NEW YORK CITY TAX APPEALS TRIBUNAL
ADMINISTRATIVE LAW JUDGE DIVISION

In the Matter of the Petitions	:	**DETERMINATION**
of	:	**TAT(H) 01-19(UB), et al.**
PROSKAUER ROSE LLP	:	

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

Petitioner, Proskauer Rose LLP (the "Firm"), filed Petitions with the New York City ("City") Tax Appeals Tribunal ("Tribunal") requesting a redetermination of deficiencies and the allowance of refunds of City Unincorporated Business Tax ("UBT") under Chapter 5 of Title 11 of the Administrative Code of the City (the "Code") for the period November 1, 1995 through October 31, 2000 (the "Tax Years").

A hearing was held before the undersigned on December 8, 2004. At that hearing, the parties submitted a Joint Stipulation of Facts with accompanying exhibits and testimony was taken. The record was left open for the submission of additional documentary evidence. On December 16, 2004, Petitioner submitted additional evidence. On September 29, 2005, the parties submitted a Revised Stipulation of Facts. The parties submitted Briefs and Reply Briefs, the last of which was submitted on January 11, 2006. Petitioner appeared by one of its partners, Abraham Gutwein, Esq. The City appeared by George P. Lynch, Esq., Assistant Corporation Counsel. Robert J. Firestone, Esq., Senior Counsel of the City's Law Department, participated on the briefs.

ISSUES

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

II. Whether Petitioner's contributions to retirement plans for the benefit of its partners are "amounts paid or incurred to a proprietor or partner" which are required to be added back to Petitioner's UBTI under Code §11-507(3).

III. Whether the add-back modification provided for in Code §11-507(3) is pre-empted by the Employees Retirement Income Security Act of 1974 ("ERISA") with respect to Petitioner's contributions to an IRC §401(k) Plan.

FINDINGS OF FACT

1. Petitioner, a New York limited liability partnership, is a law firm with an office in the City and other offices outside the City.

2. During the Tax Years, Petitioner operated under a partnership agreement (the "Partnership Agreement") dated 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, Partners who attained a specified age[1]

[1] Generally, the optional service age was 68. However, partners could elect to take Optional Service Status at age 62 without a reduction in Optional Service Plan benefits or, at age 58, with a reduction in Optional Service Plan benefits. Also, under certain circumstances, Optional Service Status could be deferred to age 72 or later.

were required to take "Optional Service Status" or retire. Upon taking Optional Service Status or retiring such Partner (the "OSP Partner" or "Retired Partner") would receive payments (the "Payments") as provided for in the Optional Service Plan.

3. Section 14 of the Partnership Agreement also contains provisions concerning payments to be made upon the withdrawal or retirement of a partner, which payments are not at issue.

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

5. Ronald S. Schacht, a retired partner of Petitioner,[2] 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 who were due to take over the management of Petitioner from the Seniors engaged in discussions with the Seniors to accelerate this 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 the Firm was purchased. The negotiations between the three groups resulted in a plan to provide payments to the departing Seniors and a plan that provided for

[2] Mr. Schacht was an active partner of Petitioner from 1969 to 1995. At various times, Mr. Schacht served as chair of Petitioner's tax department, as its managing partner, as a member of its Executive Committee, and as its tax matters partner.

annual payments to partners who have attained a certain age;[3] *i.e.*, the Optional Service Plan.

6. Mr. Schacht testified that payments made through the Optional Service Plan[4] were meant to: (a) compensate partners for their contribution to the intangible value of the Firm; (b) help provide a comfortable retirement for partners; and (c) help ensure an orderly transition of younger partners to more responsible positions by providing for retirement at a certain age.

7. In general, the Optional Service Plan provided a benefit of up to 52% of the average of the partner's five highest annual earnings.[5] Mr. Schacht testified that this calculation was meant to approximate a partner's contribution to the intangible value of the Petitioner. The amount so calculated is reduced for social security payments, certain disability benefits, and an "assumed annuity" amount related in part to payments to Petitioner's retirement plans. The Optional Service Plan also provides for cost of living adjustments.

8. An OSP Partner is free to practice law in the Firm and to retain his or her office and secretary for one year. Thereafter, Petitioner may make available guest offices for use by OSP Partners. An OSP Partner is required to leave $25,000 in his or her capital account for five years. Under the Optional Service

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[3] *See*, Footnote 1, *supra*.

