

STATE OF NEW YORK
TAX APPEALS TRIBUNAL

In the Matter of the Petition :
of :
SASH A. AND MARY M. SPENCER :
 : DECISION
 : DTA No. 812976
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 1989. :

Petitioners Sash A. and Mary M. Spencer, 251 Crandon Boulevard, Unit 164, Key Biscayne, Florida 33149-1506, filed an exception to the determination of the Administrative Law Judge issued on May 9, 1996. Petitioners appeared by Alan P. Raines, Esq. The Division of Taxation appeared by Steven U. Teitelbaum, Esq. (Craig Gallagher, Esq., of counsel).

Petitioners filed a brief in support of their exception. The Division of Taxation filed a brief in opposition. Petitioners filed a brief in reply. Petitioners' request for oral argument was denied.

Commissioner Jenkins delivered the decision of the Tax Appeals Tribunal. Commissioners DeWitt and Pinto concur.

ISSUE

Whether the Division of Taxation erred in treating the amount reported as a guaranteed payment on petitioners' nonresident income tax return as income subject to New York State personal income tax.

FINDINGS OF FACT

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

Petitioners, Sash and Mary Spencer, filed a U.S. Individual Income Tax Return for the year 1989 on which they listed their address as Unit 164 251 Crandon Blvd., Key Biscayne, Florida

33149. On this return, petitioners reported a long-term capital gain of \$10,657,929.00 arising from the disposition of an interest in Coinmach Industries Co. ("Coinmach"). They also included, as an item of other income on line 22 of their return, \$1,349,832.00. This item was described on an attached statement as "SALE OF PARTNERSHIP INTEREST - DEPRECIATION RECAPTURE". Mr. Spencer's Schedule K-1, entitled Partner's Share of Income, Credits, Deductions, Etc., from Coinmach reported a guaranteed payment to partner of \$1,349,832.00. An asterisk adjacent to this amount corresponded to a notation at the bottom of the form which stated "[t]his represents depreciation recapture due to . . . [illegible]." The Schedule D to petitioners' return, which concerned long-term capital gains and losses, reported that Mr. Spencer's interest in Coinmach was acquired on February 15, 1984 and that the interest was sold on October 28, 1989 for a sales price of \$10,657,929.00. Petitioners reported a gain of \$10,657,929.00.

Petitioners filed a New York State Nonresident and Part-Year Resident Income Tax Return for the year 1989. On this return they listed their address as Unit 164, 251 Crandon Blvd., Key Biscayne, Florida 33149. Petitioners allocated their items of income to sources within and without the State of New York. They did not include as an item of New York income either the long-term capital gain from the disposition of Coinmach or the item reported as a guaranteed payment on their Federal return.

Coinmach filed a U.S. Partnership Return of Income (Form 1065) for the period October 21, 1989 through December 31, 1989. On the return, the partnership stated that its principal business activity was a coin operated laundry. The partnership reported, as income, on the line for listing "[n]et gain (loss) (Form 4797, Part II, line 18)"¹ the amount of \$2,005,154.00. It also reported, as a deduction, guaranteed payments to partners of \$2,005,154.00. In a statement attached to the return, the partnership explained the following:

¹Form 4797 is used to report sales of business property as well as recapture amounts.

"Due to a deemed termination under Section 708(b)(1)(B) occurring on October 20, 1989, the partnership is filing a return for the short period October 21, 1989 through December 31, 1989. As detailed in the return for the final period ended October 20, 1989, a Section 754 election was made prior to the termination of the partnership.

"Just after the deemed termination occurred, John Sussman and Sash Spencer had their partnership interests liquidated under Section 736. The Section 754 election as attached hereto applies to CIC I, CIC II and Cointrol Associates. Therefore, the bases of the partnership assets must be adjusted as allowed by Section 734(b) pursuant to Section 755, Reg. Sec. 1.755-1 and 1.755-2T.

"The attached computation details this step-up. Columns A & B agree to the 10-20-89 return step-up. Col. E shows the beginning 10-21-89 balances after the deemed termination and recontribution [sic]. Finally, Col. F shows the balance sheet after the step-up due to the 736(b) payments."

