

STATE OF NEW YORK

TAX APPEALS TRIBUNAL

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In the Matter of the Petition :  
of :  
**JAMES B. AND JANE S. MURPHY** : DECISION  
 : DTA NO. 825459  
for Redetermination of a Deficiency or for Refund of :  
Personal Income Tax under Article 22 of the Tax Law and :  
the Administrative Code of the City of New York for the :  
Year 2007. :

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Petitioners, James B. and Jane S. Murphy, filed an exception to the determination of the Administrative Law Judge issued on May 7, 2015. Petitioners appeared by petitioner Jane S. Murphy and James P. Lynn, Esq. The Division of Taxation appeared by Amanda Hiller, Esq. (Marvis A. Warren, Esq., of counsel).

Petitioners filed a brief in support of their exception. The Division of Taxation filed a brief in opposition. Petitioners filed a reply brief. Oral argument was heard on June 16, 2016, in New York, New York, which date began the six-month period for issuance of this decision.

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

***ISSUE***

Whether petitioners allocated the proper amount of income to New York State for the year 2007.

***FINDINGS OF FACT***

We find the facts as determined by the Administrative Law Judge, except that we have modified findings of fact 6 and 8 to more accurately reflect the record and we have not included

finding of fact 14, a discussion of the Administrative Law Judge's acceptance or rejection of proposed findings of fact. As so modified, the facts are set forth below.

1. During the year in issue, petitioners were nonresidents of New York State.
2. From the time of its formation on September 30, 1996, petitioner James B. Murphy was a member of RMTS Associates LLC (RMTS). RMTS was a New York limited liability company that conducted an insurance business. On November 9, 1999, petitioner James B. Murphy transferred his entire 18.75 percent ownership interest in RMTS to his wife, petitioner Jane S. Murphy.
3. After the transfer of the ownership interest, litigation ensued between petitioners and RMTS and its members. By an order filed on April 28, 2004, the New York State Supreme Court concluded that the assignment of the 18.75 percent ownership interest in RMTS by James Murphy to Jane Murphy was valid.
4. By an amended complaint dated May 18, 2005, Jane S. Murphy commenced an action against RMTS and its members seeking, among other things, distributions of profits or allocation of losses to her in accordance with her 18.75% ownership interest in RMTS and punitive damages. The complaint was amended for the purpose of adding new causes of action for, among other things, a fraudulent conveyance under Debtor and Creditor Law §§ 273 and 276. Ms. Murphy also added a new party, RMTS LLC.<sup>1</sup>
5. On January 31, 2006, RMTS was dissolved.
6. In a decision and order dated July 10, 2006, Justice Charles E. Ramos referred the issue of an accounting to a Special Referee, Honorable Louis Crespo, Jr., for a report and

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<sup>1</sup> Ms. Murphy alleged that the defendants continued the business of RMTS under the similar name of RMTS LLC without any notice to Ms. Murphy in order to deprive Ms. Murphy of her court-ordered interest.

recommendation. In that report and recommendation, dated May 8, 2007, the Special Referee recommended that: (1) defendants account to plaintiff in the sum of \$593,869.65, representing her interest in RMTS as of May 1, 2004<sup>2</sup>; (2) defendants account to plaintiff in the sum of \$732,566.00, representing her interest in profit distributions of RMTS for the period January 1, 2000 through May 1, 2004; and (3) the Court award plaintiff equitable interest of 4.5% on the total sum of \$1,326,435.60 from May 1, 2004 to the date of entry of judgment. The evidence considered by the Special Referee included the testimony and reports of valuation experts.

7. On July 26, 2007, the Supreme Court of the State of New York for the County of New York: Commercial Division, by Justice Charles E. Ramos, issued, to the extent relevant herein, the following rulings: (1) increasing the sum to be awarded to the plaintiff for her interest in profit distributions of RMTS for the period January 1, 2000 through May 1, 2004 by the amount of \$311,833.00, for a total of \$1,044,399.00; (2) increasing the prejudgment interest rate to 6%; (3) confirming the post-judgment interest rate of 9%; (4) awarding prejudgment interest at the rate of 6% on the sums allocated by the special referee for plaintiff's interest in profit distributions of RMTS for each year from January 1, 2000 through May 1, 2004; (5) otherwise confirming the special referee's report and recommendation; and (6) severing the plaintiff's fraudulent conveyance claims.

