NEW YORK CITY TAX APPEALS TRIBUNAL
ADMINISTRATIVE LAW JUDGE DIVISION

In the Matter of the Petitions of MASSEY KNAKAL REALTY SERVICES OF MANHATTAN, LLC (a/k/a Massey Knakal Realty of Manhattan LLC), et al.	:	DETERMINATION TAT(H) 09-37(UB), et al.

Hauben, C.A.L.J.:

Petitioner, Massey Knakal Realty Services of Manhattan, LLC (a/k/a Massey Knakal Realty of Manhattan LLC) filed a Petition for Hearing with the New York City (City) Tax Appeals Tribunal (Tribunal) seeking redetermination of a deficiency of City Unincorporated Business Tax (UBT) under Chapter 5 of Title 11 of the City Administrative Code (Administrative Code) for the tax period 1/1/04 to 12/31/04 (Tax Year 2004).

Petitioner, Massey Knakal Realty Services of Queens, LLC (a/k/a Massey Knakal Realty of Queens LLC) filed a Petition for Hearing with the City Tribunal seeking redetermination of a deficiency of City UBT under Chapter 5 of Title 11 of the Administrative Code for the tax period 1/1/05 to 12/31/05 (Tax Year 2005).[1]

Petitioners were represented by David J. Moise, Esq., of WeiserMazars LLP. The Commissioner of Finance (Commissioner or

[1] Tax Year 2004 for Massey Knakal Realty Services of Manhattan and Tax Year 2005 for Massey Knakal Realty Services of Queens will be referred to collectively as the "Tax Years."

The Petition for Massey Knakal Realty Services of Manhattan is TAT(H) 09-37(UB). The Petition for Massey Knakal Realty Services of Queens is TAT(H) 10-08(UB).

Respondent) was represented by Andrew G. Lipkin, Esq., Assistant Corporation Counsel of the City's Law Department. The parties consented in writing to have the controversy determined on submission without the need for appearance at a hearing. The parties submitted a stipulation of facts with accompanying exhibits and filed briefs.

ISSUES

I. Whether certain payments to members of limited liability companies (LLCs) who provided services to the LLCs under independent contractor agreements with the LLCs were payments to partners for services within the meaning of Administrative Code § 11-507(3) and not deductible for UBT purposes.

II. Whether, if the payments at issue are not deductible and are added back to the income of the LLCs, a credit should be allowed to one of the LLCs for UBT paid on a portion of such income by a member of that LLC with his individual UBT Return.

FINDINGS OF FACT

Petitioners, Massey Knakal Realty Services of Manhattan, LLC (a/k/a Massey Knakal Realty of Manhattan LLC) (MKM) and Massey Knakal Realty Services of Queens, LLC (a/k/a Massey Knakal Realty of Queens LLC) (MKQ) (collectively Petitioners) are limited liability companies engaged in the business of performing real estate brokerage services. During the Tax Years, Petitioners were licenced as real estate brokers in New York and performed real estate brokerage services in the City.

For the Tax Year 2004, MKM's individual members included John Ciraulo (Ciraulo), Christine Moyle (Moyle), James Nelson (Nelson) and James Ventura (Ventura). For purposes of this proceeding, Paul Massey (Massey) and Robert Knakal (Knakal) were also individual members of MKM for Tax Year 2004. For Tax Year 2005, MKQ's individual members included Thomas Donovan (Donovan), Ciraulo, Moyle and Ventura. For purposes of this proceeding, Massey and Knakal were also individual members of MKQ for Tax Year 2005.

