STATE OF NEW YORK

DIVISION OF TAX APPEALS

In the Matter of the Petition :

of :

LAWRENCE E. WALSH
AND MARY P. WALSH :DETERMINATION
DTA NO. 806133

for Redetermination of a Deficiency or for :
Refund of Personal Income Tax under Article 22
of the Tax Law for the Years 1982 and 1983. :

Petitioners, Lawrence E. Walsh and Mary P. Walsh, 1902 Bedford, Oklahoma City, Oklahoma 73116, filed a petition for redetermination of a deficiency or for refund of personal income tax under Article 22 of the Tax Law for the years 1982 and 1983.

A hearing was held before Arthur S. Bray, Administrative Law Judge, at the offices of the Division of Tax Appeals, 500 Federal Street, Troy, New York on December 4, 1990 at 2:15 P.M., with all briefs to be submitted by April 15, 1991. Petitioners filed their briefs on January 17, 1991 and April 15, 1991. The Division of Taxation filed its brief on March 15, 1991. Petitioners appeared by DeGraff, Foy, Holt-Harris & Mealey (James H. Tully, Jr., Esq., of counsel). The Division of Taxation appeared by William F. Collins, Esq. (Michael J. Glannon, Esq., of counsel).

ISSUES

I. Whether petitioners' filing of an application for tax amnesty precludes a subsequent claim for a refund of the same taxes.

II. Whether the Division of Taxation is estopped from denying petitioners' claim for a refund of personal income taxes.

III. Whether the retirement benefits received by petitioners during the years in issue constituted a taxable annuity.

FINDINGS OF FACT

Prior to the years in issue, petitioner Lawrence E. Walsh was a partner in the law firm of

Davis, Polk & Wardell which was located in New York City. In June 1981, Mr. Walsh retired from the firm, and, during the years in issue, was a nonresident of New York.

Under the terms of the Davis, Polk & Wardell Partnership Agreement ("Partnership Agreement") dated January 1, 1981, Mr. Walsh was entitled to certain payments from the law firm as a retired partner. The agreement further provided for alternative methods of calculating the amount that he would receive. Under section 8(b)(i) of the Partnership Agreement Mr. Walsh would receive annual payments based on his interest in the net profits of the firm during the year he retired. The agreement provided that the payments would be adjusted annually depending on the increase in the compensation paid to the ten highest paid partners of the firm in the years after Mr. Walsh's retirement. The retirement payments were limited to an amount no greater than the change in the Consumer Price Index (all urban) for the New York City area. If the change in the average compensation paid to the ten highest paid partners of the firm was less than the change in the consumer price index, section 9(a) of the Partnership Agreement provided that the shortfall would be made up in later years. The same section of the Partnership Agreement provided that "any reduction which has accrued for five years and has not been paid shall be cancelled".

Under section 8(b)(ii) of the Partnership Agreement, the annual payment was based on the partner's age at the time of retirement, a fixed dollar amount and the average compensation paid to the ten highest paid partners of the firm. This alternative did not contain a consumer price index limitation.

Under the "Alternative Retirement Payment Election" a partner could, in general, elect to receive reduced retirement payments during his lifetime and, after his death, have payments made to a spouse or other designee during their lifetime or for a certain term.[1]

Section 8(e) of the Partnership Agreement prohibited former partners from engaging in the practice of law in the United States or Europe, without the consent of the law firm, as a

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[1]The definition of the terms used in the partnership agreement do not lend themselves to a brief summary. Pertinent provisions of the Partnership Agreement are set forth as an appendix.

condition to receiving retirement payments.

At the time of his retirement, Mr. Walsh did not maintain a capital account with the law firm. Further, during the years in issue, he did not have an ownership interest in the law firm.

In 1982, Mr. Walsh received $158,839.00 from the law firm as retirement payments pursuant to the law firm's Partnership Agreement. In 1983, he received $136,887.00 in retirement payments from the law firm. Each of these payments was made pursuant to section 8(b)(i) of the Partnership Agreement.

Mr. Walsh did not render any personal services to the law firm during the years 1982 and 1983. Similarly, during the years in issue, petitioners did not employ intangible personal property in any New York business involving the law firm. During the years in issue, Mr. Walsh did not receive a distributive share of the income or losses of the law firm.

