New York City Tax Appeals Tribunal

In the Matter of	:	
	:	DECISION
CITRIN COOPERMAN & COMPANY, LLP	:	
	:	TAT (E) 01-17 (UB)
Petitioner.	:	

Citrin Cooperman & Company, LLP ("Petitioner") filed an exception to a Determination of the Deputy Chief Administrative Law Judge ("DCALJ") dated July 21, 2006 (the "DCALJ Determination"). The DCALJ Determination sustained a Notice of Determination, dated April 12, 2000, issued by the New York City Department of Finance (the "Department") to Petitioner (the "Notice"). The Notice asserted a New York City Unincorporated Business Tax ("UBT") deficiency in the principal amount of $29,786 plus interest for the calendar years 1996 and 1997 (the "Tax Years").

Petitioner appeared by John K. Crossman, Esq. and Nathaniel S. Gore, Esq. of Zukerman Gore & Brandeis, LLP and the Commissioner of Finance of the City of New York (the "Commissioner" or "Respondent") appeared by George P. Lynch, Esq., Assistant Corporation Counsel, New York City Law Department. The Parties filed briefs and oral argument was held before the Tribunal. Commissioner Robert J. Firestone did not participate in this Decision.

Petitioner, a certified public accounting firm, is a New York registered limited liability partnership.[1] During the Tax Years, Petitioner engaged in business in New York City (the "City"). During the 1996 Tax Year, Petitioner operated under a written partnership agreement dated as of February 1, 1989, amended as of February 7, 1992 and February 1, 1993 (the "1996 Partnership Agreement"). During the 1997 Tax Year, Petitioner operated under the 1996 Partnership Agreement as further amended as of January 1, 1997 (the "1997 Amended Partnership Agreement").[2] Collectively, the 1996 Partnership Agreement and the 1997 Amended Partnership Agreement are known as the "Partnership Agreement." The Partnership Agreement required all partners to devote full time and attention to the affairs of Petitioner. As part of a partner's duties under the Partnership Agreement, the partner must perform services for Petitioner.[3]

Paragraph 10.1 of the Partnership Agreement provides that a partner "may elect retirement at age 62 . . . by giving three months notice." The giving of notice of retirement automatically creates a liability of Petitioner to the retiring partner. Paragraph 10.2 of the Partnership Agreement provides that upon retirement, a partner is entitled to receive "his capital and loan account, his share of undistributed net taxable income to the effective date of his retirement **and shall be compensated for past services**. . . . [Emphasis added.]"[4]

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[1]Petitioner took exception to a number of Findings of Fact made by the DCALJ. Except as noted below, the DCALJ's Findings of Fact, although paraphrased and amplified herein, generally are adopted for purposes of this Decision.

[2]We have modified the DCALJ's Finding of Fact 4, as requested by Petitioner, to reflect the fact that the January 1, 1997 amendment to the Partnership Agreement was not applicable to the 1996 Tax Year.

[3]Tribunal's Exhibit 1, Stipulation of Facts, ¶12.

[4]Petitioner took exception to the DCALJ's use of the phrases "compensation for past services", "payments for past services" and "for past services" based on its assertion that although such payments were labeled as being made for past services, they were actually payments for goodwill. In setting forth the facts in this Decision we have identified all payments using the terminology employed in the specific provisions of the relevant documents.

Paragraph 14 of the Partnership Agreement is entitled "Past Service Compensation." Paragraph 14.1 provides that an amount "shall be paid only to separated equity owning Partners **as a further compensation for prior services to the Partnership**. . . . [Emphasis added.]" Paragraph 14.1(b) of the Partnership Agreement provides that the separated equity owning partner shall receive one ninety-third of the past service liability for a period of ninety-three months. Paragraph 15.3 of the Partnership Agreement provides:

> The monthly average of the immediately preceding twenty-four (24) months of client collections (beginning with the effective date of the separation) shall be multiplied by twelve (12) to arrive at an average annual collection amount. . . . This shall then be multiplied by one and one quarter (1-1/4) times to arrive at the base upon which the separated partners equity percent shall be applied to determine the past service liability of [Petitioner].

