STATE OF NEW YORK

DIVISION OF TAX APPEALS

In the Matter of the Petition	:	
of	:	
FUCHSBERG & FUCHSBERG	:	DETERMINATION DTA NO. 817914
for Redetermination of a Deficiency or for Refund of New York State and New York City Personal Income Taxes under Article 22 of the Tax Law and the New York City Administrative Code for the Years 1994, 1995, 1996 and 1997.	:	

Petitioner, Fuchsberg & Fuchsberg, 100 Church Street, 18th Floor, New York, New York 10007-2601, filed a petition for redetermination of a deficiency or for refund of New York State and New York City personal income taxes under Article 22 of the Tax Law and the New York City Administrative Code for the years 1994, 1995, 1996 and 1997.

A hearing was held before Dennis M. Galliher, Administrative Law Judge, at the offices of the Division of Tax Appeals, 641 Lexington Avenue, New York, New York on March 22, 2001 at 10:30 A.M., with all briefs to be submitted by August 10, 2001, which date commenced the six-month period for the issuance of this determination. Petitioner appeared by Stephen Hochberg, Esq. and Theodore Silver, Esq. The Division of Taxation appeared by Barbara G. Billet, Esq. (Kevin R. Law, Esq., of counsel).

ISSUES

I. Whether the Division of Taxation correctly determined that petitioner improperly failed to deduct and remit withholding taxes with respect to payments made to petitioner's associate attorneys from revenues resulting from cases referred to petitioner by such associate attorneys.

II. Whether, assuming petitioner improperly treated its associate attorneys as independent contractors with respect to the payments described above, petitioner is nonetheless entitled to rely upon the so-called "safe harbor" provisions of section 530 of the (Federal) Revenue Act of 1978.

III. Whether any action undertaken by the Internal Revenue Service with regard to reviewing petitioner's practice of treating the above-described payments as compensation not subject to withholding tax requirements serves to preclude the Division of Taxation, pursuant to 20 NYCRR 171.3(b), from asserting such payments as subject to withholding.

IV. Whether the Division of Taxation's method of computation and its assertion of interest due with respect to the above-described payments was proper.

V. Whether petitioner has established that the deficiency asserted for the year 1994 is barred by operation of the statute of limitations on assessment.

FINDINGS OF FACT[1]

1. The facts in this matter are largely undisputed.[2] Petitioner, Fuchsberg & Fuchsberg, is, and was during the years in issue, a law firm generally representing clients who had suffered personal injury, including injury resulting from medical malpractice. Pursuant to custom among New York personal injury attorneys and firms, petitioner was paid by contingency fee, meaning that for each of its clients, it retained for itself, as its fee, a portion of the recovery, if any, that it secured.

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[1] The New York City Administrative Code contains provisions similar to the New York State Tax Law with respect to the withholding of New York City personal income and nonresident earnings taxes (***see,*** Administrative Code §§ 11-1771, 11-1775, 11-1776, 11-1908, 11-1913, 11-1914). Hence, reference to New York State taxes or to New York State tax statutes shall be deemed references, though uncited, to the parallel New York City provisions.

[2] The parties executed a Stipulation of Facts in this matter. Such stipulated facts are included in the Findings of Fact set forth herein.

2. Pursuant to custom among personal injury attorneys and firms, petitioner obtained some of its clients through referral by attorneys not affiliated with itself, and compensated each such referring attorney by paying to him or her a share of the contingency fee (if any) collected from the referred client. With respect to the compensation thus paid to referring attorneys not affiliated with itself, petitioner treated each such referring attorney as an independent contractor and withheld no payroll taxes, but instead reported all such compensation to the recipient and to the State via Forms 1099 ("Information Return").

3. During the years in issue, petitioner was composed of 2 attorneys who were equity partners and approximately 25 attorneys who were full-time employees.[3] Petitioner paid each of its full-time attorney employees ("associates") a stated sum which petitioner and its associates knew as "salary" (i.e., wage income), and on which petitioner routinely withheld payroll taxes.

4. During the years in issue, petitioner afforded each of its own associates who referred clients to petitioner compensation analogous to that which it afforded referring attorneys not affiliated with itself. Specifically, petitioner paid to each such referring associate a share of the contingency fee that any such referral ultimately produced. Contingency fee arrangements in general, as well as the sharing of contingency fees, are negotiable matters. Typically, in petitioner's case, the referring associate's share of the contingency fee in general negligence matters (e.g., automobile accidents) would be 50 percent of the firm's contingency fee. In medical malpractice cases, the firm's contingency fee is typically based on an inverse sliding scale of 30 percent of the client's recovery up to a certain dollar amount (i.e., 30% of the first X dollars of recovery), then 25 percent of the client's recovery up to a certain dollar amount, and so on. In turn, the referring associate's share of the contingency fee would typically follow the

[3] The exact number of full-time attorney employees varied from year to year.

percentages of the firm's contingency fee, i.e., 30 percent of the firm's 30 percent, 25 percent of the firm's 25 percent, and so on.

