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Unincorporated Business Tax and Bank Tax Developments

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The New York City Tax Appeals Tribunal, as it is currently structured, came into being on October 1, 1992. Since that date the Tribunal sitting *en banc* in review of Determinations made by Administrative Law Judges had never been reversed by the Appellate Division, that streak ended on March 12, 2002, when the First Department issued a decision in granting a refund of Unincorporated Business Tax to a taxpayer.

In another case with significant impact on the City's business taxes, the Chief Administrative Law Judge issued a Determination relating to the City's tax on banking corporations that involved formulary apportionment a Statement of Audit Procedure issued by the Audit Division of the City's Department of Finance and the discretionary authority of the Commissioner of Finance to vary from the statutory apportionment formula.

UBT—Payments to Partners

The UBT case, *Matter of Buchbinder Tunick & Company v. Tax Appeals Tribunal of the City of New York*,[1] the taxpayer was granted a refund of UBT based upon a finding that certain payments made to retired partners were not payments for use of capital or services and were therefore deductible under the UBT. The case involved payments made to retired partners of a public accounting firm. The retired partners, in liquidation of their partnership interests and in addition to receiving an amount equal to the cash balances of their capital accounts, also received installment payments. The parties stipulated that the payments "constitute the Retired Partner's pro rata share of Petitioner's unrealized receivables for services rendered by Petitioner [the CPA firm] to its clients." Subsequent to their retirement, the retired partners performed no services and loaned no funds to the firm. The taxpayer argued that it was irrelevant whether the unrealized receivables were generated by the retired partners or by others since the payments were made in exchange for an intangible, i.e., the retired partners' partnership interests. The taxpayer also argued that fixed payments made over a period of years without regard to partnership income are treated as guaranteed payments under Internal Revenue Code Search7RH736(a) and 707(c) but were not actually for services or use of capital.

The City denied the deductions stating that payments to partners in liquidation of their partnership interests were not allowable deductions for UBT purposes pursuant to Administrative Code Search7RH11-507(3) as amounts paid for services rendered by the retired partners. The City also argued that services rendered by the retired partners are the "underlying substance" of the payments in liquidation of the partnership interests and can not be deducted under the UBT.

Both the taxpayer and the City invoked the Court of Appeals case of *Matter of New York Yankees Partnership,*[2] in support of their positions. In *Yankees,* the Court of Appeals held that characterizations under the same provision of the Internal Revenue Code, section 736(a), should not be blindly followed in applying the UBT. The Court of Appeals held that payments to retiring partners were directed by section 736(a) to "be considered . . . as a guaranteed payment described in section 707(c)." Section 707(c) deals with payments to a partner "for services or the use of capital." The Court of Appeals stated, "[t]hat Internal Revenue Code Search7RH707(c) gives guaranteed payments the same tax treatment as payments for services or use of capital does not mean that the guaranteed payments attributable to amortized player contracts at issue here are in fact payments for services or the use of capital" for purposes of the UBT, which disallows a deduction to the partnership for such payments. The Court noted that the Federal provisions were intended to prevent taxpayers from benefitting from differences in tax rates between ordinary income and capital gains.

The City Tax Appeals Tribunal had affirmed the ALJ finding that the payments were for partner services. In reversing, the Appellate Division found that the payments were not for services performed by the retired partners. They based that finding on the fact that "[e]ven if the retiring partner had performed no services for the partnership in the year preceding retirement, a payment would still have been made." The Appellate Division concluded, citing the *Yankees* case, that the retiring partner's payment "was not based on her or his services but on a pro rata share. The language of the applicable tax provisions are clear and unambiguous" and the taxpayer was entitled to the deduction.

The City is expected to move for leave to appeal to the Court of Appeals. If upheld on appeal, this case would require a close examination of the nature of payments made to partners. The City had taken the position that almost every payment to a partner or a retired partner is disallowed as being for services or use of capital. Following *Buchbinder,* the inquiry into what the payments are actually for must be considered.

Bank Tax—Discretionary Authority

New York State and City corporate taxes provide statutory formulae for apportioning income. These provisions are subject to the exercise of discretion to vary from the statutory formula in the event the formula does not properly reflect the activities of the taxpayer. The New York City Banking Corporation Tax[3] ("Bank Tax") as well as its New York State counterpart, provide a benefit for international banking activities by excluding from state and local tax income from an International Banking Facility ("IBF"). This special treatment permits banks that establish an IBF to reduce State and City tax by treating qualifying transactions (generally those between the IBF and foreign, i.e., non-US persons) as if the transaction occurred in a foreign office of the bank.[4] Banks are then permitted to deduct the "adjusted eligible net income" from their entire net income subject to City and State tax.