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

For purposes of calculating its UBT liability in each of the Tax Years, Petitioner deducted payments to retired partners, Norman Michaels ("Michaels"), Melvin Feldman ("Feldman") and special partner Albert Horowitz ("Horowitz") (collectively, the "Retired Partners").[5] Petitioner deducted $63,405 and $117,056 for payments made to Michaels in 1996 and 1997, respectively; $35,000 for payments made to Feldman in 1997; and $150,000 for payments made to Horowitz in 1997. Petitioner provided the Retired Partners with federal Form 1065 Schedules K-1, which reported the payments as guaranteed payments.

[5]Although the Parties stipulated that Michaels, Feldman and Horowitz are the "Retired Partners", we note that Horowitz' retirement was effective January 1, 1999.

Michaels

Michaels, who had been a principal in Michaels, Sesholtz & Associates, C.P.A.s, P.C. (the "MSA Group"), an accounting firm, was admitted as a partner in Petitioner pursuant to an Agreement dated February 7, 1992 (the "Admission Agreement"). The Admission Agreement set forth the provisions regarding payments to be made to Michaels upon his retirement.

Payments to Michaels in 1996 and 1997 were made pursuant to Paragraph 6 (a) of the Admission Agreement. Paragraph 6(a) of the Admission Agreement provides, in relevant part, that:

> Upon separation from [Petitioner] by a member of the MSA Group . . . [Petitioner] shall be obligated to distribute his capital account and pay such separated MSA Group member . . . the amount set forth in paragraph 6(b) hereof **as further compensation for prior services to [Petitioner] ("Past Service Compensation")**. . . . [Emphasis added.]

Paragraph 6(b) of the Admission Agreement provides that the Past Service Compensation for each member of the MSA Group, including Michaels:

> shall be equal to sixty-two and one-half percent (62.5%) of the client collections of [Petitioner] for the immediately preceding twenty-four (24) months prior to the separation multiplied by such member's equity percentage on the date of his separation less any amount of unpaid Past Service Compensation to other partners of [Petitioner] multiplied by such member's equity percentage on the date of his separation.

Paragraph 6(c) of the Admission Agreement provides that the Past Service Compensation and capital account for a separated member of the MSA Group shall be combined and paid out in ninety-three equal monthly installments without interest.[6]

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 as payments to a retired partner (13 payments of $4,877.37) $55,796 represented "Past Service Compensation" and $7,609 represented unrealized receivables. Of the $117,056 paid to Michaels in 1997 as payments to a retired partner (24 payments of $4,877.37) $103,009 represented "Past Service Compensation" and $14,047 represented unrealized receivables. Petitioner is only protesting the add-backs for "Past Service Compensation" paid to Michaels for each of the Tax Years, *i.e.;* $55,796 in 1996 and $103,009 in 1997.

Feldman

Pursuant to Paragraph 2.5 of the Partnership Agreement the rights and obligations of Feldman and Petitioner to each other (with certain exceptions not relevant here) are governed by a prior partnership agreement dated January 1, 1983 (the "Prior Agreement"). Feldman retired effective August 31, 1997. Under Paragraph 10.2 of the Prior Agreement, upon retirement, Feldman was entitled to receive "his capital and loan account, his share of undistributed taxable income to the effective date of his retirement and **shall be compensated for past services**, . . . [Emphasis added.]"

[6]According to a Letter Agreement dated July 2, 1996 (Tribunal's Exhibit 1, Stipulation of Facts, Exhibit I) and signed by Michaels, Joel A. Cooperman, Managing Partner and Petitioner's Executive Committee, Michaels was to receive his Past Service Compensation and capital payments in 186 semi-monthly non-interest bearing installments of $5,593.68.

Paragraph 13.3 of the Prior Agreement is entitled "Past Service Compensation" and provides that an amount "shall be paid only to equity owning Partners **as a further compensation for prior services to [Petitioner]** of such separated equity owning Partner. . . . [Emphasis added.]" Paragraph 13.3(b) of the Prior Agreement provides that the separated equity partner shall receive one eighty-fourth of the past service liability for a period of eighty-four months. Paragraph 14.5 of the Prior Agreement provides that:

> The monthly average of the immediately preceding twenty four months of client collections (beginning with the effective date of the separation) shall be multiplied by twelve to arrive at an average annual collection amount. This shall then be multiplied by one and one/half times to arrive at the base upon which the separated Partner's equity percent shall be applied to determine the past service liability of [Petitioner].