In December 1985, petitioners filed Tax Amnesty Applications for the years 1981 through 1983. In conjunction with the Tax Amnesty

Applications petitioners filed joint a New York State Nonresident Income Tax Return for each of the years in issue. Each return reported the retirement income which Mr. Walsh received from the law firm. Petitioners also paid the tax and interest owed for each of the years in issue.

The returns filed with the Tax Amnesty Applications for the years 1982 and 1983 included cover letters signed by Mr. Walsh which stated:

> "I wish to take advantage of the Amnesty Program, but I do not wish to waive my right to claim a refund of this disputed income as stated in the protest attached to the return. We intend to claim a refund, and if that should be denied, we reserve the right to bring an appropriate court action to compel it."

In August 1986, petitioners filed claims for a refund of the $12,147.00 in income taxes paid in 1982 and the $11,690.00 in income taxes paid in 1983. The refund claims were premised on petitioners' position that the pension payments constituted an exempt annuity pursuant to 20 NYCRR 131.4(d). Petitioners did not mention their prior application for tax amnesty in their refund claims.

On or about August 28, 1986, petitioners' representative sent a letter to the Deputy

Commissioner and Counsel for the Department of Taxation and Finance which enclosed the refund claims and argued that the then recent decision of Matter of Pidot v. State Tax Commn. (118 AD2d 915) was distinguishable from the situation involving petitioners. This letter did not state that an amnesty application had been filed.

In a letter dated September 22, 1986, Counsel responded that Mr. Walsh's pension payments did not constitute an exempt annuity. The letter noted that the opinion stated therein was based on a limited set of facts and recommended that petitioners present all of the relevant facts regarding the refund claim to the State Tax Commission through the administrative process.

On November 18, 1986, the Division of Taxation granted petitioners' application for amnesty for the tax years in issue.

In a letter dated April 22, 1987, the Division denied petitioners' claims for refund for three reasons. First, petitioners were advised that 20 NYCRR 131.4(d), which governs tax exempt annuities, applies to former employees only and not to Mr. Walsh, who was a partner. Second, the letter stated that the pension was not an exempt annuity under 20 NYCRR 131.4(d). Lastly, petitioners were told that they waived their appeal rights when they filed their returns under the Amnesty Program.

In a letter dated May 18, 1987 to Counsel for the Division, petitioners' representative noted the denial of the refund claims and suggested that a conference would be beneficial because petitioners allegedly stood an excellent change of success.

In a letter dated June 24, 1987, petitioners' representative presented a legal argument to the Director of the Law Bureau of the Division of Taxation that this would be a proper case for the State Tax Commission to allow the refunds because the pension payments were exempt from tax.

In a letter dated July 15, 1987, the Director of the Law Bureau of the Division advised petitioners' representative that he agreed with the prior position of the Division that the pension payments did not constitute a nontaxable annuity which is exempt under the personal income tax regulations. The letter concluded with the following qualification:

> "Because the Walsh payments do not meet the requirements of the regulation, as was the case in Pidot, I cannot recommend that the Tax Commission grant a refund on the basis of Pidot under the Amnesty process. Pursuit of the refund claim is, of course, an available avenue. In the event of a denial, review by the Administrative Law Judge and even the Tax Appeals Tribunal is also available. As I had emphasized earlier, we have not seen the documentation in this matter and it is quite possible that other bases may exist for rejection of the claim that your client is receiving an annuity exempt from New York income tax. The regular administrative process is available, but not in conjunction with the benefits of Amnesty."

On October 14, 1988, the Division of Tax Appeals received the petition in this matter. The petition did not make any reference to the prior amnesty application. The answer of the Division also did not make any reference to the prior amnesty application.

In a letter dated November 29, 1990, petitioners' representative advised the Deputy Commissioner and Counsel of the Department of Taxation and Finance as follows:

> "In accordance with the correspondence had with Terrence Boyle, Director of the Law Bureau, and with you, copies of which are enclosed, and also the petition seeking administrative review, we hereby withdraw any claims to amnesty for the years in question, for the above-captioned taxpayers, and seek the administrative review process in effect in the Tax Department.
>
> I also enclose copies of the original amnesty application with an accompanying letter from Judge Walsh stating that he specifically does not waive any rights to claim a refund, and specifically reserves his right to bring an appropriate court action to compel it, if such is required."

