New York City Tax Appeals Tribunal

In the Matter of MURPHY & O'CONNELL, Petitioner.	DECISION TAT (E) 06-18 (UB)

Murphy & O'Connell ("Petitioner") filed an Exception to the Determination of the Deputy Chief Administrative Law Judge (the "DCALJ") dated May 10, 2010 (the "DCALJ Determination"). The DCALJ Determination granted the New York City Commissioner of Finance's ("Respondent's") motion for summary determination that Petitioner's payments to a pension plan for the benefit of its partners are nondeductible payments to partners under § 11-507(3) of the Administrative Code of the City of New York (the "Code"), and sustained the Notice of Determination dated June 3, 2005, issued by the New York City Department of Finance (the "Department") asserting a deficiency of New York City Unincorporated Business Tax ("UBT") for the calendar year 2001 (the "Tax Year") (the "Notice"), as amended to reflect Respondent's withdrawal of penalties.

Petitioner appeared by Patrick J. Murphy, Esq., a partner of Petitioner. Respondent appeared by Andrew G. Lipkin, Esq., Senior Counsel, New York City Law Department. Both Parties submitted Memoranda of Law and oral argument was held before the Tribunal. Additional material and letter briefs were submitted at the Tribunal's request.

Petitioner, a New York partnership, is a law firm located in New York City.[1]

For the Tax Year, Petitioner claimed a federal income tax deduction of $188,000 for the amount Petitioner contributed to a pension plan on behalf of its partners (the "Contribution Deduction"). Petitioner reported unincorporated business entire net income[2] of $73,907 from which it deducted the $5,000 compensation limit allowed for each partner under Code §11-509(a) for the partner's active services to the partnership.

On audit of Petitioner's UBT return, the Department disallowed the Contribution Deduction pursuant to Code §11-507(3) as a payment to the partners for their services. The Department issued the Notice asserting a UBT deficiency for the Tax Year in the principal amount of $8,940.28, together with interest through July 5, 2005, of $2,073.09, plus a ten percent substantial understatement of liability penalty and a five percent negligence penalty totaling $1,341.04 (the "Penalties"), for a total deficiency of $12,354.41. During proceedings before the DCALJ, Respondent withdrew the Penalties.

Petitioner repeatedly asserted that it had paid in full the deficiency including interest and the Penalties.[3] Petitioner and Respondent submitted relevant information concerning

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[1] Except as otherwise noted, the DCALJ's Findings of Fact, although paraphrased and amplified herein, generally are adopted for purposes of this Decision. Certain Findings of Fact not necessary to this Decision have not been restated and can be found in the DCALJ Determination.

[2] As defined in Code §11-501(g).

[3] Petitioner's Affirmation in Opposition to Respondent's Motion for Summary Judgment & In Support of Award of Summary Determination for Petitioner dated October 15, 2009, at 9, Petitioner's Memorandum of Law in Opposition to Respondent's Motion for Summary Determination and in Support of Award in Favor of Petitioner dated October 15, 2009, at 2, Petitioner's Exception dated June 9, 2010, at 3, Petitioner's Memorandum of Law dated June 23, 2010, at 9, Petitioner's Reply Memorandum of Law dated October 2, 2010, at 8, and Petitioner's letter brief dated March 1, 2011.

Petitioner's payment of the deficiency and letter briefs on the question of whether Respondent is required to pay interest on a refund of the Penalties. Based on the Parties' submissions we are making an additional Finding of Fact that Petitioner sent the Department a check, dated July 28, 2006, in the amount of $13,970.96, which represented the full amount of the tax, interest and Penalties comprising the UBT deficiency for the Tax Year.[4] Respondent has confirmed that Petitioner's payment was "in full satisfaction of the tax deficiency, interest due on the deficiency up to the date of payment, and the penalty."[5]

The DCALJ, finding no triable issue of fact and relying on Matter of Horowitz, New York City Tax Appeals Tribunal (September 1, 2005), *aff'd*, 41 A.D.3d 101 (1st Dept. 2007) ("Horowitz"), and Matter of Proskauer Rose LLP, New York City Tax Appeals Tribunal (November 5, 2007), *aff'd*, 57 A.D.3d 287 (1st Dept. 2008) ("Proskauer"), granted summary determination in Respondent's favor.[6] The DCALJ Determination sustained the Notice except to the extent of the Penalties withdrawn by Respondent. The DCALJ Determination made no reference to Petitioner's payment of the deficiency in full and, therefore, did not consider whether Petitioner is due a refund of the Penalties and whether interest is due on a refund of the Penalties.