Paragraph 14.7 of the Prior Agreement provides that the "past service liability of a Partner who wishes to continue working beyond the age of 65 years will be established at the end of the Partnership year in which he attains the age of 65 years. . . ."

By letter agreement dated November 4, 1994 (Tribunal's Exhibit 1, Stipulation of Facts, Exhibit K) (the "Feldman Letter Agreement") it was agreed that the balance of Feldman's "Past service compensation" and "Accrual basis capital" were to be paid in monthly payments of $8,750. The $8,750 consists of $5,591.25 representing "past service compensation" and $3,158.75 representing "unrealized receivables".[7] Petitioner is only

[7] Although DCALJ Finding of Fact 3, n.2 and Tribunal's Exhibit 1, Stipulation of Facts, ¶30 state that the $8,750 monthly payment to Feldman consists of $5,591.25 representing past service compensation and $3,158.75 representing unrealized receivables, we note that Taxpayer's Exhibit 4, Page 5, entitled "Analysis of MIF Payments Related to Buyout" refers to payments for past service compensation and accrual basis capital and provides that of the $35,000 paid to Feldman in 1997, $22,365 represents past service compensation and $12,635 represents capital. This is consistent with the Feldman Letter Agreement. In addition, the amount representing Feldman's past service compensation has two components; "past service compensation as previously agreed" and "additional past service compensation." Feldman Letter Agreement.

protesting the add-backs for "past service compensation" paid to Feldman totaling $21,980.

Horowitz

Pursuant to an agreement dated December 12, 1996 (the "Special Partner Agreement"), Horowitz (who had been a partner in Robbins, Greene, Horowitz, Lester & Co., LLP, ("RG")) was a special partner of Petitioner during the "Adjustment Period" (1997 and 1998).[8] Under the Special Partner Agreement, Petitioner paid Horowitz an "annual Draw" of $150,000 in 1997 and provided him with an office.[9] Horowitz was to retire as a special partner effective January 1, 1999.

Paragraph 2.04 of the Special Partner Agreement provides:

> Special Partner Status. As a special partner of [Petitioner] Horowitz' rights and obligations are determined solely pursuant to the terms of [the Special Partner Agreement]. Horowitz is not

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In his testimony regarding the Feldman Letter Agreement, Niles Citrin, CPA, a founding partner of Petitioner conceded that the $9,846 of "additional past service compensation" to be paid to Feldman ought not to have been deducted as "past service compensation" because it was the result of negotiations with Feldman rather than a function of the applicable provisions of the Prior Agreement. Tr. 247-50. He also testified that a portion of the $35,000 paid represented a non-deductible return of Feldman's capital based on his recalculations. Tr. 268-69. In addition, Mr. Citrin testified that "[a]t the time that we prepared and filed the tax return we took a deduction for the entire amount of money that was paid to [Feldman], to [Michaels] and to [Horowitz]. In the case of [Feldman] and [Michaels], some portion of that was unrealized receivables. . . ." Tr. 262.

[8]The "Adjustment Period" is defined in the Special Partner Agreement, Article 1.01, as "the twenty four (24) month period beginning on the Effective Date." The Special Partner Agreement does not provide a definition for the term "Effective Date." However, based on the fact that Petitioner was required to pay Horowitz an annual Draw of $150,000 during the Adjustment Period and that the first annual Draw payment was due January 15, 1997 and the last annual Draw payment was due December 31, 1998 (Special Partner Agreement, Article 2.01(a)) it appears that the Adjustment Period encompassed 1997 and 1998.

[9]Petitioner also entered into an admission agreement dated December 12, 1996 with the other partners of RG. That agreement is not part of the Record.

> 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 . . . 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 [Petitioner], and shall not share in the profits of [Petitioner]. Horowitz shall not be entitled to vote as a partner of [Petitioner].[10]

Pursuant to Paragraph 2.01(b) of the Special Partner Agreement, Horowitz was to retire as a special partner effective January 1, 1999 and was to receive payments from Petitioner "**[a]s compensation for Horowitz' past services to [Petitioner]**. . . . [Emphasis added.]" The amount of compensation for past services that Petitioner was obligated to pay Horowitz is based on a formula. The amount was to be paid in 192 equal semi-monthly installments, without interest, and was to be "equal to the sum of fifty (50%) percent times the Annual Fees of all RG Clients and RG Referrals, up to a maximum of $3,000,000 of Annual Fees, which amount shall be reduced by the total Draw paid to Horowitz [during 1997 and 1998]." According to the Special Partner Agreement, Horowitz and Petitioner were to treat these payments as ordinary income to Horowitz and deductible by Petitioner.

