

New York City Tax Appeals Tribunal

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: In the Matter of :
: : DECISION
: TOCQUEVILLE ASSET MANAGEMENT L.P. :
: : TAT (E) 10-37 (UB)
: :
: Petitioner. :
: :
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Tocqueville Asset Management L.P. ("Petitioner") filed an exception to a Determination of an Administrative Law Judge ("ALJ") dated June 17, 2014 (the "ALJ Determination") which sustained a Notice of Determination (the "Notice") issued by the New York City Department of Finance (the "Department") asserting an unincorporated business tax ("UBT") deficiency for the calendar year 2005 (the "Tax Year").

Petitioner appeared by Mark J. Hyland, Esq., Peter E. Pront, Esq., and Mandy DeRoche, Esq., of Seward & Kissel, LLP. The Commissioner of Finance of the City of New York ("Respondent") appeared by Amy H. Basset, Esq., Assistant Corporation Counsel, Frances J. Henn, Esq., and Andrew G. Lipkin, Esq., both Senior Counsel, of the New York City Law Department.

Petitioner, a Delaware limited partnership, is an investment advisor registered with the Securities and Exchange Commission ("SEC").¹

Petitioner had no employees. All of its activities were performed by Tocqueville Management Corporation its sole general partner (the "General Partner"), a Delaware corporation which elected S corporation status for federal income tax purposes. The General Partner's employees managed the portfolios of Petitioner's clients and provided them with research and related services.

The General Partner was controlled by Robert Kleinschmidt, its president and CEO, and Francois Sicart, its chairman. During the Tax Year Kleinschmidt and Sicart were each 50% shareholders in the General Partner.

The General Partner also served as a general partner of Tocqueville Securities L.P. ("TSLP"), a securities broker-dealer registered with the SEC. All of TSLP's activities were managed and performed by the General Partner's employees.

The General Partner charged Petitioner an annual management fee ("Management Fee") for the services it provided to Petitioner. The amount of the Management Fee was based on

¹ The ALJ's Findings of Fact, although paraphrased and amplified herein, generally are adopted for purposes of this Decision. Certain Findings of Fact not necessary to this Decision have not been restated and can be found in the ALJ Determination.

the expenses the General Partner incurred to provide management services. The largest component of those expenses, representing approximately two-thirds of the total for the Tax Year, was the compensation the General Partner paid to its employees for the services rendered to Petitioner and TSLP. The Management Fee was allocated between Petitioner and TSLP based on their relative gross revenues. Under rules issued by the SEC and the Financial Industry Regulatory Authority ("FINRA"), the General Partner was required to charge Petitioner and TSLP for the services of its employees.

The General Partner did not report the Management Fee as income for the Tax Year on its federal and UBT tax returns. Nor did it deduct the related expenses, including the compensation paid to its employees. Instead, Petitioner reported each of the General Partner's operating expense items comprising the Management Fee, including the compensation the General Partner paid to its employees who performed services for Petitioner, as deductions on the corresponding lines of Petitioner's federal partnership income tax return (IRS Form 1065) and UBT return (Form NYC-204). As a result, all of the expenses the General Partner incurred to operate Petitioner were reported by Petitioner as if Petitioner had incurred them.

Although Petitioner had no employees of its own, on its tax returns Petitioner deducted as salary and wages the portion of the Management Fee it paid for the services of the

General Partner's employees. The General Partner, however, issued forms W-2 and filed employment tax returns to report the compensation paid to its employees.

Before the Tax Year, some of the 77 employees of the General Partner who performed services for Petitioner were also shareholders in the General Partner. On January 1, 2005, the beginning of the Tax Year, the General Partner underwent a restructuring (the "Restructuring") in which the employee-shareholders redeemed their shares in the General Partner and were given limited partnership interests in Petitioner. On that same date, additional employees of the General Partner were given limited partnership interests in Petitioner. As a result, following the Restructuring, 29 of the General Partner's employees became limited partners in Petitioner (the "Employee-Partners").

Kleinschmidt and James Kiriakos, a certified public accountant with the firm of Pegg and Pegg LLP, testified that prior to the Restructuring it had been the General Partner's practice to increase or decrease each employee-shareholder's ownership interest in the General Partner so as to reflect his or her services and value to the General Partner. Kleinschmidt and Kiriakos both testified that it was cumbersome for the General Partner to make these adjustments because it required new shares to be regularly issued or redeemed for each employee-shareholder. As limited partners in Petitioner, the adjustments to the Employee-Partners' ownership interests

could be made more easily by amending the schedule of partner interests attached to Petitioner's limited partnership agreement.

