March 16, 2006

ALJ Determination Radically Changes New York Taxation of Partners' Retirement Income

By: Joseph Lipari and Carolyn Joy Lee

For the second time in less than a year, a decision from the New York State Division of Tax Appeals substantially changed what was the generally accepted view on an income tax issue affecting hundreds of taxpayers. Last month, in *John E. McDermott, Jr.*[1] Administrative Law Judge Thomas Sacca held that U.S. Code Title 4, section 114 (referred to herein as "Section 114", prevented New York State from taxing retirement payments made to Mr. McDermott by a law firm from which he had retired as a partner. Together with the Tax Appeals Tribunal decision in the stock option case, *Stuckless*,[2] which we wrote about last June, the Division of Tax Appeals has significantly limited the power of the New York State Department of Taxation and Finance to tax nonresidents.

The facts in *McDermott* are relatively easy to set forth. The taxpayer was a resident of Florida and was previously, from 1966 through 1998, a resident of Connecticut. Beginning in 1965, he practiced tax law at the law firm of Coudert Brothers and was a partner at that firm from 1970 until he retired on December 31, 1997.[3] Following his retirement, he was entitled to receive retirement payments under the Coudert Brothers Partnership Agreement. General partners of the firm were compensated each year by the annual payment of shares in the firm's profits. The number of profit shares was determined annually by the firm's compensation committee.

Retirement payments were determined under Article 8D of the Partnership Agreement. The provisions of this Article provided that retired partners would receive, for a period of years following retirement, payments based on the number of years the partner was a partner and his profit shares during such time. In general, partners received retirement payments based on 20 percent of the highest number of profit shares held by the partner during any of the ten years prior to retirement. A retired partner would receive such payments for 14 years if the partner was employed by Coudert for 20 years and would increase by one year for every five years the retired partner was employed over 20 years.

As of December 31, 1997, Mr. McDermott's "period of firm association" ceased.
Since he was employed by the firm for 33 years, including service as an associate, he was entitled to retirement payments over 16 years, from 1998 through 2013, equal to 20 percent of his highest number of profit shares. The ALJ noted that since the retirement provisions were fixed in the Partnership Agreement, Mr. McDermott's rights to the payments accrued year-by-year over his years of service and were "fully earned" as of the date of his retirement. The ALJ stated "Petitioner's rights to payment of retirement compensation were fixed, as they accrued each year, and the firm could not, unilaterally, reduce or eliminate them."

Mr. McDermott performed no services for the firm in 1998. Under the retirement provisions he received $118,601, as his retirement payment under Article 8(D). The firm issued him a New York State Form K-1 showing the $118,601 as his share of partnership income and providing that $47,713 was allocable to New York State under the firm's allocation percentage. The ALJ also noted that "The law firm inserted the following message on the Form K-1: 'Retirement Income Payments are retirement income paid to a retired partner over a period of fourteen years or for life pursuant to a non-qualified deferred compensation plan sponsored by the firm.'" Mr. McDermott reported all of the retirement payments to his state of residence, Connecticut, and paid income tax thereon.

When Mr. McDermott was issued the profit shares under the retirement provisions of the Partnership Agreement, the amount of the profits to be realized in future years could not be known and would necessarily vary over the 16 year payout period. Between 1998 and 2003, the value of each profit share varied between $9,874 and $11,364.

The New York State Division of Taxation issued a Notice of Deficiency

to Mr. McDermott, claiming that the partnership distribution is considered New York source income. The Tax Division stated "Your interest in the partnership Coudert Brothers was not completely liquidated prior to you [sic] retiring. Since you maintained an interest in this partnership the income you received is not considered retirement income."

In his opinion, the ALJ began by noting that, under the Tax Law, the payments to Mr. McDermott were subject to tax by New York. As a nonresident of the state, he would be taxable on income "derived from or connected with New York sources…."[4] New York source income includes income "attributable to a business, trade, profession or occupation carried on in New York State.[5] The ALJ noted that Mr. McDermott conceded that the income qualifies as New York source income. He argued, however, that New York is precluded from imposing an income tax on such payments as they constitute retirement income within the meaning and intent of section 114 of Title 4 of the United States Code.[6]

The ALJ noted that Section 114 contains two conditions to the prohibition of state taxation of nonresident retirement income. The first condition is that the retirement plan be one described in Internal Revenue Code section 3121(v)(2)(C).[7] The ALJ relied on the regulations under this section stating that the "plan, program or arrangement must provide for the deferral of compensation…and that the material terms of the plan must be in writing, i.e., the method or formula for determining the amount of deferred compensation and the time when it will be distributed."[8] The ALJ further noted that a plan provides for the deferral of compensation "only if there is a legally binding right to the compensation during a calendar year and that under the terms of the plan, such compensation is payable in a later year." As such, the amount of compensation may not be "unilaterally reduced or eliminated after the services creating the right to compensation have been performed." However, "compensation is not considered subject to elimination or reduction merely because it may be reduced or eliminated by the objective terms of the plan such as…investment losses or decreases in compensation."[9]

The ALJ reviewed the relevant provisions of Article 8(D) of the Partnership Agreement and concluded both that the payments were compensatory in nature and that the material elements of the plan were set forth in the Agreement which provided a formula for determining the amount of deferred compensation and the period of time during which it will be paid. Finally, it again noted that Coudert Brothers could not, unilaterally, reduce or eliminate the rights of the retired partners.

