NEW YORK CITY TAX APPEALS TRIBUNAL
ADMINISTRATIVE LAW JUDGE DIVISION

In the Matter of the Petition	:	**DETERMINATION**
of	:	**TAT(H)17-21(UB)**
Skidmore, Owings & Merrill, LLP	:	

Bunning, A.L.J.:

The Petitioner filed a petition for redetermination of a deficiency (Petition) of New York City (City) Unincorporated Business Tax (UBT) for its fiscal years ended September 30, 2011 and 2012 (Tax Years), under Title 11, Chapter 5, of the City Administrative Code (Admin. Code) asserted in a Notice of Determination issued by Respondent City Commissioner of Finance on December 21, 2015 (Notice).

On or about November 12, 2019, the parties, having agreed pursuant to §1-09(f) of the City Tax Appeals Tribunal (Tribunal) Rules of Practice and Procedure (20 RCNY) to have this case determined on submission without a hearing, submitted a stipulation of facts, including exhibits (Stipulation). Petitioner and Respondent filed briefs, the last of which was filed on September 11, 2020. Oral argument was held on January 14, 2021. On February 16, 2021, Petitioner submitted the documents requested at oral argument. After being granted leave, the parties made additional submissions on the applicability of *Matter of Ark Restaurants Corp.*, TAT(E)16-18 (GC) (City Tax App. Trib., Appeals Division, 2019), the last of which was Respondent's submission on March 19, 2021.

Petitioner appeared by Sidley Austin, LLP (Richard A. Leavy, Esq., of counsel). Respondent appeared by the City Corporation Counsel (Andrew G. Lipkin, Esq., of counsel).

ISSUE

Whether the deduction under Admin. Code section 11-507(3) for payments to partners may be allowed to Petitioner for deemed commission payments made to a federally-recognized domestic international sales corporation (DISC) with no employees and whose shareholders are all partners in Petitioner.

FINDINGS OF FACT

The parties stipulated to the following facts. Petitioner is an architectural, urban planning, and engineering firm originally formed in 1936. During the Tax Years, it was a New York limited liability partnership organized by a filing with the New York State Department of State on March 28, 1996.

Skidmore, Owings, & Merrill DISC, Inc. ("S-DISC") was formed as a Delaware corporation by filing a certificate of incorporation on June 28, 2004. On or about September 8, 2004, S-DISC filed an "Election by a Small Business Corporation (Form 2553) and an "Election to be Treated as an Interest Charge DISC" (Form 4876-A), with the Internal Revenue Service. S-DISC was granted authority to do business as a commissioned sales agent by the Illinois Secretary of State on September 22, 2004.

During the Tax Years, Petitioner had 22 partners, of whom 14 were active equity partners and the remaining 8 were retired partners receiving retirement payments from Petitioner.

During the 2011 and 2012 calendar years, these 14 active equity partners of Petitioner were also the only shareholders of S-DISC. S-DISC had no employees. It did not file City tax returns.

Petitioner and S-DISC entered into a commission agreement dated June 28, 2004 (Commission Agreement). The Commission Agreement was the sole document governing the relationship between Petitioner and S-DISC.

Pursuant to the Commission Agreement, Petitioner made payments to S-DISC in the form of commissions, for agency services which S-DISC was deemed to perform for federal income tax purposes. During the fiscal year ended September 30, 2011, Petitioner paid commissions to S-DISC of $23,749,999, of which $7,616,625 was apportioned to the City. During the fiscal year ended September 30, 2012, Petitioner paid S-DISC commissions of $26,000,000, of which $9,731,800 was apportioned to the City. The only payments made by Petitioner to S-DISC were these commission payments, and these payments were S-DISC's only income.

There is no dispute here that S-DISC, the Commission Agreement, and the commissions follow the applicable provisions of federal income tax law.