8. By a stipulation of partial discontinuance dated October 9, 2007, Jane S. Murphy agreed to a settlement with RMTS and the other opposing parties whereby she would receive \$2,068,917.55. In exchange, she stipulated to the dismissal of the first, second, third and sixth causes of action in the amended complaint. Each of these dismissed causes of action demanded

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<sup>2</sup> In order to calculate this amount, the Special Referee conducted an in-depth analysis of the testimony and reports regarding an anticipated operating income in order determine an adjusted equity value. Ms. Murphy's interest in RMTS as of May 4, 2004 was calculated by multiplying the adjusted equity value by her 18.75 percent interest.

Ms. Murphy's share of RMTS's profits during the 2000-2004 period. The parties to the litigation also agreed in principle that \$593,869.65 of the sum paid will be allocated as payment for Ms. Murphy's interest in RMTS Associates LLC and not as ordinary income.

9. The fourth cause of action in the amended complaint, dated May 18, 2005, alleged that Jane S. Murphy was entitled to a judgment against the defendants either setting aside the transfer of RMTS's business to another entity or decreeing that Jane S. Murphy's ownership interest in RMTS included the business fraudulently transferred by defendants to another entity, and awarding Jane S. Murphy her attorneys' fees. The fifth cause of action alleged that Jane S. Murphy was entitled to judgment against the defendants either setting aside the transfer of RMTS's business to another entity or decreeing that Jane S. Murphy's ownership interest in RMTS included the business fraudulently transferred by defendants to another entity, and awarding Jane S. Murphy attorney's fees and punitive damages.<sup>3</sup>

10. Petitioners filed a form IT-203, New York State nonresident and part-year resident income tax return, for 2007. On this return, they reported the \$2,068,899.00 payment received by Jane S. Murphy in October 2007 by allocating the entire amount to the federal column - \$593,869.00 was considered capital gain on line 7 and \$1,475,030.00 was treated as other income on line 15. None of the \$2,068,899.00 payment received by petitioner in 2007 was allocated to New York.

11. Petitioners also filed a form 1040, U.S. individual income tax return, for 2007 wherein they divided the \$2,068,899.00 payment received by Jane S. Murphy by reporting \$1,475,030.00 on line 21 as other income and \$593,869.00 on schedule D as capital gain from RMTS.

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<sup>3</sup> Ultimately, Ms. Murphy did not receive attorney's fees or punitive damages.

12. On the basis of its audit, the Division concluded that the \$1,475,030.00 reported as other income on petitioners' 2007 New York State personal income tax return should be allocated to New York based on the business allocation percentage of RMTS because it was a distribution of profits from RMTS for the period 2000 through 2004. During this period, RMTS conducted business in New York.

13. The Division issued a notice of deficiency to petitioners, dated January 8, 2013, which asserted a deficiency of New York State personal income tax in the amount of \$99,095.00 plus interest for a balance due of \$139,893.05.

***THE DETERMINATION OF THE ADMINISTRATIVE LAW JUDGE***

The Administrative Law Judge determined that the portion of the settlement reported as ordinary income, that is, \$1,475,030.00, was New York source income and that the tax on such income should be allocated to New York in accordance with the business allocation percentage of RMTS.

In support of this conclusion, the Administrative Law Judge noted that Mr. Murphy validly assigned his interest in RMTS to Ms. Murphy. He found that the effect of this assignment was to entitle Ms. Murphy to receive the distributions of RMTS' profits and losses to which Mr. Murphy would have been entitled.

The Administrative Law Judge also noted that the litigation commenced by Ms. Murphy against RMTS and its members sought, among other things, her distributive share, as assignee of Mr. Murphy's membership interest, of RMTS' profits. The Administrative Law Judge determined that the portion of the settlement that was not considered payment for her interest in the LLC was reasonably considered to be Ms. Murphy's share of the profits of RMTS. In support, he noted that this portion of the settlement was reported as ordinary income on

petitioners' 2007 income tax returns. He noted further that, as RMTS conducted business in New York during the years covered by the settlement, such income was properly allocated to New York based on RMTS' business allocation percentage.

The Administrative Law Judge rejected petitioners' claim that, as a consequence of RMTS' dissolution, the 2007 payment may not be considered profit. The Administrative Law Judge specifically found that Ms. Murphy received a distribution from RMTS and further found that the only question presented was whether the distribution was subject to New York personal income tax.

The Administrative Law Judge also rejected petitioners' argument that the income at issue was from an intangible asset and thus nontaxable to a nonresident. The Administrative Law Judge determined that the effect of Mr. Murphy's assignment of his RMTS membership was to entitle Ms. Murphy to receive Mr. Murphy's distributive share of RMTS' profits and that such profits are subject to New York income tax to the extent that they are derived from New York sources.

The Administrative Law Judge also noted petitioners' reliance upon Tax Law § 631 (b) (1) (F) in support of their position, but found that such reliance was misplaced because that provision addresses income paid from a previously conducted occupation or business, while the present matter concerns funds that should have been paid as RMTS was conducting business.

