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Income of Law Partner from Real Estate Partnerships

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Two recent decisions (that happen to involve partners in New York law firms) are significant for those taxpayers receiving income from partnerships doing business in New York. One decision, issued by the New York State Tax Appeals Tribunal,[1] relates to the taxation of income received by a partner in a New York law firm from other partnerships with real estate located outside New York. The other determination, issued by a State Administrative Law Judge,[2] involves part year New York residents and how income from a partnership is allocated to the resident and nonresident periods.

Another matter,[3] involving the ever-troubling issue of day counts for statutory residency cases, highlights the perils of taxpayers who have a place of abode in New York and must keep track of even the slightest time spent in New York. And, finally, in what many hope will be one of the last cases litigated on the issue of what constitutes a regular place of business to permit allocation of income within and without New York City under the City's business taxes, the New York City Tax Appeals Tribunal found insufficient proof to establish the existence of an office outside the City.[4]

Income from Partnerships

Generally, residents are subject to New York personal income tax on all income; nonresidents are subject to New York tax only on income derived from or connected with New York sources. Tax Law Search7RH631(a). Income derived from or connected with New York sources includes income attributable to the ownership of any interest in real or tangible personal property in New York and income attributable to a business trade, profession or occupation carried on in New York. Tax Law Search7RH631(b)(1)(A) and (B).

In the *Domber* case, a law partnership's reflection of income from partnership interests in real estate ventures in Pennsylvania and West Virginia cost the taxpayers additional New York State and City income taxes that they would not have paid had those real estate partnerships been held individually.

For the tax years in issue (1989 and 1990) Domber & Ward was a partnership engaged in the practice of law with its sole office in New York City. Mr. Domber, a general partner in the firm along with Mr. Ward, reported his income to New York based upon his distributive share of the partnership's income relating only to legal services performed by the firm. In addition to that income, Mr. Domber also received distributions from the firm representing fee income from real estate partnerships, net income from rental activities, portfolio interest and dividends, and net long-term capital gains and other gains from real estate partnerships. These distributions were excluded from Mr. Domber's New York nonresident personal income tax returns. In a case dealing with prior years, the State had successfully claimed that the real estate partnership interests were held by the law firm.[5]

The taxpayers' reason for excluding these distributions was that the partnerships from which the income was received were real estate ventures that developed low and moderate income housing projects located in Pennsylvania and West Virginia under a program administered by the U.S. Department of Housing and Urban Development ("HUD"). The fee income was claimed to be for work done in Pennsylvania and West Virginia and therefore not New York source income. Mr. Ward received the distributions from these partnerships which were deposited into the law firm's operating account. It was alleged that Mr. Ward received such distributions for himself and as trustee for Mr. Domber because Mrs. Domber "was an employee of HUD which, coupled with her marriage to Mr. Domber presented conflict of interest circumstances preventing Mr. Domber from holding direct ownership in any HUD affiliated projects." There were no documents presented in evidence to substantiate the trust agreement.

In support of the position taken on their New York tax return, the taxpayers argued that Messrs. Domber and Ward individually owned the partnership interests and that the distributions were passed through the law firm merely for convenience since the law firm's bank account was the only account held in common by them.

The Administrative Law Judge had held that tax was due on the fees since that income was related to the law firm's activities and the only office of the firm was in New York. The ALJ also held that Mr. Domber had acquired the partnership interests as a partner in the law firm but agreed with the taxpayers that the long-term gain and other income from the real estate ventures located outside New York was non-New York source income and not taxable by New York. In large part, the ALJ followed the reasoning of the Appellate Division in the case involving the prior years.

Deciding Factor Unclear

However, the Tribunal reversed that portion of the ALJ's decision that permitted the exclusion of the long-term capital gain and other real estate income, holding that the taxpayers had failed to show that the partnership interests were not employed in a business, trade or occupation carried on in New York. It is not clear whether the Tribunal was swayed by the form of the transaction, in that the law firm held the partnership interests as a part of its trade or business, or whether the fact that Mr. Domber was precluded from owning the partnership interests in his individual capacity was the deciding factor.

In *Greig*, a different issue arose regarding the reporting of income from a partnership. Mr. Greig, a partner in Cleary, Gottlieb, Steen & Hamilton, took assignments at overseas offices of the firm and moved back to New York on July 4, 1992. On his 1992 New York personal income tax return, the taxpayer pro rated his distributive share of partnership income treating 51% as attributable to his period of nonresidence and 49% attributable to his period of residence in New York. He then apportioned the distributive share for his nonresident period according to the allocation determined on the partnership's 1992 tax return. (Using the partnership's allocation of income to New York is the proper way for a nonresident partner to determine his New York source income.)

