

STATE OF NEW YORK
DIVISION OF TAX APPEALS

In the Matter of the Petition :
of :
ROBERT J. McKEAN, JR. AND SALLY H. AMENT : DETERMINATION
for Redetermination of Deficiencies or for : DTA NO. 813005
Refund of Personal Income Tax under Article 22 :
of the Tax Law for the Years 1989 and 1990. :

Petitioners, Robert J. McKean, Jr. and Sally H. Ament, 1619 Inlet Court, Reston, Virginia 22090-4429, filed a petition for redetermination of deficiencies or for refund of personal income tax under Article 22 of the Tax Law for the years 1989 and 1990.

On June 21, 1995 and June 27, 1995, respectively, petitioners, by their representative, Harold R. Handler, Esq., and the Division of Taxation by Steven U. Teitelbaum, Esq. (Craig Gallagher, Esq., of counsel) waived a hearing and agreed to submit this case for determination. All documents and briefs to be submitted were due by December 5, 1995, which date began the six-month period for the issuance of this determination. The Division of Taxation's documents were received on August 7, 1995. Petitioners' documents and their brief were filed on October 10, 1995, and the Division of Taxation's brief was received on November 15, 1995. Petitioners' reply brief was submitted on December 5, 1995. After due consideration of the record, Frank W. Barrie, Administrative Law Judge, renders the following determination.

ISSUES

I. Whether certain retirement benefits received by petitioner Robert J. McKean, Jr., who was a nonresident of New York at the time he received such benefits from the New York City law firm of Simpson¹ Thacher & Bartlett, were subject to New York personal income tax as a distributive share of partnership income or as New York source income.

¹References to the law firm in petitioners' briefs as well as the letterhead of the law firm omit a comma after "Simpson". Consequently, the name of the firm is spelled similarly in this determination.

II. Whether, if the retirement benefits at issue were not a taxable distributive share of partnership income, they constituted retirement benefits in the nature of an annuity excludable from New York income.

III. Whether, if the retirement benefits at issue were taxable to New York, petitioners are entitled to claim the \$20,000.00 exclusion from tax under Tax Law § 612(c)(3-a).

FINDINGS OF FACT

1. By a letter dated October 21, 1985 to his law partner, Cyrus R. Vance, petitioner Robert J. McKean at the age of approximately 60 "elected to retire on November 1, 1985" from the New York City law firm of Simpson Thacher & Bartlett. For the administrative record created for this submission without a hearing, petitioners did not provide an affidavit of Mr. McKean or any other evidence detailing Mr. McKean's tenure with this distinguished law firm. In their petition, petitioners alleged the following facts as their paragraph "4", which were denied by the Division of Taxation (hereinafter, "Division") in its answer for lack of knowledge and information:

"From 1953 to 1962, the Petitioner² was an associate, and

from 1963 through October 31, 1985, a partner, in the law firm of Simpson Thacher & Bartlett (the 'Firm').³ The Firm was, and remains, a partnership (that includes professional corporations) with offices in New York City and elsewhere, including locations outside of the State of New York. The Firm has engaged continuously in the practice of law for more than 100 years. As of December 31, 1993, the firm had approximately 413 lawyers, of whom 100 were partners."

2. On or about September 1, 1987, Mr. McKean, who had separated from his wife, moved from his residence in Rye, New York to Washington, D.C. In the spring of 1989, petitioner purchased his present residence in Reston, Virginia, and the following year, he was divorced and remarried Sally H. Ament.

Tax Returns As Filed

²Petitioner Sally H. Ament is a party to this matter for the sole reason that she filed a joint tax return with her husband, Robert J. McKean, Jr. for the year 1990. Consequently, references to petitioner in this determination are to Mr. McKean.

Therefore, according to this allegation, Mr. McKean's career with Simpson Thacher & Bartlett spanned approximately 30 years.

3. Included in the 221 pages submitted by the Division as its Exhibit "H", which it described as the audit work papers, are Mr. McKean's 1989 form IT-203, nonresident income tax return and petitioners' 1990 form IT-203, nonresident income tax return. In 1989, petitioner reported New York State income tax of \$34,233.00 calculated as follows:

	Federal Amount	New York State Amount
Wages, salaries, tips, etc.	\$273,675.00	\$273,675.00
Taxable interest income	27,244.00	15,578.00
Dividend income	3,268.00	
Taxable refunds of state and local income tax	25,552.00	
Capital gain	44,365.00	
Other gains	64.00	
Rents, royalties, partnerships, estates, trusts, etc.	<u>531,451.00</u>	<u>349,179.00</u>
Total	\$905,619.00	\$638,432.00
Total federal adjustments to income	<u>56,000.00</u>	
Federal amount and State amount for determining percentage for allocating base tax	\$849,619.00	\$638,432.00
New York Additions:		
Interest income on state and local bonds (but not those of New York State or its localities)	17,788.00	
Other	<u>1,458.00</u>	
Federal amount	\$868,865.00	
New York Subtractions:		
Taxable refunds of state and local income taxes	25,552.00	
Interest income on U. S. Government Bonds	2,391.00	
Pension and annuity income exclusion	20,000.00	
Other	<u>216,119.00</u>	
Total Subtractions	\$264,062.00	
New York adjusted gross income	\$604,803.00	
Less: itemized deduction	<u>21,721.00</u>	
New York taxable income	\$583,082.00	
Base tax	\$ 45,559.00	
New York income percentage ⁴	75.14%	
New York State tax	\$ 34,233.00	

4. In 1990, petitioners reported New York income tax of \$19,025.00 calculated as follows:

This percentage was calculated by determining the ratio of a New York State amount of \$638,432.00 to a Federal amount of \$849,619.00.

