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In this installment of Noonan's Notes, the authors discuss New York City's unincorporated business tax.

The internet is pretty awesome. It pretty much tells you anything you need to know. The sales tax rate in Iberia Parish in Louisiana? Google it. What sound does a bat make? Seriously, Google knows that too. How many kids does Tim have? That's there as well.

But if you want Google to tell you about the payment-to-partner modification under the New York City unincorporated business tax (UBT)? The results are underwhelming. And in 2019, how could any tax practitioner function without such internet-inspired knowledge? We're on a mission to correct this problem and it starts here at the Noonan's Notes World Headquarters. Let's figure out what this UBT payment-to-partner thing is all about.

Background

New York City imposes the UBT on the taxable income of an unincorporated business that carries on its business wholly or in part in the city.[1] An unincorporated business includes an entity such as a limited liability company, partnership, sole proprietorship, fiduciary, or a corporation in liquidation.[2] And the tax base is computed based on the entire net income of the business, minus exemptions and deductions.[3]

Typically, the taxpayer can deduct amounts that are directly connected or incurred with the conduct of the business that would be allowable for federal income tax purposes,[4] and this would include salaries of its employees. However, a taxpayer can't deduct any amounts paid to a partner that was consideration for either the partner's services or use of the partner's capital.[5] This is generally called the payment-to-partner modification. Items that the business can't deduct include salaries, commissions, and professional or consultant fees paid to a general or limited partner of the unincorporated business, and it is irrelevant whether the partner is also an employee or independent contractor.[6] Nor does it matter if the payments are made for the partner's services in his capacity as an employee of the business or as a partner — they still can't be deducted.[7] The taxpayer also can't

[1] N.Y.C. Admin. Code section 11-502; N.Y.C. Admin. Code section 11-503(a).

[2] N.Y.C. Admin. Code section 11-502(a).

[3] N.Y.C. Admin. Code section 11-505.

[4] N.Y.C. Admin. Code section 11-507.

[5] N.Y.C. Admin Code section 11-507 (3); RCNY 28-06 (d)(1)(i)(B).

[6] RCNY 28-06 (d)(1)(i)(C).

[7] *Matter of Miller Tabak Hirsch & Co.*, TAT(E)94-173(UB) (N.Y.C. Tax. App. Trib. Mar. 30, 1999).

deduct guaranteed payments paid to retired partners or interest paid to a general or limited partner for money loaned or contributed to the business.[8]

To determine whether the payment is to a partner, decisions have taken a case-by-case approach.[9] More on that later. But the regulations explain that a person will generally be considered a partner of an unincorporated business if:

- the business issues him a K-1;
- he is a party to a governing document, like the partnership agreement;
- he is liable for all or part of the debts or obligations of the business; or
- he has an interest in the assets or capital of the business.[10]

There's also a prohibition for payments to officers of corporate partners. The regulations prohibit a deduction for "amounts paid or incurred to a corporate partner for services provided the unincorporated business by the corporate partner's officers."[11] The regulation explains that a corporate officer includes the chairman, president, vice president, treasurer, assistant treasurer, secretary, assistant secretary, comptroller, or any other person charged with performing executive duties of the corporation.[12]

Not only can a taxpayer not deduct payments to its partners, but it also can't deduct payments made to partners of its member-partners for the partner's services to the business.[13] The regulations suggest that it does not matter whether these payments are made to the member-partnership or to its partner.[14]

There's also a rule called the "D Exception," named after the subsection of section 28-06 of the city tax regulations where it's found. The idea is that the taxpayer can deduct payments to a partner that represent the value of services provided by the employees of the partner.[15] Here's how this generally works: Taxpayer is owned 30 percent by Corp A, and it pays a management fee of $100,000 to Corp A for the performance of management services. The actual management services are provided by Mark, an employee of Corp A, who is paid an annual salary of $100,000 by Corp A. In this circumstance, the D Exception would allow the taxpayer to deduct the $100,000 payment to its partner, Corp A. Courts have found, however, that the "D Exception operates only where the employees are not themselves partners in the partnership."[16] So in this example, if Mark also had an ownership interest in Corp A or the taxpayer, the city would take the position that the D Exception would not apply.

Payment-to-Partner Examples

To best understand how the payment-to-partner modification and its variations work, we'll walk through a couple of examples.

Example 1

Let's start by examining the example in the regulations. See figure 1 for a visual, to follow along:

> Partnership AB, Corporation C and the individual Mr. D form a joint venture called the ABCD Construction Company to construct a building in Staten Island. Each member of the Company contributes an equal amount of capital to the venture. In addition, Mr. A, a partner in Partnership AB will serve as engineering supervisor for the construction. Ms. E, the president of Corporation C, will serve as work site

[8] *Id.*

[9] *Matter of Weeks-Lerman Group LLC*, TAT(H)05-54(UB) (N.Y.C. Tax. App. Trib., Adm. Law Judge Deter., June 10, 2008).

