STATE OF NEW YORK

DIVISION OF TAX APPEALS

In the Matter of the Petition of **WILLIAM AND IPEK TECHAR** for Redetermination of a Deficiency or for Refund of New York State Personal Income Tax under Article 22 of the Tax Law for the Year 2017.	:	DETERMINATION DTA NOS. 830479 AND 830481
In the Matter of the Petition of **ANTHONY AND JENNIFER FRASCELLA** for Redetermination of a Deficiency or for Refund of New York State Personal Income Tax under Article 22 of the Tax Law for the Year 2017.	:	

Petitioners, William and Ipek Techar and Anthony and Jennifer Frascella, filed petitions for redetermination of deficiencies or for refund of New York State personal income tax under article 22 of the Tax Law for the year 2017. These two matters have been consolidated.

A formal hearing was held before Jessica DiFiore, Administrative Law Judge, in New York, New York, on November 30, 2022, with all briefs to be submitted by March 17, 2023, which date commenced the six-month period for the issuance of this determination. Petitioners appeared by Hodgson Russ LLP (K. Craig Reilly, Esq. and Christopher L. Doyle, Esq., of counsel). The Division of Taxation appeared by Amanda Hiller, Esq. (Linda Farrington, Esq., of counsel).

ISSUES

I. Whether the Division of Taxation properly allocated petitioners' distributive shares of nonqualified deferred compensation to New York State.

II. Whether petitioners have established reasonable cause to abate negligence and substantial understatement penalties.

FINDINGS OF FACT

1. In 2017, petitioners, William Techar and Anthony Frascella, were nonresident partners of Aristeia Holdings, LP (Aristeia), which was treated as a partnership for federal and state income tax purposes.[1]

2. Aristeia was formed as a limited partnership in Delaware in 2008.

3. In 2017, Aristeia owned 100% of Aristeia Capital LLC (Aristeia Capital), a disregarded Delaware limited liability company that was formed in Delaware in 1997.

4. Petitioners were not employees of Aristeia or Aristeia Capital.

5. Aristeia Capital operates as a registered investment advisor, providing investment management services to private investment funds.

6. Aristeia Capital has provided investment management services to various investment funds, including Aristeia International Limited (AIL).

7. AIL was incorporated in the Cayman Islands in 1997 in accordance with the Companies Law (Revised).

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[1] While Ipek Techar and Jennifer Frascella are petitioners in this matter, only William Techar and Anthony Frascella were partners in Aristeia, the entity that generated the income at issue. Mrs. Techar and Mrs. Frascella are petitioners in this matter solely because they filed joint forms IT-203, nonresident and part-year resident income tax returns, with their spouses. Accordingly, unless otherwise indicated, all references to "petitioners" shall refer to Mr. Frascella and Mr. Techar.

8. Aristeia Capital continuously provided investment management services to AIL from the time of AIL's incorporation in 1997 through and beyond the end of the 2017 tax year.

9. Mr. Robert Lynch, a founder and managing partner of Aristeia, testified that Aristeia Capital's investment management services provided to AIL consisted of attracting foreign investors and U.S. tax exempt investors, identifying and researching investment strategies, and executing those investment strategies by purchasing and selling securities.

10. AIL and Aristeia Capital entered into various written investment management agreements that authorized Aristeia Capital to operate as AIL's "agent and attorney-in-fact with full power, discretion and authority to make all investment decisions concerning [AIL's investment portfolio], to enter into agreements and commitments on behalf of and in the name of [AIL], to open and close bank and brokerage accounts, to transfer assets to and from such accounts, and to effect transactions on behalf of [AIL's investment portfolio]."

11. The investment authority granted to Aristeia Capital under its investment management agreements with AIL included "the authority to exercise whatever powers [AIL] may possess with respect to any of its assets held in [AIL's investment portfolio] including, but not limited to, the right to pledge assets, the right to borrow and lend, the right to vote, the power to exercise rights, options, warrants, conversion privileges, redemption privileges, and to tender securities pursuant to a tender offer."

12. During the period covering 1998 through 2003, Aristeia Capital maintained its only office location within New York State.

13. Aristeia Capital became wholly owned by Aristeia in 2009.

14. In 2009, Aristeia Capital opened an office location in Connecticut.

15. In 2015, Aristeia Capital relocated its principal office from New York, New York, to Greenwich, Connecticut.

16. In exchange for providing investment management services to AIL, and in accordance with its investment management agreements, Aristeia Capital received both (i) management fees based on the total net assets of AIL and (ii) performance fees based on any increase or appreciation in the net asset value per share of AIL.

17. For the years ending December 31, 1998, December 31, 1999, December 31, 2000, December 31, 2001, December 31, 2002, and December 31, 2003, Aristeia Capital made irrevocable elections to defer certain percentages of the management and performance fees that it secured from AIL (Deferred Fees).

18. The combined value of the Deferred Fees totaled $29,013,693.00.

19. Aristeia International reinvested the Deferred Fees abroad.

20. The Deferred Fees were treated as though they were reinvested in Class B common shares of AIL.

21. The value of the reinvested Deferred Fees fluctuated based on the performance of AIL's Class B common shares during the relevant deferral periods. The Deferred Fees were subject to the same investment risks as other Class B common shareholders of AIL.

22. Aristeia Capital's right to receive payment of the Deferred Fees from AIL was no greater than, nor had any priority over, the right of any other unsecured general creditor of AIL.

23. Aristeia Capital did not use its potential right to receive payment of the Deferred Fees in any other business activities.

24. In 2017, when Aristeia recognized the Deferred Fees, the appreciation on the Deferred Fees totaled $97,194,568.00 (Appreciation). The collective nonqualified deferred compensation for both the Deferred Fees and Appreciation amounted to $126,208,261.00.

25. In tax years prior to 2017, Aristeia had also previously recognized portions of the Deferred Fees and Appreciation, but the majority of the Deferred Fees and Appreciation were recognized during tax year 2017 in conformity with section 457A of the Internal Revenue Code (IRC or Code), which was added to the Code in 2008 pursuant to Public Law 110-343.

