CONCLUSIONS OF LAW

A partnership doing business in the City is subject to UBT based on its UBTI which is unincorporated business entire net income allocated to the City less certain deductions and exemptions. See Code §§11-503(a) and 11-505. Unincorporated business entire net income is defined, in Code §11-501(g), as "the excess of the unincorporated business gross income of an unincorporated business over its unincorporated business deductions." Unincorporated business gross income and deductions are defined in Code §§11-506 and 11-507, respectively, by reference to federal law. Specifically, Code §11-507 provides that an unincorporated business is permitted to take as deductions "items of loss and deduction directly connected with or incurred in the conduct of the business, which are allowable for federal income tax purposes." There are, however, certain modifications which add back certain federally allowed deductions for UBT purposes, including the add-back for payments to partners for services or the use of capital. Code §11-507(3).

Accordingly, a two-step process exists for determining whether an item effectively gives rise to a deduction under the UBT. First, the item must be deductible under federal law. Second, that deduction must not be added back by a UBT modification provision.

The federal income tax treatment of payments to retired partners is governed by IRC §736.[12] The federal income tax treatment of payments upon the sale of an interest in a partnership is governed by IRC §741.[13] For federal income tax purposes,

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[12] IRC §736 provides:

(a) PAYMENTS CONSIDERED AS DISTRIBUTIVE SHARE OR GUARANTEED PAYMENT.- Payments made in liquidation of the interest of a retiring partner or a deceased partner shall, except as provided in subsection (b), be considered-

(1) as a distributive share to the recipient of partnership income if the amount thereof is determined with regard to the income of the partnership, or

(2) as a guaranteed payment described in section 707(c) if the amount thereof is determined without regard to the income of the partnership.

(b) PAYMENTS FOR INTEREST IN PARTNERSHIP-

(1) GENERAL RULE.-Payments made in liquidation of the interest of a retiring partner . . .shall, to the extent such payments (other than payments described in paragraph (2)) are determined . . . to be made in exchange for the interest of such partner in partnership property, be considered as a distribution by the partnership and not as a distributive share or guaranteed payment under subsection (a).

(2) SPECIAL RULES.-For purposes of this subsection, payments in exchange for an interest in partnership property shall not include amounts paid for-

(A) unrealized receivables of the partnership . . .or

(B) good will of the partnership, except to the extent that the partnership agreement provides for a payment with respect to good will.

(3) LIMITATION ON APPLICATION OF PARAGRAPH (2).-Paragraph (2) shall apply only if-

(A) capital is not a material income-producing factor for the partnership, and

(B) the retiring or deceased partner was a general partner in the partnership.

[Subsection (b)(3) was added by the Omnibus Budget Reconciliation Act of 1993 (P.L. 103-66).]

[13] IRC §741 provides with respect to the sale of a partnership interest that ". . . gain or loss shall be recognized to the transferor partner. Such gain or loss shall be considered as gain or loss from the sale of a capital asset." Such payments are not deductible by the partnership.

Petitioner treated the payments to Michaels and Feldman as deductible guaranteed payments under IRC §736(a)(2) and treated the Draw paid to Horowitz as a guaranteed payment under IRC §707(c). Had the Payments been treated by the Partners in the Agreements as being for goodwill or for the purchase of Horowitz' partnership interest in RGH, (collectively, "Payments for Goodwill") they would not have been deductible for federal income tax purposes. However, because the Agreements did not provide for any payments for goodwill or for the purchase of Horowitz' partnership interest in RGH (but instead provided that the payments to Michaels and Feldman were further compensation for prior services to the Firm, and the Draw paid to Horowitz represented advance payments for past services to the Firm (collectively, the "Payments for Services"), the Payments were deductible for federal income tax purposes.