The second condition of Section 114 is that the retirement income be part of a series of substantially equal periodic payments made for a period of not less than 10 years.[10] After noting that Section 114 does not define the phrase "substantially equal periodic payments", the ALJ noted Internal Revenue Code section 402(c), relating to rollovers from qualified defined contribution plans, contains the same requirement.[11] Relying on the regulations under that section,[12] the ALJ noted that the requirement of "substantially equal periodic payments" would be satisfied by a "Declining Balance of Years" methodology of amortization. That methodology provides for payments to the retiree equal to an amount computed by dividing (i) the total amount to be paid under the plan by (ii) the remaining number of years under which payments are to be made. Thus, if a plan had a 10 year payout, in year 1 the plan would pay out 1/10 of the amount in the plan, in year 2 the plan would pay out 1/9 of the remaining assets in the plan, and so forth until year ten when the remaining balance of the plan would be paid out. This methodology "allows the amortization of the retirement obligation over the specified payout period, in a uniform manner, while accounting, automatically, for differing annual profits and losses that will affect the payment of the obligation." The Tax Division had previously issued an advisory opinion, TSB-A-96(7)I, accepting that the "Declining Balance of Years" methodology of amortization satisfied the requirements of Section 114 in the context of a deferred compensation arrangement.

Under the Coudert Brothers plan, the value of the profit sharing obligation rises and falls annually, based on the firm's performance. The ALJ concluded that "Although the amount paid to petitioner each year will be different, the method employed to determine that amount is consistent throughout the period of the retirement payments…. The ALJ concluded that the payments constitute retirement income from a plan described in Code section 3121(v)(2)(C) and are part of a series of substantially equal periodic payments made for a period not less than 10 years.

The Tax Division's main argument was that the distribution of a share of partnership income to a partner who still maintains a capital account with the firm cannot be characterized as retirement income. In the same vein, the Division argued that Section 114 did not apply to the taxpayer because he was a partner, not an employee of the firm. Finally, the Division argued that the Coudert Brothers plan did not satisfy the "substantial equal periodic payments" requirement since the payments fluctuated with the profits of the firm.

The ALJ noted that whether someone is a partner is a question of fact[13] and that sharing of profits, while a factor, is not determinative "since such an arrangement may be merely the method to accomplish some other purpose, such as the payment of retirement benefits."[14] The ALJ relied on the Coudert Brothers partnership agreement which provided that a retiring partner was to withdraw from the partnership and concluded that Mr. McDermott was no longer a partner of the firm. The ALJ then dismissed the Tax Division's argument on the fluctuating payments relying on the Treasury regulations and the Technical Services Bureau Advisory Opinion described above concerning the Declining Balance of Years methodology.

If this case is upheld by the Tax Appeals Tribunal, there could be a significant impact on retirement plans of law and accounting firms in New York. Although it was not clear that retirement payments to former partners were intended to be covered by Section 114, the Tax Division has so far been unable to

demonstrate an adequate reason to exclude them from coverage.[15] It is not clear that the payment structure of the Coudert Brothers plan is commonly employed. Nevertheless, the case does set forth criteria that could be copied by other firms without too much difficulty by providing for a 10 year pay-out and requiring complete withdrawal from the partnership. Moreover, plans can be amended in many cases to conform more explicitly to the "substantial equal periodic payments" requirement if the provisions of the Coudert Brothers plan are rejected on those grounds.

One bit of irony arising from this case is that Coudert Brothers is in the process of dissolving. We are unaware what, if anything, will happen with respect to the firm's obligations to its retired partners or whether Mr. McDermott, himself, will receive the full required pay out.

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1 Division of Tax Appeals (ALJ Determination February 2, 2006)

2 *Stuckless*, New York State Tax Appeals Tribunal, DTA No. 819319 (May 12, 2005). We understand that the Department has requested that the Tax Appeals Tribunal reconsider its decision in *Stuckless* but that no decision on the request has yet been made.

3 Taxpayer handled this appeal *pro se*. Practitioners will note that a sizable number of taxpayer victories have resulted from *pro se* appeals by tax attorneys. *See, e.g. McNulty v. State Tax Commission*, 70 NY2d 788 (1987); *Haskell Edelstein*, (Tax Appeals Tribunal February 8, 1990). In contrast, tax professors have been less successful. *See, e.g., Zelinsky v. Tax Appeals Tribunal*, 1 N.Y. 3rd 85 (2003).

4 Tax Law section 631(a)(1).

5 Tax Law section 631(b)(1)(B).

6 4 U.S. Code section 114. The relevant provisions of this section are as follows:
(a) No state may impose an income tax on any retirement income of an individual who is not a resident or domiciliary of such State (as determined under the laws of such State).
(b) For purposes of this section -
(1) The term "retirement income" means any income from -

* * *

(I) any plan, program, or arrangement described in section 3121(v)(2)(C) of such Code, if such income-
(i) is part of a series of substantially equal periodic payments (not less frequently than annually) made for -
(I) the life or life expectancy of the recipient (or the joint lives or joint life expectancies of the recipient and the designated beneficiary of the recipient), or
(II) a period of not less than 10 years….

7 4 U.S. Code section 114(b)(1)(I).

8 Treas. Reg. section 31.3121(v)(2)-1(b).

9 Treas. Reg. section 31.3121(v)(2)-1(b)(3).

10 4 U.S. Code section 114(b)(1)(I)(i).

11 IRC section 402(c)(4).

12 Treas. Reg. section 1.402(c)-2, Q&A 5 (d) (1).

13 Citing, *Brodsky v. Stadlen*, 138 AD2d 662 (2d Dept. 1988).

14 Citing, *inter alia*, *Martin v. Payton*, 246 NY 213 (1927), *Matter of Steinbeck v. Gerosa* 4 NY2d 302, appeal dismissed 358 US 39 (1928).

15 Apparently in response to the Tax Division's position in this case, Representative Chris Cannon (R-Utah) introduced H.R.4019 on October 7, 2005 to amend Section 114 explicitly to cover retirement payments to nonresident partners.

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