At the beginning of the hearing, the Division raised the issue of whether petitioners' application for tax amnesty precludes a subsequent claim for a refund of the same taxes. Petitioners' counsel did not object to the Division's raising the issue.

CONCLUSIONS OF LAW

A. Relying upon chapter 66 of the Laws of 1985, the Commissioner's regulations and Mon Paris Operating Corporation v. Commissioner of Taxation and Finance (151 AD2d 822, 542 NYS2d 61), the Division maintains that petitioners were barred from filing claims for refund of taxes and interest paid under the Tax Amnesty Program. In response, petitioners maintain that Mon Paris Operating Corp. (supra) is not controlling, that petitioners' claim for a refund was not barred by the Tax Amnesty statute and regulations and that the Division is estopped from denying the possibility of administrative review of the refund claims.

B. Effective April 17, 1985, the New York Legislature approved an Amnesty Program (L 1985, ch 66). Under this program, the Legislature directed that upon the written application of a taxpayer and the payment of all designated taxes plus interest, the State Tax Commission shall waive applicable penalties (L 1985, ch 66, § 1[b]). Further, upon payment of the designated taxes plus interest, the legislation barred civil, administrative or criminal actions or proceedings against the taxpayer pertaining to the designated taxes plus interest (L 1985, ch 66, § 1[b]).

The Amnesty Program legislation further provided as follows:

> "Unless such tax commission on its own motion redetermines the amount of designated taxes plus interest, no refund or credit shall be granted of any designated taxes plus interest paid under this program." (L 1985, ch 66, § 1[e].)

C. The regulations, which were promulgated pursuant to paragraph (f) of section (1) of chapter 66 of the Laws of 1985, reflect the statutory language under which the Amnesty Program was enacted. The general effect of amnesty is set forth at 20 NYCRR 2500.6(a)(1) which provides as follows:

> "Once amnesty is granted, all penalties (as defined in section 2500.2 of this Part) are waived and any civil, administrative or criminal proceeding is barred relating to the designated tax. (Laws of 1985, chap. 66, § 1[b].)"

The regulations further provide that:

> "No refund or credit shall be granted of any designated tax plus interest paid under amnesty, unless the State Tax Commission redetermines the amount due on its own motion. (Laws of 1985, chap. 66, § 1[e].)" (20 NYCRR 2500.8[b].)

D. The leading case on the effect of amnesty is Matter of Mon Paris Operating Corp. v. Commr. of Taxation and Finance (supra). In that case a taxpayer paid the balance of an outstanding assessment under the Amnesty Program and thereafter sought a refund of all of the taxes paid under the assessment. Although the claim was denied, the Division granted a refund of the amount the taxpayer overpaid under amnesty. Petitioner commenced a proceeding pursuant to Article 78 of the CPLR seeking a refund of the taxes which allegedly had been unlawfully demanded and paid. In response, the Division sought dismissal of the proceedings on two grounds: (1) that petitioner had failed to seek timely administrative review and (2) that petitioner paid the tax under the Amnesty Program. The Supreme Court dismissed the petition on the ground that petitioner had failed to pursue its administrative remedies.

On appeal, the Appellate Division affirmed and set forth its reasoning as follows:

> "Petitioner, having taken advantage of the Amnesty Program and received the benefits therefrom, is bound by the course it elected to follow. By paying the tax due as defined in 20 NYCRR 2500.5(d)(1), petitioner made an admission that it owed the amount of tax which it paid. Petitioner thereupon was not obligated to pay any penalty arising from such admission and, by the tax amnesty provision and the regulations, the taxes were finally and irrevocably assessed (L. 1985, ch. 66 § 1[e]; 20 NYCRR 2500.8[b]). Consequently, petitioner may not maintain this proceeding to claim a refund of the tax so paid or seek damages for the payment. Supreme Court therefore properly dismissed the proceeding.
>
> We find it unnecessary to reach the other grounds Supreme Court relied on for affirmance." (Matter of Mon Paris Operating Corp. v. Commr., supra, 542 NYS2d at 62.)