Kleinschmidt testified that, after the Restructuring, the Employee-Partners "would continue to benefit from the profitability of the enterprise and they would continue to feel aligned with the interests of our clients and the overall firm." (Tr. 77) There is no claim that the Employee-Partners were not partners in Petitioner.

On Petitioner's UBT return Form NYC-204 for the Tax Year, Petitioner deducted compensation paid to the General Partner's employees, including the Employee-Partners. Petitioner, however, did not deduct compensation paid to Kleinschmidt and Sicart because both were officers of the General Partner.²

The Department conducted an audit of Petitioner's UBT return for the Tax Year and disallowed Petitioner's deductions for salaries of \$10,778,701 paid to the Employee-Partners and for \$274,753 paid to the Employee-Partners' pension plans, for a total disallowance of \$11,053,454.

The Department issued the Notice, dated December 29, 2009, asserting a UBT deficiency against Petitioner in the principal amount of \$435,938.12, plus interest, computed to

² 19 RCNY §28-06(d)(1)(ii)(B) ("UBT Rules") denies a deduction for payments to a corporate partner's officers for their services.

February 5, 2010, of \$169,368.03, for a total deficiency of \$605,306.15.

The ALJ sustained the Notice concluding that Petitioner's payments to the Employee-Partners for their services were not deductible pursuant to §11-507(3) of the New York City Administrative Code (the "Code") and UBT Rules. The ALJ concluded 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 partners of Petitioner, or that the payments were made to the General Partner rather than to the Employee-Partners.

Petitioner contends that the amounts it paid to the General Partner for the services of the Employee-Partners were not "amounts paid or incurred to a ... partner for services" under Code §11-507(3) because the Employee-Partners were employed by the General Partner and performed the services for their employer, not Petitioner.

Petitioner further contends that its payments fall within an exception to disallowance of the deduction under the UBT Rules, 19 RCNY §28-06(d)(1)(ii)(D) (the "D Exception"). The D Exception provides that payments to a partner for services are allowed as a deduction to the extent attributable to the services of the partner's employees. Petitioner argues that it satisfies the requirements of the D Exception because the Employee-Partners are employees of the General Partner.

Petitioner asserts that it is irrelevant to the operation of the D Exception that the Employee-Partners are also partners in Petitioner.

Respondent counters that, as a matter of substance, the payments in question were made to the General Partner for the services of the Employee-Partners and, therefore, are not deductible under Code §11-507(3). Respondent argues that its position is supported by the UBT Rules and established case law. Respondent also argues that the D Exception does not apply to the amounts deducted as compensation paid to the Employee-Partners because they are partners in Petitioner. For the following reasons we affirm the ALJ Determination.

The UBT is imposed “on the unincorporated business taxable income of every unincorporated business wholly or partly carried on within the [C]ity.” Code §11-503(a). An “unincorporated business” includes a partnership. Code §11-502(a). The unincorporated business taxable income of an unincorporated business is defined in Code §11-505 as the excess of its unincorporated business gross income over its unincorporated business deductions. Code §11-507 defines the “unincorporated business deductions” as “the items of loss and deductions directly connected with or incurred in the conduct of the business, which are allowable for federal income tax purposes for the taxable year” subject to certain modifications.

The sole issue before us is the applicability of one of those modifications, Code §11-507(3), which provides that: “[n]o deduction shall be allowed ... for amounts paid or incurred to a proprietor or partner for services or for use of capital.”

The requirements of Code §11-507(3) appear to be satisfied here. Petitioner has paid a management fee to the General Partner for its services. Because the payment is to a partner for services, Code §11-507(3), on its face, denies a deduction for the entire amount of the payment.

The D Exception in the UBT Rules carves out an exception to the denial of the deduction where the partner’s services are performed by employees of the partner. The D Exception 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 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.”
(Emphasis added.)

Petitioner reads the D Exception broadly to include compensation paid to any employee of the General Partner, regardless of whether the employee is also a partner in Petitioner. Thus, Petitioner contends that under the D Exception, Petitioner can deduct the portion of its payment to the General Partner representing compensation for the services of the Employee-Partners.