Following an audit, Respondent issued the Notice, dated December 21, 2015, proposing a deficiency for the Tax Years of $719,611.25 in UBT, $221,328.05 in interest, and $251,863.93 in penalty, for a total of $1,192,803.23.[1] The Explanation of Adjustments, attached to the Notice, states, "Per NYC Administrative Code §11-507(3) No deduction shall be allowed (except as provided in section 11-509 of this chapter) for amounts paid or incurred to a proprietor or partner for services or for use of capital. *Per the above code, commission expense paid to related entity and payments made to retired partners are disallowed under NYC UBT.*" (Italics in original.)

Petitioner timely requested a conciliation conference. Respondent's Conciliation Bureau issued a Partial Proposed Resolution dated June 9, 2017, with which Petitioner disagreed. A Partial Conciliation Decision was issued on August 10, 2017, abating the penalty.

On November 6, 2017, Petitioner filed a timely petition to contest the Partial Conciliation Decision; Respondent filed a timely answer.

POSITIONS OF THE PARTIES

Petitioner argues that commissions do not trigger the UBT bar on payments to partners because the S-DISC, which received the payments, is not a partner in Petitioner.

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[1] The Notice denied two deductions. Petitioner contests only one of these, for commissions paid to S-DISC. Petitioner does not contest the second challenged deduction, for payments to retired partners.

Respondent counters that S-DISC is nothing more than a mechanism to defer taxes that Petitioner's partners would otherwise have to pay. Petitioner may not deduct payments to a corporation that lacks economic substance, has no employees, and which is owned by Petitioner's active partners.

Petitioner responds that Respondent has provided no reason for looking beyond the plain meaning of the statute. It reiterates that the payments were made to S-DISC, which is not a partner, and that no payments were made on a partner's behalf. Petitioner submits that no further inquiry is required, and therefore that the Notice should be cancelled.

Respondent replies that S-DISC lacks economic substance and therefore the payments may not be deducted because they are payments to partners for services.

CONCLUSIONS OF LAW

1. Overview of the UBT

The UBT is imposed "on the unincorporated business taxable income of every unincorporated business wholly or partly carried on within the [C]ity." Admin. Code §11-503(a). An unincorporated business includes a partnership. Admin. Code §11-502(a).

The taxable income of an unincorporated business is the excess of unincorporated business gross income over its unincorporated business deductions. Admin. Code §11-505. Admin. Code

§11-507 defines "unincorporated business deductions" as "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 modification at issue here is Admin. Code §11-507(3), which provides that "No deduction shall be allowed (except as provided in §11-509 of this chapter) for amounts paid or incurred to a proprietor or partner for services or for use of capital." Admin. Code §11-509(a) provides that the deduction allowed for compensation paid to an active partner is limited to $10,000 per partner with an aggregate limit of 20% of the partnership's unincorporated business taxable income, exclusive of the deductions allowed under this subdivision or exemptions allowed under Admin. Code §11-510.

2. Federal DISC Provisions

The federal income tax provisions regarding domestic international sales corporations (DISCs) are not determinative here, but a brief overview may be helpful. Internal Revenue Code (IRC) §992 defines a federal DISC as a corporation which satisfies certain requirements, including that 95% or more of its gross receipts consist of "qualified export receipts." The net effect of the DISC "is to transfer export revenue to the export company's shareholders as a dividend without taxing it first as corporate income." *Benenson v Comm'r*, 887 F3d 511, 514 (2nd Cir. 2018), *citing Summa Holdings, Inc. v Comm'r*, 848 F2d 779 (6th Cir. 2017).

As stated in *Summa Holdings*,

> "Congress designed DISCs to enable exporters to defer corporate income tax. The Code authorizes companies to create DISCs as shell corporations that can receive commissions and pay dividends that have no economic substance at all [citations omitted]. By congressional design, DISCS are all form and no substance . . . ."

848 F2d at 786.

The parties agree that the DISC is a federally authorized fiction, in which payments are made for deemed services which are not actually performed.

3. Payments to Partners

This case is complicated by the fact that there were no direct payments to partners. There were payments to S-DISC for deemed services; the only shareholders of S-DISC are Petitioner's active partners. There is a deduction at the federal level and the question is whether that deduction is subject to being added back for UBT purposes by Admin. Code §§11-507(3) and 11-509.