	Federal Amount	New York State Amount
Wages, salaries, tips, etc.	\$ 72,341.00	\$ 72,241.00
Taxable interest income	23,343.00	13,994.00
Dividend income	4,789.00	
Taxable refunds of state and local income taxes	14,065.00	
Schedule C ⁵ business income	424.00	
Capital gain	1,530.00	
Rents, royalties, partnerships, estates, trusts, etc.	<u>243,308.00</u>	<u>105,660.00</u>
Total	<u>\$359,800.00</u>	<u>\$191,995.00</u>
Total Federal adjustments to income	39,500.00	
Federal amount and State amount for determining percentage for allocating base tax	320,300.00	\$191,995.00
New York Additions:		
Interest income on state and local bonds (but not those of New York State or its localities)	8,107.00	
Other	736.00	
Federal amount	<u>\$329,143.00</u>	
New York subtractions:		
Taxable refunds of state and local income taxes	14,065.00	
Interest income on U. S. Government bonds	297.00	
Pension and annuity income exclusion	20,000.00	
Other	<u>21,393.00</u>	
Total subtraction	\$ 55,755.00	
New York adjusted gross income	\$273,388.00	
Less: itemized deductions	22,693.00	
New York taxable income	\$250,695.00	
Base tax	\$ 19,025.00	
New York income percentage	59.94% ⁶	
New York State tax	\$ 11,404.00	

5. The \$531,451.00 reported as "rents, royalties, partnerships, estates, trusts, etc." for 1989 is detailed on a Federal Schedule E, Form 1040, a copy of which is included with the 1989 New York income tax return submitted for review, as follows:

5

A copy of Schedule C was not included in the record so the nature of petitioner's business generating this income is unknown.

6

This percentage was calculated by determining the ratio of a New York State amount of \$191,995.00 to a Federal amount of \$359,800.00.

Nonpassive income from Schedule K-1:	\$ 442,561.00
	89,210.00 ⁷
Passive loss allowed from Form 8582	(9,402.00)
Passive income from Schedule K-1	<u>9,081.00</u>
Total partnership and S corporation income	\$ 531,450.00

Petitioner allocated \$349,179.00 of the \$531,451.00 to New York. It is observed that on page 2 of Schedule E, petitioner reported "nonpassive income from Schedule K-1" totalling \$531,771.00 consisting of two amounts \$442,561 and \$89,210.00. A so-called "Statement 4" supplementing the Schedule E for New York shows further detail concerning the \$442,561.00 as follows:

Simpson Thatcher & Bartlett	\$266,338.00
Other Income	143,862.00
PYA ⁸ Simpson Thatcher & Bartlett stub period	<u>32,361.00</u>
Subtotal	\$442,561.00

6. The \$243,308.00 reported as "rents, royalties, partnerships, estates, trusts, etc." for 1990 is detailed on a Federal Schedule E, Form 1040 for 1990, a copy of which is included with the 1990 New York income tax return submitted for review, as follows:

Passive loss	(\$8,346.00)
Passive income	\$8,536.00
Nonpassive loss ⁹	(34,980.00)
Nonpassive income	278,098.00
Income	\$286,634.00
Loss	(\$43,326.00)
Net income	\$243,308.00

Petitioners allocated \$105,660.00 of the \$243,308.00 to New York.

The nonpassive income of \$278,098.00 is further detailed on a Statement 5 included in the tax return as follows:

Ordinary income from Simpson Thatcher & Bartlett	\$145,283.00
Other income from Simpson Thatcher & Bartlett	100,454.00
Simpson Thatcher & Bartlett-stub period	<u>32,361.00</u>

⁷This represented nonpassive income to petitioner from the S corporation, Robert B. McKean, Jr., P.C. as shown on a Statement 5 supplementing the Schedule E.

⁸This abbreviation was unexplained.

⁹A Statement 2 to the tax return shows that this loss was passed through to petitioners from Robert B. McKean, Jr., P.C.

Total \$278,098.00

7. The Division issued a Statement of Personal Income Tax Audit Changes dated February 23, 1993 against Mr. McKean asserting tax due of \$16,019.52 for 1989. An attached letter of explanation provided the following basis for the assertion of additional tax:

"It has been determined that the monies received from Simpson Thacher & Bartlett (STB) do not qualify as annuity payments. The amount taxable to New York State from Line 7 of the K-1 is \$140,942 ($\$143,862 \times 97.97\%$), and the \$32,361 received from the short period ended 12/31/87 (electing 4 year proration) is fully includable in the taxpayers [sic] New York State income since the taxpayer filed as a resident of New York State for tax year 1987.

This determination also affects the following New York modifications:

- 1) The subtraction of \$23,810 (pass-thru from an S-Corporation) as an annuity is disallowed.
- 2) The subtraction of \$20,000 as a 'pension and annuity income exclusion' is disallowed.

Pursuant to Internal Revenue Regulations Section 1.736-1(a)(6), a retired partner continues to be a partner for income tax purposes until his interest in the partnership has been completely liquidated. The K-1 from STB shows the taxpayer as a general partner with a percentage of ownership of capital interest and a balance in his capital account. Accordingly, the retirement payments from STB constitute a distribution of ordinary income and as such are allocable to New York State on the basis of the partnership allocation percentage."

