New York City Tax Appeals Tribunal

In the Matter of PROSKAUER ROSE LLP Petitioner.	DECISION TAT (E) 01-19(UB), *et al.*

Petitioner, Proskauer Rose LLP ("Petitioner") filed an exception to a determination of the Deputy Chief Administrative Law Judge (the "DCALJ") dated July 11, 2006 (the "DCALJ Determination"). The DCALJ Determination sustained Notices of Determination issued by the New York City Department of Finance (the "Department") asserting deficiencies of New York City Unincorporated Business Tax (the "UBT") under Chapter 5 of Title 11 of the Administrative Code of the City of New York (the "Code") for the taxable years beginning November 1, 1995 and ending October 31, 2000 (the "Tax Years"). The DCALJ Determination also disallowed refunds of UBT for the Tax Years.

Petitioner appeared by one of its partners, Abraham Gutwein, Esq. The Commissioner of Finance of the City of New York ("Respondent" or "Commissioner") appeared by George P. Lynch, Esq., Assistant Corporation Counsel, New York City Law Department. Both Parties submitted briefs and oral argument was held before the Tribunal. Commissioner Robert J. Firestone, Esq., did not participate in this Decision.

Petitioner, a New York limited liability partnership,[1] is a law firm with an office in New York City (the "City") and offices outside the City.[2]

During the Tax Years, Petitioner operated under a partnership agreement (the "Partnership Agreement") dated as of November 1, 1986, as amended, which contained a plan for "Optional Service and Fixed Income Benefits" (the "Optional Service Plan"). Under the Optional Service Plan, which was adopted effective as of November 1, 1994, partners who attain a specified age[3] are required to take "Optional Service Status" or retire. Upon taking Optional Service Status or retiring, the partner (the "OSP Partner" or "Retired Partner", respectively) receives payments as provided for in the Optional Service Plan.

Section 13 of the Partnership Agreement provides that "[n]either good will nor the right to use of [Petitioner's] name shall be given any valuation, whether in the event of death, withdrawal or otherwise, and no payment shall be made therefor."

Ronald S. Schacht, a retired partner in Petitioner[4] testified that in the early 1980s Petitioner was managed by five senior partners (the "Seniors") who, under the partnership agreement in effect at the time, owned the name of the Partnership. Three other partners,

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[1] Petitioner registered as a limited liability partnership in New York State as of January 26, 1995. Thereafter until May 15, 1997, Petitioner operated under the name "Proskauer Rose Goetz & Mendelsohn LLP."

[2] The DCALJ's Findings of Fact, although paraphrased and amplified herein, generally are adopted for purposes of this Decision except as noted below. Certain Findings of Fact not necessary to this Decision have not been restated and can be found in the DCALJ Determination. Petitioner takes exception to a number of Findings of Fact made by the DCALJ. Except as noted below, we find that the DCALJ's Findings of Fact accurately reflect the Record.

[3] Generally, the applicable age is 68. However, under certain conditions, partners can elect to take Optional Service Status or retire earlier or later.

[4] Mr. Schacht was an active partner in Petitioner from 1969 to 1995. At various times, Mr. Schacht served as chair or co-chair of Petitioner's tax department, as one of its managing partners, as a member of its executive committee and as its tax matters partner.

who were due to take over the management of Petitioner from the Seniors, engaged in discussions with the Seniors to accelerate that transition. A group of other partners also desired change in the existing arrangement. The three groups engaged in discussions and negotiations regarding Petitioner's future management. The Seniors were willing to cede management only if their ownership interest in Petitioner was purchased. The negotiations among the three groups resulted in a plan to provide payments to the departing Seniors[5] and the adoption of the Optional Service Plan.

Mr. Schacht testified that payments to Retired Partners made under the Optional Service Plan are meant to: (a) compensate partners for their contribution to the intangible value of Petitioner; (b) help provide a comfortable retirement for partners; and (c) help ensure an orderly transition of Retired Partners' clients to younger partners. Tr. at 28-30. Section 1(a) of the Optional Service Plan provides that "[t]he purpose of [the Optional Service Plan] is to establish a formal program under which a partner is required to take 'optional service status' at [a certain age] and to assure him or her of a fixed income for the remainder of his or her life. This program also leads to the orderly progression of younger partners within [Petitioner]."