26. During the 1998 through 2017 deferral periods, Aristeia Capital continued to perform ongoing investment management services on behalf of AIL. These services were performed from office locations both within and without New York State.

27. Aristeia Capital's ongoing investment management services resulted in a substantial increase in the value of the original Deferred Fees.

28. On August 31, 2010, the Division of Taxation (Division) published a Technical Services Bureau Memorandum (TSB-M), as TSB-M-10(9)I, *Income Received by a Nonresident Related to a Business, Trade, Profession, or Occupation Previously Carried on Within New York State* (the 2010 TSB-M). This guidance provided, in relevant part, that pursuant to Tax Law § 631 (b) (1) (F), an individual who receives income related to a business that was previously carried on partly within and partly without New York State must determine the New York business allocation percentage (BAP) "for the year the contract or other agreement was entered into that result[ed] in the federal income," and multiply the federal income by that New York BAP to determine the New York source income (2010 TSB-M).

29. On April 6, 2018, the Division published Technical Memorandum TSB-M-18(2)C, 3(I), *New York State Tax Treatment of Nonqualified Deferred Compensation* (the 2018 TSB-M).

The 2018 TSB-M states that for services performed before January 1, 2009, where the business, trade, profession, or occupation was carried on only in New York State in the year the services were performed, the entire amount of nonqualified deferred compensation must be included in New York source income. The 2018 TSB-M also provides that if the business, trade, profession, or occupation was carried on partly in and partly outside of New York State during the tax year the services were performed, the amount of nonqualified deferred compensation included in New York source income is determined using either the books and records of the partnership or the three factor formula described in 20 NYCRR 132.15 (c), calculated by the partnership for the tax year the services were performed.

30. The deadlines for partnerships and nonresident individuals to make 2017 estimated tax payments were April 18, 2017; June 15, 2017; September 15, 2017; and January 16, 2018, all dates that occurred prior to the release of the 2018 TSB-M.

31. After the Tax Department's April 6, 2018 release of the 2018 TSB-M, and prior to filing its 2017 partnership tax returns, Aristeia and Aristeia Capital received written tax advice on the proper allocation of the Deferred Fees and Appreciation from PricewaterhouseCoopers LLP ("PwC"), an international accounting firm.

32. PwC initially provided Aristeia with a written memorandum, dated May 18, 2018, which included the following statement regarding the proper allocation of the Deferred Fees and Appreciation:

> "While further analysis would be required to determine the merits of any alternative apportionment methodology, the most conservative approach would be to include one hundred percent (100%) of the deferred fees and all appreciation and earnings thereon, in the numerator of the New York gross income percentage."

33. Aristeia relied upon and utilized the 2017 allocation methodology that was described by PwC in its May 18, 2018 written memorandum as the "most conservative approach." This approach was to include the full value of both the Deferred Fees and the Appreciation in the numerator and the denominator of its 2017 gross income percentage.

34. Subsequent to the Division's audit of Aristeia's 2017 tax year, Aristeia obtained a second piece of written tax advice from PwC on the proper allocation of the Deferred Fees and Appreciation. The second piece of written tax advice was a 2019 written opinion letter, which included the following statements regarding the proper allocation of the Deferred Fees and Appreciation:

> "As discussed below, we do not think that the 2018 TSB-M is correct that nonqualified deferred compensation should be sourced by reference to historical business allocation percentages. However, if a partnership were to conservatively follow the 2018 TSB-M and use its historical business allocation percentages, it still has to determine how, as a mechanical matter, the historical business allocation percentage should be applied to determine NYS source income- an issue that the 2018 TSB-M does not even analyze. The approach that is most consistent with applicable law would be for the partnership to use such historical business allocation percentages to *apportion* its deferred fees to NYS (i.e.,
>
> > 1. Multiply the deferred fees by the prior year three-factor formula,
> >
> > 2. Include such amount in the numerator of the 2017 three-factor formula, and then
> >
> > 3. Multiply the deferred fees by the 2017 three-factor formula (the Apportionment Approach") (emphasis in original).
>
> "It is our opinion that Aristeia should follow the Apportionment Approach, not the Allocation Approach, insofar as it uses its prior year three-factor formula.
>
> We note at the outset that Aristeia should actually have sourced the *appreciation* earned on its deferred performance fees using the three-factor formula from ***the year of receipt*** since the appreciation was subject to substantial risk of forfeiture until 2017 and was not readily ascertainable in prior years" (emphasis in original).
>
> "Moreover, it is more likely than not that *the deferred performance fees themselves* should have been sourced using the three-factor formula from the year

> of receipt as well since they were not readily ascertainable at the time of deferral and were fully subject to investment risk-just like the capital of any other AIL investor" (emphasis in original).
>
> "In the alternative, there is also substantial authority to treat the appreciation earned on deferred performance fees as income from intangible personal property and therefore as entirely income from non-NYS sources."

35. Aristeia reported the full $126,208,261.00 value of the Deferred Fees and the Appreciation as "Other income" on its 2017 tax returns, including its form IT-204, Partnership Return.

36. Aristeia and petitioners disclosed the recognition of the Deferred Fees and the Appreciation on their 2017 New York State tax returns by affirmatively answering the listed questions related to the reporting of nonqualified deferred compensation under Pub L 110-343, Div. C, section 801 (d) (2), 122 Stat 3765.

37. New York State's 2017 form IT-204, partnership return, includes a New York allocation schedule on which partnerships compute and report their formula-based apportionment of income (i.e., BAP).

38. In 2017, Aristeia maintained 42.2668% of its real and tangible personal property within New York State and reported this percentage on the New York allocation schedule contained within its 2017 form IT-204, partnership return.

39. In 2017, Aristeia maintained 56.4762% of its payroll within New York State and reported this percentage on the New York allocation schedule contained within its 2017 form IT-204, partnership return.

40. In 2017, Aristeia sourced 88.0713% of its receipts to New York State and reported this percentage on the New York allocation schedule contained within its 2017 form IT-204,

partnership return. This calculation included adding all Deferred Fees and the Appreciation as receipts sourced within New York State.