[4] Section 1(a) of the Optional Service Plan provides that: "[t]he purpose of this plan is to establish a formal program under which a partner is required to take "optional service status" [at a certain age] and to insure 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 the firm."

[5] The benefit provided under the Optional Service Plan is computed at a rate of 1.75% per year of service for up to 30 years of service.

Plan, Petitioner will use its best efforts to continue the OSP Partner's group life, medical and disability insurance programs while he or she is on optional service.

9. Petitioner maintained retirement plans which benefitted its partners. The Partner's Retirement Plan of Proskauer Rose LLP ("Keogh Plan") was established in accordance with IRC §§401(c) and 401(d). The Keogh Plan's benefits are funded entirely by Petitioner and it is an individual defined contribution plan. The Proskauer Rose LLP Savings Plan for Staff and Partners ("401k Plan") is an individual account defined contribution plan established and maintained under IRC §401(a). The 401k Plan is subject to the requirements of ERISA. The Proskauer Rose LLP Partners' Defined Benefit Plan ("Defined Benefit Plan") is a defined benefit plan established and maintained under IRC §401(a). The Defined Benefit Plan was adopted by Petitioner, effective November 1, 1998. As set forth in the preface to each of the Keogh Plan, 401k Plan and Defined Benefit Plan (collectively, the "Plans"), the purpose of the Plans (as relevant to this determination) was to provide retirement and other benefits to partners.[6] In the event that a Partner does not fully vest under any of the Plans, so that a contribution made on behalf of that partner is not ultimately paid to him or her, Petitioner's future contributions to those Plans may be reduced and the contribution made on behalf of the non-vesting or forfeiting partner will ultimately be paid to another partner.

10. Petitioner timely filed a Form NYC-204, City UBT return, for its fiscal year ending October 31, 1996. For that year, Petitioner deducted $2,061,624 of guaranteed payments made to

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[6] There is no dispute that the Plans are qualified plans under IRC §401(a).

retired partners or to the estates of deceased partners. Petitioner also claimed as a New York subtraction $406,300 for contributions that it made to the Keogh Plan.[7] However, in arriving at its net income allocable to the City, only $313,500 of the combined contributions to the Keogh and the 401k Plans were taken into account as deductions.

Respondent issued a Notice of Determination, dated May 16, 2000, asserting a tax deficiency in the amount of $104,646.68, together with interest through April 21, 2000 in the amount of $31,472.87, for a total deficiency of $136,119.55 for the year ending October 31, 1996. The adjustment was comprised of: (a) adding back to income guaranteed payments of $2,061,624; (b) disallowing interest expense of $241,043 (which is not in dispute); and (c) adding back to income $313,500 representing a portion of the Plan contributions, for a total adjustment of $2,616,167.

11. Petitioner timely filed a Form NYC-204 for its fiscal year ending October 31, 1997. For that year, Petitioner did not claim on that original filed UBT return the guaranteed payments made to retired partners and the estates of deceased partners. Petitioner claimed as a New York subtraction $420,000 for contributions it made to the Keogh Plan.[8] However, in arriving at its net income allocable to the City, only $140,640 of the combined contributions to the Plans were taken into account as deductions.

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[7] 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 401k Plan, of which, $655,500 was contributed for the benefit of New York resident partners.

[8] 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 401k Plan, of which $703,200 was contributed for the benefit of New York resident partners.

Respondent issued a Notice of Determination, dated May 16, 2000, asserting a tax deficiency in the amount of $5,412.52, together with interest in the amount of $1,278.06 through April 21, 2000, for a total deficiency of $6,690.58 for the tax year ending October 31, 1997.[9] The adjustment was comprised of adding back to income $140,640, representing a portion of contributions to the Keogh and 401k Plans.

Petitioner timely filed an amended Form NYC-204 on April 23, 2001, for its tax year ending October 31, 1997. That amended return reduced Petitioner's taxable income (before allowances and exemptions) 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.[10]

12. Petitioner timely filed a Form NYC-204 for its fiscal 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 as a New York subtraction $418,400 for contributions made to the Keogh Plan.[11] However, in arriving at its net income allocable to the

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[9] 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. On June 27, 2001, Petitioner timely filed a Petition with the Tribunal, that was designated TAT(H)01-19(UB), requesting a redetermination of the UBT deficiencies asserted for the tax years ending October 31, 1996 and October 31, 1997.