8. The Division also issued a Statement of Personal Income Tax Audit Changes dated February 23, 1993 against both petitioners asserting additional income tax due for 1990 of \$12,279.39. A letter of explanation, similar to the one detailed in Finding of Fact "7" for the year 1989, was also attached to this statement and included the following additional allocation of income to New York:

"The amount taxable to New York from Line 7 of the K-1 is \$97,500 ($\$100,454 \times 97.059\%$), and the \$32,361 received from the short period ended 12/31/87 (electing 4 year proration) is fully includable in the taxpayers' New York State income since the taxpayer filed as a resident of New York state for tax year 1987.

This determination also affects the following New York modifications:

- 1) The subtraction of \$16,625 (pass-thru from an S-Corporation) as an annuity is disallowed.
- 2) The subtraction of \$20,000 as a 'pension and annuity income exclusion' is disallowed."

9. The Division issued a Notice of Deficiency against Robert J. McKean, Jr. dated June 28, 1993 asserting income tax due of \$12,590.16 plus interest for 1989. It also issued a second Notice of Deficiency against Mr. McKean and his wife, Sally H. Ament, dated June 28, 1993 asserting income tax due of \$10,616.26 plus interest for 1990.

10. As noted in Finding of Fact "1", the record on submission is skimpy concerning Mr. McKean's tenure at Simpson Thacher & Bartlett. It also lacks any information concerning the source of his wages of \$273,675.00 and of \$72,341.00 for 1989 and 1990, respectively, which were allocated completely to New York State. It is observed that in his letter of resignation from the law firm to Cyrus R. Vance, referenced in Finding of Fact "1", petitioner noted:

"I do not intend to 'practice law' after my retirement. However, as you know, I hope to begin a new career of educational consulting and advising, across a wide spectrum of financial and organizational concerns. I will attempt to persuade my clients, to the extent that they need it, to obtain legal advice from someone other than me (hopefully, even the Firm). I assume that I will not be in violation of the Partnership Agreement if they reject my advice and request my legal views as part of my undertaking."

No wage statements were included with the income tax returns submitted for review. Consequently, Mr. McKean's specific employment during the years at issue, reported by him as subject to New York income tax, is unknown. Further, it is observed that Mr. McKean's New York income tax returns for the years at issue do not report any Schedule C income from the conducting of a consulting business other than \$424.00 for 1990. The source of this minimal Schedule C income is unknown.

11. The Division's answer admitted paragraph "10" of the petition which set forth the following facts:

"In 1989 and 1990, respectively, the Petitioner received \$410,200 and \$245,737 respectively in retirement benefits from the Firm, pursuant to the [partnership] Agreement. He filed a New York State Income Tax Nonresident Return (Form IT-203) taking the position that the amounts received as retirement benefits should be bifurcated into two portions, those that are fully subject to New York State income tax and those that qualify for an exemption from New York State income taxation. In those returns, the Petitioner took the position that the Equity portion (paid both directly to Petitioner and to his professional corporation) of such retirement benefits (\$266,338 in 1989 and \$145,238 in 1990) was fully subject to New York State income taxation. This position is based on section 132.4(c) of the New York State Income Tax Regulations (the 'Regulations')."

12. However, the Division's answer denied paragraph "11" of the petition, which provided as follows:

"The Petitioner also claims that the Pension portion (paid both directly to Petitioner and to his professional corporation) of such retirement benefits (\$143,862 in 1989 and \$100,499 in 1990)¹⁰ qualified as an 'annuity' under section 132.4(d) of the

Regulations. This Regulation states that, despite the general rule in section 132.4(c), if compensation attributable to New York services is paid to a person 'retired from service' in New York according to certain requirements, and is an 'annuity' as defined by the Regulations, it will nevertheless not be subject to tax in New York" (emphasis in original).

13. Included in the Division's Exhibit "H" are copies of schedules K-1 from the partnership of Simpson Thacher & Bartlett to petitioner for 1989 and 1990, respectively, which show that petitioner's capital account at the end of 1989 and 1990 was \$52,188.00 and \$132,152.00, respectively. However, each schedule includes a statement that petitioner "has withdrawn all of his capital" and that "ending balance represents undistributed earnings". It is further noted that these schedules indicated that petitioner had no percentage interest in the law partnership's profit sharing or loss sharing. The schedules, however, do show that at the beginning of 1989, petitioner's percentage of ownership of capital was 0.823% while at the end of 1989 it was 0.214%, and at the beginning of 1990, it was .213700% while at the end of 1990 it was .351890%.

14. Also included in the Division's Exhibit "H" is a photocopy of a memorandum dated March 22, 1995 from attorney James G. Sweeney, who is with the law firm of Simpson Thacher & Bartlett, to the Division's representative, which includes a complete copy of the law firm's 37-page "Amended and Restated Partnership Agreement" dated as of November 1, 1985, which was the effective date of the agreement. In addition, in his memorandum, attorney Sweeney described Mr. McKean's relationship to the law firm after his retirement as follows:

10

In a footnote "1" to paragraph "11" of the petition, petitioner elaborated that "(t)he reason that the dollar amount of the Pension varied between 1989 and 1990 was because a portion of Mr. McKean's retirement benefits were paid directly from the Firm to his former spouse under a Qualified Domestic Relations Order, as that term is defined in section 414(p) of the Internal Revenue Code of 1986, as amended."

"As a result of his retirement in 1985, Mr. McKean's relationship with the Firm changed in several material respects. First, as a retired partner, Mr. McKean does not share in the losses, liabilities or assets of the Firm. . . . In other words, if the Firm were to experience a loss in any given year, for any reason, Mr. McKean would not be required to contribute anything to the Firm with respect to such loss, and, while his Pension Payments are unsecured, the amount of any future retirement payments payable to him would not be altered.