Taxpayers are given the choice of calculating the IBF benefit by using a separate accounting methodology[5] or using formula allocation method employing a three-factor formula consisting of deposits, payroll and receipts.[6]

The *Matter of Park Avenue Bank, N.A.,*[7] involved a taxpayer that elected to use the formula for determining its IBF benefit. Under the formula allocation method, the numerator of each of the apportionment factors is reduced by excluding the amount properly attributable to the IBF activity reducing the amount of those factors which otherwise would be allocable to the City.

The deposits factor of the formula specifically limits the IBF benefit to deposits from foreign sources. During the audit period, between 81.4% to 98.9% of the taxpayer's deposits were from domestic sources (which reduced the IBF benefit it could claim). The deposits factor was not adjusted by the City. The formula also limits the receipts factor of the formula to receipts from foreign sources (i.e., interest on loans to foreign persons). The payroll factor was computed using gross income ratios applied to the wages paid by the taxpayer.

On audit of the taxpayer's return, the City adjusted the receipts factor claiming that since the source of the funds for the loans made by the taxpayer were domestic, the receipts factor as reported (and the payroll factor as well since it was determined by use of a gross income ratio) were not properly foreign activity of the taxpayer. The City relied upon the above-mentioned SAP setting forth guidelines to auditors that if less than 20% of an IBF's receipts were domestically funded there would be a reduction in the IBF benefit. The City also claimed that the general discretionary authority to reach a "fair and proper allocation of income"[8] to the City permitted the adjustment. In support of its position, the current Deputy Commissioner of the City's Department of Finance, a respected authority on the Bank Tax who was integrally involved in the negotiations leading to the Bank Tax amendments of 1985, testified that permitting substantial domestic funding of foreign receipts would be a "significant" and "unanticipated" change in the IBF benefit.

The taxpayer's basic claim was that the concept of an adjustment for domestic funding was set forth in the statute for determining the deposits factor but not found with respect to the receipts factor. If the Legislature had intended to apply a limitation in the receipts factor for a source of the funds for the loans, it would have so provided. This, in fact, was the position of the State Tax Department which had examined the taxpayer's returns for the years in issue and did not make a comparable adjustment to the IBF benefit.[9]

The Chief ALJ determined that the adjustment proposed by the City was not permitted under the Bank Tax. First, he relied upon the plain meaning of the statute which sets forth how the receipts factor under the formula method to compute the IBF benefit is to be applied, without regard to domestically funded foreign receipts. Second, he decided that discretionary authority "supplements rather than supplants statutory language, it is not a substitute for amending a statute to provide an omitted rule of a general nature that could easily and practically been laid down in the statute." Third, the foregoing was especially true when the Legislature had expressed the concept of limiting the IBF benefit for domestic funding in other areas (including the deposits factor).

This case has broader significance well beyond the rather specific area of IBF's. Taxpayers are frequently faced with auditors claiming that the Commissioner's discretionary authority is applicable to a wide range of issues and that such discretion is almost limitless. Certainly, this case has unique overtones including the fact that the City had taken a position contrary to the State under laws that instructed both tax agencies "to use their best efforts . . . to take such steps as are appropriate to ensure that identical regulations and statutes are applied and interpreted uniformly and consistently."[10] In any event, claiming that discretion can read a limitation into a provision where it does not exist and is clearly set forth elsewhere, may not be supportable by the tax authority. It is expected that the City will file an exception and have the matter heard by the appellate level of the Tax Appeals Tribunal.

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[1] The Decision of the City Tax Appeals Tribunal was issued on June 14, 2000.
[2] 83 N.Y.2d 550 (1994).
[3] Administrative Code of the City of New York Title 11, Chapter 6, Subchapter 3, Part 4.
[4] Statement of Audit Procedure 99-2-BTX issued June 7, 1999 ("SAP").
[5] Administrative Code Search7RH11-641(f).
[6] Administrative Code Search7RH11-642(b)(2)(A).
[7] NYC Tax Appeals Tribunal Administrative Law Judge Division, decided January 7, 2002.
[8] Administrative Code Search7RH11-642(a)(6).
[9] An e-mail from a State Tax Department official, universally held in very high regard and deeply involved in the adoption of the Bank Tax amendments in 1985, was introduced into evidence stating the State's position on the matter.
[10] *See*, New York Laws of 1985, Chapter 298, Section 47.