[10] The Petition for the Tax Year ended October 31, 1997 includes a request for a refund of $105,949 based on the amended return for that year.

[11] 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 401k Plan, of which $781,700 was contributed for the benefit of New York resident partners.

City, only $156,340 of the combined contributions to Keogh and 401k Plans were taken into account as deductions.

Respondent issued a Notice of Determination, dated July 12, 2002, asserting a tax deficiency of $90,252.60, together with interest through August 12, 2002 of $28,004.79, for a total deficiency of $118,257.39 for the year ending October 31, 1998. 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[12] representing a portion of the amounts contributed to Keogh and 401k Plans.[13]

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 $68,418,594. The difference represents a deduction of an additional $967,421 of guaranteed payments made to retired partners which were omitted from the original return.[14]

13. Petitioner timely filed a Form NYC-204 for its fiscal year ending October 31, 1999. For that tax period, Petitioner deducted $3,905,386 of guaranteed payments made to retired partners and the estates of deceased partners. Petitioner claimed a New York subtraction of $484,345 for payments made to the Keogh Plan

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[12] The amount added back by Respondent exceeded the amount deducted by Petitioner by $110,431.

[13] 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.

[14] Petitioner timely filed a Petition with the Tribunal to request a redetermination of the deficiency and to claim a refund of $38,697 for its tax year ending October 31, 1998.

and deducted $258,336 of contributions made to the Defined Benefit Plan.[15] In arriving at its net income allocable to the City, only $159,960 of the combined Keogh and 401k Plan contributions were taken into account as deductions.

Respondent issued a Notice of Determination, dated July 12, 2002, asserting a tax deficiency of $179,781.60, together with interest to August 12, 2002 of $37,985.77, for a total deficiency of $217,767.37 for the tax year ending October 31, 1999. The deficiency was attributable to: (a) adding back to income guaranteed payments in the amount of $3,905,386; and (b) adding back to income $258,336 of amounts contributed to the Defined Benefit Plan and $330,818[16] representing a portion of the amounts contributed to the Keogh and 401k Plans.[17]

14. 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 did not deduct on its return $1,950,000 of the guaranteed payments. Petitioner also claimed as a New York subtraction $519,200 for payments made to the Keogh Plan. Petitioner deducted $210,453 of contributions made to

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[15] These amounts represented 20 percent of the total contributions made to the Keogh and Defined Benefit Plans 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 401k Plan, of which $799,800 was contributed for the benefit of New York resident partners.

[16] The amount added back by Respondent exceeded the amount deducted by Petitioner by $170,858.

[17] 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. Petitioner timely filed a Petition with the Tribunal to request a redetermination of the asserted deficiency for the tax year ending October 31, 1999.

the Defined Benefit Plan.[18] In arriving at its net income allocable to the City, only $184,490 of the combined Keogh Plan and 401k Plan contributions were taken into account as deductions.

Respondent issued a Notice of Determination, dated July 12, 2002, asserting a tax deficiency of $109,197.80, together with interest to August 12, 2002 of $11,834.19, for a total deficiency of $121,031.99 for the tax year ending October 31, 2000. The deficiency was attributable to: (a) adding back to income guaranteed payments of $2,164,815; and (b) adding back to income $210,453 of amounts contributed to the Defined Benefit Plan and $354,677[19] representing a portion of the amounts contributed to the Keogh and 401k Plans.[20]

Petitioner timely filed 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 its retired partners, for a total deduction of $4,114,815.

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[18] These amounts represent 20 percent of total contributions made to the Keogh Plan and to the Defined Benefit Plan by Petitioner that year. For that fiscal 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 401k Plan, of which $922,450 was contributed for the benefit of New York resident partners.

[19] The amount added back by Respondent exceeded the amount deducted by Petitioner by $170,187.

[20] 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 timely filed a Petition with the Tribunal to request a redetermination of the deficiency asserted for the tax year ending October 3, 2000. That Petition, which also protests the deficiencies asserted with respect to the tax years ending October 31, 1998 and October 31, 1999, has been given the designation TAT(H) 03-10(UB) and was consolidated for hearing with TAT(H)01-19(UB).

