STATE OF NEW YORK

DIVISION OF TAX APPEALS

In the Matter of the Petition	:	
of	:	
NEW YORK YANKEES PARTNERSHIP	:	DETERMINATION
for Redetermination of a Deficiency or for Refund of Unincorporated Business Tax under Article 23 of the Tax Law for the Year 1978.	:	

Petitioner, New York Yankees Partnership, Yankee Stadium, Bronx, New York 10452, filed a petition for redetermination of a deficiency or for refund of unincorporated business tax under Article 23 of the Tax Law for the year 1978 (File No. 800263).

Petitioner by Shea & Gould (Roger L. Cukras, Esq., of counsel) and the Division of Taxation by William F. Collins, Esq. (James Della Porta, Esq., of counsel) consented to have the petition determined on submission without hearing, with all briefs due by July 3, 1990. After due consideration of the record, Marilyn Mann Faulkner, Administrative Law Judge, renders the following determination.

ISSUES

I. Whether payments for unrealized receivables to a partner in liquidation of his partnership interest constitute payments for "services or use of capital" that are nondeductible by the partnership under Tax Law § 706(3).

II. Whether the partnership has met the 80% requirement of Tax Law § 706(2)(b) to be entitled to net operating loss carryover deductions.

FINDINGS OF FACT

Petitioner, New York Yankees Partnership ("partnership"), has owned and operated the New York Yankee baseball team since 1973.

As stated in its petition, the partnership derives its revenue from gate receipts, concessions, television and radio and billboard advertising. Its primary expenses are roster

costs, players' salaries and other expenses incidental to the operations of a baseball franchise, such as the rental and maintenance of Yankee Stadium.

A Notice of Deficiency, dated February 3, 1982, was issued to the partnership for unincorporated business tax in the amount of $62,260.00 plus interest for taxable year 1978.

By petition dated February 23, 1982, the partnership challenged the income tax deficiency on two grounds. It contended (1) that the Tax Commission improperly used the direct method of allocation rather than the three-factor formula in apportioning the entire net income of the partnership to New York for unincorporated business tax purposes, and (2) that the Commission erred in disallowing deductions with regard to payments made in 1978 for the liquidation of the partnership interests to two individuals (Gabe Paul and the Trust for F. J. O'Neill) in the total amount of $1,484,941.00.

On June 10, 1982, the Division of Taxation ("Division") issued a Notice of Claim increasing the amount of the original deficiency from $62,260.00 to $78,414.00. The notice stated that the greater deficiency resulted from (1) allowance of the three-factor allocation method, (2) allowance for partners' services not to exceed $5,000.00, and (3) disallowance of certain net operating loss carryover deductions because the total partnership percentage interest of partners common to the loss year and the deduction year did not equal the 80% interest as required by Tax Law § 706(2)(b).

A conference was held on August 1, 1983 to resolve these issues. The conferee's report, dated January 5, 1984, noted that an agreement could not be reached concerning the net operating loss carryover deductions, the deductibility of payments made to two partners in termination of their partnership interests, and the amount deductible for payments to partners for services rendered.

In a perfected petition, dated May 25, 1984, the partnership challenged the entire assessment of $78,414.00 plus interest alleging that the Division of Taxation erred in disallowing its 1978 deductions with respect to payments made to two retiring partners in

termination of their partnership interests[1] and in disallowing a deduction for a net operating loss carryover.

SUMMARY OF THE PARTIES' POSITIONS

Petitioner argues that amounts paid to two partners in liquidation of their partnership interests constitute deductions under Tax Law § 706 which permits deductions for all business expenses that are deductible for Federal income tax purposes.

Petitioner contends that the exception to the general rule of section 706 contained in subsection 3, which disallows deductions for amounts paid to a partner for services or for the use of capital, does not apply because the amounts in question represent payments to the partners for unrealized receivables -- player contracts that had been amortized in prior years.[2] Petitioner states, in brief, that the only dispute is whether payments for unrealized receivables constitute payments for the use of capital and that payments for the use of capital means "interest" only.

Petitioner's perfected petition contained a second argument that has not been briefed by either party. In the perfected petition, the partnership claims that the Division erred in its application of the 80% rule of Tax Law § 706(2)(b). It contends that the profit and loss sharing ratios set forth in the partnership agreement should be applied in calculating the 80% requirement and that the Division's alteration of these ratios is arbitrary and capricious.