E. Petitioners assert that Mon Paris is distinguishable for several reasons. First, they argue that in Mon Paris the taxpayer never sought administrative review as petitioners are doing herein. This argument is erroneous because it overlooks the fact that the Appellate Division's decision is based solely on the Amnesty Program and the Court expressly found it unnecessary to reach the issue of whether petitioners were required to exhaust their administrative remedies.

F. Petitioners next argue that Mon Paris is not controlling because at the time they filed their amnesty application they stated that they were not waiving their right to appeal. Petitioners also state that their filing of a petition for a refund and seeking administrative review constitutes a withdrawal of the amnesty application.

G. The foregoing arguments must also be rejected. The difficulty presented here is that petitioners attempted to simultaneously pursue conflicting paths. The legislation is clear that, upon meeting certain conditions and absent certain circumstances which preclude the granting of amnesty, the granting of amnesty was a matter of course (L 1985, ch 66, § 1[b]). Since petitioners met the statutory condition of making a written application and paying the designated taxes plus interest, the Division properly processed petitioners' amnesty application. Moreover, since the taxes and interest were paid under the Amnesty Program, petitioners were prohibited from obtaining a refund of the same taxes (L 1985, ch 66, § 1[e]). It is noted that there is no language in the refund application which can be interpreted as a request to withdraw the Amnesty Application. Additionally, any attempt to withdraw the Amnesty Application after it was granted is of no consequence. Viewing the Amnesty Program as a whole, it was obviously the intent of the legislative drafters to preclude any additional disputes regarding those taxes which were the subject of the Amnesty Program (see, L 1985, ch 66, § 1[b], [e]).

H. On the basis of the foregoing, it is concluded that petitioners have not presented any basis for distinguishing Mon Paris from the case at hand and that the Division properly found that the Tax Amnesty statute and regulations are a bar to the refunds in issue.

I. Petitioners next argue that the Tax Amnesty statutes and regulations should not prohibit petitioners' claim for a refund. In support of this position, petitioners first argue that the Division failed to plead the Tax Amnesty statute as an affirmative defense and that they were unaware that this defense would be raised until a few days prior to the hearing. Petitioners also contend that they have been prejudiced because they proceeded with the administrative review process at substantial expense based on information from the Division that their petition would be reviewed.

J. The transcript of the hearing shows that the Division raised the issue of Tax Amnesty at the outset of the hearing without any objection or claim of surprise from opposing counsel. If there was a problem with the Division's raising the issue of Tax Amnesty, it should have been mentioned at the hearing. If such an objection had been raised and it was found that the objection had merit, the Division could have moved to amend its pleading. Thereafter, an appropriate ruling could have been fashioned. In this regard the Rules of Practice and Procedure state that "[l]eave [to amend] shall be freely given upon such terms as may be just..." (20 NYCRR 3000.4[c]). Since petitioners did not raise an objection to the Division's pleading in a timely manner, it is concluded that the objection has been waived.

In reaching the foregoing conclusion, it is noted that petitioners' claim of prejudice from the Division's failure to raise the issue of Tax Amnesty in its answer is unpersuasive. The Division's letter of April 22, 1987, which denied the refund claim, clearly apprised petitioners that amnesty was a bar to the refund. The Director of the Law Bureau again explained in his letter of July 15, 1987 that the "administrative process is available, but not in conjunction with the benefits of Amnesty." In view of the foregoing, petitioner should have been aware well before the hearing that the Division considered amnesty a bar to the refund claim.

K. Petitioners next argue that the Division's tax amnesty argument should be dismissed because the pertinent statutes can not be construed as a jurisdictional limitation upon the Division of Tax Appeal's authority to consider a refund in this case. This argument confuses two distinct concepts.

The question here is whether the denial of the refund on the ground that petitioner applied for tax amnesty was proper. There is no dispute that the Tax Appeals Tribunal and the Division of Tax Appeals are authorized to review the denial of a refund claim.

L. Petitioners next argue that the Division is estopped from taking the position that they may not have administrative review of their refund claims. In support of their position, petitioners claim that in reliance on the letter dated July 15, 1987 (Finding of Fact "17"), they withdrew their amnesty application and opened themselves up to the possibility for an assessment of penalties.