41. Aristeia, therefore, included the full value of the Deferred Fees and the Appreciation (collectively, $126,208,261.00) in the numerator and the denominator of its 2017 gross income percentage.

42. New York State's 2017 form IT-204, partnership return, includes only one New York allocation schedule. The 2017 form IT-204 does not include a separate allocation schedule for reporting nonqualified deferred compensation.

43. On its 2017 form IT-204, Aristeia used the same allocation methodology for sourcing the Deferred Fees and Appreciation it received in 2017 as it used in tax years prior to 2017. In other words, Aristeia allocated Deferred Fees and Appreciation recognized prior to tax year 2017 using the property and payroll factors from the income recognition year and placing all of the Deferred Fees and Appreciation in both the numerator and denominator of the gross income factor in the income recognition year.

44. The amounts Aristeia recognized in 2017 for the Deferred Fees and Appreciation flowed through to petitioners as proportionate shares of partnership income. Petitioners reported their proportionate shares of the Deferred Fees and Appreciation on their 2017 forms IT-203, nonresident and part-year resident income tax returns.

45. Petitioners computed their 2017 New York State estimated personal income tax payments utilizing the allocation methodology selected by Aristeia.

46. Aristeia computed the amounts listed on its 2017 New York Partner's schedules K-1 using the same income allocation methodology that was used on its 2017 form IT-204, partnership return, i.e., Aristeia's 2017 New York Partner's schedules K-1 reported a BAP based

on Aristeia's current year property and payroll factors and included 100% of the Deferred Fees and Appreciation in both the numerator and the denominator of the gross income factor.

47. Petitioners reported their income from Aristeia on their 2017 forms IT-203 in accordance with the information provided on Aristeia's New York Partner's schedules K-1.

48. The Division performed audits of Aristeia and of petitioners' personal income tax returns for the tax year January 1, 2017 through December 31, 2017 (audit period).

49. The Division's audits of petitioners were initiated on April 29, 2019. The Division's audit of Aristeia was initiated on August 14, 2019. Although petitioners' 2016 tax returns were still eligible for audit under the applicable period of limitations, the Division did not audit them.

50. The Division did not make any adjustments to Aristeia's 2017 New York State BAP property or payroll percentages, and those percentages were accepted as filed.

51. During the audit, the Division determined that Aristeia failed to properly source the Deferred Fees and Appreciation it was required to report in 2017.

52. As its audit adjustments, the Division removed the Deferred Fees and the Appreciation from the numerator and denominator of the gross income factor of Aristeia's 2017 New York State BAP.

53. After removing the Deferred Fees and the Appreciation from the numerator and denominator of Aristeia's 2017 gross income factor, the Division separately allocated all of the income from the Deferred Fees and the Appreciation to New York State.

54. In removing the Deferred Fees and Appreciation from the numerator and denominator of Aristeia's 2017 gross income factor and separately allocating that income entirely to New York State, the Division relied on the guidance contained within the 2018 TSB-M, the legal advice from its Office of Counsel, and the work papers provided by Aristeia.

55. The Division made no other audit adjustments beyond the reallocation of the 2017 Deferred Fees and Appreciation.

56. The Division's audit reports indicate that, following its audits, "[t]he Department issued [audited adjustments] to reflect the deferred income being allocated to New York State utilizing the business allocation percentage of Aristeia Holdings LP for each of the tax years the services were performed as described in 20 NYCRR 132.15."

57. The computational basis for the Division separately allocating 100% of the income from the Deferred Fees and Appreciation to New York State was Aristeia's prior reporting of a 100% New York State BAP throughout the tax years 1998 through 2003.

58. The Division's auditor testified that New York State's partnership BAP schedule is "what a partnership would use to determine how much of their business activities are taking place in the State of New York" and that "traditionally," the BAP uses current year apportionment factors.

59. The Division's 2013 Nonresident Allocation Guidelines describe the "property percentage" of the three-factor allocation method as:

> "[C]omputed by dividing (i) the average of the values, at the beginning and the end of the taxable year, of real and tangible personal property connected with the business and located within New York State, by (ii) the average of the values, at the beginning and end of the taxable year, of all real and tangible personal property connected with the business and located both within and without New York State."

60. The Tax Department's 2013 Nonresident Allocation Guidelines describe the "payroll percentage" of the three-factor allocation method as:

> "[C]omputed by dividing (1) the total wages, salaries and other personal service compensation paid or incurred during the taxable year to employees, in connection with business carried on within New York State, by (2) the total of all wages, salaries and other personal service compensation paid or incurred during

> the taxable year to employees in connection with the business carried on both within and without New York State."

61. The Division's Nonresident Allocation Guidelines were revised in 2013, approximately five years after the 2008 enactment of IRC § 457A.

62. The Division's auditor testified that the Nonresident Allocation Guidelines remained applicable to Aristeia's 2017 recognition of nonqualified deferred compensation.

63. During the audit, the Division issued to petitioners each a consent to field audit adjustment, dated January 15, 2021. In the consent to Field Audit Adjustment issued to petitioners Anthony and Jennifer Frascella, the additional tax due was $1,258,375.00, plus interest and penalties. In the Remarks section of this document, it stated as follows:

> "The audit adjustment reflects the sourcing of income related to nonqualified deferred compensation as defined under IRC 457A following Technical Memorandum TSB-M-18(2)C, (3) I which addresses the treatment of nonqualified deferred compensation by nonresident individuals. The deferred income has been allocated to New York State utilizing the business allocation percentage for each of the tax years the services were performed as described in 20 NYCRR 132.15."

The last few pages of the document showed the reallocation of the Deferred Fees and Appreciation by removing them from the numerator and denominator of the gross income percentage of the BAP for tax year 2017 and finding that it was separately fully taxable as New York State income. The Consent to Field Audit Adjustment issued to William and Ipek Techar mimicked that issued to Mr. and Mrs. Frascella, except that their additional tax due was $402,715.00, plus interest and penalties, according to their proportionate share of Aristeia.