[10] RCNY 28-06 (d)(1)(iv).

[11] RCNY 28-06 (d)(1)(ii)(B).

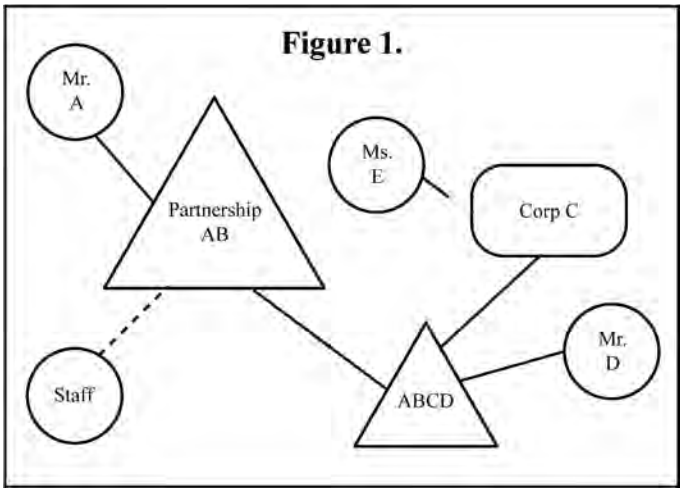
[12] *Id.*

[13] RCNY 28-06 (d)(1)(ii)(C).

[14] *See* RCNY 28-06 (d)(1)(ii)(D).

[15] RCNY 28-06(d)(1)(ii)(D); *Matter of Tocqueville Asset Management LP*, TAT(E)10-37(UB) (N.Y.C. Tax App. Trib. May 29, 2015) (noting that the D exception "applies only to payments for the services of a partner's employees, not employees of the unincorporated business.").

[16] *Matter of Tocqueville Asset Management LP*, TAT(H)10-37(UB) (N.Y.C. Tax. App. Trib., Adm. Law Judge Deter., June 17, 2014).



supervisor. Mr. D, an attorney, will handle all the legal affairs of the Company. The office staff of partnership AB will provide all the office services needed by the Company. The in-house accounting staff of Corporation C will handle all of the Company's accounting matters.[17]

ABCD pays out amounts to the various players. Here's how the regulations sort out the payment-to-partner rules:

- Payments made by ABCD to Mr. D cannot be deducted as these would be payments directly to a partner.
- Payments made to the AB staff and the C staff would fall under the D exception and could be deducted if the payments are included in the members' gross income for federal income tax purposes.
- The payments to Mr. A can't be deducted because he is a partner in Partnership AB.
- The payment to Ms. E can't be deducted, at least according to the regulations, because she is an officer of a corporate partner. The case law of these officer rules might suggest more facts are needed to make this claim.

Example 2

Here's another one. See figure 2 for an illustration.

> Partnership A has two partners: Madeline owns 80 percent of the firm, while Newco owns the other 20 percent. In turn, Newco is owned by 20 individuals who also happen to be employees of Partnership A, and they are paid wages by Partnership A for their services. But none of the employees has a direct ownership interest in Partnership A.

Can Partnership A deduct the salaries paid to the employees? The city would probably say no, and that this would fall under the prohibition of payments to partners of member-partnerships, like Mr. A's salary in the example in the regulations. But ultimately, as we'll see in some of the case discussions below, the answer may turn on the economic substance of the structure and the payments. Specifically, it could matter whether the compensation to A's employees was for services that were required to be performed Newco, the corporate partner, as opposed to services required to be performed by the employees for Partnership A that have nothing to do with any arrangements or agreements with Newco. In the latter situation, the payment-to-partner modification might not apply.

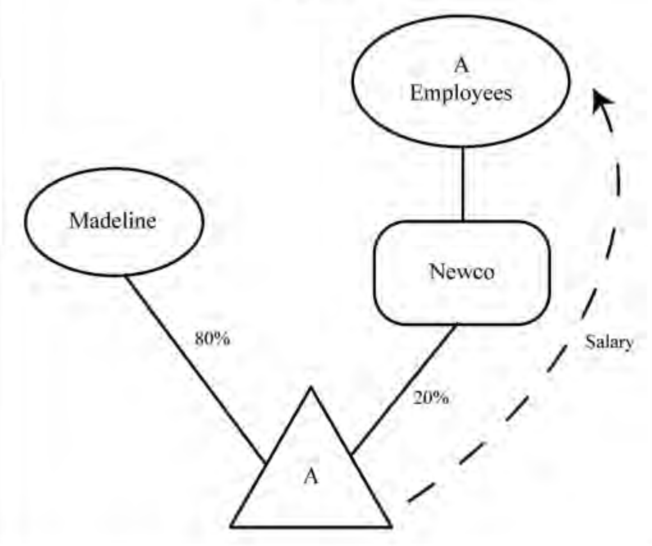
Example 3

Let's tweak Example 2. See figure 3 on the next page for this illustration.