15. On September 27, 2004, Petitioner filed a Supplemental Petition in which it requested that the Tribunal allow a deduction for the amount of all contributions made in each year to the Plans 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 in its amended UBT Return for that tax year (*see*, Finding of Fact 14, *supra*). Petitioner requested that it be allowed a refund of any reduction in tax and interest found to result from the allowance of such deductions.

16. Petitioner asserts that, in any event, the add-backs by Respondent which exceed the deductions taken by Petitioner as described in Footnotes 12, 16 and 19, *supra*, were improper (thus giving it a right to a refund since it paid the asserted deficiencies on account). Respondent agreed in its Brief to make the adjustments necessary to reduce the add-backs by the amounts noted in Footnotes 12, 16 and 19, *supra*.

STATEMENT OF POSITIONS

Petitioner contends that the Payments to its retired partners are not for services but instead were intended to compensate them for their contribution to the goodwill of the Firm, to provide for a comfortable retirement and to allow for the progression of younger partners to a position of responsibility and leadership in the Partnership. Petitioner argues that since the Payments were made pursuant to the Partnership Agreement, which did not contain a provision indicating that the Payments were for the goodwill of the Firm, the Payments were deductible for federal income tax purposes. Petitioner further argues that since the Payments were not for services or the use of capital, but were for goodwill (despite a provision in the Partnership Agreement that no payments would be made to a partner 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 thus must be added back for UBT purposes. Respondent further argues that if the Payments were, as claimed by Petitioner, for goodwill, an intangible asset, then such payments are not deductible for federal income tax purposes.

Petitioner next argues that since the contributions to the Plans were made to tax exempt entities and not to the partners directly, such payments are not subject to the UBT add-back for payments to partners. Petitioner further contends that, in any event, the UBT modification is pre-empted by ERISA with respect to payments to the 401k Plan.

Respondent counters that the payments to the Plans are payments to partners as it is a fundamental principle of income taxation that income is taxable to he who earns it. Respondent also argues that ERISA does not pre-empt the UBT add-back.

CONCLUSIONS OF LAW

A partnership doing business in the City is subject to UBT based on its UBTI. Code §§11-503(a) and 11-505.[21] UBTI is unincorporated business entire net income allocated to the City less certain deductions and exemptions. Unincorporated business entire net income is defined, in Code §11-501(g), as "the excess of

[21] UBTI is entire net income less deductions under Code §11-509 and unincorporated business exemption under Code §11-510.

the unincorporated business gross income of an unincorporated business over its unincorporated business deductions." Unincorporated business gross income and deductions are defined in Code §§11-506 and 11-507, respectively, by reference to federal law. Specifically, Code §11-507 provides that an unincorporated business is permitted to take as deductions "items of loss and deduction directly connected with or incurred in the conduct of the business, which are allowable for federal income tax purposes." There are, however, certain modifications which add back certain federally allowed deductions for UBT purposes, including the add-back for payments to partners for services or the use of capital. Code §11-507(3).

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

The federal income tax treatment of payments to retired partners is governed by IRC §736.[22] For federal income tax

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[22] IRC §736 provides:

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

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

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

(b) PAYMENTS FOR INTEREST IN PARTNERSHIP-

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

purposes, Petitioner treated the Payments as deductible guaranteed payments under IRC §736(a)(2). Had the Payments been treated by the Partners in the Partnership Agreement as being for goodwill, they would not have been deductible for federal income tax purposes. However, because the Partnership Agreement did not provide for any payments for goodwill, and instead provided that partners had no interest in the Firm's goodwill and in no event would a partner be paid for goodwill, the Payments were deductible for federal income tax purposes.