The determinative nature of the language of the Agreements is dictated by a federal statute that arose as a result of the substantial difficulty that courts had in determining the nature of payments to retired partners;[14] *i.e.*, whether such payments were for goodwill (and thus not deductible since goodwill is a non-wasting asset),[15] or for services (and thus deductible). To alleviate such uncertainty, IRC §736 was adopted in the Internal Revenue Code of 1954 to provide clear guidance to partners and partnerships.[16] In

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[14] Payments to retiring partners could be attributed in full or in part to goodwill, deferred compensation, partnership property, unrealized receivables, fees, inventory, and/or "an arrangement in the nature of mutual insurance." *See*, *Anachronisms in Subchapter K*, 100 Northwestern Law Review 379, 384-385 (2006).

[15] Goodwill was not amortizable until 1993 when IRC §197 was enacted.

[16] In enacting IRC §736, Congress took note of the confused state of the law regarding the taxation of distributions to retiring partners (*see*, *Foxman v. Commissioner of Internal Revenue*, 41 T.C. 535, 550-551, citing *H.Rept., No. 1337, 83d Cong., 2d Sess., p. 65)*, and stated its intent to provide a system with the "principal objectives [of] simplicity, flexibility, and equity as between partners." As noted in *Foxman*, *supra*:

essence, under IRC §736(b)(2)(B) and (3), payments to retired partners will only be considered payments in exchange for an interest in partnership goodwill "to the extent that the partnership agreement provides for a payment with respect to goodwill." Otherwise, such payments are treated the same as payments for services; *i.e.*, are deductible under IRC §736(a) as either a distributive share of partnership income under IRC §736(a)(1) or a guaranteed payment under IRC §736(a)(2). That a payment to a retired partner will be treated as being for goodwill only if the partnership agreement contains a provision that payments are for goodwill gives partnerships and partners great freedom in structuring transactions and determining how they wish to treat payments to departing partners.[17]

Petitioner, an accounting firm which provided accounting and tax services, carefully structured the transactions and Agreements to specifically provide that the Payments for Services were categorized as payments for services. These provisions of the Agreements and the structuring of the transactions with Horowitz and RGH had clear and predictable tax consequences. Petitioner could expect the IRS to respect the form of the transactions chosen by Petitioner[18] and that none of the payments to a Retired Partner would be treated as nondeductible Payments for Goodwill under IRC

> . . . one of the underlying objectives of the 1954 Code was to permit the partners themselves to determine their tax burdens *inter sese* . . .[theorizing] that the partners would take their prospective tax liabilities into account in bargaining with one another.. . .

[17] Likewise, partners and partnerships have great flexibility in structuring transactions and payments for the purchase, by an unrelated partnership, of a partner's interest in a partnership, to be governed by either IRC §736 or IRC §741.

[18] That is, that with respect to Horowitz, the transaction would be treated under IRC §707(c) for two years and, thereafter, under IRC §736 (rather than under IRC §741).

§736(b)(2) and (3) or under IRC §741.[19] In fact, the testimony and the explicit language of the Special Partner Agreement, confirm that Petitioner structured the transactions and the Agreements carefully to achieve this tax result.

Petitioner seeks to retain the form of its transactions with Horowitz and its categorization of the Payments in the Agreements as being Payments for Services for purposes of establishing its entitlement to the deduction under federal law, but to effectively disavow the form of its transactions with Horowitz and its categorization of the Payments in the Agreements as being Payments for Services for purposes of establishing that it is not subject to the UBT add-back. To obtain this result, Petitioner relies on *New York Yankees v. O'Cleireacain*, 83 N.Y.2d 550 (1994), where the Court of Appeals rejected Respondent's reliance on the classification of payments to retired partners under the IRC as a basis to recharacterize payments attributable to amortized player contracts as payments "for services or for use of capital." *Yankees*, however, only states that the manner in which the IRC treats a partnership payment will not necessarily determine the nature of that payment for purposes of the UBT add-back. *Yankees* does not say that the taxpayer's own carefully planned transactions and contractual characterization of a payment in its partnership agreement (which is the predicate for the deductions being added back here), should be ignored in determining what a payment is for; particularly where to do so would result in inconsistent treatment of the transaction and categorizations of the Payments for federal and City tax purposes of the same transactions and contractually provided for payments.

