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"Ladas and Parry," "Fried, Frank" Cases Impact City Law Firms

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This month's column is unusual in that it addresses two New York City Tax Appeals Tribunal decisions that directly impacts on New York City law firms. In *Ladas and Parry*, TAT (E) 98-19 (UB) (January 2, 2003), the Tribunal upheld the Administrative Law Judge's determination that its so-called "Special Partners" were not partners for purposes of the New York City Unincorporated Business Tax ("UBT") and, thus, payments made by the firm to them were fully deductible in computing the firm's UBT. In *Fried, Frank, Harris, Shriver & Jacobson*, TAT (E) 97-16 (CR) (January 23, 2003)[1], the Tribunal ruled that "base rent" for purposes of the New York City Commercial Rent and Occupancy Tax ("CRT") does not include a net rent rebate received by the firm attributable to prior years' real estate taxes which were refunded by the City to its landlord.

Special Agreements

Ladas and Parry had 17 partners who were signatories to its written partnership agreement. Prior to the years 1992 and 1993 (the "Tax Years"), the firm had separate agreements with two of its attorneys, Bryer and Simensky, who did not sign the partnership agreement. They are referred to in the decision as "Special Partners" and the agreements between them and the firm are referred to as the Special Partner Agreements. The Agreements set forth the terms governing the relationship between the Special Partners and the firm. The agreements provide that the Special Partner "shall devote his full professional energies and time to the conduct and furtherance of the business and interests of the Partnership [and] acknowledges that … he stands in a fiduciary relationship to the Partnership and owes to the Partnership the duties of a fiduciary (including, inter alia, those arising under Sections 42 and 43 of the Partnership Law of the State of New York)." The Special Partner Agreements provided that the Special Partners would be listed as members of the firm on the firm's letterhead and generally in professional listing. Consequently the firm's letterhead and Martindale-Hubbell Law Directory listing included Bryer and Simensky as members.

The Partnership Agreement of Ladas & Parry provided rules governing the admission of partners to the partnership, including execution of a new Partnership Agreement. Bryer and Simensky did not sign the firm's Partnership Agreement. Under the Partnership Agreement each General Partner was eligible to sit on the management committee, attend and vote at partnership meetings. The Special Partners were generally permitted to attend partnership meetings but could not vote nor serve on the management committee.

The Special Partners compensation was largely contingent on the profits of the firm. However, they were entitled to "minimum compensation" equal to the sum of their monthly draws for the year. General Partners had no such minimum. Although each Special Partner Agreement provided that "the Special Partner shall … bear responsibility for a share of the obligations of the Partnership…" no description was given as to how this responsibility would be computed or enforced. Each Special Partner Agreement provided that the General Partners waive any claim they might have against the Special Partner for contribution to cover partnership losses and that the General Partners would indemnify the Special Partner for any personal liability other than from the Special Partner's own professional misconduct. The Special Partners, unlike the General Partners, made no capital contributions, had no interest in the firm's assets and waived any rights to an accounting or to inspect or audit the firm's books and records.

Each General Partner received an IRS Schedule K-1, Partner's Share of Income, Credits, Deductions, etc. that was attached to the partnership's Form 1065, U.S. Partnership Return of Income, reflecting his share of the firm's profits and losses. In contrast, the firm consistently treated the Special Partners as employees for all federal, state, and local tax purposes, issuing to them Forms W-2. The firm treated their compensation as wages on its partnership tax return, withholding income tax, FICA and FUTA payments.

The tax returns of Bryer demonstrate that he consistently treated himself as an employee for tax purposes. He did not take deductions available for payments for health insurance provided to partners and did not pay self-employment tax. Simensky's tax returns were not in evidence.

Four other Ladas & Parry attorneys (referred to as "Senior Associates") had employment contracts with the firm. In many ways their rights were similar to that of the Special Partners. They were ineligible to sit on the management committee or to inspect the books and records of the partnership. They had no capital or interest in the assets of the Partnership. Like the Special Partners, the Senior Associates received compensation that was computed by reference to the income of the firm and had a monthly draw that represented their minimum compensation for the year. The health insurance of Senior Associates and Special Partners was also handled using the same criteria.