The determinative nature of the language of the Partnership Agreement is dictated by a federal statute that arose as a result of the substantial difficulty that courts had in determining the nature of payments to retired partners;[23] *i.e.*, whether such payments were for goodwill (and thus not deductible since goodwill is a non-wasting asset),[24] or for services (and thus deductible). To alleviate such uncertainty, IRC §736 was adopted in the Internal Revenue Code of 1954 to provide clear guidance to partners and

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

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

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

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

partnerships.[25] In essence, under IRC §736(b)(2)(B) and (3), payments to retired partners will only be considered payments in exchange for an interest in partnership goodwill "to the extent that the partnership agreement provides for a payment with respect to goodwill." Otherwise, such payments are treated the same as payments for services; *i.e.*, are deductible under IRC §736(a) as either a distributive share of partnership income under IRC §736(a)(1) or a guaranteed payment under IRC §736(a)(2). That a payment to a retired partner will be treated as being for goodwill only if the partnership agreement contains a provision that payments are for goodwill gives partnerships and partners great freedom as to how they wish to treat payments to retired partners.

Petitioner, a law firm, some of whose partners specialize in matters of taxation, structured the Partnership Agreement to specifically provide that no payment would be made to a partner for goodwill. This provision of the Partnership Agreement had clear and predictable tax consequences as Petitioner could expect the IRS to respect that none of the payments to a retired partner would be treated as nondeductible payments for goodwill under IRC §736(b)(2) and (3). This provision likely also had significance under state law with regard to the economic rights of Petitioner's partners, particularly since the Partnership Agreement had only to be silent

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

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

with respect to whether payments were for goodwill for Petitioner to obtain an ordinary deduction for federal income tax purposes.

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

Clearly the government, as a general rule, may bind a taxpayer to the form in which it has cast a transaction. *Spector* v. *Commissioner of Internal Revenue*, 641 F.2d 376, 381 (5th Cir. 1981), *rev'g.,* 71 T.C. 1017 (1979).[26] Nowhere is this rule more

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

important to apply than here where the initial step to deductibility under the UBT is wholly dependent upon the form of the transaction; *i.e.*, the manner in which Petitioner drafted its Partnership Agreement with respect to whether the Payments were for goodwill. *Spector, supra.* That is because the categorization of the payments now being sought by the taxpayer (*i.e.*, that it is for goodwill) would have precluded any deduction had the Partnership Agreement been written to categorize the Payments as being for goodwill rather than (as it was written) as not being for goodwill.

Petitioner effectively asserts that a fiction was created in the Partnership Agreement. There are two means to address that fiction. Either the categorization created by the taxpayer in the Partnership Agreement that the payments were not for goodwill must be consistently followed to its natural consequences and the Payments be treated as not being for goodwill for all purposes, or the categorization in the contract should be disregarded and the Partnership Agreement be rewritten to provide that the Payments, *ab initio,* be categorized as being for what Petitioner now claims they were for (goodwill). However, if the contract provision is reformed to reflect that the Payments were indeed for goodwill, Petitioner would not be entitled to deduct such payments for federal income tax purposes and would lose the deduction claimed without regard to the add-back provision.

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

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

As Congressional policy is to permit service partnerships to choose their fiction, and courts are generally reluctant to reform contracts,[27] it is not appropriate to permit Petitioner to disavow the inescapable tax consequences of the deliberate contractual language in the Partnership Agreement.[28] As noted in *Commissioner of Internal Revenue v. National Alfalfa Dehydrating & Milling Co.*, 417 U.S. 134 (1974):

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

While Petitioner has put forth evidence in the testimony of Mr. Schacht that the payments were for goodwill, Petitioner's intent in drafting its Partnership Agreement and allocating payments to partners is of no moment. *V. Zay Smith, supra*.[29] Petitioner was free to organize its affairs in the way it saw fit.

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

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

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

It dictated the federal income tax consequences that it wanted for its payments to its retired partners by making specific provisions, not to treat the Payments as being for goodwill in the Partnership Agreement. Having chosen to provide in its Partnership Agreement that no payments would be made to a partner for goodwill, it cannot escape the practical and logical consequences of its choice by evidence that it intended otherwise.

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

The Payments therefore cannot be treated as payments for the Retired Partners' interests in the goodwill of the Firm, but instead must be treated as being for what the Partnership Agreement stated they were for: "optional service." The Optional Service Plan contained a cost of living provision and a social security offset provision. Under the Optional Service Plan the OSP partners had to maintain a capital account for a period. They were entitled to a secretary and the use of an office. Petitioner would try to maintain health benefits and group life insurance for the OSP Partners. Payments under the Optional Service Plan were based in part on years of service and prior earnings. In addition, those payments were reduced by the amount of certain alternative sources of retirement funds. *See*, Finding of Fact 7, *supra*. All these factors are consistent with payments for prior service. Petitioner's partners were aware that they would be entitled to payments under the Optional Service Plan in the future and this was a clear incentive to remain with the Firm and insure the Firm the stability it desired. Accordingly, Respondent correctly added back the Payments as payments to partners for services or the use of capital. *See*, *Buchbinder, supra*; *Hawkins Delafield & Wood v. Commissioner*, 67 N.Y.2d 873 (1986).

