STATE OF NEW YORK

TAX APPEALS TRIBUNAL

In the Matter of the Petition	:	
of	:	
PETER F. AND BARBARA D. McSPADDEN	:	DECISION DTA NO. 810895
for Redetermination of a Deficiency or for Refund of New York State and New York City Personal Income Tax under Article 22 of the Tax Law and the New York City Administrative Code for the Year 1988.	:	

The Division of Taxation filed an exception to the determination of the Administrative Law Judge issued on September 9, 1993 with respect to the petition of Peter F. and Barbara D. McSpadden, 46 Carriglea Drive, Riverside, Connecticut 06878. Petitioners appeared by Hall, Dickler, Lawler, Kent & Friedman (James E. Conway , Esq., of counsel). The Division of Taxation appeared by William F. Collins, Esq. (Andrew J. Zalewski, Esq., of counsel).

The Division of Taxation filed a brief in support of its exception and a reply brief in response to petitioners' brief in opposition. Oral argument was heard on April 20, 1994, which date began the six-month period for the issuance of this decision.

The Tax Appeals Tribunal renders the following decision per curiam.

ISSUE

Whether the lump sum payment received by petitioner, Peter F. McSpadden, a nonresident employed by a New York employer, constitutes New York source income subject to personal income tax.

FINDINGS OF FACT

We find the facts as determined by the Administrative Law Judge except for findings of fact "5" and "9" which have been modified. The Administrative Law Judge's findings of fact and the modified findings of fact are set forth below.

Petitioners, Peter F. and Barbara D. McSpadden, timely filed a New York State income tax return for 1988 (Form IT-203) as full-year nonresidents. This return was filed jointly by petitioners and, at line 1, reflects total compensation (wages, salaries, tips, etc.) in the amount of $2,599,878.00. This figure, in turn, is comprised of amounts paid to petitioner Peter F. McSpadden by his former employer as follows: wages paid through May 31,1988 ($228,331.00), deferred compensation paid on March 16, 1988 for past services ($521,463.00), and a lump-sum payment made in connection with the termination of petitioner's employment as of May 31, 1988 ($1,850,000.00). In addition, petitioner Barbara D. McSpadden received a small amount of compensation for services performed for the Greenwich, Connecticut Public Library ($84.00).[1] Petitioner reported $128,362.00 as New York source income subject to New York State and City taxation, contending that the balance of his total compensation, including the deferred compensation and employment termination amounts, was not New York source income properly subject to New York State or City taxation. Petitioners' return as filed claimed a refund due in the amount of $132,418.00. However, this claimed refund was not approved for issuance due to pending audit action.

On October 29, 1990, following an audit, the Division of Taxation ("Division") issued to petitioner a Statement of Personal Income Tax Audit Changes. This statement asserted additional tax due for the year 1988 in the amount of $71,042.42, consisting of New York State tax in the amount of $69,476.57 and New York City tax in the amount of $1,565.85. The calculation of this additional tax was premised upon the Division's position that the entire amount of deferred compensation plus the employment termination payment received by petitioner in 1988 was New York source income properly subject to New York State and City of New York taxation.

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[1]Petitioner Barbara D. McSpadden's name appears in this proceeding solely by virtue of the fact that petitioners filed a joint return. There is no claim that the compensation paid to Mrs. McSpadden is subject to New York State or City taxes. Hence, all references to "petitioner" shall be references to petitioner Peter F. McSpadden only.

On December 6, 1990, the Division issued to petitioner a Notice of Deficiency asserting additional personal income tax due for 1988 in the amount of $71,042.42, plus interest. This Notice of Deficiency followed and was issued upon the same basis as was set forth in the above-described Statement of Personal Income Tax Audit Changes.