5. With respect to those payments made to its associates, and only as to those payments, petitioner afforded each such referring associate a treatment analogous to that which it afforded referring attorneys not affiliated with itself. That is, as to such payments, petitioner withheld no payroll taxes but rather reported all such compensation to the recipient and to the State via Forms 1099.

6. There is no dispute that petitioner's associates acknowledged and timely reported to New York State the compensation paid to them as referral fees, as reported by petitioner on Forms 1099, and timely paid tax on such compensation.

7. The payment to an associate of a share of a contingency fee applied and occurred only if and when an employee did in fact refer a client to petitioner (and, of course, was dependent upon successful recovery for the client thereby providing the basis for a contingency fee). Petitioner shared fees with an associate only as to a case that the associate referred to the firm. If an associate worked laboriously on a case that he had not referred, he did not share in the fee. Compensation for such work, however laborious and intensive, came only from the employee's regular salary. Conversely, if an attorney did not work laboriously on a case that he had referred, or did not work on the case at all, he nonetheless would share in the contingency fee.

8. The above-described practices as to the sharing of contingency fees, as well as petitioner's payroll tax treatment of such payments both to attorneys not affiliated with itself and to its associates (i.e., Form 1099 reporting with no withholding of payroll taxes), have been consistently followed by petitioner for at least the 19-year period spanning the beginning of 1979 through the end of 1997.

9. Petitioner provided the testimony of Mark Bower, an attorney whose practice centers on personal injury cases including specifically medical malpractice cases, to establish the general custom among personal injury lawyers concerning referrals and the payment and sharing of contingency fees, as well as the customary tax treatment thereof by personal injury firms. Mr. Bower's own belief or understanding is that associates in personal injury firms have a basic obligation to refer whatever business they generate to their employer on a right of first refusal. Attorneys develop their own reputations via a number of different means, including public educational activities, involvement in bar associations, involvement in churches, temples, PTA and like organizations. Attorneys "cast a wide net" to make the public aware of them and their services. In this regard, he acknowledged the obvious fact that successful reputation building can and does translate into financial gain. Mr. Bower, who has been an associate with petitioner during two separate time periods and who has managed other personal injury law firms, including his own firm, confirmed that the tax treatment of contingency fees shared with associates, as practiced by petitioner, was the nearly universal practice in the field of personal injury law.

10. Petitioner's long-time managing partner, Abraham Fuchsberg, explained that client referrals are not a part of petitioner's associate's duties. Many of petitioner's associates, including some who have been in petitioner's employ for many years, have never referred a case to petitioner. For purposes of hiring, petitioner (generally in the person of Abraham Fuchsberg) does not evaluate a prospective associate in terms of the likelihood that he or she will generate business for the firm via referrals. Rather, hiring is based on the specific needs of the firm in comparison to the experience, ability and maturity of the prospective associate. In the same manner, client referral activity plays no part in the establishment of an associate's initial salary

upon hiring, or thereafter with respect to salary adjustments over time, or with respect to the associate's continued employment with the firm.[4]

11. Although it does not appear to have been a regular practice, from time to time over the years petitioner has loaned money to its associates. Included in the record is a copy of a loan agreement between petitioner and one of its associates (and that associate's wife). This agreement provides, with respect to referred cases, as follows:

> WHEREAS, pursuant to the usual understanding that [petitioner] has with its associate attorneys, [borrower] is required to refer to [petitioner] all cases and legal matters in which he is retained or which are referred to him while associated with [petitioner].

The document goes on to provide an assignment of the borrower's right and interest in the "cases and legal matters," and any attendant referral fees resulting therefrom, to petitioner as security for the amount loaned.

12. Petitioner's associates are not required to refer cases to petitioner, and they are not prohibited from referring cases to law firms not associated with petitioner and may receive fees as the result of such referrals. Under such circumstances, petitioner would not share in the fee. However, when an associate refers a case to petitioner, but the case is ultimately referred to another firm (and assuming petitioner has undertaken some initial involvement with the case so as to be entitled to compensation for its services), the referring associate would share with petitioner in any fee derived from such case.

13. In November 1997, the Division of Taxation ("Division") commenced a withholding tax audit of petitioner. The scope of the audit focused on determining whether petitioner acted

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[4] Petitioner apparently has built a solid reputation in its field and, as a result, appears to be in the enviable position where it does not "want for work" and, consequently, is not in "need" of referrals *per se*. In this regard, Mr. Fuchsberg stated that "I'm not that hungry for a case, you must understand. My office is fully occupied and we have enough work to do and I don't have to chase cases . . . ."

properly in issuing to its associates Forms 1099 rather than Forms W-2 and, in so doing, not withholding taxes with respect to compensation resulting from referred cases. Upon audit, the Division determined that the referral fees paid to petitioner's associates should have been treated as wages subject to withholding. The Division added the amount of 1099 income paid to each of petitioner's associates to the amount of W-2 wage income paid to each of such associates for each year, and determined the amount of tax that should have been withheld from each such associate on such total for each year. The Division then subtracted the amount actually withheld from each associate from the amount the Division determined should have been withheld. This resulting amount, deemed underwithholding, was then subjected to interest charges accruing periodically over the course of the number of withholding periods for each year until April 15th of the following year when, at the outside, the payment of tax by the individual associates would have been due per statute. Interest thereafter was continued upon the "late" withholding interest amount (the "unpaid interest base") pending payment.