MKM, MKQ and Massey Knakal Realty Holdings, LLC (Holdings)[2] are limited liability companies organized in the State of Delaware. Each LLC operates pursuant to an LLC Agreement, dated April 2004, entered into by each respective LLC's members. Under the LLC Agreements the members indicated their intent that each LLC be treated as a partnership for Federal income tax purposes. Each member of MKM and MKQ made a capital contribution to the appropriate LLC and shared in any profits. Members were entitled to distributions as decided from time to time by each LLC's managing member.[3]

Massey, Knakal, Ciraulo, Ventura and Nelson entered into separate independent contractor agreements with MKM for the

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[2] Massey and Knakal were the equal and only members of Holdings. Holdings was a member of each Petitioner and the only manager of each Petitioner. Holdings held an 87% interest in MKM (MKM's other interests were held as follows: Ciraulo-5%; Ventura-4%; Nelson-3%; and Moyle-1%) and an 80% interest in MKQ (MKQ's other interests were held as follows: Donovan-10%; Ciraulo-5%; Ventura-4%; and Moyle-1%). Holdings was not licensed as a real estate broker in New York. For purposes of this proceeding Holdings was not a member of MKM or MKQ. Also, for purposes of this proceeding, the share of income, deductions, etc., reported on MKM's and MKQ's Schedule K-1s to Holdings is deemed to have been made directly to Massey and Knakal in equal shares.

[3] As Holdings was the managing member of MKM and MKQ, but is not a member of either for purposes of this proceeding, Holdings equal members, Massey and Knakal, are deemed the managing members of MKM and MKQ for purposes of this proceeding.

performance of brokerage services. Massey, Knakal, Ciraulo, Ventura and Donovan entered into separate independent contractor agreements with MKQ for the performance of brokerage services. Moyle was not a party to any independent contractor agreement with MKM or MKQ. Non-member brokers of Petitioners entered into independent contractor agreements with Petitioners with respect to brokerage services they performed for Petitioners. Petitioners Policy Handbook[4] set forth Petitioners' policies, guidelines and benefits for its employees and independent contractors.

All of Petitioners' individual members except Moyle were licensed as real estate brokers in New York and performed brokerage services for MKM and/or MKQ during the Tax Years.

Moyle was responsible for the administration, growth and profitability of Petitioners' offices. Her responsibilities included supervising the maintenance of Petitioners' offices, monthly financials and employee and independent contractor management. Moyle also signed sales contracts on behalf of MKRS.

The commissions in issue were earned by Petitioners in accordance with sales agreements with customers by which the customers employed Petitioners to sell or lease property owned by the customers. The sales agreements in the record are dated before or during the Tax Years and are signed for Petitioners by Massey, as Chief Executive Officer; Knakal, as Chairman; Donovan, as Executive Managing Director; Ciraulo, as President; or Moyle, as Vice President.[5]

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[4] The Policy Handbook in the record is in the name of Massey Knakal Realty Services (MKRS) which is a name used by Petitioners in doing business.

[5] Timothy D. King, Executive Managing Director of the Brooklyn office, who is not involved in this proceeding, also signed sales contracts on behalf of MKRS.

Upon the sale of a property, the customer pays Petitioners a commission. Petitioners then pay the broker(s) or member-broker(s) involved in the sale their appropriate share of the commission.

MKM filed a Federal Form 1065, Return of Partnership Income for Tax Year 2004. MKM issued Schedules K-1 to its members reflecting each member's share of MKM's profit for the year. MKQ filed a Federal Form 1065 and issued Schedules K-1 to its members for Tax Year 2005.[6]

MKM issued Forms 1099 to Massey, Knakal, Ciraulo, Ventura and Nelson for Tax Year 2004 reflecting commissions earned by them. MKQ issued Form 1099 to Donovan for Tax Year 2005 reflecting commissions earned by him.[7] The parties stipulated that MKM issued Form W-2 to Moyle for Tax Year 2004.[8]

Knakal filed UBT returns and paid UBT for each of the Tax Years. For Tax Year 2004 Knakal paid UBT of $35,774. No other member of MKM or MKQ filed UBT returns for the Tax Years.