Second, prior to the Retirement Date, Mr. McKean, as a general partner, could enter into a contract on behalf of the Firm. As a retired partner, however, Mr. McKean can no longer contract on behalf of the Firm. Third, since his retirement in 1986, Mr. McKean has not provided any services to the Firm, either within or without New York State. In addition, Mr. McKean does not maintain an office at the Firm nor does he receive any services from the Firm, secretarial or otherwise.

Fourth, since his retirement, Mr. McKean has no right to participate in, and has had no involvement in the active management of the Firm. Furthermore, Mr. McKean does not have the right to exercise any management or fiscal control over the Firm, nor does he have other partnership rights, such as an accounting. . . . Finally, since his retirement, Mr. McKean has not held himself out to be an active partner of the Firm in any manner."

The "Tax Field Audit Record", also included in the Division's Exhibit "H", referenced a particular portion of the partnership agreement's Paragraph 8, "Voluntary Retirement; Elections, Entitlements and Notices; Equity Portion; Pension Portion; Partners Remaining Active After Age 65" in showing how petitioner's retirement income was broken down into two types: (1) a pension portion and (2) a percentage interest in the residual profits of the partnership. The auditor noted that petitioner correctly allocated to New York the portion of his retirement income from the firm which consisted of a percentage interest in the residual profits of the partnership. The auditor, however, challenged petitioner's treatment of the pension portion of his retirement benefit as an annuity not taxable to New York. The auditor referenced the following provisions of Paragraph 8 of the partnership agreement:

"(a) Elections, Entitlements and Notices. A Partner may elect to retire effective on the November 1 nearest to such Partner's 60th birthday, or on any November 1 thereafter. A Partner so retiring shall be entitled to receive from the firm retirement benefits described in this Paragraph 8, subject to the limitations specified in this Paragraph 8, and subject to the adjustments (applicable to such Partner or any Successor thereof, and/or applicable, in general, to Former Partners and their respective Successors) specified in Paragraph 9 of this Agreement. Any such election shall be evidenced by written notice given to the firm by such Partner (i) at least ninety days prior to the November 1 of such Partner's intended retirement or (ii) if such Partner desires to designate an Annuitant pursuant to the provisions of subdivision (d) of Paragraph 9 of this Agreement, at least one year prior to such November 1.

(b) Equity Portion.

(i) If a Partner retires on the November 1 nearest to such Partner's 60th, 61st or 62nd birthday, such Partner will be entitled to receive from the firm, during the next succeeding seven Years commencing on such November 1, a percentage interest in the Residual Profits of the Firm in such Years calculated as follows; for each of the first three Years, 20% of the Highest Share in the Firm held by such Partner and, for each of the next four Years, 17½% of such Partner's Highest Share in the Firm.

* * *

(vi) If, having retired pursuant to the provisions of this Paragraph 8, a Partner (or the sole stockholder of a Corporation) thereafter shall die, the benefits provided in this subdivision (b) shall not cease but shall continue to be paid as provided in this Agreement to the Successor of such Partner (or the Successor of such sole stockholder, as the case may be).

(c) Pension Portion.

(i) If a Partner retires on the November 1 nearest to such Partner's 60th, 61st or 62nd birthday, such Partner will be entitled to receive from the firm, each Year until such Partner (or the sole stockholder of a Corporation) shall die, a fixed dollar amount calculated as follows; 25% of the average of the final three Years' distributions which such Partner received, or would have received, as a Partner, based upon the Highest Share in the Firm held by such Partner.

* * *

(iv) If, having retired pursuant to the provisions of this Paragraph 8, a Partner (or the sole stockholder of a Corporation) thereafter shall die, the benefits provided in this subdivision (c) shall thereupon cease; provided, however, that the Successor of such Partner (or the Successor of such sole stockholder, as the case may be) shall be entitled to receive the balance (calculated pursuant to Paragraph 12 of this Agreement) of the amounts payable to such Partner (or stockholder) under this subdivision (c) to and including the date of death; and provided further that an Annuitant shall be entitled to receive the amounts provided for such Annuitant pursuant to the provisions of subdivision (c) of Paragraph 9 hereof until the death of such Annuitant.

* * *

9. Adjustments to Retirement and Other Benefits; General Provisions Relating to Retirement.

(a) Adjustments Relating to Retirement and Other Benefits. Anything in Paragraphs 8, 10 or 11 of this Agreement expressly or impliedly to the contrary notwithstanding, the retirement benefits provided in Paragraphs 8 and 10 of this Agreement and the death benefits provided in Paragraph 11 of this Agreement shall be subject to adjustments as provided in this Paragraph 9" (emphasis in original).

It is noted that only the above-cited provisions of the complex partnership agreement were referenced by the auditor because the determination that all of petitioner's retirement

benefits from the law firm were allocable to New York was based on the auditor's conclusion that petitioner had, according to the second page of the Tax Field Audit Record, "DO-220.5", an "active capital account" in the law firm during the years at issue.

15. In order to resolve Issue "II" as framed at the beginning of this determination, it is necessary to reference further provisions of the partnership agreement, particularly those provisions which permit adjustments to be made to petitioner's retirement income. The relevant additional provisions under Paragraph 9, which set forth various adjustments that may be made to retirement income, are as follows:

"(e) Adjustments on Account of Cost of Living or Profitability.