> Here, the employee/partners in Example 2 are no longer employed by Partnership A but are employees of Newco. So they do not have an employer-employee relationship with the unincorporated business. Instead, the taxpayer pays a management fee to Newco, and Newco pays salaries to the employees from that fee.

[17]RCNY 28-06 (d)(1)(ii)(D).

Figure 2.



We think there's a good argument that the D Exception applies here. Therefore, the management fee could be deducted by Partnership A if Newco took it into income and then paid out wages to its employees. The city might think to look through the structure and determine that because the employees would also be owners of Newco, this would prohibit the application of the D Exception. But we think we'd have the better of that argument under the rules and case law.

Case Law on the Modification

There haven't been too many reported cases on payment-to-partner issues, but we'll walk through a sampling of the good ones.

The definition of a partner came into play in *Matter of Ladas and Parry*, in which the payments at issue were made to "special partners."[18] The special partners did not contribute capital, were not bound by the partnership agreement, did not have an interest in the partnership's assets nor share in its losses, had no right to participate in the management and control of the partnership, were indemnified against personal liability for partnership obligations, and were consistently treated as employees for all tax purposes. However, the special partners were listed among the members of the partnership on its letterhead and in Martindale-Hubbell, and their compensation was determined in part by the partnership's profits. The tribunal found that the special partners' salaries could be deducted because there was not a sufficient indicium that they were "true partners."

While who qualifies as a partner is relevant, the capacity in which the partner acts is not. In *Matter of Miller Tabak Hirsch & Co.*, at issue were payments made to limited partners.[19] Here, the partnership argued that the salaries paid were to the partners in their capacity as employees, and not as partners.

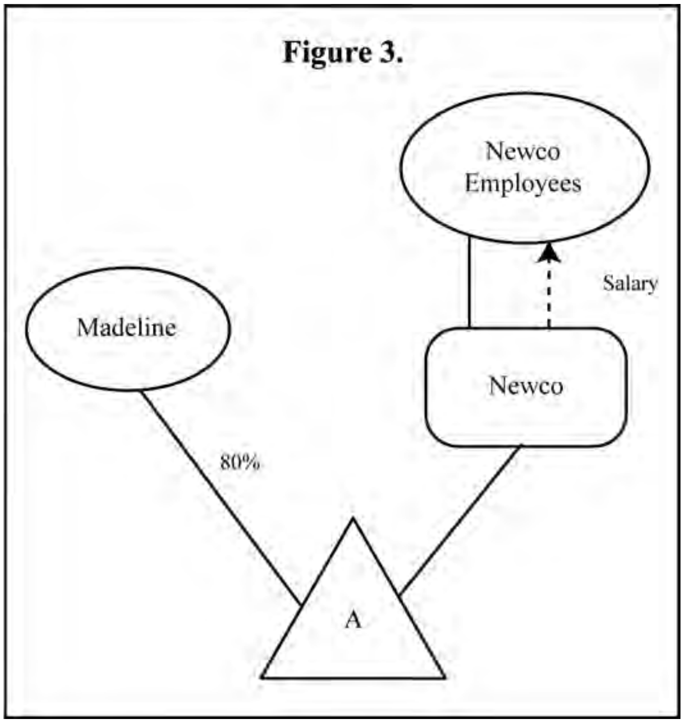
The tribunal found the capacity in which the partners were acting to be irrelevant. Since they were determined to be partners, no payments to the limited partners for their services or use of capital could be deducted.

Among the few cases in which the payments could be deducted is *New York Yankees Partnership v. O'Cleireacain*.[20] Here, the taxpayer claimed a deduction for payments made to liquidating partners for their shares in the players' contracts that had been amortized by the partnership in current or prior tax years. The court of appeals determined that these payments were deductible because they were not for the partners' services or use of capital. The court also noted that the characterization of these payments for federal income tax purposes was not controlling.

[18] *Matter of Ladas and Parry*, TAT(E)98-19(UB) (N.Y.C. Tax App. Trib. Jan. 2, 2003).

[19] *Matter of Miller Tabak Hirsch & Co.*, TAT(E)94-173(UB).