On December 12, 2008, Respondent issued a Notice of Determination asserting a UBT deficiency for Tax Year 2004 to Petitioner MKM in the amount of $166,222.00, plus interest computed to January 7, 2009 of $65,796.43 and a penalty for substantial understatement of tax liability of $13,090, for a total UBT deficiency of $245,108.43. The deficiency is based on Respondent's disallowance of deductions in the amount of $4,160,534.35 for

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[6] In 2004, MKM filed New York State Form IT-204 and City Form NYC-204. In 2005, MKQ filed New York State Form IT-204 and City Form NYC-204.

[7] The Forms 1099 in the record are in the name of Massey Knakal Realty Services and contain the payer's Federal identification number.

[8] The record does not contain a Form W-2 for Moyle for 2004.

payment of commissions to Massey, Knakal, Ciraulo, Ventura and Nelson for services rendered to MKM by them.

On July 10, 2009, Respondent issued a Notice of Determination asserting a UBT deficiency for Tax Year 2005 to Petitioner MKQ in the amount of $37,576.48, plus interest computed to July 31, 2009 of $12,468.58 and a penalty for substantial understatement of tax liability of $3,757.65, for a total UBT deficiency of $53,802.71. The deficiency is based on Respondent's disallowance of $923,659 in deductions for commissions paid to Donovan for services rendered by him to MKQ and for certain allowances. However, after other adjustments, the net adjustment was $900,659.

The record does not reflect that the auditor made any adjustments with respect to Petitioners' payments to Moyle.

POSITIONS OF THE PARTIES

Petitioners argue that the deductions that they took for Federal income tax purpose for compensation, including commissions, paid to their members were proper deductions for UBT purposes because the commissions for brokerage services were treated by them for Federal income tax purposes as occurring between a partnership and one who is not a partner. As such, the commissions were not payments to partners for services under the UBT.[9] Respondent argues that payments of brokerage commissions to broker-members are not deductible because they are "amounts paid to a partner for

[9] In the conference stage of this proceeding it appeared that payments to Moyle were in issue. However, the record does not reflect audit changes with respect to Moyle and Petitioner offers no argument regarding payments to Moyle. Thus, there is no issue with respect to Moyle to be decided. Since Petitioner makes no argument regarding payments to Moyle and in view of the result with respect to the other members, issues regarding Moyle would be considered conceded by Petitioner or determined for Respondent in any event.

services" under Administrative Code § 11-507(3) irrespective of whether the services are rendered in their capacity as members for Federal income tax purposes. Petitioner argues in the alternative that if the determinations are sustained, Petitioner MKM is entitled to a credit against the determination in the amount of $35,774 paid by Knakal for Tax Year 2004. Respondent argues that Petitioner is not entitled to a credit.

CONCLUSIONS OF LAW

The UBT is imposed "on the unincorporated business taxable income of every unincorporated business wholly or partly carried on within the City." (Administrative Code § 11-503[a].) To arrive at unincorporated business taxable income, (Administrative Code § 11-505), a taxpayer adjusts its Federal gross income in accordance with Administrative Code § 11-506. From this UBT gross income, a taxpayer takes UBT deductions in accordance with Administrative Code § 11-507, deductions allowed under Administrative Code § 11-509 and exemptions allowed under Administrative Code § 11-510. In this matter, the parties disagree as to the proper calculation of Petitioner's unincorporated business deductions.

Administrative Code § 11-507 provides that, with specified modifications:

> The unincorporated business deductions of an unincorporated business means 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 (including losses and deductions connected with any property employed in the business), . . .

The modification at issue here, Administrative Code § 11-507 (3), provides:

> No deduction shall be allowed (except as provided in Section 11-509 of this chapter) for amounts paid or incurred to a proprietor or partner for services or for use of capital.