Petitioner's reading of the D Exception produces a result directly at odds with the plain language of Code §11-507(3), which denies a deduction “for amounts paid or incurred to a ... partner for services.” Petitioner's broad reading of the D Exception causes the specific exception to negate the general rule under the statute and is incompatible with a clear statutory policy to deny a deduction for payments to a partner for services.

Provisions granting an exemption or deduction are construed in favor of the taxing authority, and the extent to which a deduction is allowed is a matter of legislative grace to which the taxpayer must prove entitlement. *Matter of Mobil Oil Corp. v Finance Adm'r of the City of N.Y.*, 58 NY2d 95, 99 (1983); *Matter of Citrin Cooperman & Co., LLP v Tax Appeals Trib. of City of N.Y.*, 52 AD3d 228 (1st Dept 2008).

Petitioner's interpretation also ignores UBT Rule 19 RCNY §28-06(d)(1)(ii)(A), which provides:

"Amounts paid or incurred to an individual partner of the unincorporated business for services provided 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."

Under UBT Rule 19 RCNY §28-06(d)(1)(ii)(A), Petitioner's payments to an "individual partner" for services are not deductible. The Employee-Partners were not merely employees of the General Partner but were also individual partners in Petitioner.

Petitioner argues that the D Exception, which allows a UBT deduction for the "services provided the unincorporated business by the employees of such partner," is clear on its face; and contains no language limiting its application where the employee is also a partner. Petitioner argues that its payments for the services of the Employee-Partners as employees of the General Partner must therefore be deductible absent language in the D Exception making it inapplicable where the employee is also a partner. However, Petitioner's argument ignores the fact that such limiting language already is included in 19 RCNY §28-06(d)(1)(ii)(A) quoted above. The D Exception, subparagraph (ii)(D), is not an exception to

subparagraphs (ii) (A), (B), or (C), only to subparagraph (i) (A).

Petitioner's interpretation requires that we read the D Exception and 19 RCNY §28-06(d)(1)(ii)(A) in isolation from one another and is contrary to the well-established principle that "[a]ll provisions of a statute must be read and construed together ..." *Astoria Fin. Corp. v Tax Appeals Trib. of State of N.Y.*, 63 AD3d 1316, 1319 (3d Dept 2009); *citing* McKinney's Cons. Law of NY, Book 1, Statutes §97. This rule of construction applies with equal force to administrative regulations. *East Acupuncture, P.C. v Allstate Ins. Co.*, 61 AD3d 202, 210 (2d Dept 2009), *citing*, *People v Mobil Oil Corp.*, 48 NY2d 192, 199 (1979).

Reading UBT Rule 19 RCNY §28-06(d)(1)(ii)(A) together with the D Exception makes it clear that Petitioner's payment to the General Partner for the services of the Employee-Partners is not deductible. As the statute evinces a clear policy to deny any deduction for payments to a partner for services, "[t]he regulation is in harmony with the statute." *Matter of Blue Spruce Farms, Inc. v New York State Tax Commission*, 99 AD2d 867, 868 (3d Dept 1984), *aff'd*, 64 NY2d 682 (1984). Similarly, Petitioner's overly broad interpretation of the D Exception, to allow a deduction for the services of a partner's employees who are also partners, must be rejected as contrary to the statute. "Regulations ... should be construed to avoid objectionable results". *East*

Acupuncture, supra, at 208, citing *Matter of ATM One v Landaverde*, 2 NY3d 472, 477 (2004).

We also reject Petitioner's related argument that the portion of the Management Fee representing compensation to the Employee-Partners is deductible because it was paid for services of the Employee-Partners in their capacity as employees, not partners. See *Matter of Miller Tabak Hirsch & Co.*, TAT(E)94-173(UB) [NYC Tax Appeals Tribunal, March 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.³ The ALJ was correct to conclude that this case is identical to *Miller Tabak* in all relevant respects, with the only distinction being that, in *Miller Tabak*, the partners were also employees of the taxpayer whereas, here the partners were employees of the General Partner. We do not see that distinction as meaningful. *Miller Tabak* held that payments to a partner for services "in whatever capacity" are not deductible.