[19] The Special Partner Agreement provides specifically that Horowitz will treat the payments as ordinary income deductible by Petitioner.

Clearly, as a general rule, the government may bind a taxpayer to the form in which it has cast a transaction. *Spector* v. *Commissioner of Internal Revenue*, 641 F.2d 376, 381 (5th Cir. 1981), *rev'g.,* 71 T.C. 1017 (1979).[20] Nowhere is this rule more important to apply than here where the initial step to deductibility under the UBT is wholly dependent upon the form of the transaction; *i.e.*, the manner in which Petitioner drafted its Agreements both with respect to the forms of the transactions as well as with respect to whether the Payments were Payments for Goodwill. *Spector, supra.* Specifically, had the Payments been treated in the Agreements as being Payments for Goodwill, as Petitioner now seeks, no deduction would have been allowed in the first instance.

Moreover, Petitioner's attempt to disregard the form of the transactions with Horowitz and RGH and avoid having the payments to him treated as being for services based on testimony that the transaction (structured as a merger of Petitioner with RGH followed by Horowitz' withdrawal from Petitioner two years later) was in reality a sale by Horowitz of his partnership interest in RGH to Petitioner, does not help Petitioner. For if the transaction with Horowitz is treated as a sale, such sale would fall within the purview of IRC §741, with the result being that Petitioner would

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[20] In *Spector*, the Fifth Circuit applied the rule set forth in *Danielson v. Commissioner of Internal Revenue*, 378 F.2d 771, (3rd Cir.), *cert. denied*, 389 U.S. 858 (1967), rather than the less stringent "strong proof" rule used by the Tax Court. In *Danielson,* the Third Circuit held that:

> . . . a party can challenge the tax consequences of his agreement as construed by the Commissioner only by adducing proof which in an action between the parties would be admissible to alter that construction or to show its unenforceability because of mistake, undue influence, fraud, duress, etc.

Under the "strong proof" rule, "when parties to a transaction . . . have specifically set out the covenants in a contract and have given them an assigned value, strong proof must be adduced by them in order to overcome that declaration." *Danielson, supra; Ullman v. Commissioner*, 264 F.2d 305 (2nd Cir. 1959).

not be entitled to deduct its payments to Horowitz for federal income tax purposes.[21] *See*, the Tax Court decision in *Spector, supra*. In any event, the terms of Petitioner's transactions with Horowitz and RGH cannot be disregarded. As stated by the Fifth Circuit in *Spector, supra*, at p. 384:

> Notwithstanding the fact that a section 736 liquidation may occur only in transactions between a partner and his or her own partnership, once the parties have agreed to structure the transaction in such a way as to comply with that requirement, "economic reality" does not provide a ground upon which that form can be set aside.

Petitioner effectively asserts that a fiction was created in each of the Agreements. Such fictions could be addressed by one of two means. Either (1) the categorization created by Petitioner in the Agreements that the payments were Payments for Services must be consistently followed and the Payments be treated as Payments for Services for all purposes, or (2) the categorization in the contracts should be disregarded and the Agreements be rewritten to provide that the payments at issue be categorized, *ab initio*, as being for what Petitioner now claims they were for (Payments for Goodwill). However, if the contractual language is reformed to reflect that such payments were indeed Payments for Goodwill, Petitioner would not be entitled to deduct them for federal income tax purposes and would lose the deductions claimed without regard to the add-back provision.[22]

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[21] Under IRC §741, capital gain treatment applies to such a sale regardless of whether there is a provision for goodwill in the partnership agreement.

[22] As already noted with respect to Horowitz, either the form of the transactions chosen by Petitioner must be consistently followed and the payments treated as being advance payments for past services for all purposes, or the form must be disregarded for all purposes and the payments treated as being for Petitioner's purchase of Horowitz's interest in RGH.