At the commencement of proceedings herein, the parties stipulated to certain facts. Specifically, the parties agreed that as a resident of Connecticut petitioner was entitled to allocate his compensation within and without New York based on a ratio the numerator of which is the number of days worked in New York and the denominator of which is the total number of days worked. In this case, the parties stipulated to an allocation ratio of 55%. In addition, petitioner conceded that the deferred compensation amount received on March 16, 1988 ($521,463.00) was properly taxable by New York State and City to the extent of the 55% allocation. Therefore, the only remaining issue in this proceeding is the treatment of the $1,850,000.00 lump-sum payment received by petitioner in connection with terminating his employment.

We modify finding of fact "5" to read as follows:

> As described, petitioner is a nonresident of New York, having lived in Connecticut for over 22 years. Petitioner holds a Bachelor of Arts Degree from Dartmouth College, and served in the United States Navy in the early 1950s. He ended his service in the Navy in 1956, at which time he went into the advertising business. Petitioner was first employed by an advertising firm known as McCann Ericson. Shortly thereafter, petitioner became employed by Danzer, Fitzgerald & Sampler ("DFS"). Petitioner was promoted through the organization at DFS such that he ultimately became its president and chief operating officer. On January 1, 1986, petitioner executed a 5-year employment contract with DFS which was to commence on such date and end on December 31, 1990. Petitioner's base salary was $400,000.00 a year plus other benefits. Paragraph 4(e)(iv) of the contract provided that if petitioner's employment were to be terminated prior to December 31, 1990 other than due to voluntary termination or termination for cause,[2] then petitioner would be entitled to his regular salary and $869,000.00 of deferred compensation payable to him on December 31, 1990.
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> Paragraph 6 of the employment agreement provided that petitioner was not required to perform job duties which required his principal office or

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[2] Termination for cause allowed DFS to terminate petitioner for such things as petitioner's failure to perform his job duties, dishonesty, drunkenness, use of drugs, conviction of a felony, material breach of contract, etc.

> residence be maintained outside New York, except with his consent. Petitioner agreed, however, to undertake reasonable travel to perform his duties.[3]

In 1986, DFS was named advertising agency of the year in an advertising trade publication. At that time, DFS had no international advertising system. DFS was, however, working with another advertising firm, the Dorland Agency of London, England, on an affiliated basis. In or about 1986, the Dorland Agency was acquired by the Saatchi & Saatchi Advertising Agency ("Saatchi & Saatchi"). In turn, Dorland suggested that it should purchase DFS, in what was described as a reverse takeover, and work toward establishing a second international system for Saatchi & Saatchi. This acquisition occurred, and DFS became DFS Dorland Agency. At this time, petitioner described his position as the number two man at the agency working directly for one Stewart Upson, who was chairman and chief executive officer. Petitioner's title continued to be president and chief operating officer, and his employment terms were set forth in a five-year employment contract with Saatchi & Saatchi.

Some six months after Dorland's acquisition of DFS, Saatchi & Saatchi also purchased the Ted Bates Company, another advertising agency which already had in place an international system. According to petitioner, the funds used by Saatchi & Saatchi to make the Ted Bates Company acquisition were the same funds which were originally to be used by DFS Dorland to build an international system. In light of these circumstances, the Saatchi & Saatchi owners approached petitioner at DFS Dorland, explaining that Saatchi & Saatchi had too many sub-groups and was badly organized. Saatchi & Saatchi suggested that DFS Dorland become a "second" to Ted Bates' international system. Petitioner rejected this suggestion on the grounds that the same would constitute bad management and result in too many client conflicts. In turn, after analyzing DFS Dorland Agency's position, petitioner decided that the best course of action would be for DFS Dorland Agency to take over Saatchi & Saatchi's operations in the United States, known then as Compton Advertising. This takeover occurred and resulted in an entity

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[3] We modified the Administrative Law Judge's finding of fact "5" by adding the last three sentences of paragraph 1 and the second paragraph to detail petitioner's employment contract with DFS in order to adequately reflect the record.

known as DFS Dorland Compton, working as a Saatchi & Saatchi domestic arm in the United States. Petitioner remained as president, while Stewart Upson remained as chairman.