14. On September 14, 1998, the Division issued to petitioner a total of eight notices of deficiency (one pertaining to each of the four years in issue for New York State tax and one pertaining to each of the four years in issue for New York City tax) asserting interest due pursuant to the above-described audit calculations. There is no dispute that the referral fee income in question was reported by the individual recipients thereof and that tax due thereon was remitted by such individuals, thus leaving at issue only interest based on the timing of payment differentials. The Division did not assert any penalties due from petitioner.

15. In 1999, the Internal Revenue Service ("IRS") performed a tax compliance check of petitioner which included, *inter alia*, reviewing and reconciling various documents concerning petitioner's practices regarding the treatment of compensation paid to its associates. The

examining IRS officer requested and reviewed the following documents for the years 1996 through 1998:

> Form 1165---U.S. Partnership Income Tax Return
> Form 941 ----Employer's Quarterly Federal Tax Return
> Forms W-2---Wage and Tax Statement
> Forms W-3---Transmittal Form for Forms W-2
> Forms W-4---Employee's Withholding Allowance Certificate
> Forms 940---Employer's Annual Federal Unemployment Tax Return
> Forms 1099---Information Return
> Forms 1096---Transmittal of Forms 1099.

After review of these forms, the examining officer advised petitioner, by letter dated May 6, 1999, that there would be no further examination. Specifically, the letter provided, in relevant part, as follows:

> Thank you for your cooperation in responding to our questions during our recent compliance check. It has been determined that an employment tax examination will not be conducted at this time.

16. Petitioner accounts for the payment of referral fee compensation (i.e., contingency fee sharing) to its associates through one account. Specifically, when payment of an award (settlement or judgment) is received, that payment check is endorsed by the client and by petitioner for deposit into petitioner's Interest On Lawyer Account ("IOLA"), an "escrow" account maintained by petitioner as required pursuant to Judiciary Law § 497. Petitioner's accountant described how petitioner accounts for the receipt of funds, including settlements and awards, and for the subsequent disbursement thereof. Such amounts are received by petitioner in check form, payable to the client and to petitioner. The check is endorsed by both payees, and is deposited in the IOLA account as described (rather than in petitioner's general business or other accounts). A closing statement is then prepared identifying the specific breakup of the deposited amount and listing the amounts and the parties to whom payments are to be made. Separate

checks are then cut from the IOLA account, payable to the parties identified on the closing statement. Such payments are made to the clients for their recovery on the lawsuit, to petitioner for its costs and disbursements in the case, to petitioner for its portion of the contingency fee, and to the referring associate (or outside attorney) for his portion of the contingency fee.[5] The checks to petitioner for its fee and for its costs and disbursements are thereafter deposited in the firm's general business account. The check to the associate for the referral fee goes directly to the associate and is reported by petitioner thereafter via Form 1099 as described.[6] In contrast to referral fees, the associate's regular biweekly salary payment comes from petitioner's payroll account which, in turn, draws its funds by transfer deposit from petitioner's general business account. These biweekly salary payments are accounted for as wages subject to withholding and reporting thereafter is via Form W-2. For tax return purposes, petitioner's Partnership Return of Income ("Form 1065") reported total revenues, which figure is then reduced by "forwarding fees" to arrive at firm revenues. Under this manner of accounting and reporting, and since petitioner pays the referral fees directly from the IOLA account and not via the firm's payroll account, petitioner does not take a "wage deduction" from its payroll account or its general business account for the referral fees paid to referring attorneys (either to its associates or to outside attorneys).

SUMMARY OF THE PARTIES' POSITIONS

17. The Division, by its audit and assertion of the deficiencies herein, has challenged petitioner's tax treatment of compensation paid to its associates. The Division asserts that the

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[5] If the case was not a referred case, then the entire contingency fee goes to petitioner.

[6] The method of deposit and payout described applies to all situations other than the five to ten percent of the firm's cases involving infant compromise and wrongful death, where the settlement or award is paid directly to the various parties by the Court.

referral compensation represented payment for an ongoing and regular part of petitioner's business, to wit, the generation and receipt of case referrals from petitioner's full-time employee associates. The Division claims these payments constituted wage income to the payee recipients which was properly subject to withholding. The Division argues that the associates were expected and obliged to refer all cases to petitioner on a right of first refusal, and that such referral activity was an overall component of employment with petitioner. The Division also maintains that petitioner may not avail itself of the protection afforded under section 530 of the Revenue Act of 1978, the so-called "safe harbor" provision, to avoid the imposition of interest or other charges stemming from its failure to withhold. In this regard, the Division maintains that petitioner treated its associates as employees and withheld tax on their wages, and thus cannot at the same time take the position that such personnel were independent contractors.

