STATE OF NEW YORK

TAX APPEALS TRIBUNAL

In the Matter of the Petition of **WARREN H. JOHNSON** for Redetermination of a Deficiency or for Refund of New York State Personal Income Tax under Article 22 of the Tax Law for the Year 1984.	:	
In the Matter of the Petition of **AUBREY AND ELSIE R. FARISS** for Redetermination of a Deficiency or for Refund of New York State Personal Income Tax under Article 22 of the Tax Law for the Years 1982 through 1986.	:	DECISION DTA Nos. 808383, 810732 and 810733
In the Matter of the Petition of **ROBERT W. AND HARRIET A. REDLIN** for Redetermination of a Deficiency or for Refund of New York State Personal Income Tax under Article 22 of the Tax Law for the Years 1982 through 1985.	:	

The Division of Taxation and petitioners Warren H. Johnson, 157 Southcote Road, Riverside, Illinois 60546, Aubrey and Elsie Fariss, 3707 Olympia, Houston, Texas 77019 and Robert W. and Harriet A. Redlin, 83 Blairmoor Court, Grosse Pointe, Michigan 48236, filed an exception to the determination of the Administrative Law Judge issue on February 27, 1995. Petitioners appeared by E. Parker Brown, II, Esq. and Hancock & Estabrook (Gerald F. Stack, Esq., of counsel). The Division of Taxation appeared by Steven U. Teitelbaum, Esq. (Andrew J. Zalewski, Esq., of counsel).

Petitioners filed a brief in support of their exception and in opposition to the Division of Taxation's exception and also filed a replybrief. The Division of Taxation filed a brief in support of their exception and also filed a brief in opposition to petitioners' exception and in reply. Oral argument, requested by both parties, was heard on December 14, 1995 and began the six-month period for the issuance of this decision.

The Tax Appeals Tribunal renders the following decision per curiam.

ISSUES

I. Whether the retirement allowances made to petitioners constitute distributive shares of partnership income a portion of which had a source in New York, taxable under Tax Law former §§ 632(a) and 637(a)(1).

II. Whether such payments are income derived from a business, trade, profession or occupation carried on in New York under Tax Law former § 632(b)(1)(B).

III. Whether such payments, even if derived from New York sources, are not taxable in New York because they constitute an "annuity" within the meaning of 20 NYCRR 131.4(d) (renum 132.4[d]).

FINDINGS OF FACT

We find the facts as determined by the Administrative Law Judge. These facts are set forth below.

WARREN H. JOHNSON

Warren Johnson ("Johnson") resides at 157 Southcote Road, Riverside, Illinois. Johnson appeared and testified at this proceeding.

Johnson was born in Chicago in 1922. He attended school in Illinois and, after serving in the Navy during World War II, he attended the University of Chicago School of Business where, in 1948, he earned a Masters Degree in accounting. He joined the audit staff of Peat, Marwick, Mitchell & Co.'s ("PMM") Chicago office that same year. In 1958, Johnson was admitted as a partner in PMM's Chicago office. Johnson's specialty was Securities and

Exchange Commission matters, not tax accounting. At the time of Johnson's retirement the rights and obligations of the partners were governed by the Articles of Partnership of Peat, Marwick, Mitchell & Co. (United States) dated July 1, 1975, as amended October 4, 1978 (the "1975 Partnership Agreement") (Ex. "3").

The 1975 Partnership Agreement defined a partner as an individual who held an interest in the goodwill and the name of the firm and who shared in the profits and losses of the firm. The 1975 Partnership Agreement provided that a partner's interest in the partnership was represented by "units of interest" allotted to him/her by the partnership. The "units of interest" were the mechanism by which voting rights and the profits and losses of PMM were allocated. Pursuant to the 1975 Partnership Agreement a retiring partner was entitled to a "retirement allowance" explained in the firm's "Retirement Allowance Plan" (Ex. "3", Art. III, Sec 4).

Under the 1975 Partnership Agreement, a partner's units of interest entitled him/her to exercise certain rights including, but not limited to, the right to share in distributions of partnership income, the right to vote on management decisions, to vote on admission of new partners and appointments to the board of directors, and the right to inspect the books and records of PMM (hereinafter, collectively "partnership rights").[1]

Johnson testified that at the time immediately prior to his retirement, his interest in the partnership was represented by 1000 allocated "units of interest", his drawing account, his capital account, his interest in unrealized receivables ("IUR") account and his accelerated cost recovery system ("ACRS") account.

The capital account was an account established by PMM to keep track of a partner's capital contributions to the firm under the 1975 Partnership Agreement. This was fixed at $75.00 per unit.

The drawing account was the partner's banking account. Each partner's drawing account was credited yearly with the partner's share of the cash basis income of PMM. PMM would debit this account as a partner made withdrawals.

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[1]Redlin and Fariss also had these "partnership rights."

When PMM changed for tax purposes from an accrual basis of reporting income to the government to a cash basis, Johnson received an IUR account, which he describes as the partners' equity account in receivables that were unbilled or that had been billed, but were not yet collected. Put another way, the IUR account was designed to track a partner's share of the difference between PMM's income computed on an accrual basis and its income computed on a cash basis.

Johnson's ACRS account was intended to recognize the difference between an accelerated method of depreciation and a straight line method, and was designed so as not to understate a partner's interest in PMM (tr., p. 300). PMM began to keep track of this difference through the use of the ACRS account when the accelerated cost recovery system of depreciation was added to the Internal Revenue Code in 1981.

W. Michael Lynskey, Director of Retirement Benefits and Partner Services for PMM, testified for petitioners. Mr. Lynskey testified that PMM's operating procedures provided for the payment of interest on unrealized receivables and ACRS accounts to retired partners[2] in addition to the retirement allowance benefits received under the 1976 retirement allowance plan. Other than the settlement of their drawing and capital accounts, no other payments were permitted by PMM's operating procedures to retired partners.

In addition to being a partner in PMM, Johnson was also a partner in other partnerships known as the "Greenbriar" partnerships and "Copem 72". Greenbriar and Copem 72 were not formally connected to PMM, although only partners of PMM could be partners in Greenbriar and Copem 72. The Greenbriar and Copem 72 partnerships operated out of offices in Manhattan.

The distributive share of income or losses derived from a series of limited partnerships known as Copem 71, Copem 72, Copem Marts and Copem 73 ("the Copem partnerships") has already been litigated up through the Court of Appeals in Matter of Ausbrooks v. Chu (66 NY2d 281, 496 NYS2d 969 [1985]). The facts in that case apply equally to Mr. Johnson.

[2]For some periods PMM had different classes of partners. Some were CPAs and some were not. Whenever used in this decision, retired "partners" refers to retired partners who were certified public accountants.

Based on the Court's decision in Ausbrooks, amounts paid to Johnson by Copem 72 are not taxable in New York.

As noted earlier, at the time of Johnson's retirement in 1983, the partnership affairs of PMM were governed by the 1975 Partnership Agreement. PMM was also governed by the operating procedures of Peat, Marwick, Mitchell & Co. (United States) dated July 1, 1975, as amended October 26, 1977 ("the 1975 Operating Procedures") (Ex. "4").

Johnson retired from PMM on June 30, 1983 at the mandatory retirement age of 60, at which point he surrendered all remaining units representing his allocated interest in the partnership. The balances in Johnson's drawing account and capital account were fixed on the date of his retirement. The $3,000.00 balance in Johnson's capital account was transferred to his drawing account, but the combined balance, pursuant to PMM's 1975 Operating Procedures, was not paid to him until one year later, i.e., June 29, 1984.

Johnson views the amounts paid to him from the capital account, drawing account, ACRS and IUR accounts as repayment of a debt owed to him by PMM. Other than the payments from these accounts and the payments from PMM's retirement plan Johnson received no other payments from PMM during fiscal year 1984.

PMM's retirement plan actually consisted of two separate plans. PMM had the "PMM & Co. Pension Plan for Partners" ("the qualified pension plan"),[3] and the "Partners Retirement Allowance Plan", effective July 1, 1976 (variously referred to as "the 1976 Plan", the "unqualified retirement allowance" or "the unqualified plan"), as revised through May 15, 1982 (Ex. "5"). The benefit payments made under the qualified plan are not an issue in this proceeding. The focus of this determination is on the payments made under the unqualified

[3]A "qualified plan" refers to a plan qualified under the Internal Revenue Service ("IRS") rules and regulations subject to the employees Retirement Income Securities Act ("ERISA"), and the partnership receives a deduction when it makes a contribution to the plan. An "unqualified" plan is not subject to ERISA and is not qualified under the IRS rules and regulations.

plan.[4] The Partners Retirement Allowance Plan is included by reference in the 1975 Partnership Agreement. The 1975 Partnership Agreement and the Partners Retirement Allowance Plan governed Johnson's rights as a partner and his rights upon retirement.