#### ***SUMMARY OF ARGUMENTS ON EXCEPTION***

Petitioners note that Ms. Murphy's assignee interest in RMTS did not allow her to participate in the management and affairs of the LLC, to become a member or to exercise any rights or powers of a member. Petitioners contend, accordingly, that Ms. Murphy should not be subject to tax as a member because she did not have a membership interest.

Petitioners also contend that an assignee interest in an LLC is an intangible asset, and that income from such an asset is generally not considered to be New York source income.

Petitioners further contend, as they did below, that the settlement payment to Ms. Murphy did not in any way constitute profit distributions of RMTS, as that entity was dissolved at the time the payment was made. Petitioners assert that the settlement payment was made by the successor LLC (in which petitioners had no interest) and the former majority member of RMTS. Petitioners note that the settlement payment was calculated by valuation experts and assert that it was intended to represent the value of Ms. Murphy's assignee interest as of May 2004. Moreover, petitioners assert that the settlement payment included interest on the amounts determined in the valuation.

Petitioners liken Ms. Murphy's situation to that of a judgment creditor. RMTS failed to pay her, she sued and the court ordered the majority member and successor LLC to pay her an amount for her interest as determined by valuation experts. Petitioners contend that the actual profits of RMTS were paid to its members during the 2000-2004 period and were, accordingly, subject to New York income tax through such members. Petitioners contend that none of the income paid to Ms. Murphy was attributable to property employed in a trade, profession or occupation carried on in New York and therefore none of such income should be subject to New York income tax.

Petitioners assert that Tax Law § 631 (b) (1) (F), effective January 1, 2010, might have served to subject the income at issue to New York income tax, but that such provision was not in effect during the period at issue. Tax Law § 631 (b) (1) (F) defines as income from New York sources "income received by nonresidents *related* to a business, trade, profession, or occupation *previously carried on* in this state" (emphasis added). Petitioners contend that there is no other

provision in Tax Law § 631 (New York source income of a nonresident individual) that supports the Division's position that the payments at issue are derived from or connected with New York sources.

It is the Division's position that the Administrative Law Judge properly determined that the portion of the settlement payment to Ms. Murphy at issue was a distribution of the profits of RMTS and was New York source income in accordance with RMTS' business allocation percentage.

The Division contends that, as an assignee, Ms. Murphy was entitled to a distribution of the profits of RMTS and that the portion of the distribution at issue was such a distribution of profits. The Division agrees with the Administrative Law Judge's analysis that, to determine what a settlement represents, one must determine the basis for the settlement. The Division asserts that the basis for the payment of the portion of the settlement at issue was to compensate Ms. Murphy for the profit distributions of RMTS to which she was entitled pursuant to the assignment. The Division agrees with the Administrative Law Judge that such profits are properly allocated to New York in accordance with the business allocation percentage of RMTS. The Division asserts that it is irrelevant that Ms. Murphy was not a member of RMTS and was therefore unable to participate in the management and affairs of RMTS. The Division also agrees with the Administrative Law Judge's rejection of petitioners' contention that the distribution at issue did not represent profits because RMTS was dissolved and no longer conducting business in New York when the payment was made. The Division asserts that such payments were made in lieu of profit distributions that should have been paid when RMTS was conducting business in New York.



***OPINION***

The New York source income of a nonresident individual, such as petitioner Jane S. Murphy, is subject to New York personal income tax (Tax Law § 601 [e]).

The New York source income of a nonresident individual is defined as, in relevant part, “the net amount of items of income, gain, loss and deduction entering into his federal adjusted gross income that are derived from or connected with New York sources, including: (A) his distributive share of partnership income, gain, loss and deduction, determined under [Tax Law § 632]” (Tax Law § 631 [a] [1] [A]).

Pursuant to Tax Law § 632, the New York source income of a nonresident partner includes “only the portion derived from or connected with New York sources of such partner’s distributive share of items of partnership income, gain, loss and deduction entering into his federal adjusted gross income, as such portion shall be determined under regulations of the [Division] consistent with the applicable rules of [Tax Law § 631]” (Tax Law § 632 [a] [1]).

As relevant here, Tax Law § 631 provides that New York source income includes income attributable to “a business, trade, profession or occupation carried on in [New York]” (Tax Law § 631 [b] [1] [B]).

The Division’s regulations provide that the New York source income of a nonresident partner “includes the partner’s distributive share of all items of partnership income, gain, loss and deduction entering into such partner’s Federal adjusted gross income to the extent that such items are . . . attributable to . . . a business, trade, profession or occupation carried on in New York State by the partnership” (20 NYCRR 137.1).