In taking exception to the DCALJ's Determination, Petitioner argues that Horowitz and Proskauer are not controlling precedent. Petitioner does not dispute any of the DCALJ's Findings of Fact. Nor does Petitioner attempt to factually distinguish this case from Horowitz and Proskauer.

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[4] Letter from Petitioner dated January 11, 2011, with attached copy of cancelled check.

[5] Letter brief from Respondent dated February 14, 2011.

[6] The Parties had requested the DCALJ to place the matter on the Tribunal's *sine die* calendar pending the final resolution of Horowitz and Proskauer.

Petitioner argues that Respondent's position and Horowitz and Proskauer are contrary to the statute. More particularly, Petitioner argues, as the taxpayers in Horowitz and Proskauer had argued, that Code §11-507(3) applies only to compensation paid directly to partners, not to a pension trust on their behalf. Petitioner also contends that Respondent cannot give effect to his interpretation of Code §11-507(3) unless Respondent promulgates a rule under the procedures described in the City Administrative Procedure Act ("CAPA"),[7] with the requisite notice, publication and opportunity for comment.[8] Petitioner argues that neither Horowitz nor Proskauer controls here because neither case raised the CAPA issue. In a related argument, Petitioner claims that Respondent's failure to promulgate a rule violated Petitioner's due process rights.

Petitioner also argues that to the extent the DCALJ Determination relies on the "substance over form" and "assignment of income" doctrines in disallowing the Contribution Deduction, those doctrines do not apply where the income to the partners in respect of the contribution is deferred for federal income tax purposes. Petitioner, thus, asserts that the federal income deferral is a statutory exception to the assignment of income doctrine that Respondent cannot overrule other than by means of legislation.

Petitioner requests a refund of the deficiency it previously paid with applicable interest, including interest on the Penalties.

Respondent argues that the DCALJ Determination should be upheld. Respondent also contends that no interest is due on the refund of the Penalties because "[t]here is no statutory or contractual obligation to pay interest on the refund of a properly imposed but subsequently

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[7] New York City Charter (the "Charter") §1041, *et seq.*

[8] Charter §1043.

waived penalty"[9] and because Petitioner did not pay the Penalties under compulsion. Respondent also requests that in the event the Tribunal reverses the DCALJ's grant of summary determination, the case should be remanded for further findings on the factual issues of (1) whether the Petitioner made the contribution in question, and (2) whether the contribution, if made, was to a qualified plan.[10]

For the following reasons, we affirm in part and modify the DCALJ Determination.

Code §11-507(3), 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." In Horowitz this Tribunal held that contributions by a sole proprietorship to a defined benefit plan on behalf of the sole proprietor were non-deductible payments to the proprietor for services within the meaning of Code §11-507(3). This Tribunal addressed the issue again in Proskauer where we held that contributions by a partnership to several qualified retirement plans on behalf of its partners were non-deductible payments to the partners for their services within the meaning of Code §11-507(3). Both decisions were affirmed. Horowitz, 41 A.D.3d 101(1st Dept. 2007); Proskauer, 57 A.D.3d 287 (1st Dept. 2008).

In reviewing the DCALJ's grant of summary determination we consider the evidence in a light most favorable to Petitioner. Hickey v. Arnot-Ogden Medical Center, 79 A.D.3d 1400, 1401 (3d Dept. 2010). We assume, therefore, that Petitioner made the contribution in question, and that the contribution was made to a qualified plan.

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[9] Letter Brief from Respondent dated February 14, 2011.

[10] Respondent's Memorandum of Law in Opposition to Exception, at 4.

We find Petitioner's facts to be indistinguishable from Horowitz and Proskauer, and therefore find those decisions to be binding precedent. Charter §170.d. The taxpayers in both Horowitz and Proskauer argued, as Petitioner does here, that payments to a tax-exempt pension trust for the benefit of a partner or a sole proprietor are outside the scope of Code §11-507(3) because the payments were not made directly to the partner or sole proprietor. In both cases this Tribunal rejected this argument and held that regardless of whether the payments are made directly to, or for the benefit of, a partner or sole proprietor, the payments are within the scope of Code §11-507(3) and not deductible.