The unqualified plan was established to work in tandem with the qualified pension plan to provide PMM's partners with what was considered a "suitable" retirement allowance (tr., p. 310). The pension rights that a partner accumulated under the qualified plan were offset or deducted from a partner's rights under the unqualified plan.

Mr. Lynskey administers PMM's qualified and unqualified pension plans. In his capacity as director, Mr. Lynskey is also involved with the out-processing of retiring partners. That includes counseling a retiree concerning his/her rights under the particular partnership agreement governing his retirement for the purposes of helping him/her understand their pension (and other) benefits. Mr. Lynskey explains to retiring partners the timing of the settlement of their accounts with the firm, their rights with regard to receiving their interest in unrealized receivables and the retirement benefits they are entitled to receive.

Mr. Lynskey testified that it is possible to compute and advise a partner, at the time of retirement, as to the amount of the retirement allowance benefit he will actually be paid, subject to cost of living adjustments. The 1976 retirement allowance plan allowed for cost of living adjustments ("COLA"), which were granted in the discretion of the Board of Directors. Cost of living adjustments, he said, are a typical, traditional, defined benefit plan mechanism for adjusting benefits. He testified further that it is not uncommon to have such adjustments in a pension plan left to the discretion of the board of directors. The record shows only one year when COLAs were not granted.

In 1983, the mandatory retirement age of partners at PMM was age 60. Johnson retired at age 60 on June 30, 1983, one month short of his 61st birthday. Lynskey testified that Johnson, at retirement, relinquished all of his units of interest in the partnership and gave up all of his partnership rights pursuant to PMM's operating procedures and the 1975 Partnership

[4]The "unqualified plan," as used infra, refers to the retirement allowances paid under both the 1960 Partnership Agreement and 1976 Retirement Allowance Plan.

Agreement.

Mr. Lynskey stated that after Johnson retired he provided no services to PMM, maintained no office at PMM, and no longer had access to PMM's secretarial staff. However, Lynskey said, Johnson was entitled to retirement benefits from PMM's qualified and unqualified plans upon his retirement. Under the unqualified plan of 1976, the amount of a partner's retirement allowance was based, Mr. Lynskey stated, upon a typical defined benefit formula which is a function of the partner's years of service with the firm and his final average salary over five years. Once the retirement allowance is calculated at the time of retirement, it is fixed and final except for possible increases due to cost of living adjustments.

The benefit that Johnson was entitled to under the "unqualified" Retirement Allowance Plan was determined in accordance with the following formula:

(i) 1.8% of a partner's retirement income base multiplied by the partner's years of service not in excess of 25 years; plus

(ii) 1% of a partner's retirement income base multiplied by years of service in excess of 25 years, but not in excess of 40 years.

A partner's retirement income base was defined as the partner's highest earnings in the five-year period preceding retirement, but limited to $40,000.00 plus 35% of his/her earnings in excess of $40,000.00. A partner's retirement allowance under the unqualified plan was not based on a partner's interest in the assets of PMM nor were such payments designed to compensate the partner for his interest in PMM.

Lynskey testified that the 1976 Retirement Allowance Plan included a limitation or cap of 15%, i.e., the benefits of all retired partners may not exceed 15% of the firm's distributive income (Ex. "5"). The 1960 Partnership Agreement had the same 15% limitation (Ex. "19").

With regard to the 15% limitation on total retirement allowances, Lynskey testified that it was ineffective as a limitation because it was unlikely to be imposed in petitioners' lifetime. This testimony he said is based on calculations and projections taking into account the total payments, the amounts of future benefit payments based upon the number of partners, their ages

and their earnings, and based on historical experience. Lynskey stated that these calculations develop projected cash flows based upon conservative estimates of earnings and, on that basis, he concludes that the total retirement allowance payments do not approach the 15% limitation in any reasonable time frame. None of the partnership agreements in this case, nor the retirement allowance plan, provide for paying in later years amounts that have been deferred in a given year due to the 15% limitation.

The 1975 Partnership Agreement and the 1976 Retirement Allowance Plan also contain a forfeiture provision. Under this provision, if a retired partner engages in the practice of accounting subsequent to leaving PMM without PMM's consent, he would forfeit his retirement allowance. According to Lynskey, this provision has never been enforced and PMM's consent is routinely granted. Aubrey Fariss is an example of a retired partner who requested and received permission to practice accounting after leaving PMM.

Using the factors testified to earlier, Mr. Lynskey testified that, for Warren Johnson, he determined a retirement income base of $110,390.38 which, based on 34.916 years of service, resulted in a gross retirement allowance of $60,622.75. This total retirement benefit was reduced or offset by the allowance of $11,963.76 which Johnson received from PMM's qualified pension plan. The $48,659.00 annual retirement benefit remaining after the offset was paid by the Partners' Retirement Allowance Plan (the unqualified plan) (Ex. "8", "9").

Johnson elected under the Partners' Retirement Allowance Plan to take his retirement benefit in the form of a straight life annuity with a "five year certain period." Under that election, even if he were to die before the expiration of that first five years, his estate would continue to receive retirement benefit payments at regular intervals for the full five years (20 quarters). If he died in the sixth year after retirement the payments would cease.

In addition to the amounts Johnson received in 1984 under the unqualified retirement plan, he was paid interest on the amounts in his drawing account, capital account, ACRS account and unrealized receivables account. Mr. Lynskey summarized the 1984 payments Johnson received as follows:

Source	FYE 6/30/84
a) Non-qualified plan:	$ 48,659.00
b) Interest on Drawing Account balance:	$ 37,719.07
c) Payment on IUR Account	$ 34,186.29
d) Payment on ACRS deferral	$ 1,008.59
Total from PMM:	$121,572.95
Final Payment on PMM's interest in PMM General Partnership:[5]	$ 1,790.00
	$123,362.95
Payments from partnerships unrelated to PMM:	
a) Greenbriar 64, 69 & 72:	$ 3,443.00
b) Copem 72	$ 3,399.00
Total All Sources:	$130,204.95

The interest on Johnson's drawing account was paid to him on June 29, 1984 when his drawing account was closed (tr., pp. 98-99; Ex. "12", "15"). As noted earlier, the Greenbriar and Copem partnerships are unrelated to PMM.

As of the date of Johnson's retirement, the amounts in his ACRS account and IUR account were frozen. Johnson elected, pursuant to section 3 of the 1975 Operating Procedures, to have the balance in these two accounts, plus interest, paid to him over the five-year period subsequent to his retirement. The combined balances of these two accounts was $175,974.42. The first installment of $35,194.88 was paid to Johnson on June 29, 1984.

Tax on amounts petitioner received from the Greenbriar partnership is not an issue in this proceeding (tr., p. 104).

As noted, Johnson also received $1,790.00 from the PMM-General Partnership in 1984 (Ex. "12"). That payment is not taxable in New York and is not an issue in this proceeding (tr., p. 103).

A letter dated February 27, 1985 from R.C. Lurie, Executive Officer of PMM, and addressed to all "Nonresident Partners" provided instructions on preparation of New York's 1984 nonresident income tax returns ("IT-203" or "the returns"). It appears that this letter was

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[5]PMM General Partnership and PMM are two separate entities.

also sent to PMM's retired nonresident partners, including Mr. Johnson. Mr. Johnson filled in the forms which were used to prepare his 1984 returns based on the instructions in Lurie's letter (Ex. "46"). Johnson testified that he never questioned the virtue of PMM's tax advice or the contents of Lurie's letter. Johnson just assumed that the PMM tax department knew what it was doing. This was especially so, since Johnson never practiced tax accounting, his specialty being the Securities and Exchange Commission. In following Lurie's instructions, Johnson referred to himself as a "partner" in PMM on his 1984 nonresident New York return. As will be seen, Redlin and Fariss used similar language on their tax returns.

The sum of (i) the retirement payments under the Partners' Retirement Allowance Plan ($48,659.00); (ii) the interest payments credited to Johnson's drawing account ($37,719.07); and (iii) the payment of the first installment of the combined balance in Johnson's IUR account and ACRS account ($35,194.88), or a total of $121,572.95, was reported to Johnson on a K-1 issued by PMM (Ex. "12", "16"). The total amount reported on the K-1 issued to Johnson was characterized by PMM as "Retirement Paymts-736(a)-IRC". Johnson testified that while he was aware that PMM had characterized the total as "Section 736A" payments, he did not know why.

The amounts received by Johnson from PMM ($121,572.95), PMM-General ($1,790.00), the Greenbriar partnerships ($3,443.00) and the Copem 72 partnership ($3,399.00), totalling $130,204.95 (Ex. "12"), were included on the supplemental computation of income or loss from partnerships on Johnson's Federal income tax return (Form 1040), Schedule E, Part II, Statement 5, attached to Johnson's New York nonresident income tax return for 1984, dated August 4, 1985 ("IT-203").[6] After the addition and subtraction of amounts from partnerships not at issue here, the resulting figure of $112,857.00 was carried over from Schedule E to the Federal column on Form IT-203 at line 13 as net income from partnerships (Ex. "KK").