[20] *New York Yankees Partnership v. O'Cleireacain*, 83 N.Y.2d 550 (1994).



There are a few cases in which the court disallowed a partnership's deduction for installment payments made to partners that were received in liquidation of the partners' interests. For example, in *Buchbinder Tunick & Co.* the court of appeals determined that payments made in liquidation of partnership interests, which were the retiring partners' pro rata share of the partnership's unrealized receivables, could not be deducted because they were payment for the partners' services to the partnership.[21] The court noted that partners do not usually receive a salary, but are compensated through profit-sharing, and these payments were simply money to which the retiring partners were entitled for their services rendered to the partnership. Similarly, in *Proskauer Rose*, the payments at issue were made to partners under an optional service plan upon a partner's retirement.[22] The partnership claimed these payments were not for the partners' services but for goodwill. However, the court found that payments could not be for goodwill because the partnership agreement expressly prohibited goodwill and denied the deduction.

Partnerships have run into a similar problem with pension plan contributions. The First Department concluded in *Murphy & O'Connell* that payments a partnership made to a defined benefit plan on behalf of its partners were not deductible.[23] A sole practitioner attorney in *Horowitz* had a similar issue with deductions that he took for:

- the contributions to a defined benefit pension plan;
- half of his federal self-employment tax; and
- the cost of his self-employed health insurance premiums.[24]

The court again denied the deductions, finding that these amounts were "remuneration for services for petitioner's benefit."

As we hinted earlier, case law suggests that taxpayers may deduct payments to officers of its corporate partners so long as the officers do not have ownership interests in the corporate partner. But if the officers of corporate partners have ownership interests in the corporate partners, these payments may not be deducted. For example, in *Matter of Guttmann Picture Frame Association*, it was held that an unincorporated business could not deduct salaries paid to its employees for services rendered to the business because the employees were officers of the corporate partner and they were either the sole shareholder or 50 percent shareholder of the corporate partners.[25]

Similarly, in *Matter of AGS Specialist Partners*, the New York City Tax Appeals Tribunal held that an unincorporated business could not deduct the wages, bonuses, and fringe benefits paid to its employees who were also the sole officers and sole shareholders of its corporate partners.[26] Here, the corporate

[21] *Buchbinder Tunick & Co. v. New York City Tax Appeals Tribunal*, 100 N.Y.2d 389 (2003).

[22] *Proskauer Rose LLP v. Tax Appeals Tribunal*, 57 A.D.3d 287 (1st Dept. 2008).

[23] *Murphy & O'Connell v. Tax Appeals Tribunal*, 93 A.D.3d 530 (1st Dept. 2012).

[24] *Horowitz v. Tax Appeals Tribunal*, 41 A.D.3d 101 (1st Dept. 2007).

[25] *Matter of Guttmann Picture Frame Association*, FHD-92-467(UBT) (N.Y.C. Department of Finance Bureau of Hearings, Sept. 4, 1992).

[26] *Matter of AGS Specialist Partners*, TAT(E)00-10(UB) (N.Y.C Tax App. Trib., May 21, 2003).

partners did not themselves have any employees or trade or business income, other than their share of income from the taxpayer. The tribunal determined that these payments could not be deducted because the services performed by the corporate officers were the specific duties of the corporate partners as laid out in the operating agreement. Just because the business treated the corporate officers as employees did not change that they were performing the duties of the corporate partners, of which they were also the sole owners. The tribunal found that it was irrelevant whether the payment was made directly to the officer or to the corporate partner for the services of the officer.

In another determination, however, an administrative law judge did allow for the deduction of the salary paid to the contingent beneficiary of a trust that was a member of an unincorporated business.[27] The contingent beneficiary's interest was found to be different from the examples above because it was contingent and not a "vested majority ownership interest in the corporate partners of the unincorporated businesses," and the services that the beneficiary provided were not analogous to those provided by a partner.

Conclusion

The payment-to-partner modification may seem straightforward on its face, but it's actually quite nuanced. What seems to be the key is that the intent of modification is to "preclude an unincorporated business from avoiding UBT by making deductible payments for services to persons who possess an ownership interest in the unincorporated entity."[28] Thus, the economic substance of the payments permeates the analysis in all of the cases; that is, whether the payments end up in the hands of someone who has an ownership interest in either the unincorporated business or its partners.[29] ■

[27] *Matter of Weeks-Lerman Group LLC*, TAT(H)05-54(UB).

[28] *Matter of AGS Specialist Partners*, TAT(H)00-10(UB) (N.Y.C. Tax. App. Trib., Adm. Law Judge Deter., Mar. 5, 2002).

[29] *See Matter of Tocqueville*, TAT(H)10-37(UB).