STATE OF NEW YORK

TAX APPEALS TRIBUNAL

In the Matter of the Petition	:	
of	:	
MICHAEL J. AND ANNA C. COLITTI	:	DECISION DTA NO. 818210
for Redetermination of a Deficiency or for Refund of Personal Income Tax under Article 22 of the Tax Law for the Year 1995.	:	

The Division of Taxation filed an exception to the determination of the Administrative Law Judge issued on April 18, 2002 with respect to the petition of Michael J. and Anna C. Colitti, 1202 Bell Flower Lane, West Chester, Pennsylvania 19380. Petitioners appeared by Gary M. Kanaley, Esq. The Division of Taxation appeared by Barbara G. Billet, Esq. (Jennifer L. Hink, Esq., of counsel).

The Division of Taxation filed a brief in support of its exception. Petitioners filed a brief in opposition and the Division of Taxation filed a reply brief. Oral argument, at the Division of Taxation's request, was heard on January 15, 2003 in Troy, New York.

After reviewing the entire record in this matter, the Tax Appeals Tribunal renders the following decision.

ISSUE

Whether certain income earned by petitioner Michael Colitti, a New York nonresident, was earned in respect of a covenant not to compete and, therefore, not subject to New York

personal income tax or whether such income was attributable to petitioner Michael Colitti's prior employment in New York and, therefore, taxable.

FINDINGS OF FACT

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

On December 9, 1999, following an audit, the Division of Taxation ("Division") issued to petitioners, Michael J. and Anna C. Colitti, a Notice of Deficiency which asserted additional income tax due from petitioners in the amount of $33,058.58, plus interest, for the tax year 1995.

Petitioners terminated their New York residency on June 30, 1991 and were thus nonresidents in 1995. The deficiency herein arises from a Division determination that certain income paid to Michael Colitti by Corning, Inc. ("Corning") in 1995 was New York source income and therefore properly subject to New York income tax under Article 22.

Petitioner Michael J. Colitti[1] was employed by Corning, located in Corning, New York, from 1964 through 1989. During the course of his career, petitioner was plant manager of a facility that manufactured laboratory glassware and one that manufactured consumer products. Later in his career he became an operation vice president of Corning and was responsible for several facilities that manufactured various lines of Corning products. While employed at Corning, petitioner acquired certain skills, as well as trade secret and proprietary knowledge.

During his employment at Corning, petitioner participated in two Incentive Stock Plan Agreements ("ISO's") dated April 24, 1986 and December 3, 1986, respectively. Corning

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[1] Anna C. Colitti is a party to this proceeding solely because she and Michael J. Colitti filed joint income tax returns for the year at issue. Accordingly, unless otherwise indicated, all references to "petitioner" herein shall refer to Michael J. Colitti.

offered the incentive stock plans to a limited number of executives as a means of retaining such executives in the employ of the company. Pursuant to each ISO, petitioner was awarded a certain number of shares of incentive stock, a portion of which vested annually according to a schedule. The incentive shares were subject to forfeiture if an employee voluntarily left the employ of Corning or if he or she retired before reaching age 60. In the event an employee's employment was terminated by Corning for any reason other than "gross deviation" from his duties and responsibilities, the ISO's provided that such employee "shall be entitled to receive" the number of incentive shares vested at the time of such termination.

In 1989, Corning terminated petitioner's employment for reasons other than "gross deviation" from his duties and responsibilities. Petitioner's vested incentive shares had a value of approximately $80,000.00 at the time of his termination.

Petitioner and Corning reached an agreement dated June 21, 1989 regarding the terms of petitioner's departure from Corning. The agreement bears the caption "Private and Confidential" and its introductory paragraph states:

> The purpose of this document is to formalize the understandings that you [petitioner] and . . . [petitioner's supervisor] have reached regarding your departure from employment with Corning Incorporated. The intent is to more fully describe the provisions that relate to your two years paid leave of absence and the unpaid leave of absence which will follow and continue until you reach age 55 at which time you will retire from Corning Incorporated.

The agreement sets forth petitioner's rights with respect to salary and benefits upon his termination from Corning. With respect to petitioner's rights with respect to the April 24, 1986 and December 3, 1986 ISO's, paragraph VIII of the agreement provides in relevant part:

> Subject to the approval of the Board of Directors and the satisfaction of the conditions contained in paragraph XII of this agreement, you will receive a pro-rata distribution of the shares granted to you on April 24, 1986 and December 3,

> 1986 under the 1983 and 1986 Incentive Stock Plans free of restrictions, as soon as practical after the July 1995 meeting of the Board of Directors. Assuming you retire on July 1, 1995 and that the conditions mentioned above are met, you could receive 6,673 of the 10,000 shares originally granted.