Of the $112,857.00 received from PMM, PMM and Johnson allocated a total of $21,983.00 to New York source income on his 1984 IT-203. This reported New York source amount came off of a form provided to Johnson by PMM entitled "Partner-Peat, Marwick,

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[6]It will be recalled that when Johnson retired in 1983, he elected to have his IUR and ACRS accounts paid to him over a five-year period.

Mitchell & Co. 1984 New York State Supplemental Tax Information". This form is attached to Johnson's 1984 IT-203 and states that $21,983.00 represents Johnson's "share of New York income with depreciation calculated using ACRS." This figure is based on PMM's income percentage allocated to New York. Johnson testified that he did not know how PMM arrived at that figure, or why it was reported as income from "Partnerships, estates, trusts and S-corporations" on page one of his 1984 IT-203. He stated, "I think that Peat Marwick was doing it the way they thought it should be handled for income tax, whether it's Federal or state, and I just followed this" (tr., p. 323; Ex. "46"), referring to Lurie's letter of instructions. After adjustments and itemized deductions, Johnson's 1984 IT-203 showed taxable New York income of $16,764.77, and resulted in total New York tax of $1,036.48, which was paid (Ex. "KK").

PMM's New York State partnership return ("IT-204") filed for fiscal year ending June 30, 1985 allocated, under the category "Partners Share of Income", $19,676.00 of the amounts paid to Warren H. Johnson out of the partnership's "net income" as New York income (Ex. "L").

Johnson filed a claim for credit or refund dated May 19, 1986 with the Division of Taxation ("Division") seeking a refund of $1,036.48. This refund claim was based on the Appellate Division's decision in Pidot v. State Tax Commission (118 AD2d 915, 499 NYS2d 482, affd without opn 69 NY2d 837, 513 NYS2d 965).

A Notice of Disallowance dated January 30, 1989 was sent to Warren Johnson denying his refund claim in full. This notice will be addressed in more detail, infra.

AUBREY AND ELSIE R. FARISS

At the time of Aubrey Fariss' and Robert Redlin's retirement, the affairs of PMM were governed by Peat, Marwick, Mitchell & Co. (United States) Partnership Agreement, dated October 14, 1959 and effective as of July 1, 1960, as amended through October 16, 1963 ("the 1960 Partnership Agreement").[7]

Pursuant to the provisions of the 1960 Partnership Agreement, Redlin and Fariss were

[7]Petitioners' witness testified that the Articles of Partnership of Peat, Marwick, Mitchell & Co. (United States) dated July 1, 1970 (Ex. "22") also applied to Fariss and Redlin (tr., p. 138). It is unclear why, since both of these partners retired prior to 1970 and testimony shows that their retirement benefits were governed by the 1960 Partnership Agreement.

voting partners[8] in PMM and allotted a percentage interest in the profits and losses of PMM, its capital and goodwill. As partners, Redlin and Fariss, like Johnson, were required to contribute to the capital of PMM, and if PMM were liquidated, they would have shared in any surplus that remained after all creditors were paid. As partners, Redlin and Fariss had the same partnership rights as Johnson. Under the 1960 Partnership Agreement a partner who surrendered his allotment would cease to be a "goodwill partner" and could become a limited partner, as will be discussed in more detail, infra (Ex. "19").

Redlin's and Fariss' interests as partners in PMM were represented by their capital account, their drawing account and their percentage interests in PMM. Beginning in 1968, Redlin (only) also had an interest as partner in the unrealized receivables of PMM (Ex. "48").

Neither Redlin nor Fariss had an ACRS account. Fariss did not have an IUR account.

Aubrey Fariss and Elsie Fariss,[9] husband and wife, reside at 3707 Olympia, Houston, Texas 77019.

Due to his advanced age and infirmity, Fariss was unable to attend this proceeding as a witness. However, Fariss did offer an affidavit, which was admitted into evidence (Ex. "47"). The contents of Fariss' affidavit was also covered in the testimony of W. Michael Lynskey, PMM's Director of Retirement Services and Partner Benefits. Mr. Lynskey substantiated the contents of Mr. Fariss' affidavit.

Fariss deposes that he graduated from college in 1925 and was licensed by Texas in 1928 as a certified public accountant. In 1940, he founded the accounting firm of Aubrey Fariss Company located in Houston, Texas. Fariss' specialty was tax accounting for the oil and gas industry. In 1950, his accounting firm was purchased by PMM and Fariss joined PMM as a special partner. In 1953, Fariss was admitted as a general partner of PMM. He retired from

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[8]Partners such as Redlin and Fariss, under the 1960 Partnership Agreement, were referred to as "'B' Partners," "goodwill partners" and "partners having allotments." Partners having no allotments ("'A' Partners") could not vote. Partners who had relinquished their allotments and retired were called "limited partners."

[9]Elsie Fariss is involved in this proceeding solely because she filed joint returns with her husband. References to "Fariss" in this determination refer to Aubrey Fariss alone.

PMM on June 30, 1965 at the age of 62, which was PMM's mandatory retirement age for partners at that time.

As a partner in PMM, Fariss' share in the profits and losses of PMM was determined based upon his percentage of interest in the partnership. That percentage was fixed on an annual basis by two-thirds vote of the voting partners. In 1965 when he retired, Fariss owned an allotted 1.20% interest (600 units) in the partnership.

At his retirement on June 30, 1965, Fariss surrendered his percentage interest in PMM and partnership rights. At that time he was repaid the balance in his drawing account and 90% of his capital account. Fariss was also paid an amount representing his interest in the goodwill of PMM.

Upon retirement as a voting partner, Fariss became a "limited partner". The term "limited partner" was a title assigned to PMM's retired partners in the 1960 Partnership Agreement.

The 1960 Partnership Agreement provided that a limited partner had no interest in the goodwill of the partnership or in the firm name, no vote and no voice in PMM's management or direction and could not participate in its practice (Ex. "19", ¶ 10). Paragraph 12 required each limited partner participating in the profits of PMM to retain a percentage of his original capital contribution with the firm. If a limited partner decided to cease being a limited partner, his capital contribution would be repaid to him within three months after the date he ceased to be a limited partner (id., ¶ 12[e]).

The 1960 Partnership Agreement also provides, in relevant part, that a limited partner would participate in the profits of the firm for each fiscal year for which he was a limited partner in an amount computed in accordance with a formula based on: (i) 1% of the annual salary he received at the date he surrendered his interest in the partnership multiplied by his years of service; plus (ii) one-tenth of the profits for the fiscal year applicable to the maximum percentage of interest held by him in PMM at any time during the five-year period ending on the date he surrendered the first portion of his interest (referred to as an "allotment") in the partnership. It is clear from this agreement that to be a limited partner, a retired partner must

maintain a capital contribution with PMM, and further, in order to continue to participate in the profits of the firm after retirement, one had to be a limited partner. Limited partners could resign and withdraw their capital contributions at any time, at which point they would no longer share in PMM's profit distributions (Ex. "19", ¶¶ 10, 11, 12). The participation of retired (or limited) partners in the profits of PMM are referred to *infra*, as their "retirement allowance", "retirement benefits", or "pension benefits".

Fariss' contribution to capital and the extent of his participation in the profits of PMM as a "limited partner" was computed as follows:

PMM (United States)

10% of capital contribution applicable to highest % of interest at any time with PMM.

Fariss' Highest % interest: 1.20%

Highest Amount of capital: $60,000.00

10% of $60,000.00: $ 6,000.00

PMM (General)[10]

Highest % in PMM: 1.20%--600 units

600 units at $15.00 per unit: $ 9,000.00

Capital in PMM (General)

10% of $9,000.00: $ 900.00

Fariss total limited partner capital contribution: $ 6,900.00

Fariss' Participation in profits (retirement allowance) as a limited partner:

1% of annual salary of $15,000. or

[10]PMM (General) is a separate partnership from PMM (United States).

150 times 14 years of service: $ 2,100.00

plus .12% of profits.

Mr. Fariss total capital contribution as a limited partner was $6,900.00, $6,000.00 of which was attributable to PMM (United States) and the remainder to PMM (General) (Ex. "21"; tr., pp. 123-124). The $6,900.00 in Fariss' capital account was repaid to him in 1968 when PMM changed its policy and returned the capital contributions to all of its limited partners. After 1968, "limited partners" were no longer required to maintain a capital contribution with PMM as a condition of receiving a retirement allowance.