The State asserted a tax deficiency based upon a regulation[6] that provides that the distributive share of partnership income to be included in New York source income for a part year resident depends upon the taxpayer's residency status during the period the partnership's tax period ends. In this case, since the taxpayer moved into New York before the December 31st tax year end of his partnership, the State contended that the entire amount of the partnership distribution was attributable to his period of residency.

The ALJ reviewed Federal income tax principles applicable to partnership distributions and prior cases involving part year New York residents[7] and found that proration of partnership income over the tax year is the appropriate way to determine New York income tax due for part year residents. The ALJ invalidated the Regulation at issue and held for the taxpayer.

This is one situation where the revenue implications are not paramount. It is impossible to forecast whether pro rating partnership income or taking the approach in the regulations (looking to the partnership's year end and the resident status at that time) would yield more revenue. Rather, the Tax Department needs to have a rule in place so it is not whipsawed by taxpayers taking one position or another depending upon the tax savings that may be achieved. The State has filed an exception to the ALJ determination, so there is more to come on this topic.

Residency Day Counts

When does having fewer than twenty meals in New York cost more than $1 million? (Hint: The answer does not depend on whether wine is included with the meal.) The answer is, when counting days spent in New York for the purposes of statutory residency.

One of the most contentious issues in audits and litigation of residency cases is the definition and documentation of days spent in New York. If one is not domiciled in New York, the imposition of New York's resident income tax is based upon maintaining a permanent place of abode and spending in the aggregate more than 183 days in New York. Tax Law Search7RH605(b)(1)(B). The regulations state that any part of a day spent in New York counts in the context of determining residency status.[8] That regulation was upheld by the Appellate Division, Third Department in *Matter of Leach v. Chu*, 150 AD2d 842 a case involving a Connecticut domiciliary, who worked from 10 a.m. to 4 p.m. on his New York days. There are four acknowledged exceptions that permit exclusion of days in New York for; active military service;[9] solely for purposes of traveling to a destination outside New York;[10] days spent as an inpatient in a hospital[11] and; "inadvertent presence" such as stepping over the New York State line (see, District Office Audit Manual).

Almost five years ago in the *Matter of Leon Moed*, (ALJ determination issued 11/18/93), one issue was whether time a taxpayer spent shopping at a grocery located in New York four minutes from his Connecticut home counted as a day spent in New York under the statutory residency test. The ALJ in *Moed* stated that it was unreasonable to count as New York days those days in which the taxpayer's only time in New York was to shop in a supermarket across the border from the taxpayer's Connecticut residence. The ALJ reasoned that the time spent shopping had no connection with the taxpayer's place of abode in New York City and involved no business activity or social events.

The Division of Taxation took exception to that finding and many taxpayers and practitioners eagerly awaited the State Tribunal's pronouncement on that issue. However, the State Tribunal did not reach the issue of the short visits to New York in *Moed*,[12] instead basing its decision in favor of the taxpayer on the grounds that his use of a New York City apartment under the unique circumstances set forth in the case did not constitute Mr. Moed's maintenance of a permanent place of abode.

Now, *Matter of John and Patricia Klingenstein* (ALJ determination dated August 6, 1998), poses the question of whether coming into New York to shop or dine counts as a New York day for residency purposes. As in *Moed*, it was undisputed that the taxpayers were domiciled in their Connecticut home a few miles from the New York border. Their place of abode in New York was in Manhattan. The Division of Taxation asserted the taxpayers spent 203 days in New York in 1989 and 192 days in 1990 including their weekend and holiday visits to New York (3 shopping and 18 dining trips in 1989 and 8 shopping and 14 dining trips in 1990). These days were referred to by the ALJ as 'border days'.

The taxpayers argued for a "common sense" approach and sought to apply a "proximity test" excluding from the New York day count visits to New York for short periods of time (it was found that each of the border day trips was of short duration and that the taxpayers left from and returned to their Connecticut home) that were "proximately related to their non-New York domicile."

Commerce Clause

The taxpayers also argued that the day count for New York residency purposes was unconstitutional as applied to them. This argument was based on the Commerce Clause of the U.S. Constitution requirement that a taxpayer have nexus with the state and the tax is fairly related to the protections, opportunities and benefits afforded by the state. The taxpayers claimed that (at least as to the border days) there was insufficient nexus and no benefits were given by New York for which New York could reasonably assert resident tax liability.

The ALJ found the border day trips were unrelated to the taxpayers' business and were "not proximate to petitioners' New York City apartment." However, the ALJ went on to say that there was no precedent for excluding time spent in New York other than those previously noted (i.e., military service, transit through the state, inpatient hospital stays and stepping over the state border).