The final paragraph of the June 21, 1989 agreement, Paragraph XII, captioned "General," states in relevant part:

> Additionally, we remind you of your obligation to hold in confidence all proprietary information relating to Corning Incorporated and its operation. In addition to whatever other remedies Corning may have for breach of such obligation, Corning will discontinue its payments to you, or cease the benefits extended to you under this agreement, in the event you accept employment with a competitor of Corning within the next six years.

Petitioner fulfilled his obligations under paragraph XII of the agreement, and pursuant to paragraph VIII of the agreement, petitioner received a pro-rata distribution of shares granted to him under the ISO's. Petitioner realized ordinary income of $647,500.00 from Corning in 1995 as a result.

Petitioner filed a 1995 nonresident return (Form IT-203) which reported zero New York income and sought a refund in the amount of income tax withheld by Corning on the $647,500.00 paid by Corning to petitioner pursuant to the June 21, 1989 agreement. On audit the Division determined that this income was subject to New York State income tax and subsequently issued the December 9, 1999 statutory notice.

THE DETERMINATION OF THE ADMINISTRATIVE LAW JUDGE

In his determination, the Administrative Law Judge noted that the New York source income of a nonresident individual is subject to New York personal income tax. Included within source income are items of income, gain, loss and deduction reported in the Federal adjusted gross income that are attributable to a business, trade, profession or occupation carried on in

New York or income from intangible personal property to the extent that such income is from property employed in a business, trade, profession or occupation carried on in New York.

The Administrative Law Judge referred to relevant case law which held that where a nonresident taxpayer receives income in exchange for giving up his or her right to pursue employment in his or her field of expertise such income is not derived from or connected with New York sources and is, therefore, not subject to New York income tax.

The Administrative Law Judge concluded that in the present matter, petitioner's right to the income at issue was contingent upon his fulfillment of the non-compete provision in the June 21, 1989 agreement. The Administrative Law Judge concluded, based upon our decision in ***Matter of Haas*** (Tax Appeals Tribunal, April 17, 1997), that petitioner had earned the income at issue by "refraining from performing competing services in New York and elsewhere" and, as such, the income at issue was not derived from or connected with New York sources. The Administrative Law Judge found that under the June 21, 1989 agreement, petitioner gave up his right to incentive shares under the April 24, 1986 and December 3, 1986 ISO agreements and acquired new rights to incentive stock which were contingent upon his fulfillment of the non-compete provision in Paragraph XII of the June 21, 1989 agreement. Therefore, the Administrative Law Judge concluded that the income at issue was paid pursuant to the June 21, 1989 agreement and not pursuant to the ISO's. As a result, the Administrative Law Judge found that the income was not attributable to petitioner's former New York employment.

The Administrative Law Judge rejected the Division's argument that the June 21, 1989 agreement was not a covenant not to compete because no money was given directly in exchange for petitioner choosing not to compete. The Administrative Law Judge found that

petitioner gave up both his right to employment with a competitor of Corning and his rights under the ISO agreements in exchange for income under the June 21, 1989 agreement.

The Administrative Law Judge also rejected the Division's position that the non-compete provision of the June 21, 1989 agreement was a *de minimis* part of an agreement in anticipation of retirement. The Administrative Law Judge found that the entire agreement depended upon the non-compete provision and such provision was not *de minimis*. The Administrative Law Judge also concluded that as a payment made pursuant to a covenant not to compete, the income at issue is not subject to tax under Tax Law § 631(b)(2) as income from intangible personal property employed by petitioner in a business, trade, profession or occupation carried on in New York. Finally, the Administrative Law Judge rejected as moot the Division's argument that the admission in evidence of a memorandum from Corning dated May 18, 1999 and the testimony of petitioner violated the parol evidence rule in that the June 21, 1989 agreement was "the final embodiment of the understandings between Corning and the petitioner." The Administrative Law Judge stated that his conclusion that the income at issue was not derived from or connected with New York sources was based on the unambiguous language of the June 21, 1989 agreement and not on the May 18, 1999 Corning memorandum or the testimony of petitioner.