The 1960 Partnership Agreement also provided that the aggregate participations of all limited partners in the profits of the firm for any fiscal year could not exceed 15% of the net profits of the firm for fiscal year. "In the event that the aggregate amounts otherwise determined in accordance with the provision of this Paragraph ELEVENTH shall exceed said fifteen per cent (15%)", such amounts were to be reduced pro rata, so that in the aggregate they would equal the 15% cap (Ex. "19", ¶ 11[e]). Put another way, Lynskey stated that, to the extent that the aggregate retirement allowance calculation exceeded the cap, the cap was substituted. Because the cap was substituted, in these instances, in Mr. Lynskey's opinion, petitioners' benefits were not based on the profits of PMM, because the linkage between the benefits and PMM's profits was lost.

The 1960 Partnership Agreement also provided, in relevant part, that "[t]he participation of a limited partner . . . shall not be less than Four Thousand Dollars ($4,000.00) per annum nor more than Twelve Thousand Dollars ($12,000.00) per annum" (Ex. "19", ¶ 11[b][1]), plus cost of living adjustments (Ex. "19", ¶ 11[b][4]). The 1960 Partnership Agreement was amended October 16, 1963 to increase these amounts to "not be less than Six Thousand Dollars ($6,000.00) per annum or more than Eighteen Thousand Dollars ($18,000.00) per annum" (Ex. "19", ¶ 11[b][1]).

While Mr. Lynskey testified that limited partners did not maintain any investment in PMM, that was only true after 1968. Up until 1968, limited partners were required, as a

condition of their status and as a condition of participating in PMM's profit distributions, to keep a portion of their original capital contributions with PMM. The concept of PMM's "limited partners" was formally abandoned in 1970 when the Articles of Partnership, effective July 1, 1970 ("the 1970 Partnership Agreement"), were adopted and eliminated the designation (tr., p. 135). However, retired partners that had been receiving retirement allowances under the 1960 partnership agreements, *et al*, continued to do so.

As noted above, Fariss was repaid his capital contribution in 1968, when PMM decided to repay the capital contributions of all its limited partners. After 1968, Mr. Fariss had no capital contribution in PMM. After 1968, a contribution to capital was not a condition of being a limited partner.

The record shows that the annual retirement allowance paid to Mr. Fariss from 1971 through 1991, as with Johnson, was equal to the ceiling (cap) amounts. Lynskey stated that because of this cap, in practice, the amounts paid as pension benefits lost their linkage to the firm's profits (tr., p. 141; Ex. "23").

The following shows the amounts actually paid to Mr. Fariss on a fiscal year basis compared to what he would have received without PMM's cap:

FISCAL YEAR	MAXIMUM BENEFIT WITHOUT 15% CAP	ACTUALLY PAID FISCAL YEAR
1982	$254,413.00	$46,653.00
1983	286,032.00	48,985.00
1984	319,166.00	50,945.00
1985	347,241.00	51,953.00
1986	362,594.00	51,557.00

Fariss reported his income from PMM on a fiscal year basis. The Schedule K-1's prepared by PMM and provided to Fariss reported the above fiscal year amounts for each year 1982 through 1986. The amounts on each K-1 are referred to as "Guaranteed payments-Retirement Paymts-736(a)--IRC" (Ex. "26").

The following shows the retirement allowance paid to Aubrey Fariss by PMM and the amounts PMM and Fariss reported as New York source income during the years 1982 through 1986 using PMM's allocation percentage of 16.88%:

FISCAL YEAR	RETIREMENT ALLOWANCE	PORTION ALLOCATED By PMM TO NY
1982	$46,653.00	$8,076.00
1983	$48,985.00	$7,985.00
1984	$50,945.00	$9,332.00
1985	$51,953.00	$9,640.00
1986	$51,557.00	$8,034.00

Aubrey and Elsie Fariss filed New York nonresident income tax returns ("IT-203") separately on one return for 1982, 1983, 1984, 1985 and 1986. They claim these returns were filed under the mistaken belief that they had received income attributable to a New York source. In filing the returns for each of the subject years, Aubrey and Elsie Fariss entered a portion of the amounts received from PMM in the New York column on said returns as net income from partnership attributable to New York and, after adjustments and deductions, paid New York income tax in the following amounts in the years specified:

YEAR	TAXABLE NY INCOME	TAX PAID
1982	$6,031.00	$121.23
1983	$5,959.00	$118.77
1984	$7,368.00	$174.74
1985	$9,414.00	$296.54
1986	$6,419.00	$176.76

Aubrey and Elsie Fariss filed claims for credit or refund dated April 11, 1986 for the years 1982, 1983, 1984 and 1985 and seeking a refund of income tax paid in the amount of $753.50. A subsequent claim for credit or refund dated April 15, 1988 was filed for 1986 seeking a refund of $176.76. The Farisses, like the other petitioners, based these refund claims on the Appellate Division's decision in Pidot v. State Tax Commission (supra).

Two notices of disallowance, both dated April 18, 1990, were sent to Aubrey and Elsie Fariss denying their refund claims in full. These notices will be discussed in more detail, infra.

ROBERT W. AND HARRIET A. REDLIN

Robert W. Redlin and Harriet Redlin,[11] husband and wife, reside at 83 Blairmoor Court, Grosse Pointe, Michigan.

Redlin did not appear as a witness in this proceeding due to ill health, but did provide an affidavit, which was admitted into evidence. The substance of Redlin's affidavit was also covered in the testimony of W. Michael Lynskey. Mr. Lynskey's testimony served to substantiate Mr. Redlin's affidavit.

Redlin states that he was born in Cleveland, Ohio in 1918 and graduated from Miami University, Oxford, Ohio in 1939. Following graduation from college, Redlin was employed as an accountant in the Detroit, Michigan office of PMM. In 1941, he was licensed in Michigan as a certified public accountant. Redlin took a leave of absence in 1942 to go into the Navy, and in 1945 he resumed his career with PMM at its Detroit, Michigan office.

In 1951, Redlin states that he became a general partner of PMM. He took early retirement from PMM on June 30, 1969 at the age of 50. Redlin states that, since 1939, he has always lived and spent his entire working career in the State of Michigan. When Redlin retired on June 30, 1969, he relinquished his entire percentage interest in the partnership and lost his "partnership rights", including, but not limited to, his right to vote on the admission of new partners, and his right to inspect the books and records of the firm. At his retirement, Redlin surrendered his percentage interest in PMM and was repaid the balances in his drawing account and capital account. Additionally, Redlin elected to have the balance in his unrealized receivables account repaid to him over a ten-year period. The unrealized receivables account was completely repaid to Redlin by the end of fiscal year 1979 (tr., pp. 172-173). Like Fariss, Redlin became a "limited partner" of PMM upon retirement. However, unlike Fariss, Redlin was not required to leave a capital contribution with the firm as a condition of being a limited partner since, by 1969, it was no longer required. Pursuant to PMM's operating procedures, Redlin was repaid his partner's capital contribution one year following his retirement, i.e. June

[11]Harriet Redlin is a named party to this proceeding solely by reason of filing joint income tax returns with her husband. Accordingly, the terms "petitioner-Redlin" or "Redlin" refer only to Robert Redlin.

30, 1970. Redlin's retirement benefits were computed pursuant to the 1960 Partnership Agreement.[12]

A memo is in the record from W. E. Hanson to all B-Partners, dated May 14, 1969 (Ex. "29"), which advised Mr. Redlin as to his retirement benefits as a B-Partner,[13] and states, in pertinent part:

> "A 'B' partner shall be entitled to a retirement allowance equal to the sum of:
>
> "1. 1% of basic compensation he was receiving at the date of retirement multiplied by the number of years of service prior thereto and 1/10 of the profits for each fiscal year applicable to the maximum percentage of interest he held at any time in the overall profits of PMM & Co., United States. The retirement allowance shall not be less than $6,000 per annum or more than $18,000 per annum.
>
> "2. In the event official statistics of the United States Government should indicate that the cost of living has increased . . . consideration shall be given to an appropriate increase in the maximum and minimum allowance referred to above . . . .
>
> "3. A 'B' partner who shall have completed 25 years of continuous service and surrendered his units after attaining the age of 50 years, and has been a 'B' partner for 10 years, may take early retirement, and if he does, his retirement allowance shall be a percentage of what his annual retirement would have been in accordance with the formula above . . . .
>
> * * *
>
> "5. In no event, shall the aggregate retirement allowances of 'B' partners exceed 10% of the overall profits of the Firm for such fiscal year. In the event that the aggregate amount exceed said 10%, then the amounts shall be reduced pro rata so that in the aggregate, they shall equal 10%."[14]

A computation taken from Redlin's personnel file and obtained for the hearing by Mr. Lynskey shows Mr. Redlin's estimated pension payments under the "Old 'B' Agreement"[15] (Ex. "30") shows a computed maximum benefit

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[12]As were the benefits of Fariss.