Petitioner and Respondent stipulated that "[t]he draw payments made to Horowitz represented a draw against future past service compensation as finally calculated and payable to Horowitz over a ten (10) year period." Tribunal's Exhibit 1, Stipulation of Facts, ¶43. Accordingly, each annual Draw was an advance payment against the compensation for past services that Horowitz would be entitled to upon his retirement from Petitioner.

[10]Neither Petitioner nor Respondent raised the issue of whether Horowitz was a partner of Petitioner for federal tax purposes or for purposes of the UBT.

Pursuant to Paragraph 5.03 of the Special Partner Agreement:

> As part of the consideration for the compensation provided under this Agreement, . . . Horowitz shall during [1997 and 1998] cooperate in all reasonable respects to transfer the RG Clients to [Petitioner] and to cause the RG Clients to stay with [Petitioner]. Horowitz shall not be required to expend on behalf of Petitioner any minimum number of hours pursuant to this Agreement, any such hours to be in Horowitz' sole discretion. [Petitioner] will fully cooperate in all reasonable respects with Horowitz in the performance of Horowitz's services and the introduction of RG Clients to [Petitioner] and [Petitioner] will use its best efforts to cause the RG Clients to become and remain clients of [Petitioner] during [1997 and 1998].

Pursuant to Paragraph 2.08 of the Special Partner Agreement, during the term of the Special Partner Agreement, Petitioner agreed to "cover Horowitz under its malpractice insurance policy at no cost to Horowitz except for services rendered to any person or entity other than a client of [Petitioner]."

Petitioner is protesting the entire add-back of the $150,000 paid to Horowitz in 1997 without reduction as no amount represents a return of capital or payment for unrealized receivables.

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 percent to 150 percent of annual fees. Tr. 37 and 59-60.

Mr. Stanton was involved as a consultant with respect to the merger of the MSA Group into Petitioner in 1992, as well as the transactions involving Horowitz and the RG partners. With respect to Horowitz, Mr. Stanton testified that Horowitz had a 50 percent equity interest in RG 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. Tr. 96. So, while he wanted to sell his share of RG and retire, Horowitz agreed to have RG 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 services for the first two years and would receive payments for the balance due him for past service over the next eight years.

The Parties stipulated that the payments made to the Retired Partners were deducted on Petitioner's Federal tax return Form 1065 pursuant to §736 of the Internal Revenue Code ("IRC").[11] Mr. Citrin testified that the label, "past service compensation" was "put into [Petitioner's] original Partnership Agreement by the attorneys because they were, in effect, dancing around what to call this since for federal income tax purposes so long as it was not labeled good will, the Internal Revenue Service would permit a deduction for this payment, . . ."[12] He testified that it was his understanding that federal law permitted Petitioner's partners and incoming partners to negotiate and agree among themselves as to the tax treatment of payments to departing partners both to Petitioner and to its partners. The partners negotiated and agreed that such payments would be ordinary income to the partners and deductible by Petitioner. Petitioner and its partners specifically avoided attributing any of the payments to goodwill so as to avoid having the payments being treated as a capital expenditure and to ensure a deduction for the Partnership.

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[11]Tribunal's Exhibit 1, Stipulation of Facts, ¶7.

[12]Tr. 288-89.

Respondent issued the Notice to Petitioner asserting a total UBT deficiency for the Tax Years of $35,295.71 including interest calculated to April 30, 2000. The deficiency asserted for the 1996 Tax Year is in the principal amount of $2,536 plus interest of $727.74, for a total deficiency of $3,260.74. The deficiency asserted for the 1997 Tax Year is in the principal amount of $27,250 plus interest of $4,784.97, for a total deficiency of $32,034.97. The deficiency for the 1996 Tax Year is based on Respondent's adding back to Petitioner's taxable income as reported, payments to partners of $63,405. The deficiency for the 1997 Tax Year is based on Respondent's adding back to Petitioner's taxable income as reported, payments to partners of $302,056 and increasing Petitioner's allocation percentage from 86.58 percent to 94 percent. Petitioner does not dispute the adjustment to the allocation percentage for the 1997 Tax Year. Petitioner also does not protest the portion of the deficiency attributable to the add-back for amounts paid to Michaels and Feldman that represented unrealized receivables or accrued basis capital. Petitioner is protesting only that portion of the deficiency attributable to the add-back for amounts paid to the Retired Partners as past service compensation (the "Payments").[13]

