STATE OF NEW YORK

TAX APPEALS TRIBUNAL

In the Matter of the Petition	:	
of	:	
NICHOLAS PENCHUK	:	DECISION DTA No. 812646
for Redetermination of a Deficiency or for Refund of Personal Income Tax under Article 22 of the Tax Law and the New York City Administrative Code for the Years 1989, 1990 and 1991.	:	

The Division of Taxation filed an exception to the determination of the Administrative Law Judge issued on October 26, 1995 with respect to the petition of Nicholas Penchuk, 51 Angelfish Cay Drive, ORC Box 6, North Key Largo, Florida 33037. Petitioner appeared by Richards & O'Neil, LLP (Anthony J. Carbone, Esq., of counsel). The Division of Taxation appeared by Steven U. Teitelbaum, Esq. (Craig Gallagher, Esq., of counsel).

The Division of Taxation filed a brief in support of its exception, petitioner filed a brief in opposition and the Division of Taxation filed a reply brief. Each party's request for oral argument was denied.

Commissioner DeWitt delivered the decision of the Tax Appeals Tribunal. Commissioner Pinto concurs. Commissioner Jenkins took no part in the consideration of this decision.

ISSUE

Whether the consideration received by a nonresident for a covenant not to compete with a corporation which had its principal executive offices in New York City constituted New York source income.

FINDINGS OF FACT

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

Petitioner, Nicholas Penchuk, was a nonresident of New York State during 1989, 1990 and 1991. He resided and was domiciled in Teaneck, New Jersey during 1989 and 1990. In 1990, he changed his residence and domicile to North Key Largo, Florida where he continues to reside and maintain his domicile.

Prior to April 26, 1989, petitioner served as executive vice-president-finance and chief financial officer of Duncanson & Holt, Inc.("Duncanson & Holt"), a manager of reinsurance pools. Prior to April 26, 1989, petitioner also owned 18,000 shares of the common stock of Duncanson & Holt. Thomas G. Brown and R. Patrick Miele owned the remaining outstanding shares of common stock in equal 18,000-share blocks.

Duncanson & Holt conducted a reinsurance pool management business. The members of the reinsurance pool included large, well-known insurance companies such as Metropolitan Life, Prudential, Cigna, CHUBB and Aetna. The underlying risks being insured related to locations throughout the United States, Europe, South America and parts of Asia.

Since its inception, Duncanson & Holt's principal executive offices have been located in New York City. During the period in question, Duncanson & Holt also maintained offices in Chicago, Illinois; Dallas, Texas; Hartford, Connecticut; Los Angeles and San Francisco, California; Philadelphia, Pennsylvania; Portland, Maine; Seattle, Washington; and overseas in London, England and Singapore.

During the period that petitioner was associated with Duncanson & Holt, his office was located at the firm's New York City headquarters. However, due to the international nature of Duncanson & Holt's business, petitioner, as well as other employees of the firm, were required to travel depending on the needs of its customers, who were located in various parts of the world.

Before joining Duncanson & Holt, petitioner was employed by Arthur Young & Co. where he developed an expertise in the areas of insurance regulation and accounting while working closely with the firm's clients in the insurance business. When he joined Duncanson & Holt in 1976, petitioner assumed responsibility for its financial and regulatory compliance including the formation of a number of reinsurance pools and subsidiary insurance companies.

Disagreements arose among the three shareholders (Brown, Miele and petitioner) concerning the management and direction of Duncanson & Holt. Because each shareholder held an equal number of shares, disagreements often resulted in stalemate situations. Therefore, the shareholders agreed that it would be in the firm's and in their best interest for Brown to buy out the shares of the other two shareholders. With this goal in mind, the shareholders entered into a Reorganization Agreement dated April 26, 1989.

The Reorganization Agreement was designed to permit Brown to use the resources of Duncanson & Holt to purchase 7,000 shares of common stock each from Miele and petitioner and to provide for the future transfer of the remaining shares. Petitioner received $3,500,000.00 for the transfer of his 7,000 shares. The result of the immediate transfer of the 7,000 shares each resulted in reducing Miele's and petitioner's interest in Duncanson & Holt to 27.5% each and increasing Brown's interest to 45.0%.

The parties were required by the terms of the Reorganization Agreement to enter into certain ancillary agreements, including (1) a Shareholder's Agreement dated April 26, 1989; (2) an Employment Agreement dated April 26, 1989; and (3) a Noncompetition Agreement dated April 26, 1989. All of these agreements resulted from arm's-length negotiations. Petitioner was 43 years old at the time of these agreements.