[13]At the time, "B" Partners were partners such as Redlin and Fariss who had all of the rights of general partners.

[14]The 10% cap in this paragraph would appear to relate to an old version of the partnership agreement since, by 1969, the cap had been increased to 15% (Ex. "19," ¶ 11[c]).

[15]It is assumed here that the old "B" agreement is the 1960 Partnership Agreement that governed "B" partners and others.

of $31,000.00 subject to a 49% discount due to his early retirement at age 51.

Mr. Lynskey's testimony and documents show the amounts paid to Mr. Redlin on a fiscal year basis compared to what he would have received without PMM's 15% benefit cap as follows:

FISCAL YEAR	MAXIMUM BENEFIT WITHOUT 15% CAP	ACTUALLY PAID FISCAL YEAR
1982	$179,202.00	$22,859.00
1983	201,098.00	24,006.00
1984	224,043.00	24,962.00
1985	243,485.00	25,455.00

As with the other petitioners, Mr. Lynskey testified that these amounts received by Mr. Redlin as retirement allowances were not tied to the profits of PMM, because the linkage was lost due to the ceiling or "cap" on the amount of the payments (tr., p. 167). Mr. Lynskey testified that other than the retirement benefits, supra, Redlin received no other amounts from PMM during the years in question, i.e., 1982, 1983, 1984 and 1985.

The following shows the retirement allowance paid to Redlin for fiscal years 1982 through 1985 and the amounts PMM and Redlin reported as New York source income:

YEAR	RETIREMENT ALLOWANCE	ALLOCATED TO NY INCOME BY PMM
1982	$22,855.00	$3,956.00
1983	$23,999.00	$3,912.00
1984	$24,955.00	$4,512.00
1985	$25,455.00	$4,723.00

Robert and Harriet Redlin filed joint New York nonresident income tax returns ("IT-203") for 1982, 1983, 1984 and 1985. Like the other petitioners, they claim these returns were filed under the mistaken belief that they had received income attributable to a New York source. In filing the returns for each of the subject years, Robert and Harriet Redlin entered a portion of the amounts received from PMM in the New York column on said returns as net income from a partnership attributable to New York and, after adjustments and deductions, paid New York income tax in the following amounts for the years specified:

YEAR	INCOME ALLOCATED TO NY	TAX PAID
1982	$3,956.00	$ 47.00
1983	$3,912.00	$ 45.00
1984	$4,512.00	$ 64.00
1985	$4,723.00	$142.00

Robert and Harriet Redlin filed separate claims for credit or refund, all dated April 13, 1986, for years 1982, 1983, 1984 and 1985 and seeking a total refund of income tax paid in the amount of $298.00. The Redlins, like the other petitioners, based these refund claims on the Appellate Division's decision in Pidot v. State Tax Commission (supra).

A notice of disallowance dated April 18, 1990 was sent to Robert and Harriet Redlin denying their refund claims in full. This notice will be discussed in more detail, infra.

Each of the petitioners receive the maximum amount allowed under the retirement provisions of the 1960 or 1975 Partnership Agreements. Such payment amounts do not fluctuate. The retirement allowances each petitioner received were fixed at retirement. Any variations since that time have been due solely to cost of living adjustments.

In each of the subject years, the partnership returns filed by PMM with the State of New York included a list of each of its partners, their state of residence, social security number, and the amount paid by PMM to each partner as their share of partnership income for the year (Ex. "L"). Johnson, Fariss and Redlin and their respective shares of PMM's profits allocated to New York appear on each of these partnership returns.

Up until 1970, the question of whether to grant a COLA in the retirement allowance of retired partners was decided by those partners having a right to vote. Since 1970, resolution of that question has been in the sole discretion of PMM's board of directors (tr., pp. 190-192). Mr. Lynskey testified that the increases in benefits actually paid to petitioners over the years were solely attributable to the COLAs (tr. 193). Lynskey also testified, and the other evidence supports, that there has never been a decrease in the retirement benefit payments from one year to the next.[16]

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[16]Under either the 1960 Partnership Agreement or the 1976 Retirement Allowance Plan.

There was no linkage between Johnson's, Fariss', or Redlin's retirement benefits and the assets of the firm, or the percentage interest each held as partner in the assets of the firm (tr., p. 164).

Redlin and Fariss were given an opportunity to switch from the retirement benefit arrangement in the 1960 Partnership Agreement to the plan which applied to Mr. Johnson. They declined to do so, because it would have resulted in less benefits.

Lynskey testified that the retirement allowances were processed by PMM in the following manner. The "partner's accounts" of Johnson, Redlin and Fariss would be credited at the beginning of each fiscal year with the amounts representing their respective retirement allowance for the year. As quarterly distributions were made to the retired partners during the year, their respective accounts were debited until at the end of the year there would be a zero balance (tr., p. 148). After 1984, the payments to retired partners of amounts representing their participation in the profits of PMM were no longer processed or passed through the "partner's account" (tr., pp. 147, 176-180; Ex. "24", "33").

Redlin, Fariss and Johnson reported their income from PMM on a fiscal year basis as required. The Schedule K-1's prepared by PMM and provided to the three petitioners reflected the fiscal year retirement allowance payments on each K-1 as "Guaranteed payments-Retirement Paymts-736(a)--IRC" (Ex."16", "26", "35").

Johnson, Redlin and Fariss were never licensed as CPAs by the State of New York, were never employed in the State of New York, and never lived in the State of New York. The sole connection of Johnson, Redlin and Fariss with New York is that they each were at one time nonresident partners of PMM, a New York partnership.

The evidence with respect to Redlin, Fariss and Johnson is that, as of the dates of their retirement, they surrendered all of their "partnership rights". After their respective retirement dates, Redlin, Fariss and Johnson no longer had the right to vote on any matter submitted to the partners for a vote, no longer had the right to participate in the management of PMM, no longer had the right to inspect the books and records of PMM and no longer were entitled to receive

financial information from PMM. After their respective retirement dates, the amounts each received as a retirement allowance was the only contact they had with PMM. The amounts received by Johnson, Fariss and Redlin did not depend on the extent of their respective interests in the partnership while they were partners.

As noted earlier, each of the petitioners applied for refunds of the New York income tax paid on their retirement allowances. Each of these refund claims were disallowed with notices of disallowance which, except for taxpayer specific information, were identical. Each of the notices of disallowance that were sent to the respective petitioners stated that upon review of that part of PMM's "partnership agreement which covers payments made to retired partners (in particular the paragraphs entitled 'Limitation of Total Retirement Allowance,' 'Forfeiture of Allowance' and 'Unrealized Receivables, Accelerated Cost Recovery System Deferred, and/or Deferred Compensation'), it has been determined that the payments received by you from the partnership as a retired partner do not qualify as an annuity" under 20 NYCRR 131.4(d) for the following reasons:

> "1. An overall limitation on payments in any year to retired partners applies. However, there is no provision for the payment of the reduced amount in a subsequent year as was the case in the decision Pidot v State Tax Commission, 118 AD 2nd 1915, aff. without opinion 69 NY 2nd 837. As a result, the payment plan would not satisfy the uniform rate test nor would it be possible to determine the total of the amounts payable at the annuity starting date.
>
> "2. A restrictive covenant condition exists which results in forfeiture of retirement allowances, if violated.
>
> "3. Retirement allowance includes payments attributable to a partner's share of unrealized receivables which are payable over a period of time. The partner would be considered a retiring partner receiving payments in liquidation of his interest in the partnership during this period. Therefore, the retiring partner's interest in the partnership would not be fully liquidated until all shares of unrealized receivables are paid to him. Full liquidation of the partner's interest in the partnership prior to receipt of retirement allowances was vital to the Court's decision in Pidot."

Kraig M. Kummer, an enrolled actuary[17] and pension and asset planning consultant with William M. Mercer, Inc., testified as an expert for Mr. Johnson. In his capacity as consultant, Mr. Kummer provides advice to corporations, non-profit agencies, hospitals, universities, and

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[17]The term "enrolled actuary" is a term of recognition conferred by the Joint Board for the Enrollment of Actuaries.

unions, etc., on the design, funding and administration of pension plans and other employment benefit plans. He also assists retirement plan sponsors in establishing investment policies and objectives. In forming his expert opinion testified to at hearing, Mr. Kummer reviewed and analyzed the Partners' Retirement Allowance Plan which became effective July 1, 1976.

As part of his duties as consultant, Mr. Kummer performs actuarial evaluations for clients to determine the minimum required and maximum deductible contributions required of the plan sponsor for the plan year. A pension plan is a promise made by the employer to provide certain benefits to employees upon retirement, and those benefits are typically due many years in the future. Mr. Kummer stated that it was his job to place a value on those promises. In doing that, he takes into account certain future contingent events such as the employee's salary just before retirement, the length of service and the continued survival of the employee.