The DCALJ concluded that the Payments must be categorized in accordance with the Partnership Agreement, the Prior Agreement, the Admission Agreement and the Special Partner Agreement (collectively the "Agreements") as being payments for services, which must be added back for purposes of computing Petitioner's unincorporated business taxable income pursuant to §11-507(3) of the New York City Administrative Code (the "Code"). Thus, the DCALJ sustained the Notice in full.

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[13]Although the Parties stipulated that the Payments are "past service compensation" and that Michaels, Feldman and Horowitz are the "Retired Partners", we note that Horowitz received $150,000 as an "annual Draw" in 1997 and that his retirement was not effective until January 1, 1999. Horowitz did not receive payments as "past service compensation" until his retirement. When Horowitz retired, the amounts due as past service compensation to Petitioner were to be reduced by the total annual Draw paid to Horowitz in 1997 and 1998.

Petitioner contends that the Payments were actually made to the Retired Partners in respect of those partners' shares of Petitioner's goodwill. However, Petitioner asserts that, pursuant to IRC §736, it was able to avoid having the Payments treated as goodwill payments for federal tax purposes by labeling the Payments in the Agreements as being for something other than goodwill. Petitioner chose the label Past Service Compensation and, pursuant to IRC §736, treated the Payments as deductible (*i.e.,* not as goodwill payments) for federal tax purposes. Petitioner contends that to determine whether the Payments must be added back for purposes of computing its unincorporated business taxable income pursuant to Code §11-507(3) as payments for services or use of capital one must look to the economic reality of the Payments and not to the label used by Petitioner for purposes of IRC §736. Petitioner asserts that the New York State Court of Appeals decision in New York Yankees Partnership v. O'Cleireacain, 83 N.Y.2d 550 (1994) supports its contention that it is the economic substance of the Payments that determines whether they must be added back and not the label used to describe the Payments. Petitioner argues that in substance the Payments were in fact payments for goodwill, and did not have to be added back for purposes of the UBT.

Respondent contends that Petitioner is bound by the form it freely chose to designate the Payments. Having chosen to designate the Payments as Past Service Compensation,[14] Petitioner must accept the tax consequences of that choice. Respondent further contends that, although neither the substance nor form of the Payments supports Petitioner's claim that they were for goodwill, even if the Payments were for goodwill, Petitioner would not be entitled to a deduction because Code §11-507 permits a deduction of only those items "which are allowable for federal income tax purposes" and payments for goodwill are not deductible under federal tax law.

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[14]*See supra* note 13.

An unincorporated business is "any trade, business, profession or occupation conducted, engaged in or being liquidated by an individual or unincorporated entity, including a partnership. . . ." Code §11-502(a). The UBT is imposed on the unincorporated business taxable income of a partnership doing business in the City. Code §11-503(a). Unincorporated business taxable income of an unincorporated business is defined in Code §11-505 as "the excess of its unincorporated business gross income over its unincorporated business deductions" less certain deductions and exemptions. Code §11-507 defines the unincorporated business deductions of an unincorporated business as "the items of loss and deduction directly connected with or incurred in the conduct of the business, which are allowable for federal income tax purposes for the taxable year" with certain modifications. One of the modifications provides that, with an exception not relevant here, "[n]o deduction shall be allowed . . . for amounts paid or incurred to a proprietor or partner for services or for use of capital." Code §11-507(3). Thus, in order for an item to be deductible for purposes of the UBT it must be deductible under federal law and it must not be the subject of a UBT modification provision requiring its addback.

IRC §736 governs the federal income tax treatment of payments to retired partners and 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
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> (2) as a guaranteed payment described in section 707(c) if the amount thereof is determined without regard to the income of the partnership.
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> (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.[15]

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

Petitioner asserts that the Payments were made, in economic substance, for the Retired Partners' shares of Petitioner's goodwill. However, pursuant to IRC §736, if the Payments had been identified in the Agreements as payments for goodwill or as payments for the retired partners' interests in property of Petitioner, the Payments would not have been deductible for federal tax purposes. Thus, in urging this Tribunal to treat the Payments as payments for goodwill, Petitioner is asking this Tribunal to treat the Payments as the one thing that they could not be called in the Agreements. In each of the Agreements, Petitioner called the Payments "Past Service Compensation" or "compensation for . . . past services to

[15] *See supra* note 10.