In general, the Optional Service Plan provides a benefit based on a rate of 1.75 percent per year of service up to 52 percent of the average of the partner's share of Petitioner's profits in the five years of his or her highest annual earnings.[6] Mr. Schacht testified that this calculation is meant to approximate a partner's contribution to the intangible value of the Petitioner. The amount so calculated is reduced for social security benefits, certain disability

[5] Payments to the Seniors were made under a different plan, not under the Optional Service Plan, and are not at issue in this case.

[6] Partners' shares of earnings are determined by Petitioner's executive committee. Partnership Agreement § 5(c)(ii).

benefits, and an "assumed annuity" amount related in part to contributions to Petitioner's retirement plans, described below. The Optional Service Plan also provides for cost-of-living adjustments under certain circumstances.

An OSP Partner, but not a Retired Partner, is free to practice law within Petitioner and to retain his or her office and secretary for one year. Thereafter, Petitioner may provide an office and a secretary as needed. OSP Partners also have access to "guest offices". An OSP Partner, but not a Retired Partner, is required to leave $25,000 in his or her capital account for five years.

Under the Optional Service Plan, Petitioner agrees to use its best efforts to continue the group life, medical and disability insurance programs of an OSP Partner while he or she is on optional service.[7]

Petitioner maintained retirement plans benefitting its partners. The Partners' Retirement Plan of Proskauer Rose LLP (the "Keogh Plan") was established as a successor to two prior plans. The Keogh Plan is an individual defined contribution plan and is funded entirely by contributions made by Petitioner. A participating partner's interest in the Keogh Plan generally vests at a rate of 20 percent per year after three years of service, becoming fully vested after seven years or upon the partner's earlier death, disability or attainment of the age of 65 while employed by Petitioner.

The Proskauer Rose LLP Savings Plan for Staff and Partners (the "401(k) Plan") is an individual account defined contribution plan. The 401(k) Plan is subject to the requirements of the federal Employee Retirement Income Security Act of 1974, as amended

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[7] It appears that a Retired Partner is entitled to this same benefit as Retired Partners generally receive the benefits available to OSP Partners. Optional Service Plan § 19.

("ERISA"). The 401(k) Plan is funded through reductions in the compensation paid to participants in the 401(k) Plan.

The Proskauer Rose LLP Partners' Defined Benefit Plan ("Defined Benefit Plan") was adopted by Petitioner effective as of November 1, 1998. A participating partner's interest in the Defined Benefit Plan is not vested until after five years of service at which time it becomes fully vested. The Defined Benefit Plan is funded entirely through contributions made by Petitioner.

As set forth in the preface to each of the Keogh Plan, the 401(k) Plan and the Defined Benefit Plan (collectively, the "Plans"), the purpose of the Plans, in relevant part, is to provide retirement and other benefits to partners.[8] In the event that a partner's interest in either the Keogh Plan or the Defined Benefit Plan is not fully vested[9] and is forfeited as a result of his or her withdrawal from Petitioner, the forfeited amount must be applied to reduce Petitioner's future contributions to those Plans.[10]

The Parties have stipulated the following facts with regard to the UBT returns filed by Petitioner, the amounts deducted by Petitioner and the adjustments made by Respondent:[11]

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[8] There is no dispute that the Plans are qualified plans under Internal Revenue Code ("IRC") § 401(a).

[9] Partners' interests in the 401(k) Plan are fully vested immediately. 401(k) Plan § 5.1. Section 14(e) of the Partnership Agreement provides that if a partner withdraws, the nonvested portion of his or her interest in the Keogh Plan will be paid to him or her as a guaranteed payment provided the withdrawing partner does not engage in certain activities competitive with those of Petitioner. Also, Mr. Schacht testified that when a partner retires, the partner is 100 percent vested in the Keogh Plan. Tr. at 47.