Kummer's testimony was limited to the 1976 Partners' Retirement Allowance Plan as it affected Mr. Johnson. Kummer testified that the 1976 Partners' Retirement Allowance Plan ("1976 plan") is an unqualified defined benefit pension plan. Under this plan, Kummer states, benefits are calculated on the retiree's length of service with the company and based on the highest earnings in any year out of the last five years of employment. These benefits are subject to a "maximum limit which is 15 percent of the cash basis net income or the pro rata share of the partner's pro rata share of the cash basis in the income of the firm" (tr. pp. 230-231). Under this plan, benefits are payable periodically under one of several optional forms of payment, but each form extends over at least the life expectancy of the retiree.

Mr. Kummer reviewed the Division's annuity rules in 20 NYCRR 132.4(d) (formerly 20 NYCRR 131.4[d]). Kummer addressed the Division's claim that, under its rules, the payments received by Mr. Johnson under the 1976 plan did not qualify as an annuity because it was not possible to determine the total amounts payable at the annuity starting date, either directly or indirectly, in accordance with sound actuarial theory. Kummer did not agree.

In setting the background for his reasoning, Mr. Kummer stated that the American Academy of Actuaries established a standard setting board in 1985 known as the Actuarial

Standards Board ("the board"). The board has produced publications, including a "Preface to Actuarial Standards of Practice" (hereinafter "Standards of Practice") and the "Fundamental Concepts of Actuarial Science" (Ex. "36"), portions of which were made part of the record. "Fundamental Concepts of Actuarial Science" (hereinafter "Fundamental Concepts"), at page 23, states:

> "Probability and statistics, the study of random variables is clearly one of the foundations upon which actuarial science is built. The impossibility of certainty is one of the facts with which all humans contend. In many situations the actuary's role is to help society, via financial security systems, to deal with uncertainty. Probability and statistics provide many of the tools on which such systems depend."

Kummer stated that a "financial security system" is any economic system that transfers risk from an individual to a collective of individuals, e.g., pension plans. Pension plans transfer the risk of a person outliving his means from the individual to the pension plan. The Board in Fundamental Concepts developed a generalized model to describe interaction between a financial security system, its individual members and the time concept of money.

Kummer stated that the cash flow from a financial security system is a time-related complex of payments. Every payment has three distinguishing elements: (i) the time when the payment is made; (ii) the amount; and (iii) the probability that the payment will be made. For example, assume a person is 55 years old and his employer promises to pay him $10,000.00 when he is 65, if he is still alive. There are three elements. There is a time of payment, an amount of payment and a probability that the payment will be made, which is the probability that the individual will survive for 10 years.

If probability of payment is assigned a zero, that denotes certainty that the payment will not be made. If the probability of payment is assigned the number "1", it denotes certainty that a payment will be made. Once cash flow from a financial security system is established, its value is determined by multiplying each expected payment by the probability that it is going to be made and then, further, by a factor which takes into account the time value of money, a discount factor. Therefore, Mr. Kummer stated, in the example, supra, if the $10,000.00 payment was assured of being made 10 years from now, the present value of that payment

would still be something less than $10,000.00 because of the time value of money.

Mr. Kummer testified that as a matter of "sound actuarial theory", the total of the amounts payable to a retiree under the 1976 partners' retirement plan is determinable at the annuity starting date from the plan itself by use of mortality tables and compound interest computations. This is so, he said, because the three distinguishing elements are present.

> "You can determine the time that each payment is to be made; you can determine the probability that it's going to be made; and you can determine the expected amount of each payment" (tr., p. 246).

Kummer stated that you could determine the expected future payments by observing the actual plan payments that have been made over a period of time. By doing so, you can determine what the underlying trend is in payments, and that can be used to determine the likelihood that the payment will be reduced at any point in the future because of the plan's 15% limit. By using "Time Series Analysis", Kummer stated that it was possible to determine the extent that Johnson's future payments would be reduced.

Using data provided by PMM, Kummer prepared an analysis which showed, for each year from 1971 through 1991, the retirement plan payments made to partners and the adjusted cash basis income of PMM (Ex. "6").[18] The figures for each year represent a time series; for example, the retirement plan payments from 1971 to 1991 is a time series. Time series analysis can help to determine the probability that Johnson's payments will be reduced in the future because of the 1976 retirement plan's 15% limit. This is done by comparing plan payments in the past to PMM's adjusted cash basis income over the same period and extending the trend lines of these previous years into the future by using "least squares analysis." "Least squares analysis" is a technique of plotting each time series on a graph and making a visual observation as to the nature of the progression to see whether the retirement plan payments, for example, strike a relatively straight line that is increasing over a curved line.

Based on information contained in Exhibit "6", Kummer plotted the observed values from

[18]Each of the calculations done by Mr. Kummer and referred to in his testimony implicitly include COLAs made for the periods covered in his testimony.

1971 to 1991 for the annual retirement payments to partners and annual plan limits under the 1976 retirement plan (Ex. "37"). Kummer stated that his graph shows that for each time series (retirement plan payments and adjusted cash basis income) there was an upward sloping curve which suggested to Kummer that he should use an application called the "Logarithmic Least Squares Application." This application is characterized by a line that slopes upward implying a constant percentage increase in the variable. Kummer stated that this analysis is completely objective in that anyone applying the same formulas would obtain the same results. A least squares analysis results in a "least squares equation" (Ex. "38").

From these various analyses, Mr. Kummer prepared a document entitled "Trended Benefits vs. Trended Limits" (Ex. "39"). This graph shows that from 1971 to 1991 the annual amounts representing the 15% limit has increased at a much faster rate than the annual increases in actual benefit payments. Kummer extended the trends demonstrated by this graph into the future in preparing a graph entitled "Projected Benefits vs. Limit" (Ex. "40").

Exhibit "40" projects the trend for both the retirement plan payments and the 15% plan limit through the year 2021. According to the projected trend lines, the benefit payments are not expected to exceed the 15% limit until the year 2019. That means that in trying to determine the actuarial present value of this income stream, the payments due to Mr. Johnson after the year 2019 would be less than what he is currently receiving. For example, in the year 2020, the expected benefit payments in total are $2,400,248,000.00 and the plan limit is $2,000,282,039.00. The ratio of the plan limit to the benefit payments is 93.1%. So, the plan payments to Mr. Johnson in the year 2020 would be 93.1% of the amount he is currently receiving. Kummer states that similar projections can be made for any date in the future (tr., pp. 258-259).

Similarly, Kummer states that, as of the annuity starting date, the amounts payable can be determined using the 1976 plan itself, mortality tables and compound interest as specified in the Division's annuity regulations, because the three basic elements necessary to value a cash flow are capable of being determined, i.e., probability that the payment will be made, the time that

the payment will be made and the expected amount of each payment. According to Kummer, it is not necessary in order to value a cash flow in accordance with sound actuarial theory to know with certainty what each future payment is going to be. Rather, he said, you need to know what the expected future payments are to be. And, in addition, you need the other key elements, the time each payment is to be made and the probability that it will be made.

The Division's regulations have a "uniform rate test" which provides that payments will qualify as an annuity if they remain uniform during the individual's lifetime or over a shorter period not less than half of said individual's life expectancy as of the date payments begin. In determining a person's life expectancy, the Division's regulations specify "Appendix A, Annuity Tables, Table "I", "Ordinary Life Annuities--One Life--Expected Return Multiples" in the Internal Revenue Code regulations (Ex. "41"). Mr. Kummer testified that since Mr. Johnson retired at age 61, his expected return multiple or life expectancy would have been 17.5 years. The projection in petitioners' Exhibit "40" indicates that the 1976 plan limit will not be reached until 2019, or 36 years after his retirement. From this, Kummer concluded on the basis of sound actuarial theory, that Mr. Johnson's retirement benefit payments would remain the same during his life expectancy.

Kummer testified that there is a high degree of likelihood that the plan limit will never be reached because of the typical growth pattern that most companies exhibit, i.e., one that is usually characterized by slow initial growth, then rapid expansion, then a leveling off as market saturation occurs. The effect of a leveling off in revenue growth is a leveling off in terms of the number of employees and, in this case, the number of partners in PMM. Exhibit "42", states Kummer, reflects the implications for PMM in terms of the 1976 retirement plan. Over time, after a period of expansion, a company's sales, revenues and profits will level off. This would result in a reduction in the number of partners which, in turn, would result in a leveling off of the retirement plan payments. A graph prepared by Mr. Kummer demonstrates that the number of partners in PMM will ultimately level off long before the year 2019 (Ex. "45"). The significance of this, says Mr. Kummer, is that if, in fact, the number of partners and principals

and, therefore, the retirement payments to be made to partners levels off long before the plan limit is expected to be reached, then the Uniform Rate Test would be satisfied, because the payments to Johnson would remain uniform during his lifetime. Taking this one step further, Kummer states that if the number of partners levels off and the plan payments to the retired partners levels off, that in fact, the 15% limit will never be reached and the Uniform Rate Test is satisfied. From this, Kummer concludes that one can assign a zero probability that the the retirement benefits would ever exceed the 15% plan limit.