The second issue is whether Petitioner's contributions to the Plans are "amounts paid or incurred to a proprietor or partner" and thus not deductible for UBT purposes. Petitioner cites Letter Rulings issued by Respondent in which similar payments to employee benefit plans were found not to be compensation for purposes of the alternative tax computation under the City's General Corporation Tax ("GCT"). While Respondent has not offered an explanation for the difference in treatment of these payments, its Letter Rulings regarding the treatment of contributions to employee benefit plans for GCT purposes are not binding on the Department for GCT, let alone UBT, purposes. Second, Petitioner argues that a Partner does not immediately vest in the Plans and may never receive the money that the Firm contributed to the Plans on his behalf. This is irrelevant as payments to the Plans, for which Petitioner received deductions, are not returned to Petitioner. Instead, in the event of a forfeiture, the Plans keep the contributions. Petitioner's future contributions could then be reduced, but ultimately all amounts contributed to the Plans are required to be paid to other partners. Third, Petitioner argues that the Partners do not have income when the contribution is made. This, however, is merely a question of timing and does not alter the fact that contributions to the Plans will ultimately be paid by the Plans to the Partners at which time they will be taxed.

The Payments to the Plans were made as compensation for services performed by Petitioner's partners. That they were not made directly to the partners is inconsequential under the UBT. *Leonard I. Horowitz*, TAT(E) 99-3(UB) *et al.* (NYC Tax Appeals Tribunal, September 1, 2005). Accordingly the payments were properly added back under Code §11-507(3).

Petitioner next claims that ERISA pre-empts the treatment of the contributions to the 401k Plan. Section 514(a) of ERISA provides, in pertinent part that "the provisions of [ERISA] shall supercede any and all State laws insofar as they may now or hereafter relate to any employee benefit plan . . .."[30]

A state law relates to an employee benefit plan "if it has a connection with or reference to such plan." *Shaw v. Delta Air Lines, Inc.*, 463 U.S. 85 (1983). "A law that refers to or has a connection with an employee plan covered by ERISA is pre-empted 'even if the law is not specifically designed to affect such plans, or the effect is only indirect, and even if the law is consistent with ERISA's substantive requirements.'" *Thiokol Corporation v. Roberts*, 76 F.3d 751 (6th Cir. 1996), citing *District of Columbia v. Greater Wash. Bd. of Trade*, 506 U.S. 125 (1992). However, a law will not be pre-empted by ERISA if it affects the employee benefit plan in "too tenuous, remote or peripheral a manner . . .." *Shaw*, *supra*, at 100, n. 21; *Thiokol*, *supra*.

[30] Under Section 514(c) of ERISA, the term "State" includes "a State, any political subdivisions thereof, or any agency or instrumentality of either."

Petitioner contends that Code §11-507(3) affects the Plans in more than a "tenuous, remote or peripheral manner." Petitioner cites *Morgan Guaranty Trust Company of New York v. Tax Appeals Tribunal*, 80 N.Y.2d 44 (1992) and *McKinsey Master Retirement Plan Trust*, DTA No. 817551 (NYS Tax Appeals Tribunal, May 8, 2003), in support of its position. In *Morgan Guaranty Trust,* ERISA pre-empted the State's Real Property Gains Tax, which would have taxed the gain realized by an ERISA plan on the sale of property owned by the plan. This would have reduced funds already contributed to the plan that otherwise would have been available to provide benefits to participants. In *McKinsey*, ERISA pre-empted the State's unrelated business income tax ("UBIT") because the UBIT affected the income, investment strategy and administration of ERISA-covered plans. The taxes at issue in *Morgan* and *McKinsey* had a direct effect on ERISA plans, in part, because the taxes reduced funds in the plan after they had been contributed to the plans. That is not the case here.