We also share the ALJ's view that Petitioner does not satisfy the technical requirements of the D Exception. One such requirement is that the payment "must be actually disbursed by the unincorporated business and included in the partner's gross income for Federal income tax purposes." The General Partner did not report the Management Fee as income on

³ This principle is also codified in the UBT Rules at 19 RCNY §28-06(d)(1)(ii)(A), (B) and (C).

its federal and UBT tax returns. If the payment is not reported as income, it is rational for the UBT Rules to deny the deduction.⁴

Furthermore, because Petitioner reports the General Partner's employees, including the Employee-Partners, as its own employees on its federal and UBT tax returns, the D Exception does not apply. It applies only to payments for the services of a partner's employees, not employees of the unincorporated business. The form in which Petitioner reported its income and expenses removes it from the scope of the D Exception.⁵

Petitioner contends that it did not satisfy the basic requirements for disallowance under Code §11-507(3), interpreting that section as requiring a payment directly to a partner for services performed directly by that partner to

⁴ Petitioner argues that we should read the word "included" in the D Exception as "includable." Petitioner relies on an interpretation of Internal Revenue Code Section 83(h), under which an employer who transfers property to an employee in connection with that employee's services is entitled to a deduction, regardless of whether the employee includes the transferred property in income. In such a case, the employer's deduction should not depend on whether the employee reports the income, over which the employer has no control. The policy behind that interpretation has no relevance to the deductibility of a management fee paid by a partnership to its general partner, which excludes the fee from its income. As both entities are under common control, allowing one a deduction without a corresponding income inclusion by the other could whipsaw the government. Petitioner, therefore, has failed to show that the term "included," as it appears in Internal Revenue Code Section 83(h), is "used in a comparable context," see Code §11-501(a), so as to be relevant to the meaning of "included" in the D Exception. We, therefore, reject Petitioner's contention.

⁵ It is notable that by reporting the Employee-Partners as its own employees, Petitioner has brought itself directly within the scope of *Miller Tabak* discussed above.

the unincorporated entity. Petitioner argues that it did not pay the Employee-Partners for their services. Instead, Petitioner paid a Management Fee to the General Partner and the General Partner, in turn, compensated its employees for the work performed for the General Partner. Therefore, Petitioner argues the payments were not "amounts paid ... to a proprietor or partner". This argument ignores the fact that Petitioner paid the Management Fee directly to the General Partner who performed the services directly for Petitioner, thus satisfying even Petitioner's narrow reading of the statute.

In advancing this argument, Petitioner is taking the position that payments to the General Partner for the services of the Employee-Partners are payments to a third party and not within the scope of Code §11-507(3), which Petitioner reads as applying only to amounts paid directly to a proprietor or partner. Petitioner argues that Respondent has no authority to elevate "substance over form" to disallow third-party payments for partner services.

Petitioner asserts that the ALJ improperly relied on UBT Rule 19 RCNY §28-06(d)(1)(i)(B), which provides:

"In addition to all other amounts otherwise included, amounts paid or incurred to a proprietor or partner for services or for use of capital shall include any amount paid to any person if, and to the extent that, the payment was consideration for

services or capital provided by a proprietor or partner.” (Emphasis added.)

Under UBT Rule 19 RCNY §28-06(d)(1)(i)(B), Petitioner’s payments “to any person,” i.e., a third party, for the services of the Employee-Partners are treated as payments to a partner for services (the “Third-Party Payment Rule”) and disallowed under Code §11-507(3). Petitioner argues that UBT Rule 19 RCNY §28-06(d)(1)(i)(B) was added two years after the Tax Year and, therefore, Petitioner had no notice of it. UBT Rule 19 RCNY §28-06(d)(1)(i)(B) was added on January 24, 2007 and became effective on February 23, 2007. It was made applicable to all open years and thus applies to 2005, the Tax Year. The rule’s Statement of Basis and Purpose states that it “make[s] clear that when taxpayers make payments to other parties, those payments may be considered to have been made to a partner if the payment was consideration for services or capital of the partner.”

Contrary to Petitioner’s assertion, the Third-Party Payment Rule was well-established in judicial precedent prior to the Tax Year. We note that it is not necessary in this case to resort to the Third-Party Payment Rule to disallow Petitioner’s payments for the services of the Employee-Partners because the Management Fee is squarely within Code §11-507(3) and subject to disallowance without resort to the Third Party Payment Rule. Nevertheless, in the interest of

completeness, we will address Petitioner's contention that the Third Party Payment Rule does not apply here.

