STATE OF NEW YORK

DIVISION OF TAX APPEALS

In the Matter of the Petition	:
of	:
NICHOLAS PENCHUK	:DETERMINATION 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.	:

Petitioner, Nicholas Penchuk, 51 Angelfish Cay Drive, ORC Box 6, North Key Largo, Florida 33037, filed a petition 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.

On November 8, 1994 and December 16, 1994, respectively, petitioner, represented by Richards & O'Neil, LLP (Anthony J. Carbone, Esq., of counsel), and the Division of Taxation, represented by Terrence M. Boyle, Esq. (Craig Gallagher, Esq., of counsel), signed an agreement consenting to have the controversy determined on submission without a hearing, with all briefs and documents due by April 25, 1995. The Division of Taxation filed its documents on February 3, 1995. Petitioner filed his brief and documents on March 10, 1995. The Division of Taxation filed its brief on April 10, 1995 and petitioner filed his reply brief on April 27, 1995, which date began the six-month period for issuance of this determination. Upon review of this entire record, Marilyn Mann Faulkner,

Administrative Law Judge, renders the following determination.

ISSUE

Whether consideration received by a nonresident for a covenant not to compete with a New York company constituted New York source income.

FINDINGS OF FACT

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 was to receive $250,000.00 per year for a five-year period.

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 increased the amount of income tax owed for 1989, 1990 and 1991 by including as taxable income the amounts petitioner received ($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

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[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.

[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.

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.

SUMMARY OF THE PARTIES' POSITIONS

Petitioner argues that the consideration he received under the Noncompetition Agreement was neither attributable to personal services rendered in New York nor attributable to intangible personal property employed in a business, trade, profession or occupation carried on in New York within the meaning of 20 NYCRR former 131.4 or 131.5. He further argues

that the payments received were not wages earned, or net earnings from self-employment, within New York City within the meaning of section 11-1902 of the New York City Administrative Code.

The Division argues that 20 NYCRR former 131.4(d) requires petitioner to report as New York income payments received for covenants not to compete because they are considered compensation for personal services to the extent those services were performed in New York State (citing, Korfund Co. v. Commissioner, 1 TC 1180). The Division further argues that money received under a consent not to compete is income sourced to the location where the competition would have taken place which, in this case, would be New York inasmuch as petitioner had previously conducted his business in New York.

CONCLUSIONS OF LAW

A. Tax Law § 631 provides that New York source income of a nonresident individual includes income or gain derived from or connected with New York sources including income derived from a business, trade, profession or occupation carried on in New York. The statute also provides that:

> "[i]ncome from intangible personal property, including annuities, dividends, interest, and gains from the disposition of intangible personal property, shall constitute income derived from New York sources only to the extent that such income is from property employed in a business, trade, profession, or occupation carried on in [New York State]" (Tax Law § 631[b][2]).

The Tax Appeals Tribunal has held that, in determining whether income is derived from or connected with New York sources within the meaning of the statute:

> "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, Tax Appeals Tribunal, May 20, 1993).

In this case, petitioner received $250,000.00 per year for five years in exchange for his right to compete in the future against Duncanson & Holt by 1) soliciting the employment of employees of Duncanson & Holt, 2) soliciting the business of past or present customers of Duncanson & Holt, and 3) engaging in any business that "offers, sells, develops, produces, markets or licenses any product or service" competitive with any product or service of Duncanson & Holt. Thus, in contrast to such benefits as severance pay or stock options which relate to past employment, the payments received by petitioner were in lieu of future employment unconnected to employment with Duncanson & Holt itself (see, Matter of Laurino, supra [and cases cited therein]). Petitioner gave up his right in the future to be self-employed or to be employed by a competitor of Duncanson & Holt. Given the national and international nature of the business of Duncanson & Holt, there is no basis to assume that a business competitive to Duncanson & Holt would be located in New York. Thus, this income is not derived from or connected with a New York source (see, Matter of Donahue v. Chu, 104 AD2d 523, 479 NYS2d 889 [no evidence that future rights would have been exercised in New York]).

B. The Division's reliance on Korfund Co. v. Commissioner (1 TC 1180 [1943]) is misplaced. Korfund involved a corporation involved in the manufacturing and selling of foundation

material, such as cork plates and vibration absorbers, and a competitor corporation located in Germany. The German corporation was paid by Korfund for its agreement not to compete with Korfund "in the United States or Canada". The court held that the competitor's right to do business in the United States, in competition with Korfund, was an interest in property in the United States and not in Germany. The court stated that what the nonresident corporation received was in lieu of what it might have received; that the situs of the right was the United States and the income that flowed from the privileges was necessarily earned and produced in the United States; and that the rights given up were property of value and the income acquired in exchange for those rights was therefore derived from the use of that property in the United States.

Thus, the reasoning in Korfund does not support the Division's position, but instead supports petitioner's position. Petitioner's agreement not to compete was not limited to a specific geographic market or location as in Korfund. Petitioner's $250,000.00 per year income was in exchange for him not to compete with Duncanson & Holt's entire market, which spanned across the United States and to customers or pool members located outside the United States. The covenant not to compete would have clearly applied to petitioner if he had engaged in a competitive business located and transacted outside New York State. This 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 (see, Matter of Hayes v. State Tax Commn., 61 AD2d 62, 401 NYS2d 876; Matter of McSpadden, Tax Appeals Tribunal, September 15, 1994).

C. The Division's reliance on 20 NYCRR former 131.4(d) is also misplaced. 20 NYCRR former 131.4(d) provides that when a nonresident receives a pension or other retirement benefit attributable to his former services in New York State, that benefit is not taxable for New York State income tax purposes if it constitutes an annuity. The regulation further provides that if the pension or retirement benefit does not constitute an annuity, then:

> "it is taxable for New York State personal income tax purposes to the extent that the services were performed in New York State. The term compensation for personal services as used in the foregoing sentence includes, but is not limited to . . . amounts received upon retirement under a covenant not to compete" (emphasis added).

The Division reasons that nonannuity retirement benefits are compensation for personal services; that "this regulation specifically states that amounts received under a covenant not to compete are considered compensation for services"; and that "[t]herefore, it would follow that the compensation the petitioner received in exchange for the covenant not to compete was properly taxed as personal service income by New York State" (Division's brief, p. 4).

Although the regulation specifically concerns pensions or other retirement benefits, the Division does not address on what basis it considers the amounts petitioner received, as a result

of the Noncompetition Agreement, to be a pension or other retirement benefit. There is no evidence in this record to support such a conclusion. From the evidence submitted, these amounts can in no way be construed as a pension or retirement benefit to petitioner. The Noncompetition Agreement resulted from the reorganization of the business whereby petitioner and Miele agreed to sell their shares of common stock so that Brown could acquire control of the company. Petitioner did not retire from the company. He divested himself of any ownership interest in the company because of conflicts in the management of the business. However, he remained employed in accordance with the terms of the Employment Agreement as part of the transition in the reorganization of the business. Therefore, there is no basis for applying this regulation to petitioner's situation.

D. The petition of Nicholas Penchuk is granted and the Notice of Deficiency, dated August 9, 1993, is cancelled.

DATED: Troy, New York
October 26, 1995

/s/ Marilyn Mann Faulkner

ADMINISTRATIVE LAW JUDGE