The matter here, however, is more analogous to *The Firestone Tire & Rubber Company v. Neusser*, 810 F.2d 550 (6th Cir. 1987) and *De Buono v. NYSA-ILA Medical and Clinical Services Fund*, 520 U.S. 806 (1997). In *Firestone*, Akron, Ohio imposed an income tax on residents and non-residents for work done within Akron. Firestone Tire & Rubber Company, which employed workers in Akron, had two benefit plans governed by ERISA. Contributions to those plans were subject to the Akron income tax. The Sixth Circuit rejected Firestone's argument that the tax was pre-empted by ERISA because it affected the amount of the participant's contributions to the plans. The Court held that since the Akron income tax was "a neutral tax of general application" that "taxes income without regard to the employee's decisions concerning plan contributions," it was not pre-empted by ERISA.

In *De Buono*, *supra*, the United States Supreme Court found that New York's Health Facility Assessment (the HFA), which imposed a tax on a health facility's gross receipts for patient services and also taxed the investment income and certain operating income of health facilities, was not pre-empted by ERISA. The Supreme Court noted that in its early cases dealing with ERISA pre-emption it had not needed to define the boundaries of ERISA's broad language. In *New York State Conference of Blue Cross & Blue Shield Plans v. Travelers Ins. Co.*, 514 U.S. 645 (1995), the Court concluded that ERISA's "relates to" language was not "intended to modify 'the starting presumption that Congress does not intend to supplant state law.'" The Court found that a person urging that a state law is pre-empted by ERISA bears "the considerable burden of overcoming 'the starting presumption that Congress does not intend to supplant state law." *De Buono*, *supra* at p. 814, *citing Travelers Ins*., *supra*. In deciding that the HFA was not pre-empted by ERISA the Supreme Court stated at 815, 816 that:

> [T]here is nothing in the operation of the HFA that convinces us it is the type of state law that Congress intended to supercede. This is not a case in which New York has forbidden a method of calculating pension benefits that federal law permits [*See*, *Alessi v. Raybestos-Manhattan, Inc.*, 451 U.S. 504, 524-525], or required employers to provide certain benefits. [*See*, *Shaw*, *supra*] Nor is it a case in which the existence of a pension plan is a critical element of a state law cause of action, [*See*, *Ingersoll-Rand Co. v. McLendon*, 498 U.S. 133, 139-140] or one in which the state statute contains provisions that expressly refer to ERISA or ERISA Plans. [*See*, *Mackey v Lanier Collection Agency & Services*, 486 U.S. 825]. . . [T]he HFA is one of a "myriad of state laws" of general application that impose some burdens on the administration of ERISA plans but nevertheless do not 'relate to' them within the meaning of the governing

> statute. . . . Any state tax . . . that increases the cost of providing benefits to covered employees will have some effect on the administration of ERISA plans, but that cannot mean that every state law with such an effect is pre-empted by [ERISA].

Thus, while the UBT may incidently increase the cost to Petitioner of providing benefits to its partners, that reason is insufficient to find that Code §11-507(3)is pre-empted by ERISA with respect to contributions to the 401k Plan.[31]

ACCORDINGLY, IT IS CONCLUDED THAT:

A. The Payments must be categorized in accordance with the Partnership Agreement as not being for goodwill, and instead be categorized as being for services in accordance with the evidence presented. The Payments must, therefore, be added back to UBTI under Code §11-507(3).

B. Petitioner's payments on behalf of its partners to the Plans are still "amounts paid or incurred to a proprietor or partner" and, therefore, must also be added back to UBTI under Code §11-507(3).

C. The add-back required under Code §11-507(3), with respect to Petitioner's contributions to the 401k Plan, is not pre-empted by ERISA.

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[31] All other arguments in this matter have been considered and found either to be without merit or, in view of the above findings, unnecessary to be decided.

The Notices of Determination dated May 16, 2000 and July 12, 2002 are sustained in full and Petitioner's claims for refunds of UBT with respect to the Tax Years are denied, except to the extent that the asserted deficiencies for the Tax Years ending October 31, 1998, October 31, 1999 and October 31, 2000 must be adjusted as provided in Finding of Fact 16, *supra*.

IT IS SO ORDERED.

DATED: July 11, 2006
New York, New York

WARREN P. HAUBEN
Deputy Chief Administrative Law Judge