64. On April 13, 2021, following the audit, the Division issued to petitioners, Anthony and Jennifer Frascella, notice of deficiency L-053133059, which asserted additional tax due for the tax year 2017 of $1,258,375.00 plus penalty and interest. On the same date, the Division

issued to petitioners, William and Ipek Techar, notice of deficiency L-053133062, which asserted additional tax due for the year 2017 of $402,715.00, plus interest and penalty.

65. The Division assessed negligence and substantial understatement penalties against petitioners under sections 685 (b) (1), 685 (b) (2), and 685 (p) of the Tax Law.

66. The Division's auditor testified that the basis for imposing negligence penalties was petitioners' disregard of "clear guidance and clear tax law."

67. On May 28, 2021, petitioners each timely filed petitions asserting that the Division erred in issuing the assessments because the notices of deficiency were based on a nonbinding Technical Memorandum that was not consistent with the New York State Tax Law and the Division's own regulations. Petitioners also alleged that the Division's assessment of penalties against the petitioners was improper as any delinquency was due to reasonable cause and not negligence, intentional disregard, or willful neglect within the meaning of Tax Law § 685 (b) and (p).

68. Pursuant to 20 NYCRR 3000.15 (d) (6), petitioners submitted 76 proposed findings of fact. In accordance with State Administrative Procedure Act (SAPA) § 307 (1), petitioners' proposed findings of fact 1 through 11, 18 through 30, 32, 33, 37, 41, 42, 44, 48 through 65, and 67 through 76 are supported by the record, and have been consolidated, condensed, combined, renumbered, and substantially incorporated herein. Petitioners' proposed findings of fact 38, 40, 43 and 66, have been modified to more accurately reflect the record and/or accepted in part and rejected in part as conclusory, irrelevant and/or not supported by the record; to the extent accepted they have been consolidated, condensed, combined, renumbered, and substantially incorporated herein, as modified. Petitioners' proposed findings of fact 12 through 17, 31, 34

through 36, 39, and 45 through 47 are rejected as conclusory, irrelevant and/or not supported by the record.

SUMMARY OF THE PARTIES' POSITIONS

69. Petitioners argue that the Division's reallocation of Aristeia's 2017 partnership income to New York State misconstrues the activities upon which the income depended. Petitioners claim that had Aristeia Capital not continued to perform its investment management services from 2003 through 2017, causing the Deferred Fees to appreciate by $97,194,564.00, Aristeia and petitioners may have instead lost the original value of the Deferred Fees. They assert that treating the income as income earned wholly within New York State, where ongoing business operations in the time between 2003 and 2017 involved operations both within and outside New York State, does not accurately identify the activities upon which the income was secured. Petitioners also assert that, in a year where the partnership carried on business both within and without New York, Tax Law § 632 requires partners to include the portion of income derived from 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, and that such income is determined pursuant to 20 NYCRR 132.15.

Petitioners claim that Tax Law § 631 (b) (1) (F) does not apply to distributive shares of partnership income, and that such provision is limited to employment related income such as employee termination payments pursuant to ***Matter of Murphy*** (Tax Appeals Tribunal, December 16, 2016, ***affd*** 166 AD3d 1096 [3d Dept 2018]). Petitioners also assert that even if Tax Law § 631 (b) (1) (F) applied to distributive shares of partnership income, the income was still required to be allocated pursuant to Tax Law § 631 (c), which imposes the three-factor allocation formula set forth in 20 NYCRR 132.15, because the partnership carried on its business

partly within and partly without New York State from 1998 through 2017. Petitioners further assert that even if the Deferred Fees qualified as income subject to Tax Law § 631 (b) (1) (F), fully allocating 100% of the Appreciation to New York State is not supported by that provision because the Appreciation related to ongoing business activities that occurred both within and outside of New York State.

Petitioners also assert that from 1998 through 2003, Aristeia Capital representatives travelled to various foreign locations and conducted other foreign business activities of Aristeia Capital, qualifying the business as carried on partly without New York State during that time. Petitioners assert that despite the fact that Aristeia Capital reported a New York State BAP of 100% for the period 1998 through 2003, it did not carry on its business wholly within New York State during that time. Petitioners explained that the BAP is a formula to determine the amount of income earned within a specific jurisdiction, not whether business was carried on in a specific jurisdiction. Petitioners also argue that because the property and payroll percentage portions of the BAP require calculations to be computed using values from the taxable year being reported, here, 2017, including the Deferred Fees and Appreciation as income sourced within New York State as part of the gross income percentage for 2017 was proper.

Petitioners also argue that the 2018 TSB-M impermissibly contradicts New York State's existing tax law and regulations. Petitioners contend that the 2018 TSB-M's direction to nonresident partners to use the BAP for the tax year the services were performed is not found in the relevant provisions of the Tax Law or accompanying regulations, and the phrase contradicts the term "taxable year" that is used when referred to the property and payroll percentages of 20 NYCRR 132.15, which petitioners assert means the current taxable year. Petitioners claim that the Division's attempts to impose new income allocation methodologies that contradict

regulations was previously rejected by the Tax Appeals Tribunal in ***Matter of Stuckless*** (Tax Appeals Tribunal, August 17, 2006). Petitioners allege that, like in ***Stuckless***, the Division is attempting to impose an income allocation methodology through a technical services memorandum that is not provided for by the current statutes and regulations, and should be rejected. Petitioners also argue that the Division's application of the 2018 TSB-M to nonresident partners violates the New York State Constitution and SAPA.

Petitioners also assert that they have established reasonable cause for the abatement of penalties. They claim they explicitly disclosed the recognition of the Deferred Fees and the Appreciation on their 2017 New York State tax returns, constituting adequate disclosure of "the relevant facts affecting the tax treatment" pursuant to 20 NYCRR 2392.1 (g) (1). Petitioners also argue that they had a reasonable and honest misunderstanding of fact or law in light of the experience, knowledge and education of the taxpayer, because they filed their 2017 returns using the same allocation methodology for sourcing deferred fees and any appreciation thereon that they used for years prior to 2017, and these returns were accepted by the Division without change. Petitioners claim that this historical treatment, in conjunction with the conflicting guidance contained within the 2018 TSB-M and existing case law from the Tax Appeals Tribunal that Tax Law § 631 (b) (1) (F) "casts no light" on the allocation of distributive shares of partnership income (***see Matter of Murphy***), made their allocations of the Deferred Fees and Appreciation for 2017 reasonable. Petitioners also assert that they relied on professional advice that the method petitioners used was the "most conservative" allocation approach.