The ALJ recognized that while "the equities in this case are at first blush appealing, the need for consistency provided by an easily defined and applied rule outweigh the equities." The case dramatically highlights the problems inherent in a rigid rule that any part of a day spent in New York counts as a day for statutory residency purposes (part days may be used for allocation of income purposes).[13] There is no statutory requirement for the residency day count to be determined without regard to a part of a day. But, most tax practitioners advise clients that the Audit Division will claim every day in which a taxpayer cannot prove absence from the State for the entire day as a day spent in New York.

Regular Place of Business

From its inception in 1966 up through tax years beginning on or before June 30, 1996,[14] New York City's unincorporated business tax ("UBT") and general corporation tax ("GCT") laws required taxpayers to maintain a regular place of business outside the City in order to be permitted to allocate or apportion income within and without the City. The rules issued under the UBT and the cases decided under the UBT, GCT and the former New York State unincorporated business tax and franchise tax (that had a similar regular place of business requirement until 1987) set forth the factors to be looked to by the courts in deciding whether a taxpayer had a regular place of business outside the State or City.

These factors included whether the taxpayer held itself out a doing business at the location, filed income tax returns in the other location's jurisdiction, paid rent or utility bills, had a telephone listing or business cards or stationery for the location. In *Orner*, the taxpayer testified that he had an accounting office in Queens, attended law school for two and one half days per week and spent one or two days per week in New Rochelle. He was the sole shareholder and employee of a corporation that was the general partner in a limited partnership that owned property in New Rochelle, New York. The taxpayer claimed that he used whatever space in the building that was not rented to tenants. He offered no evidence (i.e., telephone listings, business cards, stationery) related to the audit period (1988 and 1989). The taxpayer stated he did not meet with clients in New Rochelle nor did he maintain contemporaneously prepared records that would indicate where he performed work for clients.

The taxpayer claimed he could allocate his income to his out-of-City office based upon his books and records and establish the frequency and systematic use of a regular place of business in New Rochelle by his testimony. Although the City Tribunal had held that a regular place of business may be established by credible testimony and does not require documentation,[15] in the case at hand, the ALJ had found the testimony "evasive, conclusory, inconsistent, and self-serving" and "did not find his testimony to be credible."

As previously emphasized in this space, the ALJ's findings on credibility are given great weight in State and City Tribunal decisions.[16] The City Tribunal upheld the ALJ determination and the tax deficiency based upon the taxpayer's failure to meet his burden of proof to show the existence of a regular place of business stating, "unsupported testimony and non-contemporaneous or non-specific exhibits did not rise to the level of requiring rebuttal by the City."

This case highlights, once more, the difficulties of proving facts eight or more years after the audit period. While we cannot know what, if any, documentation existed, the failure to introduce any documents from the audit period together made the taxpayer rely solely on his own testimony. It may be possible to meet a heavy burden of proof solely on testimony, but it is a very risky undertaking.

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1 *Matter of Matthew J. and Rachel A. Domber*, (NY State Tax Appeals Tribunal, decided August 11, 1998).
2 *Matter of Robert T. and Susan M. Grieg*, (NY State Division of Tax Appeals, decided July 30, 1998).
3 *Matter of John and Patricia Klingenstein*, (NY State Division of Tax Appeals, decided August 8, 1998).
4 *Matter of Felipe E. Orner*, (NY City Tax Appeals Tribunal, decided April 7, 1998).
5 *Matter of Domber v. Tax Appeals Tribunal*, 210 AD2d 529, lv denied 85 NY2d 810.
6 20 NYCRR 154.6(a)(3)(i)(a).
7 *Matter of McNulty v. NYS Tax Comm'n.*,70 NY 2d 788 (1987); *Matter of Wertheimer*, (NYS Tax Appeals Tribunal, decided January 12, 1995).
8 20 NYCRR 105.20(c).
9 Tax Law Search7RH605(b)(1)(B).
10 20 NYCRR 105.2(c).
11 *Stranahan v. New York State Tax Commn.*, 68 AD2d 250 (3rd Dept., 1979).
12 *Matter of Leon Moed*,(NY State Tax Appeals Tribunal decision dated January 26, 1995).
13 *Matter of Kenneth J. Cort*,(NYS Tax Appeals Tribunal decided 4/13/95).
14 Effective for tax years beginning after June 30, 1996, taxpayers are no longer required to maintain a regular place of business outside New York City in order to allocate or apportion income. Chapter 625 of the Laws of 1996.
15 See, *Matter of S&S X-Ray Products*, (NYC Tax Appeals Tribunal, decided December 29, 1995).
16 See generally, *Matter of Nina Spallona T/A Nina's Corner*, (NY State Tax Appeals Tribunal, decided February 27, 1992).