Some of the applicable City UBT rules may provide assistance. City UBT Rules (19 RCNY) §§28-06(d)(ii)(A), (B), and (C) state, respectively, that a deduction is not permitted for amounts paid or incurred for services rendered by (1) a partner in the unincorporated business, (2) an officer of a

corporate partner in the unincorporated business (regardless of whether that officer is also an employee of the corporate partner), or (3) a partner in a partnership that is a partner in the unincorporated business. However, a deduction is permitted for a payment for the services rendered by an employee of a partner. 19 RCNY §28-06(d)(1)(ii)(D)(D Exception).

Both parties rely on *Matter of Tocqueville Asset Management LP*, TAT(E)10-37 (UB) (City Tax App. Trib., Appeals Division, 2015). In that case a general corporate partner provided services to the petitioner partnership. In the year at issue, that corporate general partner underwent a restructuring in which the shareholders redeemed their interests in the general corporate partner and were given partnership interests in the petitioner. On audit, the petitioner's deduction for compensation paid to these employee-partners was disallowed. The Tribunal confirmed the disallowance because the payments were to a corporate partner and the D exception did not apply because although the individuals were employees of the corporate partner, they were also partners in the petitioner.

In so holding, the Tribunal relied on its decision in *Matter of Miller Tabak Hirsch & Co.*, TAT(E)94-173(UB)(City Tax App. Trib., Appeals Division, 1999), which held that payments made to employees who were also partners in the taxpayer were not deductible, holding that payments to a partner for services "in whatever capacity" are not deductible.

The parties dispute the relevance of *Tocqueville* because there the corporation was a partner in the taxpayer, but here it

is not. However, the decision has broader relevance than its particular facts. Regardless of the status of the corporation, the payments were to partners and were therefore not deductible.

Tocqueville cites *Guttman Picture Frame Assoc. v O'Cleireacain*, 209 AD2d 340 (1st Dept 1994), which stated in part,

> "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 [citations omitted]."

Guttman has provided the basis for denying a UBT deduction for a sole proprietor's deduction for 50% of Social Security taxes, health insurance and a defined benefit plan (*Matter of Horowitz*, TAT[E]99-3[UB], [Tax App. Trib., Appeals Division, 2005]). Cases have denied UBT deductions for payments to a retirement plan (*Matter of Proskauer Rose LLP*, TAT[E]01-19[UB], [Tax App. Trib., Appeals Division, 2007]), and a pension plan (*Matter of Murphy & O'Connell*, TAT[E]06-18[UB], [Tax App. Trib., Appeals Division, 2011]).

Bearing in mind the advice to look at the economic substance of the transaction, one way to view this case is through the federal fiction of services rendered by S-DISC, which has no employees. Therefore, the only way S-DISC's services could be rendered is through its shareholders, all of

whom are active partners in petitioner. No facts were submitted to indicate that anyone else within S-DISC could provide these services. Under this analysis, the payments are to partners, and therefore the deduction for these payments must be denied.

An alternative way to view the case is to disregard the legal fiction and acknowledge that this is a federal income tax benefit conferred by a deduction which provides a tax benefit to partners by reducing their federal taxable income. It is no different than the deductions at issue in *Horowitz*, *Proskauer Rose LLP*, and *Murphy & O'Connell*, where federal income tax provisions permitted partners to reduce federal taxable income by deducting such items as 50% of their self-employment tax and contributions to retirement plans. The decisions in those cases require the denial of the deduction here.

Petitioner offers several arguments to counter this result. First, it posits that in cases where the corporate general partner is subject to City general corporation tax (GCT), there will be double taxation: a deduction of a 4% tax will be denied and an 8.85% GCT will be due. The argument is that parties will not try to save a 4% tax by incurring one that is more than twice as much. That, however, may be the result, as it was in *Tocqueville*. The corporate tax will be due in any event (assuming that the corporation is subject to City tax, which it is not in this case), and if this were the basis to allow the deduction for City UBT purposes, the UBT deduction would always be allowed, which is not the case.