18. Petitioner argues, in contrast, that it is possible to be both a wage compensated employee and an independent contractor receiving nonwage compensation from the same employer. Petitioner asserts that its associates filled such a dual role, noting that there was no requirement for any of its associates to refer cases to petitioner and that in fact many of its associates, including many long-term associates, have never referred a case. Petitioner maintains that hiring, retention, and salary compensation paid to its associates is based on the needs of the firm as an entity and hinges on the ability, experience, maturity and performance of each associate. Petitioner points out that its associates are free to refer or not refer cases, and asserts that garnering referrals is not a condition of their employment. Petitioner notes that the manner in which its associates who choose to refer cases attract such cases varies from attorney to attorney and is driven by personal style and personality. Petitioner posits that its associates are, with respect to their activities in generating referral cases, independent as to whether or not they

will seek such cases and as to the manner by which they might obtain such cases and, if successful, as to whether they will or will not refer such cases to petitioner. Petitioner also notes that it does not share any portion of a contingency fee with any nonreferring associate, but rather only shares such fees with the referring associate. On this score, it does not matter that the case may have been assigned to one or more associates in the firm who handled all aspects of the case while the referring associate had no involvement in the case. Thus, petitioner claims that its associates clearly were independent contractors with regard to remuneration received as the result of cases referred, and that the firm therefore properly reported such amounts as 1099 income not subject to withholding.

19. Petitioner also argues, in the event it is determined that such compensation constituted wage income properly subject to withholding, that it falls squarely within the parameters of section 530 of the Revenue Act of 1978, and thus must be held harmless for any failure to withhold and remit taxes on the referral-based compensation. On this score, petitioner argues that the Division has conceded that, although perhaps uncommon, a wage employee can also be an independent contractor for the same employer. Petitioner goes on to point out that its treatment of referral compensation has been the same for many years, and is fully consistent with the treatment of referral compensation paid to associates by personal injury law firms in general. Finally, petitioner challenges the computational method and result reached by the Division, arguing that the same provides a "windfall" to the Division, given that it is undisputed that each of its associates reported the compensation in issue and paid tax thereon via their individual tax returns.[7]

[7] At hearing and in its brief, petitioner raised some question as to the validity of a consent extending the period of limitations on assessment for the year 1994. However, petitioner's reply brief explicitly clarifies that the statute of limitations on assessment is not raised as a defense and is not at issue herein.

CONCLUSIONS OF LAW

A. The first issue to be addressed is whether petitioner's associates were independent contractors and not employees with regard to their activities in referring cases to petitioner, such that the compensation resulting therefrom was not subject to withholding requirements. Thereafter, and assuming such compensation is determined to have been wage income subject to withholding, the issue becomes whether petitioner qualifies for the ameliorative effect of section 530 of the Revenue Act of 1978. Finally, assuming that the compensation in question was subject to withholding and that section 530 does not apply, the issue becomes whether the Division's method and result in calculating the deficiencies in issue was proper and may be sustained.

B. Employers are required to withhold income taxes from wages pursuant to Tax Law § 671(a)(1) and 20 NYCRR 171.1(a). Regulation 20 NYCRR 171.1(a) provides that:

> Every employer maintaining an office or transacting business within New York State, and making payment of any wages taxable under Article 22 of the Tax Law to a resident or a nonresident individual, must deduct and withhold from such wages for each payroll period such . . . tax . . . [in] an amount substantially equivalent to the . . . tax reasonably estimated to be due as the result of the inclusion of the employee's wages . . . in the employee's New York adjusted gross income. (***See also***, Administrative Code of the City of New York § 11-1771[a][1]; IRC § 3402.)

C. In those instances where an employer fails to withhold tax from an employee's wages and the employee subsequently satisfies his tax liability, Tax Law § 676 provides that:

> If an employer fails to deduct and withhold tax as required, and thereafter the tax against which such tax may be credited is paid, the tax so required to be deducted and withheld shall not be collected from the employer, but the employer shall not be relieved from liability for any penalties, *interest*, or additions to the tax otherwise applicable in respect to such failure to deduct and withhold (emphasis added).

D. In contrast to the foregoing, employers are required to withhold and remit taxes only with respect to payments to "employees" and not upon payments to "independent contractors." Payments to independent contractors are accounted for by the employer's submitting an annual information return, Form 1099, to the worker and to the Division (and the IRS), reporting the income paid during the year. Petitioner asserts, case law supports, and the Division does not dispute that an individual can be both an employee earning wage income and an independent contractor performing services for the same employer (***U.S. v. Isaksson***, 744 F2d 574; ***Reece v. Commissioner***, 63 TCM 3129; ***Pulver v. Commissioner***, 44 TCM 644). As detailed, petitioner did withhold and remit taxes on its biweekly payments of salary to its associates, but did not do so with regard to the amounts paid based on referred cases. The initial question then is whether the role of the associates in obtaining and referring cases constituted that of an employee carrying out a part of his expected and usual duties for his employer, as opposed to an independent contractor operating for his own account, such that the fees received as the result of the referral of cases constituted additional wage income paid by petitioner and subject to withholding.