Petitioner testified that he became "somewhat discouraged" after the last corporate changes, due to the loss of some DFS clients occasioned by agency conflicts, to a loss of key personnel at DFS, and to the fact that he was not entirely free to manage his own agency. Petitioner testified that he considered retirement. At this same period in time, DFS Dorland Compton's clients included RJR Nabisco's Lifesaver and Confections Division and Northwest Airlines. Both of these accounts were headed by petitioner. Northwest Airlines requested the agency to prepare certain advertising to celebrate the fact that Northwest would be banning smoking on its domestic flights. This advertising was in fact prepared and run. In response, RJR Nabisco terminated its relationship with DFS Dorland Compton. Thereafter, the Saatchi & Saatchi owners met with petitioner to discuss certain negative publicity resulting from the above-described circumstances. Petitioner testified that the Saatchi & Saatchi representatives indicated to him their "desire to reduce the amount of liabilities on their financial statements", and their knowledge that he had been contemplating retirement, stating directly to petitioner that "We'd like to work out a termination agreement with you relative to your contract." Petitioner, in turn, agreed to negotiate toward termination of his employment.

We modify finding of fact "9" to read as follows:

> On November 9, 1987, petitioner entered into a letter agreement with Saatchi & Saatchi/DFS concerning the termination of his July 1, 1987 employment contract. The July 1, 1987 employment agreement was an update of petitioner's January 1, 1986 employment agreement and reflected the appropriate corporate name resulting after the many corporate changes described hereinabove. Additionally, petitioner's annual salary was increased from $400,000.00 to not less than $550,000.00. The rest of the amended employment agreement was virtually identical to the former agreement, including paragraphs 4(e)(iv) and 6. Thereafter, on May 25, 1988, petitioner entered into a second letter agreement concerning the termination of his employment. Pursuant to the May 25, 1988 termination agreement petitioner and DFS agreed to a complete satisfaction of petitioner's remaining employment contract, which was to run through December 31, 1990, in exchange for the payment to petitioner of salary and benefits due petitioner through May 31, 1988, plus a lump-sum payment in the amount of $1,850,000.00. The May 25, 1988 agreement indicates that the $1,850,000.00 payment was in complete satisfaction of all of petitioner's rights under and for the remaining balance of his July 1, 1987 employment

> contract. In addition, petitioner agreed to honor the terms of a previously agreed to restrictive covenant (dated January 1, 1986) pursuant to which petitioner had agreed not to interfere with the business relations of DFS and/or its clients for a period of two years after ceasing his employment with DFS. The restrictive covenant executed by petitioner stated that petitioner agreed to the restrictions in consideration of his continued employment with DFS. Petitioner described the May 25, 1988 termination agreement payment of $1,850,000.00 as representing a negotiated amount paid as a "buyout" of the amounts that he would be entitled to for the remaining term of his employment contract (essentially representing the sum due under that contract discounted to the date of the termination agreement [i.e., the present value of petitioner's full future employment contract rights]). Petitioner received payment of the $1,850,000.00 sum, net of 20% tax withheld, within 60 days after May 31, 1988.[4]

Petitioner was paid in full for his services rendered to DFS through May 31, 1988, pursuant to the May 25, 1988 agreement. Petitioner did not receive nor was he owed any severance or termination pay, pension monies, or any other form of compensation by DFS for any services rendered before the May 31, 1988 termination date, except for his right to receive monies from DFS' profit-sharing plan in which petitioner had participated for some 29 plus prior years. The profit-sharing payout amount was eventually received by petitioner and was rolled over into a qualified IRA.