In *Guttman Picture Frame Assoc. v O'Cleireacain*, 209 AD2d 340 [1st Dept 1994], the taxpayer, a partnership, challenged the retroactive application of a provision of UBT Rules 19 RCNY §28-06, disallowing amounts paid to the officers of a corporate partner for their services. The taxpayer argued that payments to the partner's officers were not payments to the partner and, therefore, were outside the scope of Code §11-507(3).

Guttman held that the taxing authority was not bound by the form of the payments, and could look to the economic substance of the arrangement to determine its tax consequences:

"Tax legislation should be implemented in a manner that gives effect to the economic substance of the transactions [citation omitted] and the taxing authority may not be required to acquiesce in the taxpayer's election of a form for doing business but rather may look to the reality of the tax event and sustain or disregard the effect of the fiction in order to best serve the purposes of the tax statute" [citation omitted].

Matter of AGS Specialist Partners (TAT(E) 00-10 (UB) [NYC Tax Appeals Tribunal, May 21, 2003]), like *Guttman*, involved the deductibility of payments to officers of a corporate

general partner for their services. The Tribunal considered the substance of the payments, finding that the services performed by the corporate officers were the responsibility of the corporate general partner. Notably, and relevant to this case, the Tribunal held that:

"We do not consider it material for purposes of our analysis whether the payments are made to the corporation or the corporate officers or whether the corporate officers are treated as employees of the unincorporated business." (Emphasis added.)

Under the holding in *AGS Specialist Partners*, for purposes of Code §11-507(3) it is irrelevant whether the payments are made directly to a partner or to a third-party who performs the services in discharge of the partner's duties. Applying *AGS Specialist Partners* to the present case, the payments are not deductible, regardless of whether they are made directly to the Employee-Partners or to the General Partner for their services.

In *Matter of Horowitz* (TAT (E) 99-3 (UB) [September 1, 2005], *aff'd*, 41 AD3d 101 [1st Dept 2007], *lv denied*, 10 NY3d 710 [2008]), the Tribunal held that payments by a sole proprietorship to third parties for the sole proprietor's hospital insurance and retirement plan were made for the benefit of the sole proprietor and were remuneration for his services. The third-party payments were, therefore, not deductible:

"The Payments at issue while made to third parties were made by the unincorporated business for the benefit of the proprietor and were remuneration for services rendered by the proprietor to his unincorporated business. Hence, the economic substance of these transactions requires the disallowance of the deductions."

It is evident that UBT Rule 19 RCNY §28-06(d)(1)(i)(B) was supported by existing case law and the retroactive application of UBT Rule 19 RCNY §28-06(d)(1)(i)(B) is proper. *Matter of Varrington Corporation v City of New York Department of Finance*, 85 NY2d 28 (1995).

Petitioner further asserts that it "relied on prior precedent." Petitioner's claim that it "relied on prior precedent" is without merit. The "prior precedent" cited by Petitioner consists of a private letter ruling from 1986 and a 1994 determination of an administrative law judge of this Tribunal. 19 RCNY §16-05(a) precludes any taxpayer from relying on a ruling issued to another taxpayer and New York City Charter §169(e) provides that administrative law judge determinations are not binding precedent and cannot be cited as precedent in other proceedings. Both the ruling and the determination, moreover, are distinguishable from the present case. The ruling involved payments to a corporation that was not a partner in the unincorporated business. The question decided in the determination was whether a professional corporation should be disregarded as a sham, an issue not before us. Petitioner was bound by the precedential

decisions, in effect prior to the Tax Year, which upheld the Third-Party Payment Rule.

Moreover, contrary to Petitioner's assertion that the Third Party Payment Rule is limited to situations involving assignment of income,⁶ the case law makes it clear that the Third Party Payment Rule as codified in UBT Rule §28-06(d)(1)(i)(B) applies to any payment to a third party for services rendered by a partner.

Accordingly, the ALJ Determination is affirmed and the Notice is sustained in full.⁷

Dated: May 29, 2015
New York, New York

GLENN NEWMAN
Commissioner and President

ELLEN E. HOFFMAN
Commissioner

ROBERT J. FIRESTONE
Commissioner

⁶ Petitioner's Br. at 26.

⁷ We have considered all other arguments raised by the parties and deem them unpersuasive.