E. 20 NYCRR 171.1(b) provides that:

> the provisions of the Federal Internal Revenue Code and its applicable regulations, with respect to the deducting and withholding of Federal income tax by employers from wages, including the meaning of the various Federal terms (such as *employer, employee, wages, payroll period, withholding exemptions*), apply for New York State personal income tax purposes, except as otherwise specifically provided in this Article or where such Federal rules and definitions are clearly inconsistent with and inapplicable to the provision of this Article.

F. The term "wages" is defined to mean "all remuneration . . . for services performed by an employee for his employer . . ." (IRC § 3401[a]). An individual is an employee for withholding tax purposes if the individual has the status of an employee under the usual common

law rules applicable in determining the employer-employee relationship (***see,*** Rev Rul 87-41). Generally, such a relationship exists where "the person for whom the services are performed has the right to control and direct the individual who performs the services, not only as to the result to be accomplished by the work but also as to the details and means by which the result is accomplished." (Treas Reg § 31.3401[c]-1[b].) The standard to be applied is as follows:

> The distinction between an employee and an independent contractor has been said to be the difference between one who undertakes to achieve an agreed result and to accept the directions of his employer as to the manner in which the result shall be accomplished, and one who agrees to achieve a certain result but is not subject to the orders of the employer as to the means which are used [citation omitted]. It is the degree of control and direction exercised by the employer that determines whether the taxpayer is an employee [citations omitted]. From the nature of the problem the degree of control which must be reserved by the employer in order to create the employer-employee relationship cannot be stated in terms of mathematical precision, and various aspects of the relationship may be considered in arriving at the conclusion in a particular case [citation omitted] (***Matter of Liberman v. Gallman,*** 41 NY2d 774, 396 NYS2d 159,161).

G. Obviously, the existence of an employer-employee relationship depends upon the facts of each particular case (***see***, Treas Reg § 31.3401[c]-1[d]). The Internal Revenue Service has developed a nonexclusive list of 20 factors as an aid to determine the existence of an employer-employee relationship. These factors, which are set forth in detail in Revenue Ruling 87-41, are summarized below:

> 1. Instructions. If the individual is required to comply with instructions about when, where and how the work is to be performed, it indicates that he or she is an employee.
>
> 2. Training. If a worker is trained by being required to work with an experienced employee, to work with others, to attend meetings or to use specified work methods, this indicates an employment relationship.
>
> 3. Integration. Integration of the workers into the business operation generally shows that the worker is subject to direction and control.
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> 4. Rendering Services Personally. If the services must be rendered personally, it indicates the existence of an employment relationship.

5. Hiring, Supervising and Paying Assistants. If the person for whom the service is performed hires, supervises and pays assistants, such action shows control over the workers on the job.

6. A Continuing Relationship. A continuing relationship performed at frequently recurring though irregular intervals is indicative of an employment relationship.

7. Set Hours of Work. The establishment of set hours of work by the person(s) for whom the services are performed is a factor indicating control.

8. Full Time Required. If the worker must devote substantially full time to the business, control exists over the amount of time the worker spends working and is indicative of an employment relationship.

9. Doing Work on Employer's Premises. The fact that the work is performed on the premises of the person(s) for whom the services are performed suggests control over the worker, especially if the work could be done elsewhere.

10. Setting Order or Sequence. If the services must be performed in an order or sequence set by the person(s) for whom the services are being performed, it shows that the worker is not free to follow his or her own pattern of work.

11. Oral or Written Reports. The requirement that the worker submit regular oral or written reports indicates control by the person(s) for whom the services are being performed.

12. Payment at Regular Intervals. Payment by the hour, week or month indicates an employment relationship, provided that it is not simply a way to pay a lump sum set forth in an agreement.

13. Payment of Business and/or Travel Expenses. Payment of the worker's business and/or traveling expenses by the person(s) for whom the services are being performed indicates an employment relationship.

14. Furnishing Tools and Materials. The fact that the person(s) for whom the services are being performed furnishes tools, materials and other equipment tends to show the existence of an employer-employee relationship.

15. Significant Investment. Investment by the worker in significant facilities used in performing services and not typically maintained by employees tends to indicate that the worker is an independent contractor.

> 16. Realization of Profit or Loss. A worker who can realize a profit or suffer a loss as a result of services provided (in addition to the profit or loss ordinarily realized by an employee) is generally an independent contractor.
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> 17. Working for More Than One Firm at a Time. If a worker performs more than *de minimus* services for a number of unrelated firms or persons at the same time, it generally indicates that the worker is an independent contractor.
>
> 18. Making Service Available to the General Public. The fact that a worker makes his or her services available to the general public on a regular basis indicates an independent contractor relationship.
>
> 19. Right to Discharge. The right to discharge a worker indicates that the worker is an employee.
>
> 20. Right to Terminate. An employer-employee relationship is indicated if a worker has the right to end the relationship at any time he or she wishes without incurring liability.