Petitioner rendered no services in New York or elsewhere for DFS or any of its related or affiliated entities at any time after May 31, 1988. In fact, the only work petitioner performed after June 1, 1988 was a consulting job for the American Association of Advertising Agencies. This group, and petitioner's work, was unrelated to petitioner's prior employment and was performed out of petitioner's home in Connecticut. Petitioner held no stock or stock rights in DFS or any of its affiliates. Petitioner made no claim for monies for prior services rendered for

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[4] We modified finding of fact "9" of the Administrative Law Judge's determination by deleting footnote "2" of said determination which read:

> "[t]he July 1, 1987 employment contract appears to be a renewal of petitioner's then-existing five-year employment contract re-executed in order to reflect the then-appropriate corporate employer name resulting after the many corporate changes described hereinabove,"

and by adding the second, third, fourth and ninth sentences in order to reflect the record in more detail.

DFS or any of its affiliates, did not believe he had any such claims, and the same was not a part or factor in the negotiations surrounding petitioner's employment termination.

Upon termination of his employment with DFS, petitioner either relinquished certain fringe benefits to which he was entitled under his employment contract or, if he continued memberships or ownership of assets, he paid DFS the appropriate value therefor (e.g., petitioner paid DFS for the remaining depreciated value of his company automobile which he kept; petitioner repaid DFS for the value of a membership bond in a Connecticut country club).

As its chief operating officer petitioner was in charge of all aspects of DFS' ongoing operations. DFS employed some 1,300 persons in offices within and without New York State, and petitioner's responsibilities included dealing directly with the agency's major clients. As described, much of petitioner's working time was spent out of New York travelling to areas within and without the United States. In response to a question raised on cross examination, petitioner allowed that if he had remained employed with DFS, his employment would have continued to be within and without New York as had been his pattern over the many years of his employment.

Attached to petitioner's return was an explanatory statement that those wages reflected on petitioner's Wage and Tax Statement (Form W-2) but not allocated to New York represented "payment for future services not to be performed in New York State." This statement was included on the return by petitioners' paid tax return preparer.

OPINION

The Administrative Law Judge held that petitioner possessed a right to future employment through December 31, 1990 secured by his employment contract with DFS, the remaining term value of which was an item of intangible personal property. The Administrative Law Judge then concluded that the lump-sum payment of $1,850,000.00 was received for petitioner's relinquishment of this right and, thus, was not taxable by New York. The Administrative Law Judge held that this lump-sum payment was not taxable as compensation for personal services because it was neither an amount received in connection with the termination of employment,

an amount received upon early retirement for past services, an amount for consultation services, nor an amount received in consideration for a covenant not to compete.

On exception, the Division asserts that the lump-sum payment was a taxable New York source income because it was an amount: (1) received in connection with the termination of employment; (2) received upon early retirement for past services rendered; (3) received upon retirement for consultation services; or (4) received upon retirement in consideration for a covenant not to compete. In the alternative, the Division argues that if the lump-sum payment was received in exchange for petitioner's relinquishment of his right to future employment, the right to future employment was secured by consideration having a connection with New York State and, thus, properly taxable by New York.

In response, petitioner asserts that the lump-sum payment was not attributable to personal services rendered in the past or to be rendered in the future. Instead, petitioner contends that the lump-sum payment was received in exchange for his relinquishment of the right to future employment and this right had no connection to New York sources. Petitioner also takes offense to the different litigation positions taken by the Division with respect to the characterization of the lump-sum payment in this case compared to that of Matter of Laurino (Tax Appeals Tribunal, May 20, 1993). Finally, petitioner argues that no amount of the lump-sum payment be allocated to the covenant not to compete because there was no amount assigned to this covenant in the termination agreements nor is it likely the covenant not to compete would have been enforceable.

We affirm the determination of the Administrative Law Judge for the reasons set forth below.

Tax Law § 601(e) imposes a tax on the New York source income of a nonresident individual. New York source income of a nonresident individual is defined as "the sum of the net amount of items of income, gain, loss and deduction entering into his federal adjusted gross income . . . derived from or connected with New York sources . . ." (Tax Law § 631[a], emphasis added).

Petitioner argues that under Matter of Donahue v. Chu (104 AD2d 523, 479 NYS2d 889), the lump-sum payment received by petitioner, a nonresident of New York, from petitioner's former employer was consideration for the relinquishment of his right to future employment and is not subject to taxation by New York. We agree.