The Division of Taxation argues that the payments to the two individual partners do not qualify as deductions under the threshold definition of an unincorporated business deduction of Tax Law § 706 which provides that such deductions "mean the items of loss and deduction directly connected with or incurred in the conduct of the business, which are allowable for

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[1]The perfected petition stated that the amount to the partners totalled $1,837,608.00. However, in its tax return, prior petition and initial brief to the Administrative Law Judge the amount in dispute is identified as $1,484,941.00 ($742,470.00 to Gabe Paul and $742,471.00 to the Trust for F. J. O'Neill).

[2]The Division does not dispute the characterization of the payments as unrealized receivables.

Federal income tax purposes for the taxable year." The Division's position is that the payments at issue constitute a transaction between the members of the partnership and have "no consequence or significance in regard to the operation of the baseball team, the taxpayer's business." Thus, argues the Division, the payments are not "directly connected with or incurred in the conduct" of the business.

Secondly, the Division argues that notwithstanding the failure to meet the threshold definition under Tax Law § 706, the payments for unrealized receivables are considered guaranteed payments under Internal Revenue Code §§ 736(a)(2) and 707(c) and as guaranteed payments they are for services or the use of capital. Thus, argues the Division, the payments in question are not deductible for State tax purposes under Tax Law § 706(3) which prohibits deductions for payments for services or the use of capital.

CONCLUSIONS OF LAW

A. Article 23 of the Tax Law was added by the New York Legislature in 1960 (L 1960, ch 564) and was repealed in 1978, effective in 1982 (L 1978, ch 69).

B. Section 706 in Article 23 provides, in pertinent part, that:

> "[t]he unincorporated business deductions of an unincorporated business mean the items of loss and deduction directly connected with or incurred in the conduct of the business, which are allowable for federal income tax purposes for the taxable year (including losses and deductions connected with any property employed in the business), with the following modifications:
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> * * *
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> (3) No deduction shall be allowed (except as provided in section seven hundred eight) for amounts paid or incurred to a proprietor or partner for services or for use of capital."

Thus, while section 706, as a general rule, permits unincorporated business deductions that are allowable for Federal income tax purposes, subsection 3 is an add-back provision that modifies the general rule by prohibiting such deductions if they constitute payments for "services or for the use of capital".

C. There is no dispute that the amounts in question meet the threshold requirement that they be deductible by the partnership for Federal income tax purposes. Under section 736(a) of

the Internal Revenue Code, the general rule is that payments made in liquidation of the interest of a retiring partner or a deceased partner are considered either (1) a distributive share to the recipient of the partnership income, if the amount is determined with regard to the income of the partnership, or (2) as a guaranteed payment, if the amount is determined without regard to the income of the partnership. If a payment falls under the category of a guaranteed payment in subsection (a), the retiring partner recognizes the payments as taxable ordinary income under section 61(a) and the partnership is allowed a commensurate deduction from the partnership income under section 162(a) (see, IRC § 707[c]; Treas Reg § 1.736-1[a][4]; Commissioner v. Jackson Investment Co., 346 F2d 187, 189-190 [9th Cir 1965]). Under subsection (b) of section 736, the general rule is that to the extent liquidation payments are made in exchange for the interest of such partner in partnership property, there is a recognition of capital gain to the partner and the partnership is not permitted a deduction for the payments (see, Treas Reg § 1.736-1[b]; Commissioner v. Jackson Investment Co., supra at 190). However, subsection (b)(2) of section 736 also provides a special rule whereby unrealized receivables and the good will of the partnership (except to the extent the partnership agreement provides for a payment with respect to good will) are excluded for purposes of subsection (b) as payments in exchange for an interest in partnership property. Thus, by operation of this exclusion, payments for a retiring partner's share of unrealized receivables or good will are instead considered either a distributive share of the partnership income or a guaranteed payment under subsection (a) of section 736. If the payments qualify as guaranteed payments, they are treated as ordinary income to the retiring partner with a corresponding deduction for the partnership (see, Treas Reg § 1.736[a][3]; Commissioner v. Jackson Investment Co., supra; Holman v. Commissioner, 564 F2d 283 [9th Cir 1977]). In the present case, it is undisputed that the liquidation payments in question were for unrealized receivables and were considered guaranteed payments, thereby constituting ordinary income to the retiring partners that is deductible to the partnership for Federal income tax purposes.