Under the terms of the Shareholder's Agreement, Duncanson & Holt was to purchase all the remaining common stock held by petitioner and Miele in accordance with an agreed-upon schedule and pricing formula. Until April 30, 1992, petitioner and Miele were granted the right to "put" (written notice of shareholder's intention to sell a certain number of shares to the firm

which it is required to purchase), and Duncanson & Holt was granted the right to "call" (written notice by firm of its intention to buy a certain number of shares which the shareholders were required to sell) 3,000 shares owned by petitioner and 7,000 shares owned by Miele. Other provisions provided for the firm's purchase of the remaining shares from petitioner and Miele. Petitioner ultimately received over $20,000,000.00 for his shares of common stock under this Shareholder's Agreement.

The Employment Agreement provided that petitioner would serve as a part-time chief financial officer of Duncanson & Holt until April 30, 1990, and that he would serve as manager and administrator of Rochdale Insurance Co. ("Rochdale"), a wholly-owned subsidiary of Duncanson & Holt, until (1) all of petitioner's remaining shares of common stock were repurchased; (2) Duncanson & Holt ceased to own an interest in Rochdale; or (3) Duncanson & Holt's management agreement with Rochdale terminated. Under the terms of the Employment Agreement, petitioner received $60,000.00 per year for his part-time services as the chief financial officer and $50,000.00 per year for his services as manager of Rochdale.

In order to protect the equity interest Brown was indirectly acquiring, he required that, as part of the terms of the Reorganization Agreement, petitioner consent to a Noncompetition Agreement. Petitioner had extensive experience and contacts in the reinsurance management business. As petitioner explained in an affidavit, the capital requirements for starting a new reinsurance pool management business were relatively modest. Inasmuch as such companies rely heavily on the personal reputation of their employees among the large insurance companies, petitioner, who had the experience and knowledge of the regulatory requirements and who had established a personal reputation in the business, posed a competitive threat to Brown.

Therefore, under the Noncompetition Agreement, petitioner agreed that, for a five-year period, he would not:

> "directly or indirectly, be associated with any business, or personally engage in any business, whether as a director, officer, employee, agent, partner, owner, independent contractor or otherwise, that offers, sells, develops, produces, markets or licenses any product or service competitive with any product or service which

[Duncanson & Holt] or any of its affiliates offers currently or, subject to the following sentence, offers at any time during the Noncompetition Term."

Petitioner also agreed (1) not to disclose any confidential information of which he had knowledge as a result of being an employee of Duncanson & Holt; (2) not to induce or attempt to induce, directly or indirectly, any present or former customer or pool member of Duncanson & Holt or any of its subsidiaries to cease doing business with the company or any of its affiliates or to solicit the business of any present or former customer or pool member of the company or any of its affiliates for any product or service that competes with any product or service of the company or any of its affiliates; and (3) not to solicit or attempt to solicit for employment, or cause or endeavor to cause the employment, of any employee of Duncanson & Holt or any of its affiliates. In consideration for petitioner's consent to the terms of the Noncompetition Agreement, petitioner received $250,000.00 per year during 1989, 1990 and 1991.

During 1989 through 1991, petitioner's activities in New York were limited to providing personal services as an employee of Duncanson & Holt. He maintained no office or other place of business in New York other than the office facilities provided to petitioner by Duncanson & Holt for the performance of his duties as a part-time employee.

After April 1989, petitioner conducted his business affairs in accordance with the terms of the Noncompetition Agreement receiving $125,000.00 in 1989 and $250,000.00 each in 1990 and 1991. On his nonresident income tax returns for 1989, 1990 and 1991, petitioner allocated approximately 84%, 85% and 100%, respectively, of his wage income from Duncanson & Holt to New York income.[1]

After an audit, the Division of Taxation ("Division") increased the amount of income tax owed for 1989, 1990 and 1991 by including as taxable income the amounts petitioner received

[1]In his affidavit dated March 10, 1995, petitioner noted that he currently owned interests in a pharmaceutical packaging company, the management of which he was involved in, a ski resort and a bridal gown company. He also continued to underwrite insurance as a member of Lloyd's of London as permitted by the terms of the Noncompetition Agreement.