[10] As of November 1, 2000, forfeited amounts in the Keogh Plan must first be applied toward administrative costs of the Keogh Plan and thereafter to reduce Petitioner's required contributions. Petitioner takes exception to the DCALJ's Finding of Fact 9 insofar as it stated that forfeited amounts are to be used to reduce Petitioner's contributions to the Plans and may be paid to other partners. We have modified the Finding of Fact to more fully reflect the Record.

[11] Joint Ex. C, Stipulation of Facts.

Petitioner timely filed a Form NYC-204, UBT return, for its Tax Year ending October 31, 1996. For that year, Petitioner deducted $2,061,624 of guaranteed payments made to Retired Partners and to the estates of deceased partners.[12] Petitioner also claimed as a City subtraction $406,300 for contributions made to the Keogh Plan.[13] In arriving at its net income allocable to the City, only $313,500 of the combined contributions to the Keogh Plan and the 401(k) Plan were taken into account as deductions.

Petitioner timely filed a Form NYC-204 for its Tax Year ending October 31, 1997. Petitioner did not deduct the guaranteed payments made to Retired Partners and the estates of deceased partners on that return. Petitioner claimed as a City subtraction $420,000 for contributions it made to the Keogh Plan.[14] In arriving at its net income allocable to the City, only $140,640 of the combined contributions to the Keogh Plan and the 401(k) Plan were taken into account as deductions for that year.

Respondent issued a Notice of Determination, dated May 16, 2000, asserting a tax deficiency for the Tax Year ending October 31, 1996 in the amount of $104,646.68, together with interest through April 21, 2000, for a total deficiency of $136,119.55. The adjustment resulted from: (a) adding back to income guaranteed payments of $2,061,624; (b) disallowing a deduction of interest expense of $241,043, which is not in dispute; and (c) adding back to

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[12] Pursuant to a letter addressed to the General Counsel of the Tribunal dated June 1, 2007, Petitioner is no longer seeking a deduction for payments made to the estates of deceased partners for any of the Tax Years.

[13] That amount represented 20 percent of the total contributions made to the Keogh Plan that year. For that Tax Year, Petitioner contributed $2,031,500 to the Keogh Plan, of which, $1,468,000 was contributed for the benefit of New York resident partners, and contributed $902,500 to the 401(k) Plan, of which, $655,500 was contributed for the benefit of New York resident partners.

[14] That amount represented 20 percent of the total contributions made to the Keogh Plan that year. For that Tax Year, Petitioner contributed $2,100,500 to the Keogh Plan, of which $1,495,000 was contributed for the benefit of New York resident partners and contributed $970,400 to the 401(k) Plan, of which $703,200 was contributed for the benefit of New York resident partners.

income $313,500 representing a portion of the contributions to the Keogh Plan and the 401(k) Plan, for a total adjustment of $2,616,167 for that year. That Notice of Determination also asserted a tax deficiency for the Tax Year ending October 31, 1997 in the amount of $5,412.52, together with interest through April 21, 2000, for a total deficiency of $6,690.58.[15] The adjustment resulted from adding back to income $140,640, comprising a portion of the contributions to the Keogh Plan and the 401(k) Plan.

Petitioner timely filed an amended Form NYC-204 on April 23, 2001, for the Tax Year ending October 31, 1997. On that amended return, Petitioner's taxable income (before allowances and exemptions) was reduced from the $65,175,719 originally reported to $62,526,995. The difference reflects a deduction of $2,526,373 for guaranteed payments made to Retired Partners and the estate of a deceased partner.[16]

Petitioner timely filed a Form NYC-204 for its Tax Year ending October 31, 1998. For that year, Petitioner deducted $1,989,544 of guaranteed payments made to Retired Partners and the estate of a deceased partner. Petitioner also claimed a City subtraction of $418,400 for contributions made to the Keogh Plan.[17] However, in arriving at Petitioner's net income allocable to the City, only $156,340 of the combined contributions to the Keogh Plan and the 401(k) Plan were taken into account as deductions.

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[15] Petitioner paid $155,491.27 to Respondent as a payment of the full amount of tax and interest claimed as due by Respondent for the Tax Years ending October 31, 1996 and October 31, 1997 to stop the running of interest on the deficiencies for those years.

[16] The Petition for the Tax Years ended October 31, 1996 and 1997 included a request for a refund of $105,949 based on the amended return for the Tax Year ended October 31, 1997.