Petitioner's employment contract provided petitioner with employment through December 31, 1990. Petitioner and his employer negotiated a settlement wherein it was agreed petitioner would relinquish his contractual rights under the employment agreement in exchange for a lump-sum payment of $1,850,000.00. Petitioner's rights under the employment agreement were originally secured by consideration having no connection to New York, i.e., petitioner's promise to work for DFS in the future (Matter of Donahue v. Chu, supra; Matter of Laurino, supra). Therefore, the lump-sum payment received by petitioner is not taxable by New York.

The Division, citing Matter of Donahue v. Chu (supra), argues that had petitioner continued in the employ of DFS, the contract rights would have been exercised in New York and, thus, are subject to taxation by New York. The Division points to paragraph 6 of the employment agreement which provided that petitioner would "not be required to perform duties which require that his principal office, or his residence be maintained outside the City of New York, New York, or its vicinity . . ." (Amended and Restated Employment Agreement, July 1, 1987). The Division, however, overlooks the fact that this provision of the employment agreement was DFS' promise to petitioner and not a promise made by petitioner to work in New York. Furthermore, the employment agreement provided that petitioner could have consented to work outside of New York if he so desired.

Additionally, the Division asserts that because it was elicited from petitioner on cross-examination that petitioner would have continued to work in New York had he continued in the employ of DFS (Tr., p. 54), the lump-sum payment is taxable by New York. We reject this argument. The evidence the Division relies on is speculative at best and does not support a conclusion that petitioner's contractual rights would have been exercised in New York had his employment continued (see, Matter of Donahue v. Chu, supra).

Next, we address whether the lump-sum payment was received in consideration for the covenant not to compete.

The Division argues that the lump-sum payment petitioner received was an amount received upon retirement under a covenant not to compete and, thus, taxable as compensation for personal services pursuant to 20 NYCRR 131.4(d). We disagree.

The termination agreement stated that in consideration of the lump-sum payment and notwithstanding any of the other provisions, the restrictive covenant dated January 1, 1986 would remain in effect. While the Division asserts that the covenant was such an integral part of the termination agreement so as to subject the lump-sum payment to tax, we disagree. The restrictive covenant referenced in the termination agreement was already secured by consideration. Specifically, in the restrictive covenant, petitioner agreed that in consideration of his continued employment, he would abide by the terms of the restrictive covenant during the duration of his employment and for a period of two years thereafter. "A covenant to do what one is already under a legal obligation to do is not sufficient consideration for another contract" (Ripley v. International Rys. of Cent. Am., 8 NY2d 430, 209 NYS2d 289, 295). Because it appears that petitioner was already legally bound by the terms of the restrictive covenant executed on January 1, 1986, we conclude that petitioner's promise to abide by the terms of the restrictive covenant was not consideration for the lump-sum payment. Instead, as discussed, we agree with petitioner that the lump-sum payment was an amount received in exchange for relinquishment of future contractual rights.

Finally, the Division argues that the lump-sum payment was received in connection with the termination of employment, received upon early retirement in consideration of past services, or received upon retirement for consultation services. Likewise, we reject this argument.

The Division merely makes these allegations and does not direct the Tax Appeals Tribunal to any evidence in support of their contentions. In fact, as the Administrative Law Judge noted in his determination, the facts do not support a conclusion that the lump-sum payment represented any of these things.

Accordingly, it is ORDERED, ADJUDGED and DECREED that:

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

2. The determination of the Administrative Law Judge is affirmed;

3. The petition of Peter F. and Barbara D. McSpadden is granted to the extent indicated in the Administrative Law Judge's conclusion of law "E" but is otherwise denied; and

4. The Division of Taxation is directed to modify the Notice of Deficiency dated December 6, 1990 in accordance with paragraph "3" above and refund to petitioner such sum computed in accordance with this recomputation.

DATED: Troy, New York
September 15, 1994

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

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