As Congressional policy is to permit service partnerships to choose their fiction, and courts are generally reluctant to reform contracts,[23] it is not appropriate to permit Petitioner to disavow the inescapable tax consequences of the deliberate contractual language in the Agreements.[24] As noted in *Comm. of Internal Revenue v. National Alfalfa Dehydrating & Milling Co.*, 417 U.S. 134 (1974):

> This Court has observed repeatedly that, while a taxpayer is free to organize his affairs as he chooses, nevertheless, once having done so, he must accept the tax consequences of his choice, whether contemplated or not . . ..

While Petitioner has put forth evidence in the testimony of Mr. Stanton that the Payments were Payments for Goodwill, Petitioner's intent in drafting the Agreements and allocating payments to partners is of no moment unless that intent (to purchase the Retired Partners goodwill) is borne out in the Agreements. *V. Zay Smith, supra*.[25] Petitioner was free to organize its affairs in the way it saw fit. It dictated the federal income

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[23] *V. Zay Smith v. Commissioner of Internal Revenue*, 313 F.2d 16 (10th Cir. 1962), *affg*. 37 T.C. 1033 (1962); *see, also*, *Spector, supra,* and the Tax Court decision on remand, *Spector*, T.C. Memo 1982-433.

[24] The great leeway that IRC §736 gives partnerships and partners in choosing the tax consequences to be accorded payments to retired partners (*i.e.*, to allocate very little or nothing to the goodwill of the partnership) clearly places form over substance. Congress has provided for this treatment even though there is no sound policy reason to do so. *See*, Bittker and Lokken, Federal Taxation of Income, Estates and Gifts, 3rd Ed., 1999, Vol. 4, 88-39; *Anachronisms in Subchapter K, supra* at 398-399.

[25] The Tax Court in *V. Zay Smith, supra* at 37 T.C. 1037, stated that it will not "search for the intent of the partners or attempt their own characterization" of the payments. Moreover, a substance over form analysis, which would need to be used to allow the intent of partners to override the terms of their partnership agreements, should not be used where the provisions of Subchapter K of the IRC are intended to allow form to control the tax treatment of a transaction. *See*, Reg. Sec. 1-701-2; Stephen Utz, *Determining a Partner's Share of Unrealized Receivables at the liquidation of the Partner's Interest*, TAXES, Vol. 78, No. 10, p. 37, 41-42 (2000).

tax consequences that it wanted for its payments to the Retired Partners, as negotiated with them, by including specific provisions in the Agreements to treat the Payments as being further compensation for prior services or advance payments for past services. Having chosen to provide in the Agreements that the Payments were Payments for Services (to avoid them being treated as being Payments for Goodwill), Petitioner cannot escape the practical and logical consequences of its careful choice by evidence that it intended the payments to be for goodwill.

Moreover, the amount to be treated as a payment to a retired partner under IRC §736 for goodwill is limited to the amount designated as goodwill in the partnership agreement. *Tolmach v. Commissioner of Internal Revenue*, T.C. Memo 1991-538. The Agreements made no provision for goodwill. *See, also*, *Coven v. Commissioner*, 66 T.C. 295, 307, fn. 10 (1976), which states that once a transaction is determined to be governed by IRC §736 (rather than IRC §741), an allocation to goodwill cannot be determined by the court unless there is an "operative written partnership agreement specifying payments for goodwill."

The Payments therefore cannot be treated as payments for the Retired Partners' interests in the goodwill of the Firm or for the purchase of Horowitz' interest in RGH. Instead, the Payments must be treated as being for what the Agreements stated they were for: further compensation for the prior services of Michaels and Feldmen and, with respect to Horowitz, advance payments for past services. *See*, *Buchbinder, supra*; *Hawkins Delafield & Wood v. Commissioner*, 67 N.Y.2d 873 (1986).[26]

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[26] All other arguments raised by Petitioner have been considered and found to be without merit.

ACCORDINGLY, IT IS CONCLUDED THAT the Payments must be categorized in accordance with the Agreements as being Payments for Services which must be added back to UBTI under Code §11-507(3). The Notice of Determination dated April 12, 2000 is sustained.

IT IS SO ORDERED.

DATED: July 21, 2006
New York, New York

WARREN P. HAUBEN
Deputy Chief Administrative Law Judge