Three Differences

The Tribunal noted three differences (other than percentages and dollar amounts) between the calculation of the Special Partners "share of the profits of the Partnership" and the calculation of the Senior Associates' "salary based on the gross professional income of the Partnership". The compensation to the Special Partners could be reduced if the firm's profits decline (but not below the minimum amount), the Senior Associates' salaries would not decline. The Special Partners monthly draw was less than their minimum compensation, the Senior Associates drew their minimum salaries. The computation of the additional income if profits were higher was also slightly different. The City did not assert that the Senior Associates were partners of Petitioner.

UBT Returns

Ladas and Parry filed UBT returns, Forms NYC 204, for each tax year and on its returns deducted as salaries the payments made to the Special Partners (as well as to the Senior Associates and all other employees). The City Finance Department issued a Notice of Determination against the firm disallowing the deduction for salaries of the amounts paid to the Special Partners.

The firm asserted that, under the UBT rules, federal income tax principles determine whether the Special Partners were partners. The City responded by arguing that federal tax law principles were not controlling and that, in any event, the Special Partners should be considered partners for federal income tax purposes. According to the Tribunal, "[T]he essence of [the City's] argument is that the Tribunal and the New York courts have consistently held that, where a partnership has designated an individual as a partner, the partnership and the individual are bound by the form which they have voluntarily chosen notwithstanding any functional limitations placed on that partner." The firm responded that, rather than contradicting its form, its position was consistent with the partnership's governing documents.

The Tribunal affirmed the ALJ's conclusion that Bryer and Simensky were not partners within the meaning of Code section 11-507(3). The Tribunal began by noting that the term "partner" is not defined in the Code or the City UBT Rules (19 RCNY section 28-06(d)(1)(i). The Tribunal concluded that federal income tax rules should govern citing Code section 11-501(a)(1) which provides that "[u]nless a different meaning is clearly required, any term … shall have the same meaning as when used in a comparable context in [the federal income tax laws]." The Tribunal concluded, however, that the federal tax definition ("the term 'partner' includes a member in [a partnership]") does not provide significant assistance in resolving the issue. The Tribunal then looked to the New York Partnership Law for guidance, noting, however, that the Partnership Law also does not contain a definition of the term "partner". The Tribunal notes that section 11 of the Partnership Law provides that the receipt of a share of the profits of a business is prima facie evidence that the recipient is a partner but that no such inference shall be drawn if the profits are received as payment of wages as an employee. The Tribunal also noted that under Partnership Law, section 27, someone who represents himself as a partner may be liable to a third party who has relied upon such representation (e.g. a creditor) but notes that the section of the Partnership Law states "*he is liable as though he were an actual member of the partnership*." (Emphasis added by Tribunal) and concludes that such a person does not thereby acquire all of the rights and responsibilities of a partner.

Johnson & Higgins

The Tribunal noted that the issue in this case was similar to that faced by the Tribunal in *Johnson & Higgins*, TAT (E) 93-21 (GC) (October 12, 1994) in which the Tribunal dealt with individuals who, for business reasons, held the title of officers but had little official responsibilities. The Tribunal in that case held that they were officers for purposes of the add-back under the "income-plus-compensation method" of computing the General Corporation Tax. The Tribunal agreed, however, with the ALJ who noted that, under the New York Business Corporation Law, any person who is elected or appointed as an officer by the board of directors is an officer. Similar rules do not apply under the Partnership Law.

The Tribunal concluded that the test of whether someone is or is not a partner depends upon the intent of the parties as it may be inferred from the facts. The Tribunal noted that the ALJ had culled 16 factors from the several New York tax cases addressing the issue.