[17] That amount represented 20 percent of the total contributions made to the Keogh Plan that year. Petitioner contributed $2,092,000 to the Keogh Plan, of which $1,517,000 was contributed for the benefit of New York resident partners, and contributed $1,106,605 to the 401(k) Plan, of which $781,700 was contributed for the benefit of New York resident partners.

Respondent issued a Notice of Determination, dated July 12, 2002, asserting a tax deficiency for the Tax Year ending October 31, 1998 of $90,252.60, together with interest through August 12, 2002, for a total deficiency of $118,257.39. The deficiency was attributable to: (a) adding back to income guaranteed payments in the amount of $1,989,544; and (b) adding back to income $266,771[18] comprising a portion of the amounts contributed to the Keogh Plan and the 401(k) Plan.[19]

Petitioner timely filed an amended Form NYC-204 for its Tax Year ending October 31, 1998. The amended return reduced Petitioner's taxable income (before allowances and exemptions) from the $69,384,015 originally reported to $68,416,594. The difference represents a deduction of an additional $967,421 of guaranteed payments made to Retired Partners that were not deducted on the original return.[20]

Petitioner timely filed a Form NYC-204 for its Tax Year ending October 31, 1999. For that Tax Year, Petitioner deducted $3,905,386 of guaranteed payments made to Retired Partners and the estates of deceased partners. Petitioner claimed a City subtraction of $484,345 for contributions made to the Keogh Plan and deducted $258,336 of its contributions made to the Defined Benefit Plan.[21] In arriving at Petitioner's net income

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[18] The amount added back by Respondent exceeded the amount deducted by Petitioner by $110,431. Respondent has agreed to adjust the asserted deficiency to reduce the amount added back accordingly. Joint Ex. B, Exhibit P.

[19] Petitioner paid $122,975.31 to Respondent as a payment of the full amount of tax and interest claimed as due by Respondent to stop the running of interest on the asserted deficiency for the Tax Year ending October 31, 1998.

[20] The Petition for the Tax Year ended October 31, 1998 included a request for a refund of $38,697 based on the amended return for that year.

[21] These amounts represented 20 percent of the total contributions made to the Keogh Plan and 20 percent of the payroll allocation percentage of the contributions to the Defined Benefit Plan that year. Petitioner contributed $2,420,724 to the Keogh Plan, of which $1,723,004 was contributed for the benefit of New York resident partners, and contributed $1,161,165 to the 401(k) Plan, of which $799,800 was contributed for the benefit of New York resident partners.

allocable to the City, only $159,960 of the combined Keogh Plan and 401(k) Plan contributions were taken into account as deductions.

Respondent issued a second Notice of Determination, dated July 12, 2002, asserting a tax deficiency for the Tax Year ending October 31, 1999 of $179,781.60, together with interest to August 12, 2002, for a total deficiency of $217,767.37. The deficiency was attributable to adding back to income guaranteed payments in the amount of $3,905,386 and adding back to income $258,336 of amounts contributed to the Defined Benefit Plan and $330,818[22] of the amounts contributed to the Keogh Plan and the 401(k) Plan.[23]

Petitioner timely filed a Form NYC-204 for its Tax Year ending October 31, 2000. Petitioner deducted $2,164,815 of the $4,114,815 of guaranteed payments that it made to Retired Partners and the estates of deceased partners. Petitioner also claimed as a City subtraction $519,200 for contributions made to the Keogh Plan and deducted $210,453 of its contributions to the Defined Benefit Plan.[24] In arriving at Petitioner's net income allocable to the City, only $184,490 of the combined Keogh Plan and 401(k) Plan contributions were taken into account as deductions.

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[22] The amount added back by Respondent exceeded the amount deducted by Petitioner by $170,858. Respondent has agreed to adjust the asserted deficiency to reduce the amount added back accordingly. Joint Ex. B, Exhibit P.

[23] Petitioner paid $226,455.27 to Respondent as a payment of the full amount of tax and interest asserted as due by Respondent to stop the running of interest on the deficiency determined for the tax year ending October 31, 1999.