The attached computation, which consists of the balance sheet of Coinmach, as of October 21, 1989, contains the columns described in the above statement. Column D, labeled redemption, reports capital in the amount of \$18,237,164.00. Column E, labeled "10-21-89 BEGINNING" reports capital in the amount of \$20,419,467.00 and Column F entitled "10/21/89 FINAL STEP-UP ON REDEMPTION" reports capital in the amount of \$38,625,891.00.

On or about October 15, 1991, the Division of Taxation ("Division") commenced an audit of petitioners' returns. Initially, the Division was interested in issues involving petitioners' domicile, residency and allocation of income. However, as the audit progressed, the matter which principally concerned the Division was the item reported as depreciation recapture which was characterized as a guaranteed payment on the Schedule K-1. The Division concluded that the amount characterized as a guaranteed payment was ordinary income from the sale of a New York partnership and was taxable to a nonresident.

On the basis of the foregoing conclusion, the Division issued a Notice of Deficiency, dated March 8, 1993, which asserted a deficiency of personal income tax in the amount of \$73,402.23 plus interest in the amount of \$19,848.87. This amount was reduced by payments or credits of \$93,251.10 for a balance due of \$0.00. The Statement of Personal Income Tax Audit Changes,

which was dated January 22, 1993, explained that petitioners had additional New York income of \$1,360,097.00 arising from two sources - additional New York source taxable interest of \$10,265.00 and depreciation recapture of \$1,349,832.00.

A worksheet, offered by petitioners, entitled "Jack/Sash, Recapture Calculation, 10-20-89" reported the following:

	<u>Jack</u>	<u>Sash</u>
Purchase Price	5,829,574	12,007,761
Reimb	130,671	269,158
Expenses of Sale	(130,671)	(269,158)
Net	5,829,574	12,007,761
	* * *	
Net Gain on Fixed Assets		
§ 1245 Recap <u>2,005,154</u>	<u>655,322</u>	<u>1,349,832</u>

The record does not contain any agreements pertaining to the termination of Mr. Spencer's interest in Coinmach.

OPINION

Tax Law § 631(former [a]) defined New York source income of a nonresident individual, in pertinent part, as:

"the sum of 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:

"(1) his distributive share of partnership income, gain, loss and deduction, determined under section six hundred thirty-two . . .
."

Tax Law § 632(a)(1) provides, in pertinent part, that:

"[i]n determining New York source income of a nonresident partner of any partnership, there shall be included only the portion derived from or connected with New York sources of such partner's distributive share of items of partnership income, gain, loss and deduction entering into his federal adjusted gross income, as such portion shall be determined under regulations of the tax commission consistent with the applicable rules of section six hundred thirty-one."

The Administrative Law Judge noted that petitioners cited Memorandum TSB-M-92(2)I as supporting their position. This memorandum provides, in pertinent part, as follows:

"[i]t has been the position of the Department that an interest in a New York partnership represented an interest in real or tangible personal property in this State, or constituted an intangible employed in a business, trade, profession or occupation carried on in this state. Accordingly, any gain or loss realized upon its sale was held to be gain or loss derived from or connected with New York sources pursuant to sections 631(b)(1) and (2) of the New York State Tax Law.

"Upon reviewing the matter, the Department has decided that a gain or loss (whether treated as capital or ordinary for federal income tax purposes) from the sale of an interest in a New York partnership, except in the situation described below, does not constitute gain or loss derived from or connected with New York sources and is not includible in the New York source income (the numerator of the tax allocation fraction) of a nonresident individual, estate or trust. . . .

"This new policy applies to all open tax years, and will apply regardless of the type of activity (e.g., real estate, business, etc.) that the partnership is engaged in. . . .

* * *

"This new policy also does not in any way affect the tax treatment of a partner's distributive share (including guaranteed payments) of partnership income, gain, loss, or deduction from a New York partnership. Such amounts remain taxable to the extent the partnership's income is derived from or connected with New York sources. . . ."

The Administrative Law Judge stated that it is petitioners' position that the substance of the transaction is controlling and that the evidence shows that the substance of this transaction was a sale of Mr. Spencer's partnership interest. Since there was a sale of Mr. Spencer's interest, the foregoing memorandum excludes the receipts in issue from New York tax. Petitioners now say that this is an incorrect statement of their position. In their brief on exception, petitioners state, "[t]he Judge's statement is **completely incorrect**. The essence of the petitioners' position in this case is that the so called guaranteed payment is not New York source income" (Petitioners' Brief in Support, p. 1). However, on page 2 of the same brief, petitioners state, "[w]e stated in our

original brief that the substance of the transaction should be considered a sale because such classification puts it within the gambit of TSB-M-92(2)I."