The term partnership as used throughout Article 22 of the Tax Law includes a limited liability company (LLC) that is classified as a partnership for federal income tax purposes (Tax

Law § 601 [f]). Correspondingly, the term partner necessarily includes a member of an LLC. RMTS was classified as a partnership for federal income tax purposes.

It is undisputed that, while it was operating, RMTS carried on a portion of its business in New York and that such portion is accurately reflected in RMTS' business allocation percentage as reported on its New York partnership returns. Accordingly, profits distributed by RMTS to its nonresident members during its period of operations would be New York source income to such nonresidents to the extent of RMTS' business allocation percentage.

Resolution of the present matter pursuant to the foregoing standards is complicated by the presence of two factors, either of which, according to petitioners, require a finding that no portion of the payment at issue may be deemed New York source income. First, the payment at issue was made not to a nonresident member of an LLC, but to a nonresident assignee of a membership interest. Second, the payment was made pursuant to a litigation settlement agreement following the dissolution of RMTS.

Regarding the assignment, New York Limited Liability Company Law (LLC Law) § 603 (a) (1) permits the assignment of an LLC membership interest in whole or in part, except as provided in the LLC's operating agreement. There is no such operating agreement here. Accordingly, as the Supreme Court concluded (*see* finding of fact 3), and as the Administrative Law Judge found, the assignment from Mr. Murphy to Ms. Murphy was valid (*see also Bartfield v RMTS Assoc., LLC*, 11 AD3d 386 [2004], *lv denied* 4 NY3d 708 [2005]).

The effect of such an assignment is to “entitle the assignee to receive, to the extent assigned, the distributions and allocations of profits and losses to which the assignor would be entitled” (LLC Law § 603 [a] [3]). Such an assignment does not, however, “entitle the assignee

to participate in the management and affairs of the limited liability company or to become or to exercise any rights or powers of a member” (LLC Law § 603 [a] [2]).<sup>4</sup>

We reject petitioners’ contention that Ms. Murphy’s status as an assignee of a member’s LLC interest precludes taxation of the payment at issue as New York source income. As noted previously, pursuant to Tax Law § 631 (a), a nonresident *individual’s* New York source income includes his or her distributive share of partnership or LLC income derived from New York sources as determined under Tax Law § 632. As the Division notes in its brief, Tax Law § 631 contains no language indicating that such nonresident individual must be a partner in a partnership or a member of an LLC in order for that individual’s share of partnership or LLC income to fall within the definition of New York source income. We agree and find, accordingly, that the source and character of an LLC member’s share of LLC income is not changed by the member’s assignment of his or her interest. As applied to the present matter, this means that RMTS’ payment to Ms. Murphy was subject to New York income tax to the extent that such payment was attributable to New York-sourced RMTS income. The fact that Ms. Murphy was not a member of RMTS and lacked the authority of a member has no bearing on the source and character of the payment.

We also reject petitioners’ contention that the payment at issue may not be deemed New York source income because such income is attributable to an intangible asset, i.e., Ms. Murphy’s assignment interest. In support of this contention, petitioners note that Tax Law § 631 (b) (2) provides that income from intangible personal property is considered New York source income “only to the extent that such income is from property employed in a business, trade,

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<sup>4</sup> Partnership Law § 53 similarly provides that a partnership interest may be assigned and similarly restricts the assignee’s rights to the receipt of the assignor’s profits.

profession, or occupation carried on in [New York].” Petitioners also note that an LLC membership interest is deemed to be “a general intangible asset” for purposes of the uniform commercial code (LLC Law § 603 [b]). We note that a partnership interest is similarly considered to be intangible personal property (*see* Partnership Law § 52; *Blodgett v Silberman*, 277 US 1, 11 [1928]).

The intangible nature of an LLC or a partnership interest notwithstanding, Tax Law §§ 631 and 632 plainly provide that where an LLC or a partnership carries on a business in New York, a nonresident member or partner’s distributive share of the entity’s profits is New York source income to the extent that such profits are derived from or connected with New York sources. Furthermore, as discussed previously, where such interest has been assigned, the source and character of the income flow to the assignee.

We now address petitioners’ contention that the payment at issue may not be deemed New York source income because it was made pursuant to a settlement agreement following the dissolution of RMTS.

We agree with the Administrative Law Judge that, in the context of a payment in settlement of litigation, the proper analysis is to determine “in lieu of what” the payment was made (*Getty v Commissioner*, 913 F2d 1486, 1490 [1990]). Settlement proceeds that represent profits are taxable as ordinary income (*see Milenbach v Commissioner*, 318 F3d 924, 933 [2003]; *Taracido’s Estate v Commissioner*, 72 TC 1014, 1023 [1979]).