M. In order to determine whether an estoppel should be invoked, the Tax Appeals Tribunal has utilized a three-part test which asks if there was a right to rely on the representation, whether there was such reliance and whether the reliance was to the detriment of the party who relied upon the representation (see, Matter of Harry's Exxon Service Station, Tax Appeals Tribunal, December 6, 1988).

N. Petitioners' estoppel argument does not satisfy the three-part test. The letter which petitioners allegedly relied upon to withdraw their amnesty application stated "[t]he regular administrative process is available, but not in conjunction with the benefits of Amnesty" (emphasis added). Clearly, the Division was advising petitioners that a refund application would not be entertained to recover taxes which had been paid under amnesty. Thus, the Division did not mislead petitioners into withdrawing their amnesty application.

Secondly, the only withdrawal of the amnesty application in the record was in a letter dated November 29, 1990. Since petitioners had already been granted amnesty on November 18, 1986, a letter withdrawing the amnesty application four years after the application was granted was meaningless.

O. On the basis of the foregoing, petitioners' reliance on Matter of 1555 Boston Road Corp. v. Finance Administrator of the City of N.Y. (61 AD2d 187, 401 NYS2d 536) is misplaced.

In that case the Finance Administrator of the City of New York was estopped from enforcing a settlement regarding property taxes for the tax year 1973/1974 without also being bound by the same settlement for the tax years 1971/72 and 1972/73 because, in reliance on the settlement agreement, the taxpayer did not file a tax certiorari proceeding within the deadline for the tax year 1973/74. Here, unlike the case cited by petitioners, there was no statement which should have caused detrimental reliance.

On the basis of the foregoing, the Division is not estopped from denying petitioners' claim for a refund on the basis of an earlier application for amnesty.

P. It is noted, that if one were to reach the merits, petitioners would not have prevailed. Petitioners' position relies largely upon Matter of Pardee v. State Tax Commn. (89 AD2d 294, 456 NYS2d 459). In Pardee, the taxpayer was an employee of Chase Manhattan Bank who worked in one of the bank's New York offices from 1937 to 1973. The bank had an employee profit-sharing plan which was funded through a Federally tax-exempt trust to which the bank and the employees contributed. The fund established two separate accounts for each participant, an "allocation account" for bank contributions and a "current deposit account" for the employee's contribution.

The taxpayer, who was a resident of New Jersey throughout all of the pertinent periods, retired in 1973. At the time of his retirement, he was paid $65,000.00 as a lump-sum distribution. For the year 1973, the taxpayer and his wife filed a joint nonresident New York State income tax return in which they reported as income that portion of the distribution which constituted the bank's contribution but omitted the portion representing the dividends, interest, net gains and appreciation on the investments of his and the bank's contributions. Thereafter, the Division issued a Notice of Deficiency on the basis that petitioners should have included all income and gains derived from both accounts because they constituted deferred income. Upon review, the State Tax Commission found, to the extent relevant herein, that the income and gains arising from the bank's contributions were taxable to petitioners as being derived from New York sources within the meaning of Tax Law former § 632(a) (now Tax Law § 631[a]).

In the Article 78 proceeding which followed, the State Tax Commission's determination was annulled. In reaching this conclusion the Court first found that the income and gains derived from the bank's contribution did not constitute income or gain from "a business, trade, profession or occupation carried on in this state" within the meaning of Tax Law former § 632[b][1][B] (now Tax Law § 631[b][1][B]). This result followed from the Court's analysis of 20 NYCRR 131.4(b) which stated that the income and gains from the bank's contribution may be included in the adjusted gross income under this category only if they are "compensation for personal services entering into his Federal adjusted gross income, but only if, and to the extent that, his services were rendered within New York State". The Court reasoned that the income and gains in issue could not be considered "compensation for services" rendered to the bank. This conclusion was based on several factors. The Court found it significant that once the bank made the contribution, it did not retain control over the funds. Second, the risk of loss was borne by the employee. Third, the value of the bank's contribution was not related to the employee's performance. Lastly, the Court felt that the Internal Revenue Service would not treat income and gains from similar employer's contributions as additional compensation for personal services.

