New York City Tax Appeals Tribunal

In the Matter of LEONARD I. HOROWITZ Petitioner.	DECISION TAT (E) 99-3 (UB) et al.

Leonard I. Horowitz ("Petitioner") filed an Exception to the Determination of an Administrative Law Judge ("ALJ") dated September 15, 2004.[1] The ALJ sustained the Notices of Determination issued by the New York City Department of Finance (the "Department") asserting unincorporated business tax ("UBT") deficiencies for the calendar years 1996, 1998, 1999 and 2000 (the "Tax Years"). Petitioner appeared *pro se* and the Commissioner of Finance of the City of New York (the "Commissioner" or "Respondent") appeared by George P. Lynch, Esq., with Robert J. Firestone, Esq. participating on the brief, Assistant Corporation Counsels, New York City Law Department. Both parties filed briefs and a request for oral argument was granted by the Tribunal.

Petitioner, Leonard I. Horowitz, a Connecticut resident, is an attorney engaged in the unincorporated business of the practice of law as a sole proprietor in New York City (the "City") and in Connecticut.[2] During the Tax Years, Petitioner derived between 78% and

[1]TAT(E) 99-3 (UB); TAT(E) 02-37 (UB); TAT(E) 02-38 (UB); and TAT(E) 02-39 (UB) are decided herewith. *See* footnote 5 *infra*.

[2]The ALJ's Findings of Fact although paraphrased in part have generally been adopted for purposes of this Decision.

91% of his unincorporated business income from City sources.

Petitioner timely filed City UBT Tax Returns (Forms NYC 202) for the Tax Years (the "Returns"). He requested a UBT refund for 1996 in the amount of $1,000;[3] he neither reported UBT due nor requested any refund for 1998 and 1999; and he initially reported $229 of UBT due for 2000, and then, in a subsequently filed amended return, requested a refund of $229.

On Schedule B of each Return, "Computation of Total Income," Petitioner reported the following subtraction modifications to unincorporated business gross income: for 1996, $51,322; for 1998, $105,215; for 1999, $99,877; and, for 2000, $228,618. In an attachment to each Return, Petitioner explained that he was adjusting unincorporated business gross income by subtracting amounts representing the following items of deduction reported on his U.S. Individual Income Tax Returns (Federal Forms 1040) filed for each of the Tax Years: (a) one-half of his federal self-employment tax; (b) an amount equal to a "self-employed health insurance deduction;" and (c) an amount representing contributions made to a "defined benefit plan."

For 1996, the subtraction modification was comprised of: $720 representing one-half of Petitioner's self-employment tax; a self-employed health insurance deduction of $607; and a defined benefit plan contribution of $49,995. For 1998, the subtraction modification was comprised of: $5,817 representing one-half of Petitioner's self-employment tax; a self-employed health insurance deduction of $1,028; and a defined benefit plan contribution of $109,801. Petitioner applied a percentage of 0.9020 to the total 1998 subtraction modification, with the written explanation that the calculation represented the percentage that

[3]On June 26, 1997, Respondent issued to Petitioner the requested refund for 1996.

1998 City gross income bore to total 1998 gross business income from all sources. For 1999, the subtraction modification was comprised of: $6,585 representing one-half of Petitioner's self-employment tax; a self-employed health insurance deduction of $1,438; and a defined benefit plan contribution of $120,025.78. Petitioner applied a percentage of 0.78 to the 1999 subtraction modification amount. And for 2000, the subtraction modification was comprised of: $8,433 representing one-half of Petitioner's self-employment tax; a self-employed health insurance deduction of $1,805; and a defined benefit plan contribution of $240,000. Petitioner applied a percentage of 0.913602 to the 2000 subtraction modification amount.

