

## New York City Unincorporated Business Tax deduction disallowance sustained

August 12, 2015

### Overview

The New York City Tax Appeals Tribunal (Tribunal) recently affirmed an Administrative Law Judge's (ALJ) decision in favor of the New York City Department of Finance (Department). In its decision, the Tribunal sustained a New York City Unincorporated Business Tax (UBT) expense disallowance for payments by an investment adviser limited partnership to its general partner for services rendered to the partnership by individuals who were both employees of the general partner and limited partners in the partnership.<sup>1</sup>

This Tax Alert summarizes the Tribunal's decision and provides some taxpayer considerations.

### Background

Tocqueville Assessment Management LP (Tocqueville LP), an investment adviser limited partnership, did not have its own employees. Tocqueville LP's sole general partner, an S corporation for federal income tax purposes, managed the portfolios of Tocqueville LP's clients and provided research and related services. The general partner was required, under financial regulatory rules, to charge Tocqueville LP for the services of the general partner's employees. Compensation expense paid to the general partner's employees was the largest component of the annual management fee charged by the general partner to Tocqueville LP. The management fee was not reported as income by the general partner and the related expenses were not deducted by the general partner on its federal and UBT returns. Instead, Tocqueville LP reported the expenses of its general partner (including the general partner's employee compensation) as if Tocqueville LP had incurred these payroll expenses itself.

As a result of a 2005 ownership restructuring, a number of the general partner's employees became limited partners in Tocqueville LP.<sup>2</sup> In 2005, consistent with prior years, Tocqueville LP deducted compensation paid to the general partner's employees on its 2005 UBT return, including the compensation paid by the general partner to individuals who were both employees of the general partner *and* limited partners in Tocqueville LP (GP employee/Tocqueville limited partners).

Pursuant to N.Y.C. Admin Code § 11-507.3, no deduction is allowed under the UBT for amounts paid or incurred to a partner for services. Upon audit of Tocqueville LP's 2005 UBT return, the Department disallowed expenses claimed by Tocqueville LP for salaries and payments to pension plans made by the general partner on behalf of the GP employee/Tocqueville limited partners.

### Administrative Law Judge decision

Before the ALJ, Tocqueville LP contended that the amounts it paid to the general partner for the services of the GP employee/Tocqueville limited partners were not amounts paid or incurred to a partner for services under N.Y.C. Admin Code § 11-507.3 because the GP employee/Tocqueville limited partners were employed by the general partner and performed the services for the general partner, not Tocqueville LP.<sup>3</sup>

Tocqueville LP also asserted that its payments fell within an exception to the disallowance of the deduction under 19 RCNY § 28-06(d)(1)(ii)(D), referred to herein as the D Exception.<sup>4</sup> The D Exception provides that payments to a

<sup>1</sup> TAT(E) 10-37(UB), NY City Tax Appeals Tribunal (May 29, 2015) which may be accessed [here](#).

<sup>2</sup> In the years before 2005, the tax year at issue, certain employees of the general partner S corporation were granted shares of the S corporation. On January 1, 2005, the general partner underwent a restructuring to reduce the administration of regularly issuing and redeeming shares of the employee-shareholders of the S corporation and instead issued such employees limited partnership interests in Tocqueville LP. The two individuals who controlled the general partner S corporation testified in the ALJ case that the economics of the 2005 structure were intended to be identical to the structure in 2004 and earlier years. The ALJ concluded that the "motives were blameless, but the 2005 restructuring created a situation where the deduction for compensation paid to the corporate employees was lost once they became partners of [Tocqueville LP]." In the Matter of Tocqueville Asset Management L.P., TAT(E) 10-37(UB), NY City Tax Appeals Tribunal, Administrative Law Judge Division, June 17, 2014, p.12.

<sup>3</sup> NY City Tax Appeals Tribunal, Administrative Law Judge Division (Jun. 17, 2014) at 6.

<sup>4</sup> Id. at 6-7. 19 RCNY §28-06(d)(1)(ii)(D) provides: "For purposes of paragraph (1)(i) of this subdivision (d), payments to partners for services do not include amounts paid or incurred by an unincorporated business to a partner of such business which reasonably represent the value of services provided the unincorporated business by the employees of such partner, and which, if not for the provisions of paragraph (1)(i) of this

partner for services are allowed as a deduction to the extent attributable to the services of the partner's employees. Tocqueville LP argued that it satisfied the requirements of the D Exception because the GP employee/Tocqueville limited partners were employees of the general partner (not of Tocqueville LP).

The ALJ rejected Tocqueville LP's arguments, finding that under the statute it was irrelevant that the payments were for services performed in a dual capacity, as employees of the general partner and as limited partners of Tocqueville LP; or that the payments were made to the general partner in the form of a management fee rather than directly to the GP employee/Tocqueville limited partners.