[24] These amounts represent 20 percent of the total contributions made to the Keogh Plan and 20 percent of the payroll allocation percentage of the contributions to the Defined Benefit Plan that year. For that year, Petitioner contributed $2,596,000 to the Keogh Plan, of which $1,848,000 was contributed for the benefit of New York resident partners and contributed $1,338,730 to the 401(k) Plan, of which $922,450 was contributed for the benefit of New York resident partners.

Respondent issued a third Notice of Determination, dated July 12, 2002, asserting a tax deficiency for the Tax Year ending October 31, 2000 of $109,197.80, together with interest to August 12, 2002, for a total deficiency of $121,031.99. The deficiency was attributable to adding back to income guaranteed payments of $2,164,815 and adding back to income $210,453 of amounts contributed to the Defined Benefit Plan and $354,677[25] representing a portion of the amounts contributed to the Keogh Plan and the 401(k) Plan.[26]

Petitioner timely filed an amended Form NYC-204 on February 13, 2004, for its Tax Year ending October 31, 2000, which reduced Petitioner's taxable income (before allowances and exemptions) from $95,557,356 to $93,607,356. The difference represents a deduction of an additional $1,950,000 of guaranteed payments made to Retired Partners, for a total deduction of $4,114,815.

On September 27, 2004, Petitioner filed a Supplemental Petition with the Tribunal in which it requested that the Tribunal allow a deduction for 100 percent of the contributions made to the Plans in each of the Tax Years allocable to New York resident partners (the "Contributions") and requested that, for the Tax Year ending October 31, 2000, it be allowed to deduct the full amount of its guaranteed payments to Retired Partners as reflected on its amended UBT Return for that year. Petitioner requested a refund of any reduction in tax and interest found to result from the allowance of such deductions.

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[25] The amount added back by Respondent exceeded the amount deducted by Petitioner by $170,187. Respondent has agreed to adjust the asserted deficiency to reduce the amount added back accordingly. Joint Ex. B, Exhibit P.

[26] Petitioner paid $125,860.60 to Respondent as a payment of the full amount of tax and interest asserted as due by Respondent to stop the running of interest on the asserted deficiency for the Tax Year ending October 31, 2000.

Petitioner contends that the payments made to Retired Partners for which Petitioner now claims a UBT deduction for the Tax Years (the "Payments") were not for services but were intended to compensate Retired Partners for their contribution to Petitioner's goodwill, to provide for a comfortable retirement and to allow for the progression of younger partners to a position of responsibility and leadership in Petitioner. Petitioner argues that, because the Partnership Agreement did not contain an express provision indicating that the Payments were for goodwill, the Payments were deductible for federal income tax purposes under IRC section 736(a). Petitioner further argues that because the Payments were not for services or the use of capital but were in substance for goodwill, they are not required to be added back for UBT purposes.

Respondent contends that the Payments were for services or the use of capital and must be added back for UBT purposes. Respondent further argues that if the Payments were for goodwill, then such payments are not deductible for federal or UBT purposes and, thus, no addback is necessary.

Petitioner also argues that because the Contributions were made to tax exempt entities under the Plans and not to the partners directly, the Contributions are not subject to the UBT addback for payments to partners.[27]

Respondent counters that the Contributions are payments to partners as it is a fundamental principle of income taxation that income is taxable to the person who earns it.

For the reasons set forth below, we affirm the DCALJ Determination.

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[27] Petitioner did not take exception to the DCALJ's conclusion that Respondent's addback of contributions to the 401(k) Plan was not pre-empted by ERISA.

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 section 11-505 as "the excess of its unincorporated business gross income over its unincorporated business deductions" less certain deductions and exemptions. Code section 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, 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 section 736 governs the federal income tax treatment of payments to retired partners and provides, in relevant part:

> (a) Payments considered as distributive share or guaranteed payment.– Payments made in liquidation of the interest of a retiring partner . . . shall, except as provided in subsection (b), be considered–
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> (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).
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> (2) Special rules.– For purposes of this subsection, payments in exchange for an interest in partnership property shall not include amounts paid for–
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> (A) unrealized receivables of the partnership . . . or
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> (B) good will of the partnership, except to the extent that the partnership agreement provides for a payment with respect to good will.
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> (3) Limitation on application of paragraph (2). – Paragraph (2) shall apply only if–
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> (A) capital is not a material income-producing factor for the partnership, and
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> (B) the retiring . . . 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.