The Court further held that the income and gains in issue were not includible under Tax Law former § 632(b)(2) (now Tax Law § 631[b][2]) as income from intangible personal property since this category is limited to situations where the property is "employed in a business, trade, profession, or occupation carried on in this state" (Tax Law former

§ 632[b][2]). In addition, the property must be the taxpayer's and not the employer's.

Q. If the Pardee case were regarded as controlling precedent, a strong case could be made for the proposition that Mr. Walsh's retirement income was not subject to New York income tax under Tax Law former § 632(b)(1)(B) or (b)(2). However, in order to evaluate the weight to be accorded Pardee, one must examine subsequent precedent.

In Matter of Michelsen v. New York State Tax Commn. (107 AD2d 389, 486 NYS2d 479, modified 67 NY2d 579, 505 NYS2d 585) the petitioner was granted certain stock options by his New York employer under a stock option plan. Pursuant to this plan, petitioner purchased 3,000 shares of Avon capital stock in 1972 and an additional 3,000 shares of capital stock in 1973. Subsequently, in 1973 petitioner sold the 6,000 shares and derived a gain of $179,761.00. Petitioner reported the gain from the sale of the stock as ordinary income on his Federal income tax return but did not report any portion of this gain on his 1973 New York nonresident income tax return. The Division issued a Notice of Deficiency and, after a hearing, the State Tax Commission found that the stock was acquired through the exercise of a stock option plan connected with petitioner's employment and, further, that the gain on the sale of the stock was subject to New York State income tax.

Petitioner commenced an Article 78 proceeding and Special Term found that the stock option plan by which the stocks were acquired was granted either as compensation for past services or as an incentive for future services. Therefore, there was a rational basis to conclude that the income was subject to tax under Tax Law former § 632(a) and (b).

On appeal before the Appellate Division, petitioner conceded, and the Appellate Division agreed, that the stock options were granted as compensation connected with employment in New York and were therefore taxable in New York. However, citing Pardee, the Court further held that there was no evidence connecting the granting of the options with the subsequent appreciation in the market value of the stock and, as a result, no connection with the rendering of services in New York. Thus, the Court concluded that the only income attributable to New York was the value of the stock option on the date it became exercisable.

Subsequently, the Court of Appeals modified the order of the Appellate Division. Initially, the Court held that the options granted to petitioner were compensation attributable to a "business, trade, profession or occupation carried on a this state" and therefore taxable under Tax Law former § 632(b)(1)(B). The Court of Appeals was troubled with the Appellate Division's method of calculating the value of the options because that method differed from Federal law and left much of the compensation untaxed. The Court then noted that "[t]he employee's compensation comes from the employer's willingness to let the employee benefit from market appreciation in the stock without risk to his own capital." (Michelsen v. State Tax Commn., supra, 505 NYS2d at 588.) Further, the Court stated that when the option becomes exercisable it is worth more than the difference between the fair market value of the stock and the option price. Therefore, in conformity with Federal law, the Court held "that the proper method of valuing the compensation derived from an option that has no readily ascertainable market value on the date it is granted is to subtract the option price from the fair market value of the stock on the date the option is exercised" (id., 505 NYS2d at 589). Lastly, the Court held that any gain realized by petitioner between the time the option was exercised and the time the stock was sold was investment income and not compensation. Consequently, petitioner could not be taxed on this amount.

Although Pardee dealt with a pension plan and not a stock option plan, the reasoning in Michelsen casts a great deal of doubt on the precendential value of Pardee. Both cases concerned the manner of taxing the appreciation in the value of the assets. In Michelsen the Court of Appeals refused to divide the value of the option into the two parts suggested by the Appellate Division -- the value of the option between the time it was obtained and when exercisable and the value of the option between when it was exercisable and the time it was exercised. If the Court of Appeals had reviewed Pardee one may surmise that it would have similarly concluded that the increase in the value of the profit sharing plan was compensation for services in the same manner as the increase in the value of the stock option was compensation for services. A failure to follow this approach would have led to the same problem as concerned the Court of Appeals in Michelsen -- a substantial portion of the economic value of the profit sharing plan would not be taxed (see, Matter of McDonald v. Director, Division of Taxation, 10 NJ Tax 556, mod on other grounds 247 NJ Super 326 [which noted the implications of Michelsen on the precedential value of Pardee]).