70. The Division asserts that federal law is clear that deferred fees, despite being recognized for tax purposes years later, are attributable to services performed in the specific period of service, and that the deferred fees at issue were indisputably compensation for services

in the years they were originally earned, namely 1998 through 2003. It also contends that any appreciation of these fees must be treated as ordinary income as compensation for services.

The Division also argues that pursuant to Tax Law § 631 (b) (1) (F) and 20 NYCRR 132.4 (c), petitioners' nonqualified deferred compensation must be sourced to the years it was earned. The Division asserts that because the compensation was for services carried on in New York during the years 1998 through 2003, they are required to be sourced solely to New York. It also contends that even if Aristeia Capital had conducted business within and without New York during 1998 through 2003, the only reasonable interpretation of Tax Law § 631 (b) (1) (F) would be to use the allocation rules in effect during the year the income was earned. The Division also points out that the regulations do not specify the time frame used in computing the allocation factor, and instead use the term "taxable year," which is an accounting period.

The Division asserts that the guidance issued in the 2018 TSB-M was proper, reasonable, and consistent with the Tax Law and regulations. It contends that the 2018 TSB-M provides clear, explicit guidance as to how nonqualified deferred compensation is sourced under the existing Tax Law. In doing so, it explains how the rule that was created by Tax Law § 631 (b) (1) (F) and outlined in the 2010 TSB-M, applies to the nonqualified deferred compensation at issue.

The Division argues that it properly imposed penalties because petitioners negligently failed to properly allocate their nonqualified deferred compensation resulting in a substantial understatement of tax. It claims petitioners failed to show reasonable cause for the abatement of penalties. The Division asserts that reliance on professional advice alone is not sufficient grounds to abate penalties, and that, even if it were, petitioners did not follow the advice provided by the professionals they engaged. The Division also contends that the claim that

petitioners made an honest misunderstanding of fact or law is contradicted by the facts of this case, given the clear guidance provided in the 2018 TSB-M, Tax Law § 631 (b) (1) (F) and 20 NYCRR 132.4 (c).

CONCLUSIONS OF LAW

A. IRC (26 USC) § 457A (a) provides that "[a]ny compensation which is deferred under a nonqualified deferred compensation plan of a nonqualified entity shall be includible in gross income when there is no substantial risk of forfeiture of the rights to such compensation." Section 457A was added to the Code by section 801 (a) of the Tax Extenders and Alternative Minimum Tax Relief Act of 2008, (Pub L 110-343 [Div. C], Title VIII, § 801 [a] 122 Stat. 3929 [October 3, 2008] [TEAMTRA]). Section 801 (d) (1) of TEAMTRA provides that "the amendment made by this section shall apply to the amounts deferred which are attributable to services performed after December 1, 2008." Section 801 (d) (2) provides a transition rule where nonqualified deferred compensation for services performed before 2009 must be includible in gross income in the later of the last taxable year beginning before 2018 or the taxable year of vesting. In addition to requiring tax recognition of the original deferred management fee, the grandfathered provision required recognition of the appreciation on these fees to be treated as ordinary income for tax purposes (***see generally***, IRS Notice 2009-8, Interim Guidance Under § 457A).

It is undisputed in the instant matter that the compensation was deferred under a nonqualified deferred compensation plan for a nonqualified entity, and that it was included in gross income in 2017, the last taxable year before 2018. Additionally, both the Division and petitioners allocated all of the Deferred Fees and Appreciation to New York. At issue here, is whether the Deferred Fees and Appreciation should be allocated as New York income included

in the gross income percentage and ultimately the BAP for 2017 or allocated separately as New York income in its entirety utilizing the BAP for the years the services were performed (here 1998 through 2003).

B. New York State imposes personal income tax on the income of a nonresident that is derived from or connected to New York sources (***see*** Tax Law § 631 [a] [1]; ***see also*** Tax Law § 601 [e] [1]; ***Matter of Zelinsky v Tax Appeals Trib. of State of N.Y.***, 1 NY3d 85, 89-90 [2003], ***cert denied*** 541 US 1009 [2004]). New York source income includes a taxpayer's "distributive share of partnership income, gain, loss and deduction" (Tax Law § 631 [a] [1] [A]). The New York source income of a nonresident partner includes his distributive share of all items of partnership income, gain, loss, and deduction entering into his federal adjusted gross income to the extent such items are derived from or connected with New York sources (***see*** Tax Law § 632 [a] [1]). This portion is determined "under [the] regulations of the tax commission consistent with the applicable rules of section six hundred thirty-one of this part" (***id.***).

C. Tax Law § 631 (b) (1) (F) provides that income, gain, loss, and deduction derived from New York sources includes as follows:

> "income received by nonresidents related to a business, trade, profession or occupation previously carried on in this state, whether or not as an employee, including[,] but not limited to, covenants not to compete and termination agreements. Income received by nonresidents related to a business, trade, profession or occupation previously carried on partly within and partly without the state shall be allocated in accordance with the provisions of subsection (c) of this section."

Subsection (c) of Tax Law § 631 provides that where a business is carried on partly within and partly without New York State, the income, gain, loss, and deduction derived from New York sources shall be determined by apportionment and allocation under such regulations.