Petitioner asserts that, in substance, the Payments were made for the Retired Partners' shares of Petitioner's goodwill. However, pursuant to IRC section 736, if the Payments had been expressly identified in the Partnership Agreement 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 Partnership Agreement and as the one thing for which section 13 of the Partnership Agreement prohibits payment.

Petitioner argues that the New York State Court of Appeals decision in New York Yankees Partnership v. O'Cleireacain, 83 N.Y.2d 550 (1994) requires the Tribunal to look to the economic substance of the Payments. 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 UBT purposes, 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 section 736(a)(2) treated those payments as guaranteed payments under IRC section 707(c), and because IRC section 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 under Code section 11-507(3) as payments for "services or for use of capital". The Court of Appeals found that the Commissioner's argument based on the statutory language alone was "untenable" and concluded that the taxpayer was entitled to a deduction for the payments in question. We do not agree with Petitioner's contentions that Yankees Partnership requires the Tribunal to treat the Payments as made for goodwill based on the economic substance of the Payments where section 13 of the Partnership Agreement specifies that no payment is to be made for goodwill.[28]

Section 13 of the Partnership Agreement states that "[n]either good will nor the right to use of [Petitioner's] name shall be given any valuation, whether in the event of death,

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[28] 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 section 11-507(3).

withdrawal or otherwise, and no payment shall be made therefor." Petitioner asserts that section 13 does not apply to payments to Retired Partners but was meant to apply only to payments made to partners withdrawing under paragraph (c) of section 14 of the Partnership Agreement. Tr. at 40-42. However, as conceded by Mr. Schacht, there is no cross reference in section 13 to paragraph (c) of section 14 and, when that paragraph was repealed in 1995, section 13 was not similarly repealed. Tr. at 64-65. Based on the foregoing, we are not persuaded that there is any ambiguity or limitation in the application of section 13 of the Partnership Agreement.

Petitioner should be held to the unambiguous provisions of the Partnership Agreement 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 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.* 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) 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.

Id. at 775.

The Second Circuit Court of Appeals has not clearly adopted or rejected the "Danielson rule", which that court has characterized as "a virtual parol evidence rule". Estate of Rogers v. Commissioner of Internal Revenue, 445 F.2d 1020, 1022 (2d Cir. 1971). As this Tribunal recently noted in Matter of Citrin Cooperman & Co., LLP, TAT(E)01-17 (UB) (September 10, 2007), the Second Circuit has not permitted taxpayers to disregard the terms of written agreements that were entered into for tax purposes. However, in the present case, the Record is silent as to whether section 13 of the Partnership Agreement, prohibiting payment for goodwill, was adopted for tax purposes.[29]

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. . . .[Citation omitted.]" *See also* Matter

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[29] We note, however, that section 19 of the Partnership Agreement provides that the "unincorporated business tax imposed with respect to distributions to a . . . retired partner . . . shall be charged against said . . . retired partner. . . ." Similarly, paragraph (c) of section 19 of the Optional Service Plan provides that "[a] retired partner agrees to indemnify [Petitioner] and hold it harmless against any tax liability, interest or penalty asserted against [Petitioner] as a result of such partner being treated by [Petitioner] as a retired partner rather than an optional service partner." These provisions imply that Petitioner was not unmindful of the tax consequences of payments to Retired Partners and that Petitioner anticipated that the amounts paid to Retired Partners might not be deductible for tax purposes.

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.