Respondent performed desk audits of the Returns. On March 4, 1998, Respondent issued to Petitioner a Notice of Determination for UBT for 1996, asserting additional UBT due of $1,721.80, with interest of $156.56, computed to April 3, 1998, for a total amount due of $1,878.36 (the "1996 Notice"). On September 10, 2002, Respondent issued a Notice of Determination to Petitioner for UBT for 1998, asserting additional UBT due of $3,869.87, with interest of $1,191.50, computed to October 10, 2002, for a total amount due of $5,061.37 (the "1998 Notice"). On September 10, 2002, Respondent issued to Petitioner a Notice of Determination for UBT for 1999, asserting additional UBT due of $4,509.34, with interest of $929.24, computed to October 10, 2002, for a total amount due of $5,438.58 (the "1999 Notice"). On September 10, 2002, Respondent issued to Petitioner a Notice of Determination for UBT for 2000, asserting additional UBT due of $9,781.53, with interest of $1,009.70, computed to October 10, 2002, for a total amount due of $10,791.23 (the "2000 Notice"). Each Notice of Determination was based on Respondent's disallowance of Petitioner's reduction of his unincorporated business gross income by: (a) one-half of his self-employment tax; (b) an amount equal to a "self-employed health insurance deduction;" and (c) an amount representing contributions made to a "defined benefit plan."[4]

[4]Any other adjustments reflected in the Notices of Determination were not contested at the Tribunal.

Petitioner filed a request for Conciliation Conference with the Department's Bureau of Conciliation with respect to the 1996 Notice. The Department's Conciliation Bureau issued a Conciliation Decision, discontinuing the proceeding. Petitioner timely filed a Petition with the Tribunal requesting a redetermination of the 1996 Notice. Petitioner timely filed Petitions with the Tribunal requesting a redetermination of the 1998, 1999 and 2000 Notices. Subsequently, the parties requested, in writing, that the four petitions be consolidated and that the consolidated matter be determined on submission without the need for a formal hearing, pursuant to the Rules of Practice and Procedure of the New York City Tax Appeals Tribunal at 20 RCNY §1-09(f). Both requests were granted by the ALJ.[5]

Petitioner asserted that in computing UBT due for the Tax Years, he was entitled to modify City unincorporated business gross income by subtracting amounts representing the following deductions taken on his U.S. Individual Income Tax Returns (Federal Forms 1040) for the Tax Years: (a) one-half of his self-employment tax; (b) an amount representing the cost of "self-employed health insurance;" and (c) the amount of contributions made to a "defined benefit plan." Respondent asserted that Petitioner was not entitled to deduct the above modifications, as they represented amounts paid or incurred to a proprietor for services or for use of capital pursuant to §11-507(3) of the New York City Administrative Code (the "Code").

The ALJ concluded that the payments by Petitioner's unincorporated business of one-half of his federal self-employment tax, the cost of his self-employed health insurance premiums and contributions to a defined benefit plan, could not be deducted from Petitioner's unincorporated business gross income as such payments were amounts paid or incurred to

[5]The four petitions that were consolidated are: TAT(H) 99-3(UB); TAT(H) 02-37(UB); TAT(H) 02-38 (UB); and TAT(H) 02-39 (UB). The ALJ issued an Order consolidating the petitions as TAT(H) 99-3 (UB) et al.

a proprietor for his services. Thus, the ALJ found that the Respondent correctly denied the deductions and included the amounts in Petitioner's unincorporated business taxable income.

On appeal, Petitioner argues that the payments by his unincorporated business[6] of one-half of his federal self-employment tax, the cost of his self-employed health insurance premiums and contributions to a defined benefit plan were deductions directly connected with or incurred in the conduct of Petitioner's business, were allowable deductions for federal income tax purposes and are deductible from Petitioner's unincorporated business gross income. Petitioner contends that the items are not amounts paid or incurred to a proprietor for his services or for use of capital within the plain meaning of §11-507(3) of the Code. Respondent asserts that the ALJ's Determination should be affirmed in full as the three items are non-deductible as they were paid or incurred to a proprietor for services pursuant to §11-507(3) of the Code.