[Petitioner]."[16] By so identifying the Payments, Petitioner sought to ensure a deduction for federal tax purposes for the Payments pursuant to IRC §736(a)(2).

Code §11-507(3), provides that in computing the UBT "[n]o deduction shall be allowed . . . for amounts paid or incurred to a proprietor or partner for services or for use of capital." Thus, if Petitioner's classification of the Payments as "Past Service Compensation" controls for UBT purposes, the Payments have to be added back for purposes of computing UBT. Having obtained a federal tax deduction for the Payments using the classification "Past Service Compensation", Petitioner now seeks to disclaim that classification for purposes of the UBT; arguing that in substance the Payments were for goodwill and not for services, to avoid having to add back the Payments in computing its unincorporated business taxable income.[17]

Petitioner argues that the Court of Appeals decision in Yankees Partnership, 83 N.Y.2d 550 requires the Tribunal to look to the economic substance of the Payments and not merely at the label Petitioner used in the Agreements to identify them. Petitioner further contends that the evidence presented by it clearly shows that the Payments were for goodwill and not for services. At issue in Yankees Partnership was the deductibility, for purposes of the UBT, of unrealized receivables of the taxpayer that were attributable to the retiring partners' shares in amortized player contracts. There was no disagreement between the parties in Yankees Partnership that the payments at issue were attributable to the retiring partners' shares in amortized player contracts. While no portion of the payments at issue in Yankees Partnership were specifically for services or use of capital, the Commissioner argued that because IRC

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[16]*See supra* note 13.

[17]However, Petitioner asserts that the Payments should be treated as for goodwill only for purposes of Code §11-507(3) so as to avoid the add back but should be treated as Past Service Compensation for all other UBT purposes so as to ensure their deductibility in the first instance.

§736(a)(2) treated those payments as guaranteed payments under IRC §707(c), and because IRC §707(c) applies to payments for "services or the use of capital", the payments at issue were required to be added back for UBT purposes because Code §11-507(3) disallowed a deduction for payments for "services or for use of capital." The Court of Appeals found that the Commissioner's assertions based on the statutory language alone were "untenable" and concluded that the taxpayer was entitled to a deduction for such payments. We do not agree with Petitioner's contentions that Yankees Partnership requires the Tribunal to look at the economic substance of the Payments where the Agreements, freely negotiated and adopted by Petitioner, specify that they are being made to compensate retired partners for past services.[18]

Petitioner should be held to the unambiguous Agreements it has freely adopted. While there is some disagreement among the various courts as to the legal principles applicable where a taxpayer seeks a tax result at variance with the unambiguous terms of the taxpayer's own written agreements governing a transaction, the conclusion in this case is clear. The United States Tax Court generally applies a "strong proof rule" unless the case is appealable to a federal circuit that has adopted the more stringent "Danielson rule." Elrod v. Commissioner of Internal Revenue, 87 T.C. 1046, 1066 (1986). The "strong proof rule" requires a "taxpayer to present 'strong proof' that is, more than a preponderance of the evidence, that the terms of the written instrument do not reflect the actual intentions of the contracting parties" in order for a taxpayer to ignore unambiguous terms of a binding agreement. *Id.* at 1066. The "Danielson rule" is based on the Third Circuit Court of Appeals' decision in Commissioner of Internal Revenue v. Danielson, 378 F.2d 771 (3d Cir. 1967)

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[18]Our reading of Yankees Partnership is consistent with the Court of Appeals' subsequent decision in Buchbinder Tunick & Co. v. Tax Appeals Tribunal of the City of New York, 100 N.Y.2d 389 (2003), in which the court distinguished Yankees Partnership and, holding the taxpayer partnership to its stipulation that unrealized receivables were for services rendered by it, found that payments to retired partners for their share of those unrealized receivables must be added back as payments for services under Code §11-507(3).

where the court 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 to the agreement would be admissible to alter that construction or to show its unenforceability because of mistake, undue influence, fraud duress, etc.