Petitioner relies on *In re Arthur Zaks T/A South Brooklyn Medical Associates*, TAT(H)93-130(UB)(City Tax App. Trib., ALJ Division, 1994) and Finance Letter Ruling No. 28-UB-4/86 (April 7, 1986). Neither of these is precedential.[2]

As noted by the Tribunal in *Tocqueville*, "the question decided in the [*Arthur Zaks*] determination was whether a professional corporation should be disregarded as a sham, an issue not before us." This issue is also not present here.

The Finance Letter Ruling (FLR) considered a corporation owned by two shareholders, who were both 15% partners in a limited partnership, to which the corporation was to provide management services. The corporation also provided management services to other entities in which the two shareholders were partners, and it was found that it carried on a bona fide business. The FLR concluded:

> "Thus under the facts of the situation you present the payments made to the corporation appear to be for services provided by the corporation. This does not appear to be a situation where the payment for the services of the partner is merely being directed to a non-partner corporation. Accordingly, payments made to the corporation are not considered payments made to a partner for services. If these payments are otherwise allowable business deductions under S46-6.0 [now section 11-507] of the Administrative Code, they may be deducted by the partnership in the situation you have described."

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[2] City Charter §168(d) provides that determinations of administrative law judges are not binding precedent and may not be cited in other proceedings. 19 RCNY §16-05(a) provides that Respondent's rulings are binding on Respondent only with respect to the person to whom the ruling is issued.

The key fact which supported the result in the FLR is not present here. Unlike the facts considered in the FLR, here Petitioner's payments are being directed to a non-partner corporation, in which all the active partners are shareholders. Accordingly, the ruling, besides being non-binding, is easily distinguishable.

The parties discussed the City Tribunal's decision in *Matter of Ark Restaurants Corp.*, TAT (E) 16-18 (GC) (City Tax App. Trib., 2019). This case considered the City general corporation tax (GCT) consequences of an election at the federal level to take the "excess FICA" provision[3] as a credit rather than a deduction. Federal income tax law permitted it to be taken as a credit or deduction, but if it were taken as a credit, no federal deduction is allowed, so taking the credit did not reduce federal taxable income, as taking a deduction would.

The taxpayer claimed the benefit as tax credits on its federal income tax return, and then, because there was no corresponding City credit, sought to deduct the amount of the tax benefit from GCT taxable income. The Tribunal did not permit this, holding that federal taxable income is the starting point for GCT, and that there is no City modification that would permit a City deduction where the federal deduction was not allowed because the taxpayer had taken a credit.

[3] Under IRC §45B, an eligible employer may claim a credit against federal income tax for FICA (Social Security) taxes paid with respect to certain tip income of its employees to the extent it exceeds the amount that would have been paid had the employee received minimum wage.

Petitioner uses this case to argue that "[i]n the absence of any such express modification, federal conformity requires that Petitioner be allowed the UBT deduction claimed in respect of the Commissions paid to S-DISC." (Petitioner's Surreply at p. 6.) Respondent bases an argument on *Ark Restaurants Corp.*, that the deduction must be disallowed because the payments were to partners.

Ark Restaurants Corp. is not controlling here. Federal taxable income is the starting point for computing UBT taxable income. The issue here is whether there is a provision that requires the commissions to be added back in computing UBT. In this case, there is such a provision because, as explained above, when the economic substance is analyzed, the payments are to partners or for their benefit. (*Horowitz*, *Proskauer Rose LLP*, and *Murphy & O'Connell*.)

ACCORDINGLY, IT IS CONCLUDED THAT the commission payments are in effect to Petitioner's partners and may not be deducted. The Petition is denied and the Notice is sustained.

IT IS SO ORDERED.

DATED: July 30, 2021
New York, New York

/s/
David Bunning
Administrative Law Judge