The Unincorporated Business Tax Rules of the City of New York ([19 RCNY] § 28-06[d][1]) (Rule § 28-06[d][1]) provides in part as follows:

> (1) *Proprietor's services or use of capital.*
>
> (i) *General.*
>
> (A) No deduction shall be allowed, except as provided in Sec. 28-08 of these [Rules], for amounts paid or incurred to a proprietor or partner for services or for use of capital.
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> (B) In addition to all other amounts otherwise included, amounts paid or incurred to a proprietor or partner for services or for use of capital shall include any amount paid to any person if, and to the extent that, the payment was consideration for services or capital provided by a proprietor or partner.
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> (C) Examples:
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> * * *
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> *Example b*: Salaries, commissions, consultant fees or professional fees paid to a general or limited partner for personal services rendered by the partner, either as an employee or an independent contractor of the unincorporated business may not be deducted by the partnership.
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> * * *
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> (ii) *Services:*
>
> (A) Amounts paid or incurred to an individual partner of the unincorporated business for services provided the

> unincorporated business by such an individual shall not be allowed as a deduction under paragraph (1)(i) above. The fact that the individual is providing such services not in his capacity as a partner within the provisions of Sec. 707 of the Federal Internal Revenue Code will not change the result.

This matter concerns the proper treatment of deductions claimed by Petitioners for amounts paid to Massey, Knakal, Ciraulo, Donovan, Nelson and Ventura for services they rendered to MKM and MKQ. The parties agree that Petitioners, limited liability companies, are subject to the UBT. The parties also agree for purposes of this proceeding that Massey, Knakal, Ciraulo, Donovan, Ventura and Nelson were members of one or both of the Petitioners during the Tax Years. The parties further agree that payments to members were for services rendered by the members to the Petitioners.

Petitioners claim that as Massey, Knakal, Ciraulo, Donovan, Ventura and Nelson were paid for brokerage services rendered to Petitioners as independent contractors and that as such payments were deducted for Federal income tax purposes and are considered, according to Petitioners, as "occurring between the partnership and one who is not a partner" under Section 707(a) of the Internal Revenue Code, these payments are fully deductible for UBT purposes under Administrative Code § 11-507(3). It is the Petitioners' view that these individuals' status as members of Petitioners is a mere complication that should not result in payments to them as independent contractors being added back to unincorporated business taxable income under Administrative Code § 11-507(3). Petitioners cite Administrative Code § 11-501(a) (*see infra*) as requiring the conclusion that commissions paid for brokerage services, deductible for Federal income tax purposes, are fully deductible for UBT purposes as they are not payments to partners as such. Petitioners

contend that the City's Rules went beyond the statute, that the Tribunal Decision in *Miller Tabak Hirsch & Company,* TAT(E) 94-173(UB),(New York City Tax Appeals Tribunal (March 30, 1999)), should be revisited and that the LLC members are not partners for purposes of Administrative Code § 11-507(3).

In *Miller Tabak*, limited partners were also employees of the partnership. There, the Petitioner contended that payments to these individuals for their work as employees were not payments to partners for UBT purposes and were therefore deductible because they were deductible for Federal purposes as payments to partners "not acting in their capacity as partners" within the meaning of Internal Revenue Code § 707(a). The Petitioner in *Miller Tabak* also argued that Rule § 28-06(d)(1) should be invalidated as being inconsistent with the statute and that the dual-status limited partners were not partners for UBT purposes.

The Tribunal Commissioners disagreed with the Petitioner in *Miller Tabak* and found that payments for services by a partner, even though not performed in his/her capacity as a partner, are not deductible for UBT purposes. " . . . the focus should be on whether the Individuals are partners . . .." Once found to be partners, no payment to them for services or use of capital is deductible for UBT purposes. As in *Miller Tabak*, the focus here must be on whether Massey, Knakal, Ciraulo, Nelson, Ventura and Donovan were partners for UBT purposes, and if so, payments to them "for services or for the use of capital (in whatever capacity)" are not deductible *(Miller Tabak*, at 14).