The Second Circuit Court of Appeals has not clearly adopted or rejected the "Danielson rule" but the case law in this Circuit generally takes a dim view of taxpayers' efforts to disregard the terms of written agreements that were entered into for tax purposes, as is the case here. In Hoffman Motors Corp. v. United States, 473 F.2d 254, 257 (2d Cir. 1973), without addressing either the "strong proof rule" or the "Danielson rule" but rather using a more general substance over form analysis, the Second Circuit Court of Appeals stated "[i]n no case that we have found has a taxpayer been permitted to benefit from substance over form if his motives were predominantly tax avoidance." In Estate of Rogers v. Commissioner of Internal Revenue, 445 F.2d 1020, 1022 (2d Cir. 1971), the Second Circuit found that it was not necessary to consider adopting the "Danielson rule," which it characterized as "a virtual parol evidence rule", because the taxpayer had failed to meet the "strong proof rule". The Eastern District Court, while recognizing that the Second Circuit had not addressed the "Danielson rule" directly, nevertheless applied the "Danielson rule" where the taxpayer chose to structure its transactions in a manner that would offer tax benefits to potential limited partners. In re Tax Refund Litigation, 766 F. Supp. 1248 (E.D.N.Y. 1991), *aff'd in part and rev'd in part on other grounds*, In re: MDL-731--Tax Refund Litigation, 989 F.2d 1290 (2d Cir. 1993). It was the opinion of the District Court that the Second Circuit Court's analysis in Hoffman Motors, *supra*, should apply "to tax shelter promoters as well as to entities which seek to avoid taxes on their own behalf." Tax Refund Litigation, *supra* at 1263. "Moreover, many of the policies underlying the *Danielson* rule support its application in a case such as this one. As is aptly pointed out by the cases adopting that rule, to allow plaintiffs such as these to challenge the form of their own transactions, encourages others to misrepresent the nature of their transactions intentionally. In a system premised upon voluntary compliance, such a policy could be enormously damaging." *Id.*

The New York State Tax Appeals Tribunal (the "State Tribunal") has addressed similar issues regarding the modification of unambiguous contracts and agreements. In Matter of Shechter, New York State Tax Appeals Tribunal, October 13, 1994, the State Tribunal did not permit the taxpayer to argue that the terms of a contract should be modified based on an oral "understanding" between the parties conditioning the contract upon the completion of another contract. The State Tribunal found that "[i]t is well established that in the absence of fraud, accident or mistake, the parol evidence rule prohibits resort to extrinsic evidence to vary the meaning of a contract that is unambiguous. . . ." *See also*, Matter of Spencer, New York State Tax Appeals Tribunal, February 20, 1997, *aff'd,* 251 A.D.2d 764 (3d Dept. 1998) where the State Tribunal adopted a "Danielson rule" analysis in ruling that a taxpayer could not recast a transaction structured as a liquidation of a partnership interest.

In Coleman v. Commissioner of Internal Revenue, 87 T.C. 178, 203 (1986), *aff'd without opinion,* 833 F.2d 303 (3d Cir. 1987) the Tax Court, while using a "strong proof rule" standard, declined to "ignore the form of a transaction structured to obtain tax benefits in one jurisdiction and to restructure the transaction, at the insistence of the taxpayer, in order to confer tax benefits in another jurisdiction -- in short, to enable the taxpayer to play both ends against the middle." Petitioner is only seeking to modify the language of the Agreements with respect to one aspect of the UBT (to avoid having to add back the Payments for purposes of computing its unincorporated business taxable income). At the same time Petitioner wants to retain that same classification to obtain tax benefits for federal and all other UBT purposes.

Based on the foregoing authorities, we conclude that under any of the possible legal theories, where Petitioner's own unambiguous Agreements, knowingly adopted to achieve a specific federal tax result, provide that the Payments were made as compensation for prior services to Petitioner, Petitioner should be held to the provisions of the Agreements and should not be permitted to argue otherwise for UBT purposes.[19]

Accordingly, the DCALJ Determination is affirmed and the Notice is sustained in full.

Dated: September 10, 2007
New York, New York

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GLENN NEWMAN
President and Commissioner

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ELLEN E. HOFFMAN
Commissioner

[19]We have considered all other arguments raised by Petitioner and deem them unpersuasive.