H. Upon consideration of all of the facts present in this case, and focusing directly upon the actions and means by which petitioner's associates obtain and bring referral clients to petitioner, it becomes clear that with regard to this aspect of their work, the associates were independent contractors such that the contingency fees shared by petitioner with those of its associates who referred cases were not wages. It follows therefrom that petitioner was free to treat and report the compensation paid to such associates based upon the referral of cases as "1099" income rather than as wages subject to withholding. In reaching this conclusion, it is significant that the associates' initial and continuing employment with petitioner was in no way contingent upon referral of cases to the firm. There was no quota of cases or dollar value required to be brought to the firm, and indeed many if not most of petitioner's associates, including long-term associates, never brought any cases to the firm via referral. Clearly the potential for financial gain was present for those associates who referred cases, and petitioner itself obviously stood to benefit from the referral of cases which added to the firm's general

revenues and thus contributed to its overall existence and prosperity. Nonetheless, petitioner imposed no requirement that associates generate referrals, nor any requirement that referrals must be brought to petitioner in the first instance, save for the requirement of assignment of fees earned from any referred cases as security in those infrequent situations where the firm had loaned money to an associate (***see,*** Finding of Fact "11"). Significant also is the fact that petitioner set no rules on how associates should or might obtain referral cases, and the associates who generated referral cases did so in their own manner, on their own time and expense, and in their own various ways. Associates were free to refer cases to other firms, as they determined, and there was no direction or criteria with respect to the types of cases which could be referred to petitioner. Not only were petitioner's associates free to refer cases to firms other than petitioner in the first instance (***see,*** Conclusion of Law "L"), but they were also free to refer a case initially brought to but rejected by petitioner to another firm. Petitioner of course retained the right to reject a referred case if the case did not fit within the parameters of the types of cases handled by petitioner, or based upon petitioner's evaluation of the merits of the case or in consideration of the dollar amounts involved in the case (i.e., a case which would likely be costly to pursue with no likelihood of a positive result for the client or the firm, either in legal result or from a financial perspective).

I. It is also significant that petitioner controlled the manner in which all cases, including referred cases, were handled within the firm. In fact, the referring associates often did not work directly on the cases they referred. Petitioner paid each of its associates a salary for ongoing, everyday legal work to be performed on any of the cases in the firm's inventory to which the associate was assigned, as directed by petitioner's managing partner, Abraham Fuchsberg. Such assignments were made based upon attorney availability and individual qualification for

handling the particular type of case or issue involved. In sum, petitioner's associates were hired as legal practitioners and not as sources of client referrals. The additional money paid to the referring associate upon successful recovery in a referred case was not paid to that associate for his or her legal work on the case, per se, but rather occurred strictly as the result of the referral of the case to petitioner. In effect, an associate's opportunity to gain additional compensation by independent efforts leading to referred cases simply provided an opportunity to share in the equity of such cases without necessarily performing "legal" work on such cases. In this regard, as well as for tax reporting purposes, petitioner's associates are treated in the same manner as outside attorneys (i.e., those not employed by or affiliated with petitioner) with respect to referred cases.

J. In practice, petitioner's associates were free to do as they saw fit and as opportunities for referrals arose. Apparently, referrals occurred commonly or frequently for some associates, occasionally or infrequently for others, and never for still others. Whether by happenstance (the misfortune of injury to a relative, friend or acquaintance), or as the result of reputation or *self* promotion in any number of venues (public involvement in bar associations and other legal groups, PTA and other community groups, church or temple involvement, and the like) the opportunity to gain additional remuneration via case referrals was simply an option always available to petitioner's associates. However, it remains that such activity was not a *required* part of an associate's job. Furthermore, while petitioner certainly did not discourage outside involvement in activities from which referrals might be generated, the firm nonetheless was not necessarily pro-active in this area. In this regard, petitioner's associates, and not petitioner, paid their own costs of bar and other association memberships and their own travel expenses to attend association events. Generally, petitioner did not allow firm time off to attend or participate in

such events and activities, or allow compensatory time thereafter based on such attendance or participation.

K. Petitioner's associates regularly (i.e., every two weeks) received their salary, and received such amount as set at the time of their hiring and as periodically reviewed and presumably increased over time based on experience, ability and value to petitioner. In addition to salary payments, Mr. Fuchsberg also alluded in testimony to the payment of bonuses. These payments were not fully described in detail. However, it does not appear that they resulted from or were in any way tied to the referral of specific cases as opposed to being extra payments of wage income based upon the firm's overall success and the value of the legal work performed by each of petitioner's associates. This type of "bonus" payment differs from any additional money received as shared contingency fees which resulted solely from an associate's inclination and ability, on his or her own, to garner and refer cases to the petitioner. If no such activity and no referrals occurred, whether resulting from lack of motivation or ability, no additional money was paid.