(i) As of October 31 in each Year, commencing with October 31, 1986, there shall be determined the percentage increase or decrease in the cost of living during the period commencing the immediately preceding November 1 and ending on such October 31 as measured by the Consumers' Price Index for Urban Wage Earners and Clerical Workers, published by the United States Department of Labor, Bureau of Labor Statistics

(f) Adjustments Relating to 15% of Total Firm Income.

Subject to the provisions of subdivision (h) of this Paragraph 9, if for any Year of the firm the sum of (i) all amounts payable to Pre-Plan Retirees, plus (ii) all amounts payable to Post-Plan Retirees, plus (iii) all charges to Retired Partners in such Year by reason of the designation of contingent annuitants . . . shall in the aggregate exceed 15% of the Net Income of the Firm Available for Distribution for such Year, then such aggregate amount shall be reduced to that amount which equals 15% of such Net Income of the Firm Available for Distribution and the amount of such reduction shall be allocated as set forth below; provided, however, that the amount so allocated to any Retired Partner subject to an annual charge of the character referred to in clause (iii) of this subdivision (f) shall be further reduced by the amount of such charge:

(A) the aggregate dollar amount of the excess over 15% will be determined.

(B) the aggregate dollar amount of (x) all amounts payable to Pre-Plan Retirees and (y) all charges to Pre-Plan Retirees of the character referred to in clause (iii) above will be determined.

(C) the aggregate dollar amount of (x) all amounts payable to Post-Plan Retirees and (y) all charges to Post-Plan Retirees of the character referred to in clause (iii) above will be determined.

(D) the excess amount determined under subclause (A) above will be allocated between the Pre-Plan Retirees as a group and the Post-Plan Retirees as a group in the same ratio that the amounts determined in subclauses (B) and (C) above bear to the total of such subclauses.

(E) the amount allocated to Pre-Plan Retirees will be further allocated, pro-rata, among themselves.

(F) the amount allocated to Post-Plan Retirees will be further allocated, pro-rata, among themselves.

* * *

(g) Adjustments Relating to 10% of Total Firm Income.

Subject to the provisions of subdivision (h) of this Paragraph 9, and without duplication of any reduction required under subdivision (f) immediately above, if for any Year of the firm the sum of (i) all amounts payable to Pre-Plan Retirees, plus (ii) all amounts payable to Post-Plan Retirees, plus (iii) all charges to Retired Partners in such Year by reason of the designation of contingent annuitants as provided in subdivision (c) of Paragraph 9 of the Existing Agreement or as provided in subdivision (c) of this Paragraph 9, shall in the aggregate exceed 10% of the Net Income of the Firm available for Distribution for such Year, then such aggregate amount shall be reduced to that amount which equals 10% of such Net Income of the Firm available for Distribution and the amount of such reduction shall be allocated pro-rata among the Post-Plan Retirees; provided however, that the amount so allocated to any Post-Plan Retiree subject to an annual charge of the character referred to in clause (iii) of this subdivision (g) shall be further reduced by the amount of such charge.

Any allocation made for any Year of the firm as aforesaid shall be made by the Policy Committee pursuant to Paragraph 3 of this Agreement and the allocation so made shall be final and not subject to further review.

* * *

(j) General Provisions Relating to Retirement.

* * *

(iii) A Retired Partner (or the sole stockholder thereof) shall not engage in the practice of law in the States of New York, New Jersey, Connecticut or Ohio, or in the District of Columbia, or in any other jurisdiction where the firm, at the time of the proposed commencement of practice by such Retired Partner (or stockholder), has established an office for the regular practice of law or has determined by action of the Policy Committee . . . to establish such an office; provided, however, that the provisions hereof shall not apply to legal services rendered by a Retired Partner (or the sole stockholder thereof) (i) to or at the request of the firm, or (ii) to others with the approval of the Policy Committee

(iv) Payments by the firm to Retired Partners . . . shall be made to such Retired Partners at the same times as advances to, or distributions of profits among, the Partners. Such payments shall be treated as advances. . . . It is understood that, because certain Persons who retire hereunder will have been associated and/or Partners of the firm prior to having become the sole stockholder of a Corporation, the retirement benefits payable under Paragraph 8 of this Agreement . . . may be required to be allocated between such Person and such Corporation. Such allocation shall be made by paying to the Person (or Successor thereof) that portion of the total benefits payable which is derived by multiplying such total benefits by a fraction the

numerator of which is all years of service with the firm of such Person as an associate and as a Partner and the denominator of which is all years of service with the firm of such Person and such Corporation . . ."(emphasis in original).

Further, pursuant to paragraph 4(c) of the partnership agreement, Mr. McKean, as a retired partner, does not share in the losses of the law firm.

16. Petitioners submitted for review as their Exhibit G, an affidavit of Christopher A. Conroy dated October 2, 1995. Mr. Conroy described his position with Simpson Thacher & Bartlett as follows:

"1. From 1984 until the present, I have served as the Director of Finance of Simpson, Thacher & Bartlett. . . . As Director of Finance, my responsibilities include the administration and supervision of the Firm's retirement plans for partners set forth in the Firm's partnership agreement."

He also described Mr. McKean's status with the firm during the years at issue as follows:

"As a retired partner, Mr. McKean was entitled to (1) equity payments for seven years which fluctuated according to annual firm profits and (2) pension payments for life which fluctuated according to an annual cost-of-living adjustment. Because both firm profits and the cost-of-living adjustment were not known at year end, a portion of Mr. McKean's equity and pension payments for a given year were not distributed to him until the following year. Consequently, 'capital account balances,' which appear on Mr. McKean's Schedule K-1 statements at a year-end after December 31, 1985, are a function of undistributed equity and pension payments, and not capital in the Firm."