Petitioner cites two Tax Court decisions as supporting its position that "it is perfectly permissible for a payment to be for goodwill where the partnership agreement specifies that no valuation in payment for goodwill is to be made. . . ."[30] Tolmach v. Commissioner of Internal Revenue, 62 T.C.M. (CCH) 1102 (1991) involved a situation where the partners entered into an agreement under which departing partners would receive a specified amount in exchange for their interest in the fixed assets and goodwill of the partnership and additional amounts for their share of unrealized receivables. Stating that it would "not read into a partnership agreement a larger payment for goodwill than there provided for" the Tax Court rejected the parties' argument that notwithstanding the agreement, a far larger portion of the amounts paid represented payments for goodwill. *Id.* at 1108. Similarly, in Cooney v. Commissioner of Internal Revenue, 65 T.C. 101 (1975), the Tax Court found that the law partnership in question had no assets other than goodwill and unrealized receivables but stated that where "the partnership agreement expressly provided that no value would be attributed to goodwill . . . [IRC] section 736(b)(2)(B) leaves us no latitude. No part of the payment can be treated as a payment for goodwill." *Id.* at 112. Rather than supporting Petitioner's argument that payments to the Retired Partners can constitute payments for goodwill despite the provision in the Partnership Agreement to the contrary, these cases strongly indicate that the Tax Court will hold partners to the terms of their agreements.[31]

[30] Petitioner's Brief in Support of Exception, at 23.

[31] *See also* Smith v. Commissioner of Internal Revenue, 37 T.C. 1033 (1962), *aff'd*, 313 F.2d 16 (10th Cir. 1962).

Petitioner also cites Dawson v. White & Case, 88 N.Y.2d 666 (1996) in support of its position that a law partnership can have goodwill. In that case, the New York Court of Appeals agreed that a law firm could value goodwill under appropriate circumstances. However, the court ruled that because the partnership agreement at issue in the case before it expressly provided that goodwill was to be deemed to have no value, the court would hold the partners to their agreement as reflecting the "binding written expression of the terms under which these partners assented to associate with each other. . . ." *Id.* at 672.

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 asserts that the Payments should be treated as for goodwill only for purposes of Code section 11-507(3), so as to avoid the addback. At the same time, Petitioner relies on the absence of any express provision requiring or permitting payments for goodwill in the Partnership Agreement to support its deduction of the Payments for federal and all other UBT purposes in the first instance.

Based on the foregoing authorities, we conclude that under any of the possible legal standards, because Petitioner's own unambiguous Partnership Agreement provides that no payment is to be made with respect to goodwill, Petitioner should not be permitted to argue otherwise for UBT purposes.

Having rejected Petitioner's argument that the Payments represent payments for goodwill, the issue remains whether they represent payments for "services or for use of capital" for purposes of Code section 11-507(3).[32] In general, the Optional Service Plan provides a benefit of 1.75 percent per year of service up to 52 percent of the average of the partner's share of Petitioner's profits in the five years of his or her highest annual earnings. Petitioner's executive committee was responsible for determining partners' shares of Petitioner's earnings. Mr. Schacht testified that the criteria used in that process included: clients brought in by the partner; the income generated by those clients; the actual yield on the partner's billings; the hours worked; the partner's contribution to management; teaching young associates and other factors. Tr. at 57-58. Thus it is apparent that the benefits payable under the Optional Service Plan are almost exclusively a function of services rendered to Petitioner by the Retired Partner.

We are not persuaded by Petitioner's contention that the Payments are not for past services of the Retired Partners. Petitioner argues that the Payments were not made for "services" because partners do not practice law with Petitioner after retirement and do not receive any payment under the Optional Service Plan if they die before retirement. As the issue before us is whether the Payments were made to Retired Partners for services rendered prior to, and not after, retirement, the first part of this argument is irrelevant. While a partner dying before retirement or electing "optional service status" does not receive payments under the Optional Service Plan, section 15 of the Partnership Agreement provides for a separate death benefit that, in part, also is related to the deceased partner's earnings and years of service.[33]

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[32] Because the partnership agreement in Matter of Citrin Cooperman & Co., LLP, TAT(E)01-17 (UB) (September 10, 2007) described the payments in question as "past service compensation," this Tribunal concluded that in that case it was unnecessary to make a separate determination as to whether the payments were in fact payments for services or the use of capital for purposes of Code section 11-507(3).

[33] The fact that no payment under the Optional Service Plan is made to a partner who dies before retiring or electing "optional service status" also would appear inconsistent with Petitioner's argument that the Payments are for the partner's share of Petitioner's goodwill.