R. Following the approach set forth above, the income in issue is considered employee compensation which is taxable to a nonresident, pursuant to Tax Law former § 632(b)(1)(B), as a "business, trade, profession or occupation carried on in this state". A separate and independent basis for finding that the income in issue was taxable by New York is that the term "compensation for personal services" is defined by 20 NYCRR 131.4(d) as including "amount received upon retirement under a covenant not to compete". The provisions of section 8(c) of the Partnership Agreement constitute a covenant not to compete and therefore, since the covenant not to compete was a condition to receiving retirement benefits, the amounts received were taxable by New York.

S. The remaining cases cited by petitioners in their brief, Matter of Delmhorst v. State Tax Commn. (92 AD2d 981, 461 NYS2d 499, affd 60 NY2d 628, 467 NYS2d 352) and Matter of Epstein v. State Tax Commn. (89 AD2d 256, 456 NYS2d 454), concern income received by a nonresident from an intangible not used in a business, trade, profession or occupation carried on in this State and consequently have no bearing on this matter.

T. It is petitioners' position that the payments received by Mr. Walsh pursuant to section 8(b)(i) of the Partnership Agreement complied with the requirements of an annuity because the payments varied with a recognized cost of living index. Petitioners argue that the fact that they might have received payments pursuant to an alternative formula without a cost of living limitation is irrelevant because the formula under which petitioner received payments constituted an annuity.

U. The pertinent provisions of the regulations provide that in order for an annuity to be nontaxable, it must meet the following requirements:

"(iii) It must be payable:

(a) at a rate which remains uniform during such life or period; or
(b) at a rate which varies only with:

(1) the fluctuation in the market value of the assets from which such benefits are payable;
(2) the fluctuation in a specified and generally recognized cost-of-living index; or
(3) the commencement of social security benefits;" (20 NYCRR 131.4[d][2][iii]).

Contrary to petitioners' arguments, neither section 8(b)(i) nor 8(b)(ii) of the Partnership Agreement satisfy the conditions of a tax exempt annuity. Under the section 8(b)(i) alternative there is a consumer price index limitation. However, the fluctuation is not based on a cost-of-living index. Rather the fluctuation is principally based on the compensation paid to the highest paid active partners. This is not one of the permissible bases for a fluctuation in the payments. Further, petitioners' argument that any payments which are below the cost of living index would be made up in later years overlooks section 9(a) of the Partnership Agreement which states that "any reduction which has accrued for five years and has not been paid shall be cancelled". This latter fact provides one basis for distinguishing this matter from Matter of Pidot v. State Tax Commn. (118 AD2d 915, 499 NYS2d 482, affd 69 NY2d 837, 513 NYS2d 965) which concluded that the deferral of a portion of the payment to later years does not provide a rational basis for finding that the payment was a distributive share of partnership income or that the payment rate was impermissibly variable.

The fact that petitioner had the opportunity to receive payments under section 8(b)(ii) provides a separate and independent basis for rejecting petitioners' argument. This alternative does not contain any measure which would make it uniform within the meaning of (20 NYCRR 131.4[d][2][iii][a]) or utilize one of the permissible bases upon which the rate may vary (see, 20 NYCRR 131.4[d][2][iii][b]). Further, the total amounts payable are not determinable at the annuity starting date (20 NYCRR 131.4[d][2][iii][c]).

The Division has accurately observed that Matter of Norris v. State Tax Commn. (140 AD2d 876, 528 NYS2d 694) presents an almost identical set of facts. In Norris the retirement benefits were paid pursuant to a written severance agreement which provided that the annual amount paid would be the lesser of the final year's salary or petitioners' share of the firm's profits. The Court concluded that the payments were not exempt from tax because:

> "[t]he subject regulation does not authorize a rate variation dependent upon the former employee's profits (see, 20 NYCRR 131.4[d][2][iii][a], [b]). Nor does the benefit qualify as an annuity under 20 NYCRR 131.4(d)(2)(iii)(c) because payments commenced prior to the close of the 1982 tax year and the total amount payable could not be determined at the annuity starting date." (Matter of Norris v. State Tax Commn., supra, 528 NYS2d at 695.)