### New York City Tax Appeals Tribunal decision

In affirming the ALJ's decision, the Tax Tribunal initially ruled that Code § 11-507(3) "on its face" denied a deduction for the entire management fee payment made by Tocqueville LP to its general partner because the payment was made to a partner for its services.<sup>5</sup>

The Tribunal then rejected the claim that the D Exception applied under these circumstances, stating that Tocqueville LP's "broad reading of the D Exception" negated the general rule of the statute, and "provisions granting an exemption or deduction are construed in favor of the taxing authority."<sup>6</sup>

The Tribunal also ruled that Tocqueville LP's interpretation ignored 19 RCNY § 28-06(d)(1)(ii)(A), which states that payments to "individual partners" for services are not deductible.<sup>7</sup> The Tribunal noted that this regulation is not limited by the D Exception. Therefore, since the GP employee/Tocqueville limited partners were individual partners in Tocqueville LP, and not merely employees of the general partner, deductions for amounts paid to the general partner for services provided to Tocqueville LP were not permitted.<sup>8</sup>

The Tribunal also observed that Tocqueville LP did not satisfy a technical requirement set forth in the D Exception, namely, that payments "must be actually disbursed by the unincorporated business and included in the partner's gross income for Federal income tax purposes," which the general partner failed to do. Because the management fee payments were not appropriately reported as income by the general partner, and Tocqueville LP reported the general partner's employees, including the GP employee/Tocqueville limited partners, as its own employees on its federal and UBT returns, the D Exception did not apply in this instance.<sup>9</sup>

Finally, the Tribunal rejected as without merit Tocqueville LP's argument that it "relied on prior precedent" for the position that its payment of management fees to its general partner was deductible. Such precedent consisted of a 1986 private letter ruling and a 1994 determination of a New York City Administrative Law Judge. The Tribunal noted that 19 RCNY § 16-05(a) precludes any taxpayer from relying on rulings that are specifically issued to other taxpayers. Furthermore, New York City Charter § 169(e) provides that ALJ determinations are not binding precedent and cannot be cited in other proceedings.<sup>10</sup>

### Considerations

The Tribunal in this decision, as well as other courts, have broadly interpreted the UBT statute and regulations requiring expense disallowance for payments to partners for services.<sup>11</sup> Accordingly, taxpayers should discuss this decision with their tax advisers. As part of those discussions, taxpayers may wish to consider the potential effect this Tribunal decision and certain events or transactions (such as restructurings) may have on their tax position

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subdivision (d), would constitute allowable business deductions under Sec. 28-06(a). The amounts paid or incurred for such employee services must be actually disbursed by the unincorporated business and included in that partner's gross income for Federal income tax purposes."

<sup>5</sup> TAT(E) 10-37(UB), NY City Tax Appeals Tribunal (May 29, 2015) at 8.

<sup>6</sup> *Id.* at 9.

<sup>7</sup> *Id.* at 10. 19 RCNY §28-06(d)(1)(ii)(A) provides: "Amounts paid or incurred to an individual partner of the unincorporated business for services provided to the unincorporated business by such an individual shall not be allowed as a deduction under paragraph (1)(i) above. The fact that the individual is providing such services not in his capacity as a partner within provisions of §707 of the Federal Internal Revenue Code will not change the result."

<sup>8</sup> TAT(E) 10-37(UB) at 12. The Tribunal found this case to be "identical" to its earlier case, *Matter of Miller Tabak Hirsch & Co.*, TAT(E)94-173(UB) (NY City Tax Appeals Tribunal, Mar. 30, 1999), which held that amounts paid to employees who were also partners in the taxpayer were not deductible, regardless of the capacity in which the payments were received. The Tribunal did not find meaningful the distinction that in *Miller Tabak* the partners were also employees of the partnership whereas in the instant case the partners were employees of the general partner. The Tribunal noted that *Miller Tabak* stands for the principle that payments to a partner for services "in whatever capacity" are not deductible.

<sup>9</sup> TAT(E) 10-37(UB) at 13.

<sup>10</sup> *Id.* at 18.

<sup>11</sup> *Matter of AGS Specialist Partners* (TAT(E) 00-10 (UB), NYC Tax Appeals Tribunal, May 21, 2003; *Matter of Horowitz* (TAT (E) 99-3 (UB) NYC Tax Appeals Tribunal, Sept. 1, 2005, *aff'd*, 41 AD3d 101 (1st Dept 2001), *lv denied*, 10 NY3d 710 (2008).

regarding the deductibility—for UBT purposes—of expenses for payments to partners that may otherwise be deductible for federal income tax purposes.

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