

STATE OF NEW YORK

DIVISION OF TAX APPEALS

In the Matter of the Petition :
of :
JAMES B. AND JANE S. MURPHY : DETERMINATION
for Redetermination of a Deficiency or for Refund of : DTA NO. 825459
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 a petition for redetermination of a deficiency or for refund of personal income tax under Article 22 of the Tax Law for the year 2007.

Petitioners, appearing pro se, and the Division of Taxation, by Amanda Hiller, Esq. (Michele W. Milavec, Esq., of counsel), waived a hearing and agreed to submit the matter for a determination based on documents and briefs to be submitted by November 14, 2014, which commenced the six-month period for the issuance of this determination. After review of the evidence and arguments presented, Arthur S. Bray, Administrative Law Judge, renders the following determination.

ISSUE

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

FINDINGS OF FACT

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 members of RMTS. 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.¹

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 recommendation. In a Report and Recommendation dated May 8, 2007, Justice Crespo recommended that: (1) defendants account to plaintiff in the sum of \$593,869.65, representing her interest in RMTS as of May 1, 2004²; (2) defendants account to plaintiff in the sum of \$732,566.00, representing her interest in profit distribution of RMTS for the period January 1,

¹Ms. 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.

²In order to calculate this amount, Justice Crespo conducted an in-depth analysis of the testimony 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 her adjusted equity value by her 18.75 percent interest.

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.

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 from RMTS and, in exchange, she stipulated to the dismissal of all claims other than the fourth and fifth causes of action in the amended complaint. It was "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.³

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.

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.

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

14. In accordance with State Administrative Procedure Act § 307(1), the Division's proposed findings of fact have been generally accepted and incorporated herein. However, proposed finding of fact 10 was rejected because an unsigned judgment has limited probative value. In a reply brief, petitioners suggested additions to the Division's proposed findings of fact. Petitioners' proposed changes have generally been included in the determination. However the assertion that the amount reported on the federal return appeared as a result of a default on the computer program has been omitted from the findings of fact because petitioners are responsible for what is reported on their return.

CONCLUSIONS OF LAW

A. New York imposes personal income tax on the taxable income of nonresident individuals to the extent that the taxable income is derived from New York sources (Tax Law § 601[e][1]). New York source income includes that which is attributable to a business, trade, profession or occupation carried on in New York State (Tax Law § 631[b][1][B]). In ***Matter of Zelinsky v Tax Appeals Trib.*** (1 NY3d 85, 89-90 [2003], *cert denied* 541 US 1009 [2004]), the Court of Appeals stated:

“Although a state may tax all the income of its residents, even income earned outside the taxing jurisdiction, it may constitutionally tax nonresidents only on their income derived from sources within the state (see Shaffer v. Carter, 252 U.S. 37, 57 [1920]). In New York, the income of nonresidents is thus taxed by the State if it is ‘derived from or connected with New York sources’ (see Tax Law §§ 601 [e] [1]; 631 [a] [1]).[footnote omitted] New York source income includes income attributable to a business, trade, profession or occupation carried on in this state (see Tax Law § 631 [b] [1] [B]).”

The New York source income of a nonresident individual includes the sum of the net amount of items of income, gain, loss and deduction entering into the individual's federal adjusted gross income “derived from or connected with New York sources, including: (A) his

distributive share of partnership income, gain, loss and deduction, determined under [Tax Law] section six hundred thirty-two . . .” (Tax Law § 631 [a] [1][A]).

B. The issue is whether the Division correctly concluded that petitioners erroneously failed to allocate any of the settlement proceeds to New York. Here, the Division has correctly noted that Limited Liability Law § 603, entitled “Assignment of membership interest,” provides, in relevant part that:

“(a) Except as provided in the operating agreement,
(1) a membership interest is assignable in whole or in part . . . and (3) the only effect of an assignment of a membership interest 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”

C. In accordance with this provision, the Supreme Court of the State of New York determined that James B. Murphy’s assignment of his interest in RMTS to Jane S. Murphy was valid. Moreover, as noted by the Division, the only effect of such an assignment was to entitle Jane S. Murphy to receive the distributions of profits and losses to which James B. Murphy would be entitled.