D. The Division's claim that the payments in liquidation of the partners' interest do not

meet the threshold requirement that such payments be "directly connected with or incurred in the conduct of the business" is contradicted by the legislative intent of Tax Law § 706, the statutory tax scheme in general and the case law. In the Governor's Message in support of the passage of Article 23 of the Tax Law, he noted that Article 23 was intended to simplify tax returns by conforming the State law to Federal law which imposes tax on unincorporated businesses (1960 McKinney's Session Laws of NY, at 2026-2027). As noted in Conclusion of Law "C", the payments for unrealized receivables in termination of a partner's interest that qualify as guaranteed payments (i.e., are made without regard to the partnership income) are clearly deductible by the partnership from its unincorporated business income for Federal tax purposes. Thus, inasmuch as these payments are deductible for purposes of Federal unincorporated business tax, there is no basis to assume that they are not deductible for State purposes given the underlying legislative intent. Moreover, inasmuch as the Division does not dispute that the unrealized receivables at issue relate to player contracts, it would be counter-intuitive to conclude that such payments in liquidation of a partner's interest were not "directly connected with or incurred in the conduct" of the partnership's business.

E. In the alternative, the Division claimed that the payments in question cannot be deducted because subsection (3) of Tax Law § 706 prohibits deductions for amounts paid to a partner for "services or use of capital". While there is case law interpreting what is meant by "services" under section 706(3) (see, Matter of Faulkner v. State Tax Commission, 63 AD2d 764, 404 NYS2d 735; Matter of Panichi v. State Tax Commission, 81 AD2d 987, 440 NYS2d 80), there is no case law concerning the meaning of "use of capital" under section 706(3). However, as noted in Conclusion of Law "D", the legislative intent of section 706 was to simplify State tax returns by conforming the State law with Federal law with regard to unincorporated business tax. Thus, an examination of the Federal law is warranted. Internal Revenue Code § 736 provides as follows:

> "(a) PAYMENTS CONSIDERED AS DISTRIBUTIVE SHARE OR GUARANTEED PAYMENT. -- Payments made in liquidation of the interest of a retiring partner or a deceased partner shall, except as provided in subsection (b), be

considered --

> (1) as a distributive share to the recipient of partnership income if the amount thereof is determined with regard to the income of the partnership, or
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> (2) as a guaranteed payment described in section 707(c) if the amount thereof is determined without regard to the income of the partnership.
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> (b) PAYMENTS FOR INTEREST IN PARTNERSHIP. --
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> (1) GENERAL RULE. -- Payments made in liquidation of the interest of a retiring partner or a deceased partner shall, to the extent such payments (other than payments described in paragraph (2)) are determined, under regulations prescribed by the Secretary, to be made in exchange for the interest of such partner in partnership property, be considered as a distribution by the partnership and not as a distributive share or guaranteed payment under subsection (a).
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> (2) SPECIAL RULES. -- For purposes of this subsection, payments in exchange for an interest in partnership property shall not include amounts paid for --
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> (A) unrealized receivables of the partnership (as defined in section 751(c)), or
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> (B) good will of the partnership, except to the extent that the partnership agreement provides for a payment with respect to good will."

Thus, pursuant to section 736, payments made in liquidation of a retiring or deceased partner's interest shall be considered either a distributive share or a guaranteed payment described in section 707(c) except as provided in subsection (b) of section 736. Inasmuch as subsection (b) specifically excludes, by way of a special rule, unrealized receivables from the definition of a property interest under subsection (b), they are considered either a distributive share or guaranteed payment. As noted in Conclusion of Law "C", the unrealized receivables in question are considered guaranteed payments described in section 707(c). Section 707(c) provides as follows:

> "(c) GUARANTEED PAYMENTS. -- To the extent determined without regard to the income of the partnership, payments to a partner for services or the use of capital shall be considered as made to one who is not a member of the partnership, but only for the purposes of section 61(a) (relating to gross income) and, subject to section 263, for purposes of section 162(a) (relating to trade or business expenses)."