L. It is true that the language in the loan agreement (***see*** Finding of Fact "11") is somewhat troubling for its inconsistency with petitioner's claim that there was no obligation to refer cases to petitioner in the first instance (i.e., on a reserved right of first refusal basis). However, the balance of the evidence establishes that such language served primarily to provide a security interest function with respect to the amounts loaned. The fact that there was no requirement to obtain referral cases as a condition of initial or continuing employment with petitioner supports the conclusion that, where money was loaned, petitioner's specific written reservation of rights by assignment on any such referral cases in fact served as a means of security for the sums loaned. In the same vein, the general expectation would seem to be that an

associate would naturally refer cases to the firm with which he was associated, at least on a basis of first refusal, and here the tenor of the testimony as well as common sense lead to a conclusion that such was in fact the case in most instances. The fact of petitioner's obvious long-term success and standing in the field of personal injury law itself would presumably provide strong motivation for an associate to make "in-house" referrals. However, whether such was the fact by custom or even by unwritten expectation, it remains that petitioner imposed no requirement for referral activity nor any requirement for in-house referrals on a first refusal basis or otherwise. Abraham Fuchsberg admitted that over the years he heard rumors of cases referred to other firms by his firm's associates. However, he did not inquire into such matters or pursue such rumors with the associates, noting that there are any number of instances, such as cases not large enough (monetarily) for petitioner, or not of the type handled by petitioner, or even involving sensitive or potentially embarrassing personal matters of an associate's family or relatives, where referral to another firm would occur. Accordingly, since referrals were not required as a condition of an associate's employment or retention, since referrals were generated by associates in their own independent capacity by their own means, and since the payments were based on the fact of the referral and not on the basis of the amount, nature or quality of legal work performed on the referred case by the referring associate, the sharing of fees on such referred cases did not constitute the payment of wage income subject to withholding.

M. Even if the referral fee payments at issue were determined to be wages subject to withholding, petitioner would qualify for relief under section 530 of the Federal Revenue Act of 1978 (26 USCA § 3401). Section 530 provides a "safe harbor" that permits a taxpayer to avoid liability for failing to fulfill employment tax withholding duties for past periods, regardless of

whether individuals working for the taxpayer would be properly considered employees subject to withholding. Section 530 provides, in relevant part, as follows:

> If (A) for purposes of employment taxes, the taxpayer did not treat an individual as an employee for any period, and (B) in the case of periods after December 31, 1978, all Federal tax returns (including information returns) required to be filed by the taxpayer with respect to such individual for such year are filed on a basis consistent with the taxpayer's treatment of such individual as not being an employee, then for purposes of applying such taxes for such period with respect to the taxpayer, the individual shall be deemed not to be an employee unless the taxpayer had no reasonable basis for not treating such individual as an employee. § 530(a)(1)(A)-(B)[8]

N. Section 530 (a)(2)(A)-(C) describes a number of circumstances under which an employer would be deemed to have had a reasonable basis for not treating an individual as an employee. Relevant to this matter is one set of such circumstances, set forth at section 530 (a)(2)(C), which provides that a taxpayer "shall . . . be treated as having a reasonable basis for not treating an individual as an employee for a period if the taxpayer's treatment of such individual for such period was in reasonable reliance on . . . long-standing recognized practice of a significant segment of the industry in which such individual was engaged."

With respect to the foregoing statutory section for establishing reasonable basis, as with the general issue of whether an individual is an employee subject to withholding, the taxpayer bears the burden of proof (***Boles Trucking v. United States***, 77 F3d 236; ***Springfield v. United***

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[8] Application of this so-called "safe harbor" provision of the IRC may be made in view of 20 NYCRR 171(b) which provides as follows:

> For purposes of this Article, the *provisions* of the Federal Internal Revenue Code and its applicable regulations, with respect to the deducting and withholding of Federal income tax by employers from wages, including the meaning of the various Federal terms (such as *employer, employee, wages, payroll period, withholding exemptions*), apply for New York State personal income tax purposes, except as otherwise specifically provided in this Article or where such Federal rules and definitions are clearly inconsistent with and inapplicable to the provision of this Article (emphasis added).

States, 873 F Supp 1403, 1412, ***revd*** 88 F3d 750). However, when a taxpayer establishes, *prima facie*, a reasonable basis for not treating an individual as an employee pursuant to section 530 (a)(1)(A)-(B), under the specific terms of section 530(a)(2)(C), section 530(e)(4)(A) goes on to specifically place the burden of showing there was no reasonable basis for such treatment (i.e., the burden of countering reasonable basis) upon the government.[9]

O. Petitioner's assertion of safe harbor protection rests directly on section 530(a)(2)(C). In turn, the record is clear in this case that petitioner has treated its associates as independent contractors for purposes of referral fee income, issuing Forms 1099 and not withholding taxes on such income from at least 1979 through and including each of the years at issue herein. In addition, testimony at hearing established that such treatment is the normal and accepted practice of virtually every personal injury law firm in petitioner's geographic area, if not the norm throughout the realm of personal injury law firms. This testimony came from petitioner's managing partner, who described his general discussions on this topic with other managing partners and members of personal injury law firms, as well as his familiarity with the topic over his many years of involvement with the Trial Lawyer's Association. Additional testimony came from petitioner's witness Mark Bower who described his own experience and discussions with others who, like he, managed various personal injury law firms over many years. In sum, petitioner was confident that its practice was the prevailing practice in the industry, believed that such practice was reasonable, proper and correct, and relied on this knowledge and belief in its tax treatment of the referral fees paid to its associates. In fact, it is noteworthy that the Division

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[9] Any other placement of the burden of proof with respect to the final portion of section 530(a)(1)(A)-(B), which negates "safe harbor" upon a showing that "the taxpayer had *no* reasonable basis for not treating such individual as an employee," would leave a taxpayer in an untenable position. That is, instead of facing the burden of establishing that it *had* a reasonable basis for nonemployee treatment (as required under the statute), a taxpayer would be required to establish the antithesis of its own argument, i.e., that it had *no* reasonable basis for its treatment.

imposed no penalty against petitioner regarding the lack of withholding thus at least signaling tacit acceptance that the practice represented a reasonable position.