The record makes clear that the settlement payment here was made in consideration of the discontinuance of the causes of action by which Ms. Murphy demanded her share of the profits of RMTS for 2000 through 2004 (*see* finding of fact 8). The record also makes clear that, of the \$2,068,917.55 total payment, \$593,869.65 was attributable to Ms. Murphy’s assignee interest in

RMTS (*id.*). It is reasonable to conclude, therefore, that the portion of the settlement payment at issue (i.e., \$1,475,030.00) was attributable to Ms. Murphy's interest in the profit distributions of RMTS and thus reportable as ordinary income. Accordingly, petitioners properly reported the settlement payment on their 2007 federal income tax return (*see* finding of fact 11).

While petitioners agree that the portion of the settlement payment at issue is ordinary income, they contest the Administrative Law Judge's conclusion that such income was New York source income to the extent of the business allocation percentage of RMTS.

“[I]n determining whether income is ‘derived from or connected with New York sources’ it is necessary to identify the activity upon which the income was secured or earned” (*Matter of Laurino*, Tax Appeals Tribunal, May 20, 1993 citing *Matter of Halloran*, Tax Appeals Tribunal, August 2, 1990; *see also Matter of DeGroat*, Tax Appeals Tribunal, October 23, 2008).

Petitioners bear the burden of proof to demonstrate that the ordinary income at issue was not secured or earned pursuant to activities connected with or derived from New York sources (*see Matter of DeGroat*).

As noted, the portion of the settlement payment at issue was attributable to Ms. Murphy's interest in the profit distributions of RMTS. The activity upon which such income was earned was the business of RMTS. Such business was conducted, in part, in New York. Accordingly, the income at issue was derived from or connected with New York sources in accordance with RMTS' New York business activity as measured by its business allocation percentage.

Petitioners observe, correctly, that the amount of RMTS' profits during the 2000-2004 period was based on the testimony and reports of valuation experts. Petitioners further note that the payment at issue was not made by RMTS, but was made by either the successor entity or a former member of the dissolved RMTS. Such facts notwithstanding, it remains that the activity

upon which Ms. Murphy's share of the profits was earned was the business of RMTS. The facts noted by petitioners do not change the character of this income.

Petitioners also assert the settlement payment included interest on the amounts determined in the valuation. With respect to this assertion, we observe that the July 26, 2007 Supreme Court ruling noted the imposition of interest (*see* finding of fact 7). The same ruling valued Ms. Murphy's interest in profit distributions at \$1,044,399.00 (*id.*). The litigation, however, was not resolved by the court, but by a stipulation between the parties that does not allocate any portion of the settlement to interest (*see* finding of fact 8). Moreover, we find no other evidence in the record establishing that any portion of the stipulated settlement was attributable to interest. We conclude, therefore, that petitioners have not met their burden of proof to establish that the amount at issue included interest (*see Matter of DeGroat*).

Finally, we agree with the Administrative Law Judge that Tax Law § 631 (b) (1) (F) does not support petitioners' position. Subparagraph (F) was added to Tax Law § 631 (b) (1), effective January 1, 2010, to counter the "widespread abuse of post-employment severance packages" perceived to have resulted from two Tribunal decisions, each of which determined that consideration given for post-employment noncompetition agreements was not New York source income (*see* Memorandum in Support, Jamie Woodward, Acting Commr. of Tax. and Fin. [at p 6], Bill Jacket, L 2010, c 57 [citing *Matter of Haas*, Tax Appeals Tribunal, April 17, 1997; *Matter of PENCHUK*, Tax Appeals Tribunal, April 24, 1997]). The payment at issue, however, was not a severance payment, but rather, represents Ms. Murphy's share of RMTS' profits that should have been paid to her in the regular course of business. Tax Law § 631 (b) (1) (F) thus casts no light on the present dispute.

Accordingly, it is ORDERED, ADJUDGED and DECREED that:

1. The exception of James B. and Jane S. Murphy is denied;
2. The determination of the Administrative Law Judge is affirmed;
3. The petition of James B. and Jane S. Murphy is denied; and
4. The notice of deficiency, dated January 8, 2013, is sustained.

DATED: Albany, New York  
December 16, 2016

/s/ Roberta Moseley Nero  
Roberta Moseley Nero  
President

/s/ James H. Tully, Jr.  
James H. Tully, Jr.  
Commissioner

/s/ Dierdre K. Scozzafava  
Dierdre K. Scozzafava  
Commissioner  
By JAM with permission