Where "the language of a statute is clear and unambiguous, the court should construe it so as to give effect to the plain meaning of the words used." (*New York Yankees Partnership v*

O'Cleireacain, 83 NY2d 550, 555 [1994]). Administrative Code § 11-507(3) is clear and without qualification. (*New York Yankees Partnership v O'Cleireacain*, 194 AD2d 314, [1st Dept 1993], *affirmed*, 83 NY2d 550, [1994]; *Buchbinder Tunick & Co. v Tax Appeals Tribunal of City of New York*, 100 NY2d 389 [2003]). As noted by the Tribunal Commissioner's in *Miller Tabak*, Petitioner's interpretation of "payments to partners" in Administrative Code § 11-507(3) would require the addition of the words "in his or her capacity as (partners)." It is not the function of the Tribunal to "add words to a statute which has a rational meaning as written." *(Richmond Constructors v Tishelman*, 61 NY2d 1,6 [1983], motion for reargument or reconsideration denied, 61 NY2d 905 [1984]).

Moreover, the Legislature, in considering the UBT Law, know how to write a provision that gives special treatment to payments treated under the Internal Revenue Code as being to a partner not in his capacity as a partner. (*See*, Administrative Code § 11-506(a)(2) which concerns the character of a partner's distributive share and provides in part "this paragraph shall not apply to payments to a partner treated as occurring between the unincorporated entity and one who is not a partner under section seven hundred seven of the internal revenue code . . ."). No special treatment appears in Administrative Code § 11-507(3) for particular types of payments to partners for services or use of capital.

Also, the parties disagree as to whether the payments here even qualify under IRC § 707(a). Determining whether a particular payment is properly characterized under IRC § 707 is a fact question and may be complex. *(See* William S. McKee, William F. Nelson, Robert L. Whitmore, *Federal Taxation of Partnerships and Partners,* §§ 14.01 - 14.03 [2007]). However, it is not necessary

to make that determination. Even if the payments were to the members not in their capacity as members and therefore entitled to specific Federal tax treatment under the Internal Revenue Code the recipients of the payments were still members and the payments were still for their services.

Petitioner's reliance on Administrative Code § 11-501(a) to support its argument that the City must follow the Federal income tax treatment of its payments to its partners is misplaced. Administrative Code § 11-501(a) provides that

> . . . Unless a different meaning is clearly required, any term used in this chapter shall have the same meaning as when used in a comparable context in the laws of the United States relating to federal income taxes.

The starting point in calculating UBT liability is Federal gross income. That amount is then modified, where necessary, by various UBT provisions. This is not a case where Respondent changed Petitioners' Federal gross income, Federal deductions or Federal taxable income because it disagreed with the Federal application of a term used in the Internal Revenue Code. This matter concerns a City modification to Petitioner's Federal income and deductions which Respondent accepted. "This is an instance where New York law deviates from the Federal, and New York simply does not allow this unrestricted deduction." *(Faulkner, Dawkins and Sullivan v State Tax Commission*, 63 AD2d 764 [3rd Dept 1978]). Thus, Administrative Code § 11-501(a) does not help Petitioner. Respondent taxes partnerships as an entity, unlike under Federal law, and is thus more concerned with the calculation of a partnership's taxable income. As this matter concerns a modification provision, accepting and then adjusting Petitioners' Federal income and deductions, a different treatment of payments to partners would be clearly required for UBT purposes in any event.

Petitioner argues, as did the Petitioners in *Miller Tabak*, that Rule § 28-06(d)(1) should be invalidated because the Rule goes beyond the clear intent of the UBT law. This argument is also premised on Petitioner's claims that Administrative Code § 11-507(3) is ambiguous and that Administrative Code § 11-501(a) requires that the City treat the payments in question as payments not made to partners.