D. Following the judicial determination that the assignment of the membership interest was valid, Jane B. Murphy commenced an action against RMTS seeking, among other things, distributions of profits or allocations of losses. In October 2007, Ms. Murphy and RMTS reached a settlement whereby she received \$2,068,917.55 and, in turn, agreed to the dismissal of certain causes of action. The parties also agreed that \$593,869.65 of the sum paid would be considered as payment for Ms. Murphy’s ownership interest in RMTS and not as ordinary income.

E. An analysis of the issue of how the sum that was not considered payment for Ms. Murphy’s ownership interest, \$1,475,030.33, should be treated for tax purposes begins with the

premise that, unless a different context is clearly required, interpretations of New York income tax law should conform with comparable federal provisions (*see* Tax Law § 607[a]; *Matter of Hunt v. State Tax Commn.*, 65 NY2d 13[1985]; *Matter of Friedsam v. State Tax Commn.*, 64 NY2d 76 [1984]). Under federal law, settlement proceeds that represent profits are taxable as ordinary income (*see Millenback v. Commissioner*, 318 F3d 924, 933 [9th Cir 2003]). In order to determine what a settlement represents, one asks the question in lieu of what were the damages awarded (*Getty v. Commissioner*, 913 F2d 1486, 1490 [9th Cir 1990]).

F. The evidence in the record clearly supports the Division's position that \$1,475,030.00 represents Ms. Murphy's interest in the profits of RMTS. The settlement agreement awarded Ms. Murphy a total sum of \$2,068,899.00. Of this amount, the parties specifically agreed that \$593,869.65 would be allocated to Ms. Murphy's ownership interest in RMTS. The allocation of \$593,869.65 to an ownership interest, leaves a balance of \$1,475,030.00 attributable to Ms. Murphy's interest in the distribution of profit. This amount is properly allocated to New York based upon the business allocation percentage of RMTS.

The Division has correctly pointed out that petitioners' federal return for 2007 is consistent with the foregoing conclusion. That is, petitioners reported the \$2,068,899.00 payment received by Ms. Murphy in 2007 by listing \$593,869.00 on Schedule D as a capital gain from RMTS and \$1,475,030.00 as ordinary income.

G. In opposition to the foregoing analysis, petitioners take issue with the information appearing on a Schedule K-1 for the year 2006 that was sent to a law firm in New York City. This argument is rejected because the analysis set forth above is not based on a Schedule K-1. The conclusion is based on an analysis of the litigation between petitioners and RMTS and the settlement that resolved a portion of the litigation.

H. In a reply brief, petitioners argue that the distributions from RMTS may not be considered profits since RMTS became insolvent. This argument confuses the relevant facts. There is no dispute that Ms. Murphy received a distribution from RMTS. The only question is whether that distribution is subject to New York personal income tax. In view of the fact that the distribution was from a firm conducting business in New York, the Division correctly concluded that the portion of the distribution considered past profit was subject to tax.

I. Petitioners' claim that the income in issue is from an intangible is also without merit. The assignment of the partnership interest from Mr. Murphy to Ms. Murphy did not convert taxable income from the operation of a business in New York to income from an intangible. To the contrary, the only effect of the assignment was to entitle Ms. Murphy to receive the assignor's assignment of profits and losses (Limited Liability Law § 603 [a] [1]).

J. It is noted that petitioners' reliance upon Tax Law § 631(b)(1)(F) is misplaced since the income at issue in this matter concerns funds that should have been paid as the business was conducting its activities and not funds involving a previously conducted business.

K. The petition of James B. and Jane S. Murphy is denied and the Notice of Deficiency, dated January 8, 2013, is sustained together with such interest as is lawfully due.

DATED: Albany, New York
May 7, 2015

/s/ Arthur S. Bray
ADMINISTRATIVE LAW JUDGE