The UBT is imposed "on the unincorporated business taxable income of every unincorporated business wholly or partly carried on within the [C]ity." Section 11-503(a) of the Code. An unincorporated business "means any trade, business, profession, or occupation conducted, engaged in or being liquidated by an individual or unincorporated entity . . . ." Section 11-502(a) of the Code. The unincorporated business taxable income of an unincorporated business is "the excess of its unincorporated business gross income over its unincorporated business deductions, allocated to the city, . . ." Section 11-505 of the Code. Section 11-506(a) of the Code defines unincorporated business gross income of an unincorporated business as "the sum of the items of income and gain of the business, of whatever kind and whatever form paid, includible in gross income for the taxable year for federal income tax purposes . . ." with specific statutory modifications. Section 11-507 of

[6]Neither party has disputed that the amounts were paid by the unincorporated business.

the Code defines 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 specific statutory modifications. The specific statutory modification at issue is §11-507(3) of the Code which, in relevant part, provides that "[n]o deduction shall be allowed . . . for amounts paid or incurred to a proprietor or partner for services or for use of capital."

Petitioner reduced his "total income" as shown on his U.S. Individual Income Tax Return (Federal Form 1040) for each of the Tax Years by one-half of his self-employment tax; a self-employed health insurance deduction; and a defined benefit plan contribution. Petitioner an attorney engaged in the unincorporated business of the practice of law within the City as a sole proprietor, was subject to the UBT during the Tax Years. The sole question before us on appeal is whether the three items are allowable unincorporated business deductions for purposes of reducing Petitioner's unincorporated business gross income or whether they are non-deductible items (pursuant to §11-507(3) of the Code) representing amounts paid or incurred to a proprietor for services or for use of capital. We find, as did the ALJ, that each of the three items is remuneration for services Petitioner, as proprietor, rendered to his unincorporated business and that Respondent correctly disallowed the deduction of these three items from Petitioner's unincorporated business gross income for each of the Tax Years.

Petitioner argues that for a deduction to fall within the plain meaning of §11-507(3) of the Code, the payment must be made to the proprietor and must be paid for services or for use of capital. Petitioner contends that neither requirement is present with respect to the three deductions at issue and, thus, §11-507(3) of the Code cannot provide the basis for disallowing the three deductions.

Petitioner asserts that since the payments were made to third parties (United States Treasury in the case of the self-employment tax payments; the successor to Petitioner's former employer in the case of self-employed health insurance premiums; and a defined benefit plan in the case of defined benefit plan contributions) and not directly to himself as proprietor, §11-507(3) of the Code is inapplicable. This cannot be the rule applicable to the UBT. The Appellate Division, First Department in Guttmann Picture Frame Associates, etc, et al. v. O'Cleireacain, 209 A.D. 2d 340 (1st Dept. 1994), *affg.*, FHD-92-467(UBT) (New York City Department of Finance Bureau of Hearings, September 4, 1992) affirmed the Department's disallowance of deductions for payments by the partnership to officers of the corporate partners for services performed, for the partnership, by those officers. In finding that the Department properly applied section 6-4 of the City UBT Regulations (currently 19 RCNY §28-06)[7] retroactively to the facts of Guttmann, *supra*, the Court stated:

> Tax legislation should be implemented in a manner that gives effect to the economic substance of the transaction [citation omitted] and the taxing authority may not be required to acquiesce in the taxpayer's election of a form for doing business but rather may look to the reality of the tax event and sustain or disregard the effect of the fiction in order to best serve the purposes of the tax statute. [Citations omitted.]

The payments at issue while made to third parties were made by the unincorporated business for the benefit of the proprietor and were remuneration for services rendered by the proprietor to his unincorporated business. Hence, the economic substance of these transactions requires disallowance of the deductions.