The applicable regulation, 20 NYCRR 132.15, provides that if a nonresident carries on a business, trade, profession, or occupation both within and without New York State, the items of income, gain, loss, and deduction attributable to such business, trade, profession or occupation must be apportioned and allocated to New York State on a fair and equitable basis in accordance with approved methods of accounting (20 NYCRR 132.15 [a]). If the books of the business disclose the proportion of the net amount of the items of income, gain, loss, and deduction derived from or connected to New York State sources, the books may be used to determine the allocation (***see*** 20 NYCRR 132.15 [b]). However, if the books and records of the business do not disclose the proportion of the net amount of the items of income, gain, loss, and deduction attributable to the activities of the business carried on in New York State, such proportion is determined by multiplying the net amount of income, gain, loss, and deduction of the business by the average of the property percentage, the payroll percentage, and the gross income percentage (collectively the BAP referenced above) as described therein (***see*** 20 NYCRR 132.15 [c]). Additionally, 20 NYCRR 132.4 (c) provides as follows:

> "If personal services are performed within New York State, whether or not as an employee, the compensation for such services includible in Federal adjusted gross income constitutes income from New York sources, regardless of the fact that (1) such compensation is received in a taxable year after the year in which the services were performed . . ."

Here, both parties used the BAP method to determine the amount of income that should be allocated to New York. Petitioners assert the Deferred Fees and Appreciation should be included in the gross income percentage and ultimately averaged with the property and payroll percentages for 2017 to determine the 2017 BAP, and the Division asserts the New York State BAP from the time the services were performed should be used, here, 100%.

The Division found that Tax Law § 631 (b) (1) (F) as explained by the 2018 TSB-M and 20 NYCRR 132.4 (c), directed that the Deferred Fees and Appreciation sourced to New York State as part of ordinary income on the partnership's return, and ultimately, the petitioners' returns, should be sourced based on business done in New York at the time the services were performed generating the income, not included with other income from the tax year it was reported. In reaching the determined amount due, the Division found that all of the income from the Deferred Fees and Appreciation should be allocated to New York as Aristeia Capital's New York BAP was 100% during the years the fees were earned. The Deferred Fees were taxable at the time they would have been received but for the election to defer. Therefore, the Division's separate allocation of the Deferred Fees and Appreciation using the BAP from the time the services were performed pursuant to Tax Law § 631 (b) (1) (F) and 20 NYCRR 132.4 (c) was proper.

D. Petitioners contend that the Division's application of the New York BAP from the time the Deferred Fees were earned misconstrues the activities upon which that income was secured because business was done both within and without New York State from 1998 until the Deferred Fees and Appreciation were repatriated in 2017. Petitioners suggest that utilizing the 2017 BAP is the only proper methodology because during that time business was performed both within and without New York. This argument is rejected. Both petitioners and the Division allocated all of the Deferred Fees and Appreciation to New York State, indicating that all of the income from the Deferred Fees and Appreciation thereon should be sourced to New York. Additionally, regardless of the business income earned within and without New York during the years between 2003 and 2017, and the New York BAPs that were calculated for those years, the New York BAP the petitioners assert should be used is determined solely by the income,

property, and payroll percentages calculated for 2017. Therefore, their argument about business performed in the years in between is irrelevant.

Additionally, in a footnote of petitioners' brief, and without citation to any authority for their position, they assert that if it is determined that the Deferred Fees were earned entirely within New York State, the Division erred in failing to treat the Appreciation as income from intangible property that does not qualify as New York State-source income. This argument is also rejected. Recognition of appreciation on deferred fees must be treated as ordinary income for tax purposes (***see*** IRC [26 USC] § 409A [b] [4]; IRS Notice 2009-8, Interim Guidance Under § 457A at A-23). Moreover, to the extent petitioners assert that a different BAP should be used for the Appreciation than for the Deferred Fees because the Appreciation related to ongoing business activities that occurred both within and without New York, this argument lacks merit. Petitioner does not offer any legal authority for this position and as mentioned above, when filing their returns, petitioners also allocated all the Appreciation to New York.

E. Petitioners assert that Tax Law § 631 (b) (1) (F) does not apply to the distributive share of a partner's profits, citing to ***Matter of Murphy*** and the legislative history for such provision. These arguments lack merit. The issue in ***Murphy*** was whether petitioner allocated the proper amount of income to New York State for tax year 2007. The relevant income was a distribution of profits from an LLC for the tax period 2000 through 2004, where one petitioner assigned his ownership interest in an LLC to the other petitioner, his wife, and his wife then sued the partnership for her share of the profits (***id.***). Before that case was resolved, the partnership was dissolved (***id.***). Thereafter, the wife received the amount determined to represent the profit distributions of the partnership and she reported this income as other income on the petitioners' shared 2007 form IT-203, New York nonresident and part-year resident income tax return (***id.***).

The Division asserted that this income should be allocated to New York utilizing the BAP of the partnership because it was a distribution of profits (***id.***). Petitioners argued that, had Tax Law § 631 (b) (1) (F) been in effect at the time she reported the income, it may have been subject to New York income tax, but because that provision was not in effect at that time, there was no other provision that required her to source the income to New York (***id.***).

In ***Murphy***, the Tax Appeals Tribunal (Tribunal) found that to determine whether income should be treated as New York source income, it is necessary to identify the activity upon which the income was secured (***id.***). Finding that the income originated from the business of the partnership, which was conducted, in part, in New York, the Tribunal held that the income at issue was derived from New York sources in accordance with the partnership's New York BAP (***id.***).

The Tribunal went on to note that Tax Law § 631 (b) (1) (F) did not apply and was added to counter abuse of post-employment severance packages (***id.***). The Tribunal explained that the payment at issue was not a severance payment but was instead the profit the petitioner should have been paid in the regular course of business and was not for a previously conducted occupation or business, and therefore, "Tax Law § 631 (b) (1) (F) . . . casts no light on the present dispute" (***id.***). Here, unlike in ***Murphy***, the income at issue is for previously conducted business. Accordingly, the holding in ***Murphy*** does not control the outcome here. However, the Tribunal's analysis that in order to determine whether income is derived from New York sources, it is necessary to identify the activity upon which the income was earned, and its holding that the income should be measured based on the partnership's BAP, support the Division's assessment in this case (***see id.***). The Tribunal must have been referring to the partnership's BAP during the years the profits were earned, because at the time the petitioner in ***Murphy*** reported

the income (2007), the partnership had already been dissolved and would not have had a BAP (***see id.***). Therefore, ***Matter of Murphy*** supports the Division's assertion that the Deferred Fees and Appreciation should be reported according to Aristeia's BAP at the time the services were performed.