In considering the validity of this Rule in *Miller Tabak*, the Tribunal Commissioners found the Rule valid because it "is a reasonable interpretation of § 11-507(3) of the Code and [the payments in question] would not be deductible regardless of whether they are IRC § 707(a) or IRC § 707(c) payments." (*Miller Tabak*, at 17). The Commissioners also found that "[p]etitioner has not pointed to any evidence that the drafters of § 11-507(3) intended that section [not to apply] to payments under IRC § 707(a)." *(Miller Tabak*, at 14). There is no reason to come to a different conclusion in this matter. The statute is clear and unambiguous. (*Yankees*, at 555, *Buchbinder*, at 393). Rule § 28-06(d)(1) is in conformity with the statute. It is not out of harmony with the statute. Petitioner has not shown that the Legislature intended to limit the scope of Administrative Code § 11-507(3). And in Administrative Code § 11-506 the Legislature carved out special treatment for payments treated under IRC § 707 as payments to one who is not a partner. It did not do so in Administrative Code § 11-507(3). As found in *Miller Tabak*, the Rule is a reasonable interpretation of Administrative Code § 11-507(3) and is valid.

Petitioners also argue that the Members were not "partners" for purposes of applying Administrative Code § 11-507(3) when they were providing brokerage services. Petitioners do not dispute that the members otherwise were partners for UBT purposes. Petitioners

are limited liability companies organized under the laws of Delaware. Petitioners have members not partners. Petitioners' members signed limited liability company agreements as members and paid in capital for their limited liability company interests. Petitioners and their members are treated as partnerships and partners for Federal income tax and UBT purposes.

For business reasons, Petitioners chose to organize and operate as Delaware limited liability companies whose main business function was to perform brokerage services. Petitioners chose to make the individuals here members of the limited liability companies and the members are parties to LLC agreements. For business reasons Petitioners chose to have the members act as independent contractors in performing tasks for which the limited liability companies were formed. Petitioners cannot now claim that these individuals were not members when they were performing such services because Petitioners' business decisions have unanticipated tax consequences. (*Miller Tabak*, at 16, *Ter Bush & Powell v State Tax Commission*, 58 AD2d 691 [3rd Dept 1977], *Faulkner, Dawkins and Sullivan v State Tax Commission*, 63 AD2d 764 [3rd Dept 1978]).

"[T]he plain meaning of the . . . phrase 'amounts paid . . . to a partner for services or for use of capital' . . . includes the payments made here to partners regardless of the capacity in which the payee was acting." (*Miller Tabak, at 16, 17).* The payments to Petitioners' members in dispute here in their capacity as independent contractors clearly fall within the meaning of "amounts paid . . . to a partner for services or for use of capital" under Administrative Code § 11-507(3) and the Commissioner properly disallowed deductions for such payments in determining Petitioners' UBT liability.

Petitioners argue, in the alternative, that in the event that it is found that the payments at issue are not deductible, that Petitioners should be allowed a credit for unincorporated business tax paid by Knakal as an individual on his earnings that were added back to the incomes of the Petitioners. Petitioners argue that to not allow a credit would subject the same income to double taxation. In this matter, the taxation of the same income twice is the result of erroneous filing; filing that occurred in the light of a clear statute, express Rules and a Tribunal Decision upholding Respondent's interpretation of the statute and the Rules. The payment of UBT twice on the same income cannot be blamed on the UBT law. Where there is erroneous filing, the remedy is to amend the filing and seek a refund within the time allowed by law. And here, Knakal, not Petitioners, is the one with the claim, if any. There is no provision in the UBT law allowing Petitioner a credit or exemption in this situation.

All other arguments have been considered and found to be unpersuasive.

ACCORDINGLY, IT IS CONCLUDED THAT the amounts paid to Petitioners' MKM and MKQ's members for brokerage services that the members performed for the Petitioners under independent contractor agreements are payments to partners for services or for the use of capital under Administrative Code § 11-507(3) and are not allowed as deductions for UBT purposes. Petitioners are not entitled to a credit for unincorporated business tax paid by Knakal for 2004.

The Petitions of Massey Knakal Realty Services of Manhattan (a/k/a Massey Knakal Realty of Manhattan LLC) and Massey Knakal Realty Services of Queens (a/k/a Massey Knakal Realty of Queens

LLC) are denied and the Notices of Determination dated December 12, 2008 and July 10, 2009 are sustained.

DATED: October 25, 2012
New York, New York

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WARREN P. HAUBEN
Chief Administrative Law Judge