The tax consequences of a sale of a partnership interest may be quite different from a liquidation of the same interest (see generally, 2 McKee, Nelson and Whitmire, Federal Taxation of Partnerships and Partners, ¶ 15.02[2] [2d ed 1990] [which discusses several major differences in the treatment of liquidations and sales]). In general, Internal Revenue Code (hereinafter "IRC") § 736 applies to "payments made to a retiring partner or to a deceased partner's successor in interest in liquidation of such partner's entire interest in the partnership" (Treas Reg § 1.736-1[a]). In addition, this section "applies only to payments made by the partnership and not to transactions between the partners" (Treas Reg § 1.736-1[a]). To the extent that a payment is considered a guaranteed payment under IRC § 736(a)(2), it is deductible by the partnership under IRC § 162(a) and is taxable to the recipient under IRC § 61(a) (Treas Reg § 1.736-1[a][4]).

The sale or exchange of an interest in a partnership is governed by IRC § 741. The pertinent regulation provides that:

"[t]he sale or exchange of an interest in a partnership shall, except to the extent section 751(a) applies, be treated as the sale or exchange of a capital asset, resulting in a capital gain or loss measured by the difference between the amount realized and the adjusted basis of the partnership interest, as determined under section 705" (Treas Reg § 1.741-1).

IRC § 741 applies whether the partnership interest is sold to members of the partnership or to individuals who are not members of the partnership. This section also applies when the sale of the partnership results in a termination of the partnership under IRC § 708(b) (Treas Reg § 1.741-1[b]).

The Administrative Law Judge noted that in Spector v. Commissioner (641 F2d 376, cert denied 454 US 868) the taxpayer presented a similar argument to that which is at issue here. Specifically, the question in Spector was whether the transaction wherein the taxpayer gave up

his partnership interest was a "sale" resulting in a long-term capital gain under IRC § 741 or whether the transaction was a "liquidation" under IRC § 707(c) resulting in ordinary income under IRC § 736(a)(2). The taxpayer argued that the form of the transaction was not controlling and that the substance of the transaction was a sale and not a liquidation of the interest in the partnership. The Tax Court found that there was "strong proof" that the agreements that the taxpayer signed did not reflect reality as far as his status in the partnership was concerned and that the substance of the transaction was a sale and not a liquidation. The Tax Court concluded that, except for certain payments which were allocated to a covenant not to compete, the transaction resulted in a long-term capital gain pursuant to IRC § 741 and not ordinary income pursuant to IRC § 736(b)(2)(B).

On appeal, the court held that the proper standard to apply was that adopted by the Third Circuit in Commissioner v. Danielson (378 F2d 771, cert denied 389 US 858). The court quoted the portion of the decision in Danielson wherein it was stated that:

"a party can challenge the tax consequences of his agreement as construed by the Commissioner only by adducing proof which in an action between the parties would be admissible to alter that construction or to show its unenforceability because of mistake, undue influence, fraud, duress, etc." (Spector v. Commissioner, supra, at 380, quoting Commissioner v. Danielson, supra, at 775).

The court in Spector noted that one difficulty with the Tax Court's approach was that from the perspective of "economic reality" a substantial difference did not exist between a section 736 liquidation and a section 741 sale of a partnership interest. After reviewing several policy considerations, the court concluded that the rule in Danielson appropriately balances the interests of the Commissioner in the proper administration of the tax laws and the need for flexibility and fairness in a particular case. As a result, the decision of the Tax Court was reversed for a determination of whether the taxpayer presented proof of mistake, fraud, undue influence or other ground that, in the event of an action between the parties, would warrant setting the agreement aside or altering its construction.