Thus, it is by operation of section 707(c) that guaranteed payments, as payments to a

partner for "services or the use of capital", are permitted as a business deduction by the partnership. Inasmuch as the payments for unrealized receivables were deductible for Federal tax purposes as payments for "services or the use of capital", these payments should maintain the same tax characteristics for State tax purposes particularly in view of the fact that subsection (3) of Tax Law § 706 is an add-back provision under State law with regard to Federal deductions. In other words, the payments for unrealized receivables are initially deductible under the threshold requirement of Tax Law § 706 by virtue of their deductibility under Federal law (see Conclusion of Law "B"). However, the ability to take the same Federal deductions for State purposes under Tax Law § 706 is subject to further modifications under subsections (1) through (10). Subsection (3) disallows deductions for amounts paid to a partner for "services or for the use of capital". It would be illogical to strip the payments in question of their character as payments for "services and use of capital" under subsection (3) when it is by virtue of this character that they qualified as a Federal deduction, and hence as a State deduction, in the first instance. Consistent tax treatment of the payments for unrealized receivables is warranted throughout section 706 in the absence of any provision in Article 23 that would have specifically excluded unrealized receivables from the category of "services or the use of capital" under subsection (3). In sum, given the legislative history of Article 23, the tax characteristics taken on by unrealized receivables in this instance under the Federal law should be applied uniformly throughout section 706. This interpretation of the statute is reasonable, is consistent with the Federal tax treatment of the payments in question and preserves the symmetry of section 706.

Moreover, "[w]hether and to what extent a deduction shall be allowed is a matter of legislative grace and, therefore, the taxpayer bears the burden of establishing its right to a particular deduction" (Matter of Royal Indemnity Co. v. Tax Appeals Tribunal, 75 NY2d 75, 550 NYS2d 610, 611, citing Matter of Grace v. New York State Tax Commission, 37 NY2d 193, 197, 371 NYS2d 715). Petitioner has not met its burden in this case. Petitioner's argument that the term "use of capital" was limited to "interest" under the Federal law is not persuasive

particularly in view of the plain language in IRC §§ 736 and 707(c); otherwise, unrealized receivables and good will would not be considered guaranteed payments described in section 707(c) and thereby would not qualify for the Federal deduction. Clearly, this was not the intent of the Federal statute (see, Holman v. Commissioner, 564 F2d 283 [9th Cir 1977]; Woodhall v. Commissioner, 454 F2d 226 [9th Cir 1972]; Commissioner v. Jackson Investment Co., supra). While petitioner cites to references made in the legislative history of section 707(c) and by commentators that guaranteed payments cover services rendered or "interest" payments on capital, these statements do not imply that the term "use of capital" is restricted only to interest payments.

F. The second issue raised by petitioner challenges the Division's application of the 80% rule of Tax Law § 706(2)(b) with regard to disallowances of certain net operating loss carryovers. Neither the Division nor petitioner have discussed this issue in their briefs. In its perfected petition, the partnership argues that the Division erred in its calculation of the 80% by its failure to apply the simple profit and loss sharing ratios set forth in the partnership agreement. On its face, petitioner's method of calculating the proportionate interests of the partners in the loss year and deduction year may not comport with the holding in Goodbody & Co., Inc. v. State Tax Commission (118 AD2d 1025, 500 NYS2d 826). In Goodbody, the Court noted that the calculation should, in addition to such sharing ratios, take into account salaries and interest paid to partners that were deductible under the Federal tax law but were nondeductible under New York Tax Law § 706(3). Whether the Division in fact recalculated the percentages using the method approved under Goodbody, however, cannot be determined from the information in the record. Under Tax Law § 689(e)(3), the Division of Taxation has the burden of proof with regard to any increase in a deficiency when asserted after a Notice of Deficiency has been mailed and a petition has been filed. Inasmuch as the deficiency with regard to the net operating loss carryover was made in a Notice of Claim after the mailing of the Notice of Deficiency and filing of the initial petition (see, Findings of Fact "3", "4" and "5"), the Division carries the burden of proof on this issue. While the Division, in its answer,

affirmatively stated that petitioner was not entitled to a net operating loss carryover deduction under Tax Law § 706(2)(b), no other evidence was submitted as to how the 80% was calculated in assessing the greater deficiency. Thus, the Division has not met its burden of proof on this issue.

G. The petition of New York Yankees Partnership is granted to the extent of Conclusion of Law "F"; the Division of Taxation is directed to cancel the Notice of Claim issued June 10, 1982, and except as so granted, the petition is denied in all other respects.

DATED: Troy, New York

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ADMINISTRATIVE LAW JUDGE