With regard to the possibility that petitioner's pension payments might be reduced because of the 15% cap noted in the partnership agreement, Mr. Conroy noted as follows:

"The Firm's partnership agreement provides that in certain remote instances, a retired partner's retirement payments may be decreased in a given year if the sum of all retirement payments payable by the Firm exceeds a certain percentage of Firm profits for such year. To date, however, this limitation has never been implemented to decrease a retirement payment payable to Mr. McKean or any other retired partner of the Firm. In fact, since Mr. McKean's retirement, the relationship between the Firm's profits and its retirement payment obligations has been such that there has not been even a remote chance that Mr. McKean's retirement payments would be affected by this limitation. Moreover, based on the income history of the Firm and the Firm's estimated future retirement obligations, it appears extremely unlikely that the limitation on retirement payments . . . will ever be triggered."

17. Pursuant to Paragraph 1(b) of the partnership agreement, "Former Partner" was defined to mean the following:

"(i) a Deceased Partner, (ii) a Retired Partner, (iii) any Person who, having been a party to the Existing Agreement, left the firm for a reason other than death or retirement before the Effective Date of this Agreement, (iv) any Person who is or

becomes a Partner and who leaves the firm on or after the Effective Date of this Agreement for a reason other than death or retirement and (v) any Corporation which is or becomes a Partner, the sole stockholder of which causes such Corporation to leave the firm on or after the Effective Date of this Agreement for a reason other than death or by causing such Corporation to retire; and, as the context requires, the term "Former Partner" shall also include the sole stockholder of a Corporation."

Paragraph 1(b) also includes the following definition of "Retired Partner":

"(i) any Person who, having been a party to the Existing agreement, retired prior to the Effective Date of this Agreement pursuant to any provision of the Existing Agreement, (ii) JWP Corporation or the sole stockholder thereof, (iii) any Person who is or becomes a Partner and who retires on or after the Effective Date of this Agreement pursuant to the provisions of this Agreement or, in the case of Cyrus R. Vance and Richard M. Dicke, pursuant to the provisions of the Existing Agreement, and (iv) a Corporation which is or becomes a Partner, the sole stockholder of which shall cause such Corporation to retire on or after the Effective Date of this Agreement pursuant to the provisions of this Agreement or, in the case of Eliot B. Weathers, P.C. or Roy L. Reardon, P.C., pursuant to the provisions of the Existing Agreement."

SUMMARY OF THE PARTIES POSITIONS

18. Petitioners contend that under well-established New York law, Mr. McKean was retired from his law firm. Although during the years at issue, "Mr. McKean's Equity Payments required that he maintain a small profits interest" in the law firm, other more important factors support the conclusion that he was not a partner of the firm but rather was retired from the firm (Petitioners' brief, p. 12). Petitioners point to the following factors in support of their contention that Mr. McKean was not a partner in the law firm during the years at issue: (1) He did not share in the firm's losses and could not be held personally liable for such losses, (2) He had no involvement in the active management of the firm and its investment decisions; (3) He had no right to exercise any management or fiscal control over the firm; (4) He did not maintain an office at the firm and did not receive any secretarial assistance from the firm; (5) He did not hold himself out to a partner and was not named as a partner; and (6) Under the partnership agreement, Mr. McKean's status was that of a retired or former partner

According to petitioners, even if the Division is correct that the "completely liquidated" test should be used to determine whether Mr. McKean was a partner during the years at issue, his "entire share in the Firm's contributed capital was paid to him in full", and "[f]rom that point

forward, Mr. McKean's only interest in the Firm has been a small profits interest and a capital account for undistributed profits at the end of any year" (Petitioners' brief, p. 15). Petitioners explain that "because both firm profits and the annual CPI Adjustment is not known until after the year-end, Mr. McKean's capital account reflects Equity and Pension Payments which remain to be distributed for that fiscal year" (Petitioners' brief, pp.15-16).

Petitioners also argue that the pension payments received by Mr. McKean during 1989 and 1990 met all four of the requirements set forth by 20 NYCRR 132.4(d)(2) so that it constituted an annuity not taxable to New York as New York source income. Such payments were made in fixed dollar amounts, at a regular yearly interval, and pursuant to the partnership agreement which was a written instrument. According to petitioner, there "was only a remote possibility that any limitation on the Pension Payments could be triggered" (Petitioners' brief, p. 19). Petitioners contend that such "theoretical possibility of any limitation should be disregarded" (Petitioners' brief, p. 19).

In the alternative, petitioners maintain that if the payments are viewed as taxable to New York, "Mr. McKean should be afforded the \$20,000 pension and annuity exclusion available under Tax Law § 612(C)(3-A)" (Petitioners' brief, p. 22).

19. The Division counters that "[t]he 15% cap found in the partnership agreement of STB eliminates the possibility that these retirement payments are made at a uniform rate based upon sound actuarial theory" (Division's brief, p. 4). The Division cites Matter of Pidot v. State Tax Commission (118 AD2d 915, 499 NYS2d 482, affd 69 NY2d 837, 513 NYS2d 965) and Norris v. State Tax Commission, (140 AD2d 876, 528 NYS2d 694) in support of its position. In the matter at hand, the Division points out that the partnership agreement "fails to set forth a method of recapturing the income that may be lost due to the partnership's fluctuating profits" (Division's brief, p. 4).