Additionally, while the legislative history referenced severance packages and termination agreements, where the interpretation is based on the plain language of the statute and there is an absence of ambiguity on its face, it is not necessary to look to the legislative history for guidance (***see Matter of Lepage***, Tax Appeals Tribunal, May 17, 2021). "The best evidence of the Legislature's intent is the text of the statute itself" (***Matter of Stewart's Shops Corp. v. New York State Tax Appeals Trib.***, 172 AD3d 1789, 1792 [3d Dept 2019]). As the Division points out in its brief, the income derived from or connected with New York sources includes "income received by nonresidents related to a business, trade, profession or occupation previously carried on in this state, *whether or not as an employee, including but not limited to,* covenants not to compete and termination agreements" (emphasis added) (Tax Law § 631 [b] [1] [F]). The language of this provision makes clear that the income received is not limited to income received as an employee, but also other income related to a business (***see id.***). Additionally, the statute expressly states that the income received includes, but is not limited to, covenants not to compete and termination agreements (***see id.***). Notably, the fact that the legislative history specifically mentions one type of income that the legislation was meant to capture does not mean it is limited exclusively to that income (***see Matter of Lepage***). This is particularly true here, given the broad language therein (***see id.***). Accordingly, the plain language of the statute supports the Division's interpretation and application to the Deferred Fees and Appreciation.

Additionally, after Tax Law § 631 [b] [1] [F] was enacted, the Division issued guidance explicitly instructing taxpayers how to apply that provision on August 31, 2010 (***see*** 2010 TSB-M). The 2010 TSB-M instructed taxpayers that the BAP used to determine how income should be sourced to New York was from the year the contract or other agreement was entered into that resulted in the income (***see id.***).

F. Petitioners argue that the regulations require that the Deferred Fees and Appreciation reported as part of Aristeia's income for 2017 be allocated to New York by adding the income to the gross income percentage piece of the BAP used to determine the portion of income that should be sourced to New York for 2017. Petitioners argue that because the property percentage and the gross income percentage provided in 20 NYCRR 132.15 refer to the "taxable year," here, 2017, the gross income percentage for 2017 must include the Deferred Fees and Appreciation because that is the taxable year that is being reported and the year petitioners are required by law to repatriate the Deferred Fees and Appreciation.

This argument is rejected. New York source income is income derived from New York sources (***see*** Tax Law § 631 [a] [1]). Tax Law § 631 (b) (1) (F) provides that "[i]ncome received by nonresidents related to a business, trade, profession or occupation previously carried on partly within and partly without the state shall be allocated in accordance with [20 NYCRR 132.15]." This statement does not require that the allocation needs to be integrated as part of the BAP for the current taxable year. It is directing that the income be determined using the method established by 20 NYCRR 132.15. To determine the correct amount of income derived from New York sources and comply with the Tax Law, Tax Law § 631 (b) (1) (F) supports, as relevant here, looking to the property percentage, payroll percentage and gross income percentage creating the BAP from the same year the services were rendered, utilizing the

formula provided by 20 NYCRR 132.15. Petitioners' methodology ignores the plain language of Tax Law § 631 (b) (1) (F).

The only reasonable interpretation of Tax Law § 631 (b) (1) (F) is that the BAP to be utilized is from the year the services generating the income were performed. To find otherwise would be to determine that the New York source income originating from business that took place in a prior year is nonetheless integrated with business done within and without New York at the time the nonqualified deferred compensation is repatriated, even though the business that generated the Deferred Fees occurred in a different taxable period and, as is the case here, when a different percentage of income from Aristeia Capital was sourced to New York. Additionally, the term "taxable year" used in 20 NYCRR 132.15 does not mean "current taxable year," as petitioners suggest, and instead, is an accounting period (***see*** IRC [26 USC] § 441 [b]). Accordingly, the use of the term "taxable year" in 20 NYCRR 132.15 (d) and (e) does not dictate that the repatriated nondeferred compensation must be included in the gross income percentage for that year simply because it is being reported in that year. To interpret otherwise would result in New York receiving more or less income than what was derived from New York sources, which is in direct contradiction of the applicable statutes (***see*** Tax Law §§ 601; 631; 632).

G. Petitioners assert that the Division's creation of and reliance on a TSB-M for the authority for the Division's audit methodology was struck down previously in ***Matter of Stuckless***, and that like in ***Stuckless***, the Tax Law and regulations do not support the Division's sourcing of income in the present matter. However, the facts and law in ***Stuckless***, are distinguishable from the instant case.

In ***Stuckless***, the Division determined that the gain from petitioner's stock options that was secured or earned through his New York employment was properly considered New York

source income even though the petitioner exercised the stock options and sold stock thereafter while he was a nonresident of New York. The Division then apportioned the gain realized on the exercise of the stock options to New York, using the number of New York working days from the option grant date to the exercise date, which was several years later, compared to the total number of days worked both in and out of New York for the same period (***id.***). This resulted in the Division issuing notices of deficiency for the years during which the stock was exercised (***id.***). In making its determination, the Division relied on a TSB-M, which set forth the Division's audit methodology (***id.***). The Division argued that in issuing the relevant TSB-M, its method therein was authorized pursuant to a catchall provision in 20 NYCRR 132.25 (formerly 20 NYCRR 132.34) and caselaw (***id.***). This provision provided that where allocation and apportionment of a nonresident's income was not calculated in a fair and equitable manner under the express methods provided in the regulations, the Division was allowed to require a taxpayer to apportion and allocate those items under an alternative method as long as it resulted in a "fair and equitable apportionment and allocation" (20 NYCRR 132.25).