Petitioner also argues that the Payments do not represent deferred payments of compensation to Retired Partners because all of Petitioner's net income is distributed on a current basis. Section 1(d) of the Optional Service Plan provides that payments under the plan are "a first obligation on the earnings" of Petitioner and, thus, would appear to be charged against earnings *before* distributions of net income to the active partners. In any case, the fact that the Payments are not made out of a funded deferred compensation arrangement is not sufficient to establish that they are not payments for services.

Section 1(a) of the Optional Service Plan provides that "[t]he purpose of [the Optional Service Plan] is to establish a formal program under which a partner is required to take 'optional service status' [at a certain age] and to assure him or her of a fixed income for the remainder of his or her life. This program also leads to the orderly progression of younger partners within [Petitioner]." If the goal of the Optional Service Plan is to provide a Retired Partner with a minimum standard of living, there is no reason why the amount payable should differ based the prior earnings or years of service of the Retired Partner. While the Optional Service Plan does require partners to retire upon reaching a specified age, which would lead to a transfer of control of Petitioner to younger partners, the fact remains that the amounts payable under the Optional Service Plan are almost exclusively based on factors relating to services rendered to Petitioner by Retired Partners prior to their retirement. Based on the foregoing, we conclude that Petitioner has not provided sufficient evidence to support a finding that the Payments are not for "services" of the Retired Partners. Thus, we agree with the DCALJ that the Payments must be added back in determining Petitioner's unincorporated business taxable income for the Tax Years under Code section 11-507(3).

We turn now to the question of whether the Contributions should be added back in determining Petitioner's unincorporated business taxable income as payments for "services or for use of capital". Petitioner argues that the Contributions should not be added back because they are paid to tax exempt trusts established under the Plans and not paid to the partners. We find this argument to be without merit. This Tribunal has recently held that Code section 11-507(3) is applicable to payments to third parties for the benefit of the sole owner-employee. Matter of Horowitz, TAT(E) 99-3 (UB) *et al.*, (September 1, 2005) *aff'd*, 41 A.D.3d 101 (1st Dept. 2007).

Petitioner asserts that Respondent's position with respect to the Contributions is contrary to letter rulings issued by the Department under the City General Corporation Tax. In those rulings, the Department ruled that contributions to qualified pension or profit-sharing plans for the benefit of officers and certain shareholders were not required to be included as salaries or compensation for purposes of the alternative "income plus compensation" tax computation because the contributions were not "compensation paid to" such officers or shareholders.[34] Rulings of the Department have no precedential value before this Tribunal and are binding on the Department only with respect to the taxpayer to whom they are issued. 19 RCNY §16-05(a). In any case, the 1989 rulings are inconsistent with a subsequent decision of the State Tribunal in which it held that a portion of a management fee paid by a subsidiary to its parent corporation, including amounts relating to salaries and "pension plans and employee benefit plans", must be included in the equivalent alternative tax base under the New York State Corporate Franchise Tax under former Tax Law section 210(1)(a)(3). Matter of Landauer Associates, Inc. N.Y., New York State Tax Appeals Tribunal (April 11, 1991), *aff'd*, 183 A.D.2d 972 (3d Dept. 1992). Moreover, the Department subsequently issued FLR 93-1 (January 22, 1993), in which it ruled that contributions to a 401(k) plan, which were fully vested at the time the contributions were made, were subject to the alternative tax computation. Finally, this Tribunal has recently held in Matter of Horowitz, *supra,* that for UBT purposes, contributions by a sole proprietorship to a defined benefit plan on behalf of

[34] FLR (10)-GC-2/89 (February 16, 1989); FLR (20)-GC-3/89 (March 13, 1989); FLR (27)-GC-4/89 (April 4, 1989).

the sole owner-employee were required to be added back under Code section 11-507(3). Based on the foregoing authorities, we find that the Contributions represent payments made by Petitioner on behalf of its partners for "services" under Code section 11-507(3) that must be added back in determining Petitioner's unincorporated business taxable income for the Tax Years.

Accordingly, the DCALJ Determination is affirmed.[35]

Dated: November 5, 2007
New York, New York

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GLENN NEWMAN
President and Commissioner

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ELLEN E. HOFFMAN
Commissioner

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