The Division also argues that Mr. McKean was properly deemed a partner because he had not completely liquidated his interest in the partnership relying on Megson v. State Tax Commission (105 AD2d 481, 480 NYS2d 615) "where the court determined that substantial

evidence existed to deem a 'retired partner' a 'partner' for income tax purposes when that individual maintained both a capital account and received a percentage interest of the firm's profits" (Division's brief, pp. 6-7). The Division also references I.R.C. § 736 in support of its position that the payments at issue were "properly characterized as a distributive share of partnership income" (Division's brief, p. 8).

The Division rejects petitioners' alternative argument that they should be afforded the exclusion under Tax Law § 612(c)(3-a) because such provision applies only to residents of New York.

20. Petitioners in their reply brief distinguish Norris v. State Tax Commission (*supra*), which was relied upon by the Division, from the facts at hand. They also again reject the Division's use of the completely liquidated test for determining Mr. McKean's status as a retired partner, and maintain that even if such test is used, Mr. McKean's capital account was completely liquidated.

Finally, citing Matter of Blue (Tax Appeals Tribunal, April 6, 1995), petitioner contends that a nonresident may be entitled ~~CONCLUSIONS OF LAW~~.

A. The parties' arguments, as summarized in paragraphs "18", "19", and "20", failed to address the decision of the Tax Appeals Tribunal in Matter of Blue (April 6, 1995), which focused upon the same issues raised in this proceeding.¹¹

In Matter of Blue, the Tribunal noted that there were two independent bases to tax income received by a retired partner of a New York law firm: (1) if the income constituted a distributive share of partnership income, and (2) if the income was attributable to a profession or occupation carried on in New York. Addressing the first basis, the Tribunal cited Tax Law former § 632(a)(1)(A), which during 1989 and 1990 was substantially the same as Tax Law former § 631(a)(1), effective for such years, which provided as follows:

¹¹In its reply brief, petitioners merely cited Matter of Blue in support of a minor point without any elaboration. They made no attempt to distinguish the facts in Blue from the matter at hand.

"(a) General. The New York source income of a nonresident individual shall be 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" (Emphasis added.)

In Blue, the Tribunal decided that the retirement payments at issue therein did not constitute a distributive share of partnership income. Citing Matter of Pidot v. State Tax Commn. (*supra*) and Matter of Kestenbaum v. State Tax Commn. (107 AD2d 955, 484 NYS2d 371), the Tribunal noted the following test for determining whether a payment constitutes a distributive share of partnership income thereby taxable to New York:

"[T]he meaning of 'distributive share' for purposes of Tax Law former Sec. 632(a)(1)(A) is determined by the meaning of this phrase in sections 704(a) and 736(a) of the Internal Revenue Code. Under section 704(a) of the Code, the Court in each case held, that a partner's distributive share is determined by the partnership agreement. If the agreement gives the taxpayer no interest in the partnership's income or losses and distributed 100% of income and losses to individuals other than the taxpayer, then the Court concluded the taxpayer has no interest in the partnership and did not receive a distributive share under section 704(a) of the Internal Revenue Code. Further, the Court in Kestenbaum and Pidot held that payments were not a distributive share under section 736 of the Code, if the payments were made after the taxpayer's interest in the partnership had already been completely liquidated."

Finding that Mr. Blue had no right to share in the profits or losses of the partnership and that this right was given 100% to others, as well as the fact that Mr. Blue had retired from the partnership and his interest in the partnership had been completely liquidated, the Tribunal concluded that the payments to Mr. Blue "were not a distributive share under either section 704(a) or 736 of the Internal Revenue Code nor, therefore, under Tax Law former Sec. 632(a)(1)(A)."

B. The matter at hand is complicated by the fact that the payments received by Mr. McKean were broken into an equity portion, which he concedes is subject to New York taxation, and a pension portion which he claims is nontaxable. Petitioner concedes that the equity portion is subject to New York taxation because the amount of such payment is tied to the law firm's profitability. Petitioner emphasizes that the pension portion of the payments received were fixed amounts. Nonetheless, the Division may properly treat the total amount of

payments received by petitioner as a distributive share of partnership income because by Mr. McKean's receipt of the equity portion, he retained the right to share in the profits of the law firm. As a result, unlike the taxpayers in Pidot and Kestenbaum, it cannot be said that Mr. McKean's interest in the partnership had been completely liquidated. Consequently, the total amount of the retirement payments, including the pension portion, may be treated as a distributive share of partnership income subject to New York tax.

C. In Matter of Blue (*supra*), the Tribunal noted that, in addition to treating a nonresident's retirement benefits as taxable to New York because it is a distributive share of partnership income, under Tax Law former § 632(b)(1)(B) there "is a separate, independent basis upon which to tax the income at issue." During 1989 and 1990, this provision was substantially the same as Tax Law former § 631(b)(1)(B), effective for such years, which provided as follows:

"(b) Income and deductions from New York sources. (1) Items of income, gain, loss and deduction derived from or connected with New York sources shall be those items attributable to:

* * *

"(B) a business, trade, profession or occupation carried on in this state. . . ."

Referencing its earlier decision in Matter of Walsh (Tax Appeals Tribunal, November 19, 1992, confirmed on other grounds, 196 AD2d 367, 609 NYS2d 405), the Tribunal in Blue noted that "payments from a New York partnership to a retired nonresident partner were derived from or connected with New York sources within the meaning of former section 632(b)(1)(B)."