($125,000.00 in 1989, $250,000.00 in 1990 and $250,000.00 in 1991) under the Noncompetition Agreement multiplied by an 84% allocation ratio.[2]

The Division issued to petitioner a Notice of Deficiency, dated August 9, 1993, asserting additional income tax owed for the years 1989 through 1991 of $44,526.41, plus penalty and interest, for the total amount of $58,125.45.

Petitioner requested a conference with the Bureau of Conciliation and Mediation Services and then withdrew that request by letter dated December 7, 1993. This request was acknowledged by the Bureau by letter dated December 17, 1993.

Petitioner filed a petition, dated March 4, 1994, arguing that the consideration received under the Noncompetition Agreement was not derived from sources in New York State within the meaning of Tax Law § 631 and did not constitute wages earned or net earnings from self-employment within New York City within the meaning of the New York City Administrative Code. Petitioner contended that the covenant not to compete was not associated with New York, but with petitioner's worldwide business.

The Division filed an answer, dated May 19, 1994, alleging that petitioner failed to properly compute and pay tax on his New York source income and that he had the burden of proving that the Division's recomputation of tax owed was erroneous or improper.

OPINION

In her determination, the Administrative Law Judge concluded that the income received as a result of the covenant not to compete was not derived from or connected with a New York source. The payments received by petitioner were in lieu of future employment which was unconnected to employment with Duncanson & Holt. Petitioner gave up his right in the future to be self-employed or to be employed by a competitor of Duncanson & Holt and, given the national and international nature of the business of Duncanson & Holt, the Administrative Law

[2]According to the audit workpapers, the Division's auditor arrived at 84% as an average of the allocations for the three years -- using 83% from 1989, 85% from 1990 and 85% from 1991. The use of 85% for 1991 appears to be incorrect inasmuch as petitioner's nonresident income tax return for 1991 clearly shows that he allocated 100% of his wages from Duncanson & Holt to New York State.

reasoned that there was no basis to assume that a business competitive to Duncanson & Holt would be located in New York.

The Administrative Law Judge also concluded that since the covenant not to compete would have applied to petitioner if he had engaged in a competitive business located outside New York State, the amount received by petitioner in exchange for the covenant not to compete was not connected with, or derived from, New York sources on the mere speculation that petitioner could have located a competitive business in New York State as well as outside New York State.

Additionally, she concluded that there was no evidence in this record to support a conclusion that the consideration received was a pension or retirement benefit to petitioner. Therefore, the Administrative Law Judge determined that there was no basis for applying 20 NYCRR former 131.4(d) to petitioner's situation.

The Division argues that the Administrative Law Judge erred in concluding that there is no basis on which to assume that a business competitive to Duncanson & Holt would be located in New York. It argues that at least in part, the covenant not to compete was intended to protect the New York business of Duncanson & Holt since that company continued to maintain its headquarters there. Further, petitioner continued to work in New York City throughout the years at issue herein. Therefore, the Division asserts that the situs of the right which petitioner gave up (to compete with Duncanson & Holt for a specified period of time) was New York.

Relying on the decision of the United States Tax Court in Korfund Co. v. Commissioner (1 T.C. 1180), the Division argues that payments received for a covenant not to compete are sourced to the jurisdiction in which the promisor agrees not to compete. The market in which petitioner may have competed with Duncanson & Holt should be limited to the market in which petitioner has actually worked. While the covenant might have been intended to cover additional territories, since petitioner conducted most of his business in New York, at least in part the covenant was intended to prevent petitioner from competing with Duncanson & Holt in New York. The Division also argues that petitioner did, in fact, retire from Duncanson & Holt

and the consideration received as a result of the covenant not to compete was a retirement or pension benefit. Pursuant to 20 NYCRR 131.4(d), the consideration at issue should be treated as compensation for personal services attributable to services performed in New York State. Contrary to petitioner's position, the Division argues that monies received pursuant to a covenant not to compete are taxable as compensation for personal services and not as income derived from an intangible.

Petitioner, in opposition, argues that the Administrative Law Judge correctly concluded that the consideration received for the covenant not to compete was not New York source income. Tax Law § 631(b)(2) provides that income received by a nonresident from intangible personal property is income derived from New York sources only to the extent that the income is from property employed in a business, trade, profession or occupation carried on in New York. To the extent petitioner "employed" the covenant not to compete, he employed it to facilitate his sale of stock to Duncanson & Holt. Neither the isolated sale of stock nor the observance of a covenant not to compete constitutes the conduct of a business, trade, profession or occupation. The fact that Duncanson & Holt had its headquarters in New York and petitioner performed services for Duncanson & Holt after the reorganization do not affect the source of the consideration paid for the covenant not to compete.