The Tribunal cancelled the notices of deficiency, finding that the Division's use of a multiple year allocation method based on a day count ratio over the years from the grant to the exercise of stock options was not supported either by existing caselaw or the Tax Law and regulations (***see Stuckless***). The Tribunal held that the issue in that case was one of statutory interpretation that did not require agency deference and reliance on the Division's TSB-M (***id.***). The Tribunal also interpreted 20 NYCRR 132.25 to only apply on a case-by-case basis, where the general rules of the regulations would produce an unfair or inequitable result (***id.***). The Tribunal found this provision did not grant the Division the authority to issue a TSB-M that articulated new rules for general application (***id.***).

As in ***Stuckless***, the issue here is one of statutory interpretation that does not require deference to the Division's TSB-M. However, unlike ***Stuckless***, the Tax Law and regulations expressly authorize the method used by the Division to apportion the income at issue here (***see*** Tax Law § 631 [a], [b] [1] [F]; 20 NYCRR 132.15).

H. Petitioners also assert that the Division's application of the 2018 TSB-M to nonresident partners violates the New York State Constitution and SAPA. The New York Constitution provides that in order for a rule or regulation to have legal effect, such rule or regulation must be formally promulgated in accordance with the procedures established by the Legislature (NY Const, art IV, § 8). SAPA provides for uniform procedures for the promulgation of rules and regulations of administrative bodies, requires publication of proposed rules in the State Register and a period of public comment, and hearings, before the rules may be imposed (SAPA § 202).

TSB-Ms are "informational statements of the Division of Taxation's policies" (20 NYCRR 2375.6 [a] [1]). As such, they are "advisory in nature" and "do not have legal force or effect" (20 NYCRR 2375.6 [c]; ***see Matter of Friesch–Groningsche Hypotheek Bank Realty Credit Corp.***, Tax Appeals Tribunal, December 28, 1990, ***confirmed*** 185 AD2d 466, 468 [3d Dept. 1992]). As the actions of the Division and the directions in the 2018 TSB-M are explanatory and have no legal effect, are provided for by the existing Tax Law and corresponding regulations, and no new rules were created, they do not violate the New York Constitution or SAPA.

I. The Division imposed penalties on petitioners pursuant to Tax Law § 685 (b) (1) and (2), for negligence in reporting their tax liabilities for 2017, and Tax Law § 685 (p), for a substantial understatement of the amount of income tax required to be reported on their returns.

Pursuant to Tax Law § 689 (e), petitioners had the burden of proof to show that the deficiencies herein did not result from negligence or an intentional disregard of the Tax Law (***see*** Tax Law § 685 [b] [1] and [2]) or that the substantial understatements of tax were due to reasonable cause and not willful neglect (***see*** 20 NYCRR 2392.1 [g] [1]). Petitioners seek cancellation of the penalties for the following reasons: (i) they reported recognition of the Deferred Fees and Appreciation on their 2017 returns; (ii) they had a reasonable and honest misunderstanding of fact or law because they used the same allocation methodology for tax year 2017 as they did for reporting tax years prior to 2017; (iii) the 2018 TSB-M conflicted with 20 NYCRR 132.15, and an earlier decision from the Tribunal stated that Tax Law § 631 (b) (1) (F) "casts no light" on the allocation of distributive shares of partnership income (***see Murphy***); and (iv) they relied on written tax advice from an international accounting firm.

It cannot be said that petitioners acted without negligence in these matters. Petitioners chose to ignore the applicable provisions of the Tax Law and regulations, as well as the guidance from the Division. Reporting the full value of the Deferred Fees and Appreciation on their 2017 tax returns and affirming that these amounts were nonqualified deferred compensation, without more, is not sufficient to establish reasonable cause to abate penalties. Despite acknowledging that the nonqualified deferred compensation was included in their returns, which they were required to report pursuant to section 801 (d) (1) of TEAMTRA, petitioners still ignored the Tax Law and regulations, and the guidance provided by the Division, by including such nonqualified deferred compensation in their New York BAP for 2017.

Petitioners argue an "honest misunderstanding of fact or law" for their failure to follow the guidance provided in the 2018 TSB-M pursuant to Tax Law § 631 (b) (1) (F). Such argument is rejected. Allocation of nonqualified deferred compensation was clearly addressed in

the 2018 TSB-M, which was issued pursuant to Tax Law § 631 (b) (1) (F) and 20 NYCRR 132.15 (c). Petitioners chose not to follow it. Moreover, as established above, the facts in ***Matter of Murphy*** are clearly distinguishable from the instant matter, as it involved payment of income that should have been paid in the regular course of business, not for services previously performed. Petitioners assert that because the Division chose not to audit petitioners' 2016 returns where they included deferred fees and any appreciation thereon in the 2016 BAP, they were reasonable in treating the Deferred Fees and Appreciation in 2017 the same way. This argument is also rejected for the reasons stated above.

Petitioners also argue that penalties should be abated because they relied on professional tax advice. "Reliance upon advice from a professional does not in itself insulate a taxpayer from penalties" (***Matter of Tweed***, Tax Appeals Tribunal, May 23, 1996). Rather, even where a taxpayer relies on a tax professional, the taxpayer must show that he "acted with ordinary business care and prudence in attempting to ascertain his tax liability," and thus, must show that his reliance on professional advice was reasonable (***Matter of McGaughey***, Tax Appeals Tribunal, March 19, 1998, ***confirmed*** 268 AD2d 802, 803 [3d Dept 2000]). Here, petitioners did seek and receive professional advice. However, such advice was not necessary due to the clear instructions provided in the 2018 TSB-M, and as such advice contradicted the explicit instructions in the 2018 TSB-M, following it cannot be found to be reasonable. Accordingly, penalties cannot be abated on such grounds.

Having determined that petitioners' disregard for the applicable law and guidance constituted negligence, the penalties imposed pursuant to Tax Law § 685 (b) (1), (2) and (p) were proper.

J. The petitions of William and Ipek Techar and Anthony and Jennifer Frascella are denied, and the notices of deficiency L-053133059 and L-053133062, are sustained.

DATED: Albany, New York
September 7, 2023

/s/ Jessica DiFiore
ADMINISTRATIVE LAW JUDGE