D. The Tax Appeals Tribunal has consistently noted that administrative law judges may not moot issues (*see*, Matter of Bankers Trust, Tax Appeals Tribunal, March 14, 1995). Consequently, although it has been concluded that the payments at issue may be treated as a distributive share of partnership income taxable to New York, whether such payments may be viewed as an annuity excludable from New York income under 20 NYCRR 132.4(d)(2) (formerly 131.4[d][2]) will be addressed. This regulation provides, in relevant part, that in

order to qualify as a nontaxable annuity, a pension or other retirement benefit must meet the following requirements:

"(i) It must be paid in money only

"(ii) It must be payable at regular intervals, at least annually, for the life of the individual receiving it, or over a period not less than half of such individual's life expectancy as of the date payments begin

"(iii) It must be payable:

"(a) at a rate which remains uniform during such life or period; or

(b) at a rate which varies only with:

(1) the fluctuation in the market value of the assets from which such benefits are payable;

(2) the fluctuation in a specified and generally recognized cost-of-living index; or . . .

(c) in such a manner that the total of the amounts payable is determinable at the annuity starting date either directly from the terms of the contract or indirectly by the use of either mortality tables or compound interest computations, or both"

If the payments at issue do not meet the above regulatory test to determine whether they constitute annuity payments, pursuant to 20 NYCRR 132.4(d)(2) (formerly 131.4[d][2]):

"[I]t is compensation for personal services and, if the individual receiving it is a nonresident, 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 in connection with the termination of employment, amounts received upon early retirement in consideration of past services rendered, amounts received upon retirement for consultation services, and amounts received upon retirement under a covenant not to compete [emphasis in original]."

Once again, the Tribunal's decision in Matter of Blue (supra) provides guidance. The partnership agreement at issue in Blue had a similar provision to the one in the matter at hand, which permits the reduction in a retirement payment if a certain specified percentage of the firm's profits are insufficient to cover the sum of all retirement payments payable by the law firm.

As noted in Finding of Fact "16", according to the affidavit of Christopher A. Conroy:

"in certain remote instances, a retired partner's retirement payments may be decreased in a given year if the sum of all retirement payments payable by the Firm exceeds a certain percentage of Firm profits for such year".

Mr. Conroy then goes on to minimize the possibility of such reduction occurring:

"To date, however, this limitation has never been implemented to decrease a retirement payment Moreover, based on the income history of the Firm . . . it appears extremely unlikely that the limitation on retirement payments . . . will ever be triggered."

The Tribunal in Blue rejected a similar attempt to minimize the possibility of a reduction in benefits, and affirmed the administrative law judge's determination that a possibility of a reduction was a sufficient basis to conclude that the uniformity requirement was not satisfied.

E. The Tribunal's decision in Blue is also dispositive of the issue concerning petitioners' alternative argument that they are entitled to claim the \$20,000.00 exclusion from tax under Tax Law § 612(c)(3-a) if the payments at issue are viewed as taxable retirement benefits (see also, Matter of LaPorte, Tax Appeals Tribunal, May 18, 1995). This provision excludes from New York adjusted gross income of a resident:

"(3-a) Pensions and annuities received by an individual who has attained the age of fifty-nine and one-half . . . to the extent includible in gross income for federal income tax purposes, but not in excess of twenty thousand dollars, which are periodic payments attributable to personal services performed by such individual prior to his retirement from employment which arise (i) from an employer-employee relationship or (ii) from contributions to a retirement plan which are deductible for federal income tax purposes"

The Tribunal, in reversing the administrative law judge on this issue, noted:

"[T]he Legislature did not intend 'employee' to include a partner for purposes of the section 612(c)(3-a) subtraction modification and, therefore, that the income at issue cannot be excluded from petitioners' New York income on this basis."

Similarly, since petitioner was a partner in Simpson Thacher & Bartlett, and not an employee of the law firm, he is not entitled to claim this subtraction modification.

F. Petitioner is correct that in determining whether an individual is a "partner", New York courts have consistently applied a balancing test in which they weigh several factors (see, e.g., Blaustein v. Lazar Borck & Mensch, 161 AD2d 507, 555 NYS2d 776). However, petitioners ignore the analysis of the Tribunal in Blue (supra) which did not focus on petitioner's status as a partner per se, but rather focused on whether the payments at issue were a distributive share of partnership income. Moreover, as noted in Finding of Fact "1", the factual record created for the submission of this matter is skimpy. Petitioners did not submit an

affidavit of Mr. McKean concerning his involvement in the law firm after his retirement. Mr. Conroy's affidavit, as detailed in Finding of Fact "16", is limited in scope. As noted in Finding of Fact "13", the Division submitted as part of its Exhibit "H" a photocopy of a memorandum from Simpson Thacher & Bartlett attorney James G. Sweeney which did describe Mr. McKean's relationship to the law firm after his retirement. However, this memorandum, which is not in affidavit form, can be given little weight. In short, petitioners face the predicament of not having offered sufficient evidence to support a conclusion that, even if the balancing test for determining partner status was relevant herein, Mr. McKean was no longer a partner during the years at issue. It is further observed that the parties did not stipulate to any facts.

G. As a final note, it is observed that:

"[O]n January 6, 1996, Title 4 of the United States Code was amended to provide that, for amounts received subsequent to December 31, 1995, no state may impose an income tax on the retirement income of an individual who is not a resident or domiciliary of that state" (Matter of Wolf, Tax Appeals Tribunal, March 3, 1996).

Unfortunately for petitioners, that provision has no effect on the taxability of the 1989 and 1990 payments at issue herein.

H. The petition of Robert J. McKean, Jr. and Sally H. Ament is denied, and the notices of deficiency dated June 28, 1993 are sustained.

DATED: Troy, New York
May 2, 1996

/s/ Frank W. Barrie
ADMINISTRATIVE LAW JUDGE