The 1960 Partnership Agreement and the 1976 Retirement Allowance Plan both have in common that: (i) benefits to retired partners are calculated as a function of the partners' years of service with PMM and their highest annual salary during certain years; (ii) are subject to the same 15% cap on payments to retired partners; (iii) have similar forfeiture provisions for retired partners who engage in the practice of accounting without obtaining the consent of PMM; and (iv) provide that retirement allowance payments to a retired (limited) partner are distributions of profits, e.g., "[e]ach partner who shall have become a limited partner . . . shall participate in the profits of the firm for each fiscal year for which he shall continue to be a limited partner. . ." (Ex. "19", ¶ 11[a][1]). "The Partners' Retirement Allowance Plan (effective July 1976) is a defined benefit pension plan . . . whereunder quarterly payments are made from the Firm's current income to eligible retired partners" (Ex. "5", p. 1). Since the two plans share these common features, Mr. Kummer's testimony regarding the 1976 Retirement Allowance Plan is deemed equally applicable to the payments computed and paid under the 1960 Partnership Agreements.[19]

OPINION

The primary issue in this case is whether the retirement payments made pursuant to the unqualified plan to petitioners who were nonresidents of New York and who had not performed services in New York prior to their retirement are subject to New York State income tax. The

[19]Actually we are only dealing with the benefits computed under the 1960 Partnership Agreement (for Fariss and Redlin) and under the 1975 Partnership Agreement and the 1976 Retirement Allowance Plan (for Johnson). Although the 1970 Agreement is in evidence, it is not germane to this discussion.

Division has two possible bases upon which to tax these payments: (1) as a distributive share of partnership income under former section 632(a)(1)(A) of the Tax Law or (2) as an item of income derived from a business, profession or occupation carried on in this State under former section 632(b)(1)(B) of the Tax Law (Matter of Blue, Tax Appeals Tribunal, April 6, 1995). Tax Law former § 632(a)(1)(A) provides:

"The New York adjusted gross income of a nonresident individual shall be the sum of the following:

> "(1) The net amount of items of income, gain, loss and deduction entering into his federal adjusted gross income, as defined in the laws of the United States for the taxable year, derived from or connected with New York sources, including:
>
> "(A) his distributive share of partnership income, gain, loss and deduction, determined under section six hundred thirty-seven . . . ."

Tax Law former § 632(b)(1)(B) provides as follows:

> "Income and deductions from New York sources.
>
> "(1) Items of income, gain, loss and deduction derived from or connected with New York sources shall be those items attributable to:
>
> "(B) a business, trade, profession or occupation carried on in this state."

The Administrative Law Judge concluded that the retirement payments were distributive shares of partnership profits, but that the payments were excludable from petitioners' New York income because the payments constituted an annuity under former 20 NYCRR 131.4(d). This regulation provides as follows:

> "(d) Pensions or other retirement benefits constituting an annuity. (1) General. Where an individual formerly employed in New York State is retired from service and thereafter receives a pension or other retirement benefit attributable to his former services, the pension or retirement benefit is not taxable for New York State personal income tax purposes if the individual receiving it is a nonresident and if it constitutes an annuity as defined in paragraph (2) of this subdivision. Where a pension or other retirement benefit does not constitute an annuity, it is compensation for personal services and, if the individual receiving it is a nonresident, it is taxable for New York State personal income tax purposes to the extent that the services were performed in New York State. The term compensation for personal services as used in the foregoing sentence includes, but is not limited to, amounts received in connection with the termination of employment, amounts

received upon early retirement in consideration of past services rendered, amounts received upon retirement for consultation services, and amounts received upon retirement under a covenant to to compete. . . .

"(2) Definition. To qualify as an annuity, a pension or other retirement benefit must meet the following requirements:

"(i) It must be paid in money only, not in securities of the employer or other property.

"(ii) It must be payable at regular intervals, at least annually, for the life of the individual receiving it, or over a period not less than half of such individual's life expectancy, as of the date payments begin . . . .

"(iii) It must be payable:

"(a) at a rate which remains uniform during such life or period; or

"(b) at a rate which varies only with:

"(1) the fluctuation in the market value of the assets from which such benefits are payable;

"(2) the fluctuation in a specified and generally recognized cost-of-living index; or

"(3) the commencement of social security benefits; or

"(c) in such a manner that the total of the amounts payable is determinable at the annuity starting date either directly from the terms of the contract or indirectly by the use of either mortality tables or compound interest computations, or both, in conjunction with such terms and in accordance with sound actuarial theory. The term annuity starting date in the case of any contract or plan is the first day of the first period for which an amount is received as an annuity by the individual under the contract or plan.

"(iv) The individual's right to receive it must be evidenced by a written instrument executed by his employer, or by a plan established and maintained by the employer in the form of a definite written program communicated to his employees" (20 NYCRR former 131.4[d]).

On exception, the Division argues that the Administrative Law Judge erred in concluding that any of the retirement payments constitute an annuity under former section 131.4(d) of the regulations. In their exception, petitioners argue that the Administrative Law Judge erred in concluding that the retirement payments were distributive shares of partnership income.

Petitioners also argue that the retirement payments cannot be sourced to New York pursuant to Tax Law former § 632(b)(2) and, therefore, because the payments are not derived from a New York source we need not address the issue of whether the payments were excludable because they were an annuity.

We will first address petitioners' exception and the question of whether the retirement payments were distributive shares of partnership income. The Administrative Law Judge determined that the "overwhelming evidence in this case is that during the subject years, all of the petitioners had retired and had relinquished all but one of their partnership rights" (Determination, conclusion of law "B"). This retained right was the right to participate in the profits of the firm which the Administrative Law Judge held petitioners enjoyed through the retirement payments and which the Administrative Law Judge held constituted distributive shares of partnership income.

As petitioners note, the facts with respect to petitioners' relationship to the partnership are substantially similar to those in Matter of Blue (supra). In Blue, we held that the fact that the retired partner's payments were paid out of partnership profits did not mean that the retirement benefits were a distributive share of partnership income within the meaning of Tax Law former § 632(a)(1)(A). Instead, we stated that:

> "[t]ogether Matter of Pidot v. State Tax Commn. (118 AD2d 915, 499 NYS2d 482, affd 69 NY2d 837, 513 NYS2d 965) and Matter of Kestenbaum v. State Tax Commn. (107 AD2d 955, 484 NYS2d 371) establish that the meaning of 'distributive share' for purposes of Tax Law former § 632(a)(1)(A) is determined by the meaning of this phrase in sections 704(a) and 736(a) of the Internal Revenue Code. Under section 704(a) of the Code, the Court in each case held, that a partner's distributive share is determined by the partnership agreement. If the agreement gives the taxpayer no interest in the partnership's income or losses and distributes 100% of income and losses to individuals other than the taxpayer, then the Court concluded the taxpayer has no interest in the partnership and did not receive a distributive share under section 704(a) of the Internal Revenue Code. Further, the Court in Kestenbaum and Pidot held that payments were not a distributive share under section 736 of the Code, if the payments were made after the taxpayer's interest in the partnership had already been completely liquidated" (Matter of Blue, supra).

Petitioners, like the petitioners in Kestenbaum, Pidot and Blue, had no right to share,

under the relevant agreements, in the profits or losses of the partnership and this right was given 100% to others. In the case of Johnson, the relevant partnership agreement is the 1975 Partnership Agreement (Exhibit "3") which provides at Article VI, Section I that "sharing of profits and losses, and required contributions to capital, shall be in accordance with the ratio of each Partner's Units of Interest to all Units of Interest outstanding." At Article III, section 6 of this agreement, it is provided that "[u]pon the death or effective date of retirement of any Partner, such Partner shall cease to be a holder or owner of Units of Interest in the Partnership." The governing agreement with respect to Redlin and Fariss is the 1960 Partnership Agreement (Exhibit "19"), which provides, at Paragraph Third, that the profits, losses, capital and goodwill of the partnership will be shared by those having an allotment or percentage. At Paragraph Tenth of this agreement, it is provided that a partner will surrender his entire allotment over a period of two years after reaching the mandatory retirement age of 60. Further, Mr. Redlin and Mr. Fariss like the petitioners in Blue, Pidot and Kestenbaum had retired from the partnership and their interest in the partnership had been completely liquidated prior to the years at issue. Thus, the significant facts with respect to Mr. Redlin and Mr. Fariss cannot be distinguished from Pidot and we conclude that the same result must apply, i.e., that the retirement payments are not a distributive share of partnership income within the meaning of Tax Law former § 632(a)(1)(A).