We next turn to Petitioner's argument that the "substance over form" and "assignment of income" doctrines do not apply where Petitioner's partners realize no federal taxable income from the contribution in question because the resulting income to the partners is deferred under the Internal Revenue Code ("IRC"). It is irrelevant to the deductibility of a payment under Code §11-507(3) whether the amount of that payment is included in the federal taxable income of the individual partners. A payment, otherwise deductible for federal income tax purposes, becomes non-deductible for purposes of the UBT under Code §11-507(3) if it is made to a partner or for the benefit of a partner for that partner's services. Under federal income tax law the payment in question was deductible only if it was compensation for services actually rendered.[11] The statutory requirements for disallowance under Code §11-507(3), thus, were satisfied, *i.e.*, a payment by Petitioner compensating its partners for their services. We can find nothing in Code §11-507(3), or in the case law

[11] Treas. Reg. §1.404(a)-1(b), in relevant part, provides: "to be deductible under section 404(a), contributions must be expenses which would be deductible under section 162. . . . Contributions may therefore be deducted under section 404(a) only to the extent that they are ordinary and necessary expenses during the taxable year in carrying on the trade or business or for the production of income **and are compensation for personal services actually rendered.**" (Emphasis added.) *See also* IRC §401(c), which treats Petitioner's partners as "employees" for purposes of these provisions.

construing it, that suggests that disallowance under that section also requires that the payment in question be included in the individual partners' federal taxable income. Petitioner has cited no authority to that effect.

We next address Petitioner's argument that in order for Respondent to apply Code §11-507(3) to the specific facts of Petitioner's case, *i.e.*, to Petitioner's contribution to a pension plan on behalf of its partners, Respondent was required to first promulgate a rule under the CAPA rule-making procedures.

We conclude that Respondent's application of Code §11-507(3) to the specific facts in Horowitz and Proskauer was not a "rule," and that Respondent may rely on those decisions as precedent in support of his disallowance of the Contribution Deduction in the present case.

A rule is a statement by an agency of "general applicability"[12] that controls future cases before it. More specifically, it is a "fixed, general principle to be applied by an administrative agency without regard to other facts and circumstances relevant to the regulatory scheme of the statute it administers. . . ." Roman Catholic Diocese of Albany v. New York State Dept. of Health, 66 N.Y.2d 948, 951 (1985) (*rev'g on dissent below*) 109 A.D.2d 140 (3d Dept. 1985) (Levine, J., dissenting in part) ("Roman Catholic Diocese"). In Roman Catholic Diocese the New York State Court of Appeals adopted the reasoning of the dissenting Appellate Division Justice Levine who stated that an administrative agency need not promulgate a rule for every action it takes in individual cases, but

> is free to evolve standards, if consistent with the statutory framework, **on a case-by-case basis** and to apply them to the **individual proceeding** at hand [emphasis added]. "And the

[12] Charter §1041.5.

> choice made between proceeding by general rule or by individual, *ad hoc* litigation is one that lies primarily in the informed discretion of the administrative agency."[13] [Citation omitted.]

The dissenting Appellate Division Justice's reasoning adopted by the Court of Appeals in Roman Catholic Diocese relied on United States Supreme Court precedent holding that agencies may evolve policies by litigating individual cases, with the decisions in those cases serving as precedent for future cases.[14]

For the reasons stated in Roman Catholic Diocese Respondent may proceed case-by-case to resolve the legal and policy questions that result from an audit of a taxpayer's tax return. In Horowitz and Proskauer, Respondent interpreted Code §11-507(3) to disallow the payments at issue. The taxpayers litigated Respondent's interpretation and Respondent prevailed. Respondent may rely on those decisions as precedent when encountering the same issue on subsequent audits. CAPA does not require Respondent to promulgate a separate rule, in advance, for every conceivable legal issue he might encounter on audit, and Respondent may choose to develop his policy concerning particular issues on a case-by-case basis.

The absence of a rule, moreover, did not deprive Petitioner of due process. Petitioner was afforded notice and an administrative hearing prior to a final decision fixing its tax liability and obligation to pay. The requirements of due process, thus, were satisfied. *See*, 439 East 88 Owners Corporation v. The Tax Commission of the City of New York, 2002

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[13] 109 A.D.2d at 148, (Levine, J., dissenting) *quoting* Securities Commn. v. Chenery Corp., 332 U.S. 194, 203 (1947).

[14] 140 A.D.2d at 148 (Levine, J., dissenting).