ARGUMENTS ON EXCEPTION

On exception, the Division argues that pursuant to our decisions in ***Matter of McSpadden*** (Tax Appeals Tribunal, September 15, 1994) and ***Matter of Haas*** (***supra***), petitioner's income should be considered New York source income because petitioner had a prior employment relationship with Corning when he renegotiated his employment in the

June 21, 1989 agreement. The Division asserts that the original stock option agreements were employment agreements that stemmed from the initial hiring of petitioner and were an additional monetary incentive to retain his services. In consideration for the June 21, 1989 agreement, petitioner exchanged $80,000.00 in vested stock options from the stock option agreements. This, maintains the Division, allowed petitioner to continue his relationship with Corning while he began the six-year phase out from Corning in anticipation of his retirement. In doing so, he exchanged his right to the vested stock options for his rights under the upgraded employment agreement of June 21, 1989.

The Division points out that the June 21, 1989 agreement contained numerous conditions in addition to the non-competition clause. The Division argues that the inclusion of the *de minimis* non-competition clause did not convert the June 21, 1989 agreement into a covenant not to compete. The Division maintains that such agreement lacked geographic parameters within which competition could not take place, failed to establish the duration of time of the non-competition and did not set forth the nature of the business in which petitioner was not to engage. The Division also insists that in order to be a valid covenant not to compete, the agreement required a separately bargained-for benefit.

The Division further argues that our decision in ***Matter of Haas*** (***supra***) should be reconsidered because it is inconsistent with federal tax treatment of income from a covenant not to compete as compensation for personal services. The Division maintains that ***Haas*** reached an erroneous conclusion that refraining from performing an activity does not equate with carrying on an activity. This, alleges the Division, is inconsistent with federal case law which has equated refraining from services as the equivalent of performing services in the area

of covenants not to compete for federal taxation purposes. As a result, the Division urges a conclusion that income received by a nonresident from a covenant not to compete is not necessarily sourced outside of New York

Petitioner argues, in opposition, that the Administrative Law Judge was correct in finding this case factually indistinguishable from ***Matter of Haas*** (***supra***). Petitioner disputes the Division's attempt to distinguish the ***McSpadden*** and ***Haas*** decisions on the basis of the consideration given by petitioner to obtain the right to the income at issue. Petitioner maintains that under ***McSpadden***, a promise to work in the future does not have its source in New York State. In the same fashion, petitioner believes that a promise not to work in the future cannot be considered to have its source in New York State. Petitioner asserts that his prior employment relationship with Corning does not serve to source the income petitioner received pursuant to the June 21, 1989 agreement to New York State. Petitioner disagrees with the Division's position that the June 21, 1989 agreement was intended to retain petitioner's services as an employee of Corning. Rather, petitioner alleges that he gave up a vested right under the prior 1986 agreements and he subjected the proceeds of his retirement to forfeiture through his June 21, 1989 covenant not to compete. Therefore, petitioner argues, the 1989 agreement was not an extension of the 1986 agreements or an employment contract. Instead, it was a covenant not to seek employment with a competitor of Corning.

Petitioner disputes the Division's argument that the June 21, 1989 agreement contained conditions in addition to the non-competition clause which petitioner had to meet in order to receive the income at issue. Petitioner argues that the only condition on which petitioner's

ability to receive payment depended was that he was not to accept employment with one of Corning's competitors.

Petitioner asserts that the 1989 agreement was a valid covenant not to compete and challenges the Division's authority for its position that the 1989 agreement did not meet the criteria for such a covenant. Petitioner also maintains that federal principles concerning the taxation of income earned pursuant to covenants not to compete do not require that petitioner be found liable for New York taxes on the income at issue. Petitioner argues that federal law is concerned with the nature of such income as ordinary income while the issue herein is the geographic source of such income. As a result, petitioner argues that federal rules determining the nature of such income are inapplicable herein.

OPINION

Tax Law § 631(a)(1) provides that the New York adjusted gross income of a nonresident individual shall include, among other items, 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. Items of income, gain, loss and deduction "derived from or connected with New York sources" are those which are either: (a) attributable to a business, trade, profession or occupation carried on in New York; or (b) income from intangible personal property to the extent that such income is from property employed in a business, trade, profession or occupation carried on in New York (***see***, Tax Law § 631[b][1][B] and [b][2]).

In ***Matter of Laurino*** (Tax Appeals Tribunal, May 20, 1993), we considered whether a lump sum payment made to a nonresident pursuant to a termination of employment agreement

constituted New York source income. We stated that when determining whether income is derived from or connected with New York sources:

> it is necessary to identify the activity upon which the income was secured or earned [and that] in making this determination, the consideration given by petitioner in exchange for the right to the income at issue is the controlling factor (***Matter of Laurino, supra***).