With respect to Johnson, the facts are slightly different than Pidot and Blue because Mr. Johnson's interest in the partnership was not completely liquidated prior to the year in issue (1984). In 1984, Johnson was repaid the balance in his Capital Account and his Drawing Account and had received the first payment liquidating his interest in his IUR and ACRS Accounts. However, we conclude that these are not significant facts with respect to the taxability of the retirement payments because the amount of these retirement payments was not related to the amounts in the Accounts. In other words, if Johnson's interest in these Accounts had been completely liquidated by the year in question, the amount of the retirement payment would not have been affected. Because the retirement payment was unrelated to the amounts

paid in liquidation of Johnson's Accounts in the partnership, we conclude that the Court's reasoning in Pidot applies with equal force to the retirement payments paid to Johnson in 1984, i.e., the retirement payments were not paid to liquidate an Account and, thus, were not a guaranteed payment under section 736(a). We also note that the Division has not made the alternative argument that the difference in liquidation status would cause the retirement payments to Johnson to be taxable even if we were to find in favor of Redlin and Fariss on this issue.

The Division argues that the retirement payments paid to all three petitioners are guaranteed payments under section 736(a) of the Internal Revenue Code and, therefore, are distributive shares of partnership income. The Division questions our reliance on Pidot for the proposition that if a partner's interest in a partnership has been completely liquidated, a retirement payment cannot be a guaranteed payment under section 736(a) of the Internal Revenue Code. The Division states that "[t]he court's brief analysis in Pidot offers no inkling as to why the payments received by the petitioner could not have been properly classified as [a section 736(a) payment because they were] 'otherwise not in exchange for his interest in partnership property' (See Treas. Reg. 1.736-1[a][3])" (Division's brief in opposition and reply, p. 10). The fact that the Court did not engage in an expansive analysis and review of each provision of the applicable Federal regulation does not give us the freedom to ignore the clear holding of the Court, i.e., that a retirement payment paid to a retired partner whose interest in the partnership has been completely liquidated is not a guaranteed payment under section 736(a).

In any event, it appears to us that the Division's arguments as to the meaning of the regulations under section 736(a) were before, and rejected by, the Court in Pidot. The State Tax Commission decision in Pidot was based on the reasoning that the payment to the

> "petitioner is properly considered a guaranteed payment for tax purposes under I.R.C. section 736(a) and under the applicable Treasury regulation, petitioner continues to be viewed as a 'partner' for tax purposes (although he is a retired partner). See Treasury Reg. Section 1.736-1(a)(1)(ii). Therefore, the income he received from [the partnership] was taxable to New York State in accordance with Tax

> Law sections 632(a)(1)(A) and 637" (Matter of Pidot, State Tax Commn., January 18, 1985).

The Division also relies heavily on the fact that petitioners and the partnership made tax filings for the years in question that indicate that petitioners were partners for these years and that the amounts in question were distributive shares of partnership income. As petitioners note, Pidot involved similar tax filings by the petitioner and partnership and these filings did not affect the resolution of the issue as to the nature of the payments.

The next issue is whether the retirement benefits are subject to tax by New York under Tax Law former § 632(b)(1)(B) as being derived from a business, profession or occupation carried on in New York. In Blue and in Matter of Walsh (Tax Appeals Tribunal, November 19, 1992, affd on other grounds Matter of Walsh v. Tax Appeals Tribunal, 196 AD2d 367, 609 NYS2d 405), we held that retirement payments from a New York partnership to a retired nonresident partner were derived from or connected with New York sources within the meaning of Tax Law former § 632(b)(1)(B). In each of those cases, we concluded that the retirement payments were derived from or connected with New York sources because they were paid in consideration of services rendered to the partnership in New York prior to the partners' retirement. The Division asks us to reach the same result here, even though petitioners, unlike the petitioners in Blue and Walsh, did not perform any services for the partnership in New York prior to their retirements.

The Division does not tax retirement benefits received by former employees who did not work in New York. During the period in issue, former 20 NYCRR 131.20 stated, in pertinent part, the following rule for retirement benefits paid to nonresident individuals: "[i]f the pension or other retirement benefit is attributable to services performed wholly outside New York State, no part of the amount received is includible in the individual's New York adjusted gross income." Former 20 NYCRR 131.4(d), set forth earlier, enunciates the same rule.

In Blue, it was the principle that retired partners and employees should be treated similarly that led us to conclude that Tax Law former § 632(b)(1)(B) was applicable to retired partners. We can see no reason to now reverse this principle and conclude that although section

632(b)(2)(B) applies to both, this statute treats former partners who did not perform services in New York differently from former employees who did not perform services in New York. Instead, we conclude, as did the Court in Pidot when interpreting Tax Law former § 632(b)(2), that we see nothing "which would justify disparate tax treatment for former employees and former partners who retain no interest in the partnership and do not share in partnership profits or losses" (Matter of Pidot v. State Tax Commn., supra, 499 NYS2d 482, 483). Therefore, we hold that because petitioners did not perform services in New York prior to their retirement, no portion of the retirement payments in issue are subject to tax under Tax Law former § 632(b)(1)(B).

The only support the Division offers for the conclusion it seeks is the "well settled principle that all members of a partnership are conducting a trade, business or profession in New York if their partnership is conducting business in New York State. (See Matter of Weil v. Chu, 120 AD2d 781, affd 70 NY2d 783, appeal dismissed 485 US 901)" (Division's brief in opposition and reply, p. 13). This well settled principle deals with active partners in a partnership and the taxability by New York of a distributive share of partnership income under Tax Law former § 632(a)(1)(A). We have already determined under Pidot, Kestenbaum and Blue that petitioners were not partners in the partnership for the years in question, they did not receive a distributive share of partnership income for the years in question and that the income at issue is not subject to tax under Tax Law former § 632(a)(1)(A). Therefore, we do not find the partnership principles upon which the Weil case was decided to be determinative here.

As a result of our decision that the retirement payments are not subject to New York taxation, there will be no further review of our decision on this issue and we need not address the question of whether the retirement payments would be excluded from tax as an annuity under former 20 NYCRR 131.4(d). We must, however, address that portion of the Division's exception that claims that the refund of Aubrey Fariss for 1982 was not timely filed.

Section 687(a) of the Tax Law provides that "[c]laim for credit or refund of an overpayment of income tax shall be filed by the taxpayer within three years from the time the

return was filed or two years from the time the tax was paid, whichever of such periods expires the later, or if no return was filed, within two years from the time the tax was paid." Section 687(h) provides that "any return filed before the last day prescribed for the filing thereof shall be considered as filed on such last day, determined without regard to any extension of time granted the taxpayer."

The Division's assertion that Mr. Fariss' 1982 refund claim was required to be filed by April 15, 1986 assumes that the 1982 return was timely filed. In fact, we have found nothing in the record to indicate when the 1982 return was filed and consequently we cannot find when the refund period commenced or expired (see, Matter of Jencon, Inc., Tax Appeals Tribunal, December 20, 1990). Thus, we will treat the 1982 refund claim as timely.

Lastly, we must address petitioner Johnson's claim that "[t]he payment of the drawing account represented a payment for Johnson's interest in partnership property as described in IRC § 736(b) and, thus, cannot be sourced to New York" (Petitioners' exception).

The pertinent facts, to which petitioners have not taken exception, state "[t]he drawing account was the partner's banking account. Each partner's drawing account was credited yearly with the partner's share of the cash basis income of PMM. PMM would debit this account as a partner made withdrawals" (Determination, finding of fact "8"). We conclude that petitioner Johnson has not established that the Administrative Law Judge erred in concluding that the payment from the drawing account was a distributive share of partnership income, allocable to New York State.

Accordingly, it is ORDERED, ADJUDGED and DECREED that:

1. The exception of Warren H. Johnson, Aubrey and Elsie R. Fariss and Robert W. and Harriet A. Redlin is granted to the extent that the retirement payments from the unqualified plan are held not to be subject to New York State taxation;

2. The exception of the Division of Taxation is denied;

3. The determination of the Administrative Law Judge is modified to the extent indicated in paragraph "1" above, but is otherwise affirmed;

4. The petitions of Warren H. Johnson, Aubrey and Elsie R. Fariss and Robert W. and Harriet A. Redlin are granted to the extent indicated in paragraph "1" above, but are otherwise denied; and

5. The Division of Taxation is directed to grant petitioners' refunds in accordance with paragraph "4" above.

DATED: Troy, New York
May 30, 1996

/s/John P. Dugan
John P. Dugan
President

/s/Francis R. Koenig
Francis R. Koenig
Commissioner

/s/Donald C. DeWitt
Donald C. DeWitt
Commissioner