N.Y. Slip Op. 50731(U) *available at* 2002 WL 32799697, *aff'd*, 307 A.D.2d 203 (1st Dept. 2003).

Based on the foregoing, we conclude that the tax deficiency asserted by Respondent in the Notice was correct. However, because Respondent has withdrawn the Penalties, Petitioner is due a refund in the amount of the Penalties. Respondent does not dispute that Petitioner is entitled to a refund of the Penalties.

The remaining issue is whether Respondent is required to pay interest on the refund of the Penalties. Code §§11-526 and 11-528 require Respondent to refund an overpayment of UBT with interest computed from the date of the overpayment. Code §11-525(h) provides that the negligence and substantial understatement penalties imposed under Code §11-525(b) and (j) "shall be assessed, collected and paid in the same manner as taxes, and any reference in this chapter to tax or tax imposed by this chapter, shall be deemed also to refer to the additions to tax and penalties provided by this section." Therefore, pursuant to Code §§11-526 and 11-528, Petitioner is entitled to interest on a refund of the Penalties from the date of the overpayment, which we find to be the date of Petitioner's check, July 28, 2006.[15] *See* Salley v. United States, 239 F.Supp. 161 (S.D. Texas 1965) (reading IRC Section 6611(b)(2), which is substantially identical to Code §11-528, as requiring interest on a refund of penalties).

Respondent argues that Petitioner is not entitled to interest on the refund of the Penalties because "[t]here is no statutory or contractual obligation to pay interest on the refund of a properly imposed but subsequently waived penalty" and because Petitioner did

[15] Neither Party presented an alternative argument or evidence as to a different date for the date of the overpayment.

not pay the Penalties under compulsion.[16] None of the cases on which Respondent relies support his argument. Brodsky v. Murphy, 25 N.Y.2d 518 (1969) and Matter of City of New York v. Tully, 55 N.Y.2d 960 (1982) (citing Brodsky v. Murphy) are inapposite. In Brodsky, the New York Court of Appeals held that no interest was payable on a refund of New York State mortgage recording tax where the statute was silent on the payment of interest. However, the statutory authority absent in Brodsky is present here. The UBT statute quoted above expressly treats the Penalties as tax for purposes of the payment of refund interest. Other cases cited by Respondent apply Article VIII, Section 1 of the New York Constitution, which precludes a city or other local governmental unit from making a payment of public funds unless it is pursuant to a binding legal obligation. Antonopoulou v. Beame, 32 N.Y.2d 126 (1973); Piro v. Bowen, 76 A.D.2d 392 (2d Dept. 1980). Neither case applies here. The UBT statute imposes a legal obligation on Respondent to pay interest on a refund of the Penalties. We, therefore, reject Respondent's arguments.

We disagree with Respondent's assertion that Petitioner's payment of the amounts asserted in the Notice before final resolution of the matter affects Petitioner's right to interest on a refund of the Penalties. Petitioner was under no compulsion to pay the tax and interest asserted in the Notice in advance of our decision in this matter, yet, Respondent does not suggest that Petitioner would be precluded from receiving interest on a refund of those amounts had we ruled in Petitioner's favor. There is nothing in the UBT statute that prohibits Petitioner from paying on account all, or any part, of the amounts asserted in the Notice prior to a final resolution of this case, or denies Petitioner interest on a refund of any of those amounts. To deny refund interest on a prepayment of amounts asserted in a notice of determination because they were "voluntarily paid" without "compulsion" would discourage

[16] Letter Brief from Respondent dated February 14, 2011. There is nothing in the Record regarding the issue of whether or not the Penalties "were properly imposed" and Respondent has not challenged the DCALJ's Finding of Fact that the Penalties were withdrawn.

taxpayers from paying any of those amounts until the entire procedure for contesting them was complete. It also would give Respondent the interest-free use of Petitioner's funds paid as penalties without any economic incentive to timely refund them.

Accordingly, the DCALJ Determination is modified to grant Petitioner a refund of the Penalties Petitioner paid during the pendency of the proceedings below, together with applicable interest from July 28, 2006, and in all other respects is affirmed.[17]

Dated: July 26, 2011
New York, New York

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GLENN NEWMAN
President and Commissioner

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ELLEN E. HOFFMAN
Commissioner

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ROBERT J. FIRESTONE
Commissioner

[17] We have considered all other arguments raised by the Parties and find them to be unpersuasive.