In ***McSpadden***, we considered whether an amount paid to a nonresident employed by a New York employer to settle an existing employment contract was New York income. In the termination of employment agreement, 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. We found that 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 [the employer] in the future" (***Matter of McSpadden, supra***). The taxpayer's promise to work in the future and the consideration given to the taxpayer in exchange for that right were the subject of the original employment agreement. When that agreement was terminated and replaced by a new agreement, valuable consideration was given not for the promise to work in the future but for the surrender of the right to be employed in the future. Therefore, the Tribunal concluded that the lump-sum payment received by the taxpayer in ***McSpadden*** was not taxable by New York.

In ***Haas***, we considered whether an amount paid pursuant to a covenant not to compete was New York income to a nonresident taxpayer. We found that when the taxpayer entered into the covenant not to compete with his employer, he obtained a contractual right to payment which was essentially no different from the right to the lump sum payment afforded to the taxpayer in ***McSpadden***. We noted in ***Haas*** that income received as a result of a covenant not

to compete need not result from the termination of an employment relationship in order to be excluded from New York income. Rather, we stated that "[i]f, as this Tribunal concluded, consideration paid to the taxpayer in ***McSpadden*** in exchange for his right to work in the future for a New York employer in New York State had no connection to New York, then we fail to see how consideration paid to petitioner in the instant case in exchange for his right to compete in any capacity in the future with [his employer] can be sourced to New York" (***Matter of Haas, supra***). In ***Haas***, we concluded that the income in question was earned "by refraining from performing competing services in New York and elsewhere" (***Matter of Haas, supra***). On this basis, we held that such income was not attributable to a business, trade, profession or occupation carried on in New York within the meaning of Tax Law § 631(b)(1)(B).

In the present matter, the Administrative Law Judge found that petitioner's situation was factually indistinguishable from that of the taxpayer in ***Haas***. The Administrative Law Judge concluded that under the June 21, 1989 agreement, petitioner gave up his right to incentive shares under the April 24, 1986 and December 3, 1986 ISO agreements and acquired new rights to incentive stock. These rights depended on petitioner not accepting employment with a competitor of Corning for six years. The Administrative Law Judge concluded, therefore, that the income at issue was not derived from or connected with New York sources. We agree. Although the June 21, 1989 agreement contained conditions in addition to the requirement that petitioner could not accept employment with a competitor of Corning for six years, the forfeiture of petitioner's right to compensation under that agreement was tied to that non-competition clause alone. Based on this, we reject the Division's argument that the non-competition clause was an inconsequential element of the agreement.

We do not accept the Division's argument that our decision in ***Haas*** is inconsistent with federal tax treatment of income from a covenant not to compete. In the present case, as in ***Haas***, the Division relies for its argument on ***Korfund Co. v. Commissioner*** (1 T.C. 1180) and ***Cox v. Helvering*** (71 F2d 987).

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 was subject to withholding taxes.

Pursuant to Tax Law § 631, the Legislature has defined what items of income, gain, loss and deduction are considered to be derived from or connected with New York sources. 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.

In ***Cox***, the Court compared payment under a covenant not to compete to earned income and stated: "[i]f [the taxpayer] sells his services for wages or salary, what he receives is income. If he refrains from exercising his skill and ability in a particular line for a definite period, what he receives in compensation in the common understanding is just as much a gain and is income" (***Cox v. Helvering***, ***supra***, at 988). In the present case, there is no argument that the income petitioner received pursuant to the covenant not to compete is ordinary income to petitioner. However, to be taxable by New York, this income must be attributable to a business, trade, profession or occupation carried on in New York. If there was no covenant not to compete, petitioner might have obtained employment in or out of New York with a competitor of Corning. If such competing services were rendered in New York, tax on the earnings therefrom would have been payable to New York. However, the payment was made to petitioner for the observance of the covenant not to perform competing services without geographic restriction. 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 June 21, 1989 agreement and would not have earned the compensation which is now sought to be taxed. If New York can tax petitioner because he might have performed services in New York but for the covenant, then petitioner 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) (***Milligan v. Commissioner***, 38 F3d 1094, 1098 "[n]oncompetition does not constitute the carrying on of a trade or business" ***quoting Barrett v. Commissioner***, 58 T.C. 284). Under the Division's logic, petitioner's income under the agreement could be sourced to all taxing jurisdictions in which petitioner might have but did not perform services for a competitor of Corning. Based on the foregoing, 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 Judged is affirmed;

3. The petition of Michael J. and Anna C. Colitti is granted; and

4. The Notice of Deficiency dated December 9, 1999 is canceled.

DATED: Troy, New York
June 19, 2003

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

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