On the basis of Spector, petitioners' argument, which focuses on the "economic reality" of the transaction, was rejected by the Administrative Law Judge. As pointed out in Spector, there is no substantial difference between a section 736 liquidation and a section 741 sale of a partnership interest. Therefore, it is more productive to examine how the parties structured Mr. Spencer's separation from the partnership. Petitioners did not present any evidence of Mr. Spencer's separation agreement from the partnership.² The Administrative Law Judge concluded that the documents in the record support the inference that the parties to the severance of Mr. Spencer's interest in the partnership agreed to proceed by a liquidation pursuant to IRC § 736. This conclusion is directly supported by the statement attached to the partnership return (Finding of Fact "3" of the Determination). It is also supported by the partnership's reporting of a deduction for guaranteed payments and Mr. Spencer's corresponding reporting of income from guaranteed payments. The Administrative Law Judge concluded that since petitioners have not presented any evidence of mistake, fraud, undue influence or other ground which would warrant setting aside the agreement, Mr. Spencer is bound by the agreement he reached with the partnership. The Administrative Law Judge also concluded that the Division properly treated the transaction as a liquidation and that the guaranteed payments were subject to New York State personal income tax (see, Matter of Baum v. State Tax Commn., 89 AD2d 646, 453 NYS2d 268, lv denied 57 NY2d 607, 455 NYS2d 1026).

Petitioners argued below that the partnership never received a benefit for the deduction of the guaranteed payments. This argument was also rejected by the Administrative Law Judge. As the Administrative Law Judge noted, the record contains only the first page of the partnership return and does not include a copy of the Form 4797. The record does not show the source of the net gain on line six. The Administrative Law Judge concluded that, in view of the holding in

²Petitioners offered a copy of the Amended and Restated Agreement of Limited Partnership of Coinmach Industries Co. with their reply brief below. Since no provision was made for the receipt of this document into the record, it was returned to petitioners' representative (see, Matter of Anzilotti, Tax Appeals Tribunal, February 22, 1996).

Spector, the result reached herein would be the same even if the partnership did not receive the benefit of the deduction since it was the apparent intent of the parties to proceed by a liquidation.

Next, the Administrative Law Judge addressed petitioners' argument that this case should be governed by the Revenue Reconciliation Act of 1993. The House Committee Report on the Omnibus Budget Reconciliation Act of 1993 (Pub Law 103-66) explains the function of the Act, in part, as follows:

"The bill generally repeals the special treatment of liquidation payments made for goodwill and unrealized receivables. Thus, such payments would be treated as made in exchange for the partner's interest in partnership property, and not as a distributive share or guaranteed payment that could give rise to a deduction or its equivalent. The bill does not change present law with respect to payments made to a general partner in a partnership in which capital is not a material income-producing factor"

The Administrative Law Judge stated, in dicta, that if the transaction at issue had occurred at a later date, then on its face the section relied upon by petitioners might have a bearing on this matter. However, this question is not presented because the House Committee Report also states that "[t]he provision generally applies to partners retiring or dying on or after January 5, 1993." Therefore, the Administrative Law Judge concluded that Congress did not intend to apply the 1993 amendment to IRC § 736 retroactively and that petitioners' reliance upon this amendment was misplaced.

Petitioners, on exception, argue that the Administrative Law Judge erroneously relied on case authority which dealt with service partnerships, rather than "cash intensive" partnerships, like Mr. Spencer's. Petitioners argue that Coinmach is not a service partnership and did not receive a tax deduction for the "so-called" guaranteed payment to petitioners. In support of this argument, petitioners state in their brief that they "have reviewed the Form 4797" and it supports their position. However, petitioners never offered the Form 4797 in evidence.

Petitioners also challenge the Administrative Law Judge's rejection of their argument that the substance of this transaction should be considered a sale because such classification puts it within the gambit of the Division's Technical Services Memorandum TSB-M-92(2)I.

Further, petitioners urge that the Administrative Law Judge erred in refusing to apply the Revenue Reconciliation Act of 1993 to the guaranteed payments in this case.

We affirm the determination of the Administrative Law Judge.

We find that the Administrative Law Judge completely and adequately addressed the issues before him. A review of the record below shows that petitioners failed to present any evidence or legal authority which would cause us to make a change in the conclusions reached by the Administrative Law Judge and, therefore, we affirm his determination for the reasons stated therein.

Accordingly, it is ORDERED, ADJUDGED and DECREED that:

1. The exception of Sash A. and Mary M. Spencer is denied;
2. The determination of the Administrative Law Judge is affirmed;
3. The petition of Sash A. and Mary M. Spencer is denied; and
4. The Notice of Deficiency issued March 8, 1993 is sustained.

DATED: Troy, New York
February 20, 1997

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

/s/Carroll R. Jenkins
Carroll R. Jenkins
Commissioner

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