The factors listed are:

> whether the purported partner: (1) held himself out as a partner to clients and to the courts; (2) signed the partnership agreement or otherwise consented to its terms; (3) was required to contribute to the partnership's capital; (4) had an interest in partnership assets; (5) participated in partnership decisions as to management; (6) was entitled to periodic financial statements show-

> ing information about the partnership's financial condition; (7) was entitled to a share of the profits; (8) was liable for partnership losses; (9) reported the compensation from the partnership as partnership income; and (10) claimed a deduction for a contribution to a Keogh plan. Also relevant is whether the partnership: (1) withheld income taxes or FICA from the purported partner's compensation; (2) issued IRS Form W-2 rather than Form K-1 to the purported partner; (3) paid the employer's share of FICA and other employment taxes with respect to the compensation paid to the purported partner; (4) deducted the compensation paid to the purported partner as employee wages; (5) represented to a government agency that the individual was a partner; and (6) listed the individual as a partner on its letterhead or in its listing in an industry directory such as the Martindale-Hubbell Law Directory. (Citations omitted).

After noting that this approach requires a case-by-case analysis and that the facts in this case indicate that Bryer and Simensky possessed some of the characteristics of a partner, the Tribunal focused on the similarity in the treatment of compensation between the Special Partners and the Senior Associates. The Tribunal decided that the policy of Code section 11-507(3) was to limit deductions paid to the proprietors of a business and concluded that Bryer and Simensky were not "co-proprietors" in the business.

With the proliferation of "Counsel" and "Non-equity Partner" arrangement in a myriad of forms, the impact of *Ladas and Parry* is likely to be substantial. All firms with different categories of partners should consider whether payments to less than full equity partners may be deductible for UBT purposes.

Real Estate Taxes

In the *Fried Frank* case, the firm's real estate lease contained a common provision under which the tenant was entitled to a rebate of a portion of real estate taxes paid by its landlord (since real estate taxes are generally a basis for computing rent either on the initial lease signing or as part of the cost escalations.) Fried Frank received a rebate in its 1993 fiscal year attributable to taxes paid by its landlord for the years 1984 through 1992. In filing its Commercial Rent Tax return for its 1993 fiscal year, it reported as its "base rent" on which CRT is computed the net amount payable by the firm to its landlord after application of the rent rebate. Since the firm had previously made quarterly payments on its gross rent before the rebate was received, it determined that it overpaid its CRT for the year and requested a refund.

The City denied the refund and assessed a deficiency on the ground that the rebate could not be used to reduce the 1993 CRT liability. Rather, any rebate must be applied retroactively to the years in which the real estate taxes were paid and refund claims must be filed for such years. Not coincidently, the CRT has an 18-month statute of limitations for refunds under Code section 11-709, and, consequently, virtually none of the rebate would be eligible for such a claim. Fried Frank argued that since real estate tax refund proceedings generally take year's to resolve, the City's position deprived it of due process. The ALJ upheld the City's position and responded to Fried Frank's due process argument by noting that the firm could have filed a Protective Refund Claim.

Upon appeal, the Tribunal reversed the ALJ and held that the rebate did reduce base rent for CRT purposes. The Tribunal largely deferred to the rent rebate provision of Fried Frank's lease agreement for guidance, an approach that the Tribunal apparently found justified because the "provision of the Lease [did] not appear … to have been crafted with any tax reduction purpose in mind."

Rent Rebate

The lease provision provided for any rent rebate to be registered as a "credit" against Fried Frank's rent due in the rent period following the time of receipt. Fried Frank and the ALJ had previously differed over the meaning of "credit" for purposes of determining "rent". The ALJ argued that it had the same meaning as used in Code §11-701.6 that defines "rent," to include "all credits". The ALJ reasoned that in stating that the landlord shall "credit" the tenant with its share of the real estate tax refund, the tenant was purchasing rent with the credit and was subject to CRT on that amount. The Tribunal, however, invoking arguments raised in the *Amicus*, sided with Fried Frank to the contrary, reasoning that the meaning of "credit" contemplated in the lease agreement differed materially from that contemplated in the Code definition of "rent". The Code usage implied a transfer of value from the credit grantee (Fried Frank) to the credit grantor (landlord), whereas the lease usage implied a transfer of value in the opposite direction, e.g. as reimbursement for excessive past transfers of value to the credit grantor.

Conclusion

In relying so heavily on the terms of the lease, law firms should be cautioned to review their lease terms to insure that the rent rebate terms are consistent with the provisions used in this case.

[1] This firm submitted a brief in this case, as *Amicus Curiae*, on behalf of the Real Estate Board of New York, Inc.