Petitioner also argues that 20 NYCRR former 131.4(d) applies only to pension or retirement benefits attributable to a person's prior services to his employer. Petitioner argues that there is no basis on which to conclude that the amounts received pursuant to the covenant not to compete were attributable to petitioner's services to Duncanson & Holt prior to the reorganization. Therefore, section 131.4(d) does not apply and these payments are not compensation for personal services attributable to services performed in New York State.

In Matter of Haas (Tax Appeals Tribunal, April 17, 1997), we considered issues similar to those involved in this proceeding. In that decision we stated:

> "[t]he Division argues that Korfund Co. v. Commissioner (supra) requires that we consider the source of this income to be New York

> because petitioner had a right to compete with MLSI in New York and that is where he gave up that right. In Korfund, the Tax Court considered whether the taxpayer, a New York corporation, was liable for withholding tax on amounts paid to certain nonresident aliens pursuant to an agreement not to compete with the taxpayer. The Tax Court found that the rights of the nonresident aliens to do business in the United States were interests in property in this country. Since the situs of their right to income from this property was in the United States, the income derived from foregoing the use of these rights for a specified period of time was earned and produced in the United States and subject to withholding taxes.
>
> "We do not find Korfund to be dispositive of the issues in the present case. The Legislature has specified what it considers to be income derived from or connected with New York sources in Tax Law § 631. There is no indication that the Legislature intended that the provisions of the Internal Revenue Code concerning the source of income for nonresident aliens would apply to a determination of taxable income pursuant to Tax Law § 631. Section 861 of the Internal Revenue Code defines those items of gross income which are treated as income from sources within the United States. Such items of income include, among others, all items of interest and dividends of domestic corporations, rents and royalties from any interest in property within the United States and all social security benefits. In sum, the items included in source income from within the United States form a much broader category than those which are included in the income of a nonresident pursuant to Tax Law § 631 and have little applicability in determining the issue at hand" (Matter of Haas, supra).

Similarly, we do not agree with the Division's argument in the present matter that Korfund requires that the payments made pursuant to the agreement not to compete must be sourced to New York State.

As we concluded in Haas, a payment made pursuant to a covenant not to compete is ordinary income to the petitioner. Tax Law § 631(a) provides that the New York source income of a nonresident individual is the sum of the net amount of items of income, gain, loss and deduction included in the individual's Federal adjusted gross income which are "derived from or connected with New York sources." Relevant to this proceeding, items of income, gain, loss and deduction "derived from or connected with New York sources" are those items which are either: (a) attributable to a business, trade, profession or occupation carried on in New York; or (b) income from intangible personal property only to the extent that such income is from property employed in a business, trade, profession or occupation carried on in New York (Tax Law §§ 631[b][1][B] and 631 [b][2]). If there were no covenant not to compete, petitioner

might have exercised his skill and ability in competition with Duncanson & Holt in New York. If such competing services were rendered in New York, tax on the earnings therefrom would have been payable to New York. However, the contractual payment was made for the observance of the covenant not to perform competing services in New York and elsewhere. Therefore, the taxpayer could only comply with the terms of the contract and be entitled to compensation pursuant to the agreement by refraining from performing competing services in New York and elsewhere. If petitioner did perform competing services in New York, he would have been in breach of his agreement and not have earned the compensation which is now sought to be taxed. If he is taxed by the jurisdiction where he would have performed services but for the covenant, then he is being taxed on a business, trade, profession or occupation not carried on in New York, clearly a situation not embraced by Tax Law § 631(b)(1)(B).

As to the argument by the Division that the consideration received as a result of the covenant not to compete was a retirement or pension benefit and, therefore, taxable pursuant to 20 NYCRR 131.4(d), we agree with the Administrative Law Judge that petitioner did not retire from Duncanson & Holt and the funds at issue were not paid as part of a retirement package.

As a result, we affirm the determination of the Administrative Law Judge.

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 Nicholas Penchuk is granted; and
4. The Notice of Deficiency, dated August 9, 1993, is cancelled.

DATED: Troy, New York
April 24, 1997

/s/Donald C. DeWitt
Donald C. DeWitt
President

/s/Joseph W. Pinto, Jr.
Joseph W. Pinto, Jr.
Commissioner