P. The Division argues that section 530 should not apply to petitioner since petitioner admittedly classified its associates as employees subject to withholding requirements and filed tax returns, including information returns, reflecting such classification. This argument, however, fails to differentiate between an associate's regular work duties and salary (wages) versus referral fee activities and payments, or to recognize that one can work under different circumstances for the same employer, i.e., as an employee subject to withholding and as an independent contractor not so subject. In fact, the payments at issue herein are those derived solely from the work performed by petitioner's associates for their own accounts. Such sums are distinct from the associates' regular salary income paid by petitioner, and such sums are accounted for separately and differently from salary income as described. Accordingly, petitioner is entitled to relief from the notices at issue herein in any event under the safe harbor provisions of section 530.

Q. Petitioner also asserted that the Division should be precluded from pursuing this matter because the IRS examined petitioner's practices relative to withholding and approved the same. Petitioner's claim stems from the described IRS compliance check and from 20 NYCRR 171.3(b) which provides, in relevant part, as follows:

> A determination by the Internal Revenue Service which relieves an employer from withholding responsibility with respect to payments to an employee also applies for purposes of withholding New York State personal income tax, except as otherwise provided in this subdivision.

R. The IRS compliance check and resulting letter indicating that no further action would take place is not binding on the Division nor is it particularly persuasive. First, the result did not follow the conduct of an audit. While an IRS decision not to challenge petitioner's practice may

in fact have signaled the IRS's agreement with such practice, it is at least equally likely that the IRS determination not to further inquire or challenge stemmed from any of a number of other considerations, including time and personnel constraints vis-a-vis conducting an audit or simply insufficient potential deficiency to justify a full audit examination. So too, the purpose of the compliance check, which included in the documents reviewed certain "transmittal" forms such as Forms W-3 and Forms 1096, may have been simply to assure that timely physical filing of the requisite forms was occurring. The IRS did not make any affirmative statement endorsing petitioner's practices, but rather simply determined, for whatever reason, not to conduct an audit. The concluding letter from the IRS states only that "an employment tax examination will not be conducted at this time." Such a result is not dispositive as to the correctness of petitioner's method of dealing with referral fees and withholding, but rather at most adds weight to the claim that such treatment was not unreasonable.[10]

S. Finally, the parties have addressed the issue of the validity and appropriateness of the Division's interest calculation method. Notwithstanding petitioner's argument to the contrary, it is clear that an employer who fails to withhold and remit taxes on behalf of its employees in a timely manner is not immune from the imposition of, *inter alia,* interest for such failure, even though the employees subsequently pay their tax liabilities by April 15 of the following year (i.e., in a timely manner or, per petitioner's phrase, "in ordinary course") (Tax Law §§ 676, 684[a]; 20 NYCRR 176.1; ***compare*** IRC §§ 6205, 3402[d] which, in contrast, provide an interest free adjustment provision). Petitioner's argument fails to recognize that the employer's duty to

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[10] Petitioner argues by brief that the Division's regulation at 20 NYCRR 171.3(b) speaks only of an IRS "determination," and does not specify that the same must be an "audit determination" or result from an "audit" in order to apply for New York purposes. This argument is diminished when considered in light of the ground for reasonable basis specified in section 530(a)(2)(B), to wit, " reliance on a past Internal Revenue Service *audit* of the taxpayer [concerning the taxpayer's treatment of individuals for withholding tax purposes]." (Emphasis added.)

withhold and remit, and the time frames for doing so, are separate and distinct from the employee's own individual duty to pay tax. At the same time, however, the Division's "policy" of simply computing interest from the periodic withholding remittance due dates through April 15th of the following year, fails to consider the *actual* date of any payments of tax, including specifically estimated tax payments by the employees per Tax Law § 685(c), as a limiting factor in the computation of interest. Indeed, estimated payments are the functional equivalent of withholding tax payments each of which prepays an employee's tax liability. In any event, the conclusion that the compensation at issue was not wage income subject to withholding renders the parties' arguments concerning the methodology by which the asserted deficiencies were calculated moot. Moreover, as in ***Matter of Republic New York Corporation*** (Tax Appeals Tribunal, October 16, 1997), it is unnecessary to decide whether the Division's interest calculation policy was improper since the record does not contain evidence of the dates on which petitioner's associates received referral fee compensation or the dates on which estimated tax payments may have been made by any of such associates.

T. The petition of Fuchsberg & Fuchsberg is hereby granted and the notices of deficiency dated September 14, 1998 are canceled.

DATED: Troy, New York
January 10, 2002

/s/ Dennis M. Galliher
ADMINISTRATIVE LAW JUDGE