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[7]The UBT Rules at 19 RCNY §28-06(d)(1)(ii) provide in relevant part:

> . . .(B) Amounts paid or incurred to a corporate partner for services provided the unincorporated business by the corporate partner's officers shall not be allowed as a deduction under paragraph (1)(i) above. . . .

In order to give effect to the purpose of §11-507(3) of the Code disallowing payments to a proprietor for services or for use of capital as deductions from unincorporated business gross income,[8] it cannot matter whether the amounts at issue are paid directly to the proprietor or to a third party where the payment to the third party is made for the benefit of the proprietor and is remuneration for services rendered by the proprietor to the unincorporated business.[9] It is the sole proprietor who has chosen the form of the transaction *i.e.*; to have such payments made by the unincorporated business for his benefit.

The item most clearly disallowed under §11-507(3) of the Code is one-half of Petitioner's self-employment tax. The payments made by the unincorporated business with respect to such tax satisfied Petitioner's personal federal income tax obligations and were indisputably income to Petitioner, as proprietor. While the payments for self-employed health insurance premiums and contributions to a defined benefit plan did not satisfy a personal obligation of the proprietor, the payments were made for the benefit of the proprietor and were paid as compensation for the services of the proprietor.[10] There is no evidence in the record that these items were anything other than compensation for services rendered by the proprietor. While the items at issue were available to reduce Petitioner's income for purposes of his individual federal income tax, they are not deductible for purposes of the UBT, a tax on the unincorporated business.

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[8]Permitting instead the deduction of an amount as provided for in §11-509(a) of the Code as "reasonable compensation not in excess of five thousand dollars for personal services of the proprietor. . ."

[9]Petitioner argues for purposes of his analysis of the "plain meaning" of §11-507(3) of the Code, that the statute must be read as if the word "directly" modifies the phrase "payments paid or incurred to a proprietor." However, to impose such a limitation (which is not present in the statute) would disregard the substance of the transaction and permit the deduction of non-deductible amounts which represent compensation to the proprietor.

[10]Contributions to a defined benefit plan on behalf of an owner-employee "may be made only with respect to the earned income of such owner-employee. . . ." *See*, Internal Revenue Code §401(d).

Whether payments were made to the proprietor or to a third party is not determinative of whether the deductions should be disallowed pursuant to §11-507(3) of the Code. To allow an unincorporated business to take deductions for one-half of a proprietor's self-employment tax, the cost of a proprietor's personal health insurance premiums, and contributions to a defined benefit plan for the proprietor would ignore the economic substance of the transaction and "would circumvent the statutory purpose of [§11-507(3) of the Code.]" AGS Specialist Partners a Partnership and Partners Schwarz Jr. Co., Inc. Reichhelm SJ Co. Inc., et al., TAT(E) 00-10 (UB) (New York City Tax Appeals Tribunal, May 21, 2003). Applying the Appellate Division's analysis in Guttmann, *supra*, and this Tribunal's analysis in AGS, *supra*, to the facts before us requires the disallowance of the three deductions at issue in computing Petitioner's unincorporated business taxable income.

In reaching our conclusion, we reject Petitioner's contention that disallowing the three deductions would result in the disallowance of all payments by a sole proprietorship of business expenses remitted to third parties as deductions from unincorporated business gross income because the payments would be on behalf of the proprietor who is solely responsible for all of the debts of the business. The disallowance provided by §11-507(3) of the Code is clearly not intended to reach all business expenses of an unincorporated business but only amounts paid to a proprietor for services or use of capital including amounts paid to a third party such as those items at issue herein.[11]

[11]We have considered all other arguments raised by the parties and find them unpersuasive.

Accordingly, the ALJ's Determination is affirmed and the Notices of Determination issued for the Tax Years are sustained in full.

Dated: September 1, 2005
New York, New York

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GLENN NEWMAN
Commissioner and President

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ARTHUR A. STRAUSS
Commissioner