V. Petitioners' last argument is that since the retirement funds came from the law firm's current revenues, the assets from which the benefits were paid were law firm revenues. Thus, it is argued that the annuity payments are exempt from tax because the payments fluctuated in accordance with 20 NYCRR 131.4(d)(2)(iii)(b)(1) which allows a variation with "the fluctuation in the market value of the assets from which such benefits are payable." This argument is erroneous because the assets being referred to in the regulation are tangible or intangible assets which fluctuate in a recognized market. Thus, the law firm's assets are not the type of assets contemplated by 20 NYCRR 131.4(d)(2)(iii)(b)(1).

W. The petition of Lawrence W. Walsh and Mary P. Walsh is denied.

DATED: Troy, New York

ADMINISTRATIVE LAW JUDGE

APPENDIX

Section 8(b) of the Partnership Agreement provides as follows:

"Retirement Payments" Subject to the provisions of paragraph (c) of this Section 8, the Retirement Payments of a Retired Partner shall be equal for each year during his Retirement Pay Period to the remainder obtained by subtracting his HR-10 Plan Offset from the greater of

(i) the sum of the Retirement Floor Amount applicable to such Partner and the Adjustment Factor Bonus applicable to such year; and

(ii) the Applicable Minimum Amount with respect to such Partner and such year.

"Adjustment Factor" means, with respect to Retirement Payments to a retired Former Partner, for each year following the year in which such Former Partner retired, the fraction of which the average Net Compensation received from the firm by the ten Partners receiving the highest Net Compensation from the firm in such subsequent year is the numerator and the average Net Compensation received from the firm by the ten Partners receiving the highest Net Compensation from the firm in the year in which such Former Partner retired is the denominator; provided, that, the Partners' Committee shall have the right, at any time within three years after the date of retirement of such Former Partner, to adjust such denominator, for the purpose of this definition, if and to the extent that the Partners' Committee determines that the net profits for the year in which such Partner retired are nonrepresentative because of such factors as extraordinary and nonrecurring items of expense or income.

"Adjustment Factor Bonus" means, with respect to any retired Former Partner and any year following the year in which such Partner retired, the amount, if any, by which the product of the Retirement Floor Amount applicable to such Partner times the Adjustment Factor for such year exceeds such Retirement Floor Amount; provided, that, if in such year the Adjustment Factor Bonus so determined, when added to all preceding Adjustment Factor Bonuses received by such Former Partner in years subsequent to the year in which such Former Partner retired, would exceed the amount such Former Partner would have received as Adjustment Factor Bonuses in all such years had, in each of such years, the Adjustment Factor been the fraction of which the Consumer Price Index (all Urban) for the New York City area for such year is the numerator and such Index for the year in which such Former Partner retired is the denominator, the Adjustment Factor Bonus for such year shall be reduced (but not below zero) to such amount as is required in order that there would be, on the foregoing basis, no such excess.

Alternative Retirement Payment Election. Any Partner may, at or prior to the time of his retirement, elect to receive, in lieu of Retirement Payments based on paragraph (b) of this Section 8, an alternative arrangement providing for reduced payments to such Partner during his lifetime and after his death payments either to his spouse during her lifetime or during a term certain if she should survive him or to another person or persons during a term certain or during the lifetime of one of such persons; provided, however, that any such alternative payment arrangement must be been approved by the Partners' Committee. The Partners' Committee shall not approve any such arrangements without the approval of the then Partners constituting at least three-fourths in number and having at least 75% of the Assigned Points unless the Partners' Committee has determined that (i) the arrangements are the actuarial equivalent, as near as may be determined at the time of such election, of the Retirement Payments based on paragraph (b) of this Section and (ii) the arrangements are not anticipated to require the payment of less than 50% of the estimated benefits over the anticipated lifetime of such Partner following retirement, nor more than 20% of the estimated benefits in any calendar year. An Alternative Retirement Payment Election shall be irrevocable from and after the date of retirement of such Partner except that at any time prior to his death such Partner shall have the right to elect to have the amounts otherwise payable to his spouse or other designated beneficiary or beneficiaries payable to his estate following his death. References herein to the spouse of a Partner shall refer solely to the spouse of the Partner on the date an Alternative Retirement Payment Election shall become irrevocable.

"Applicable Minimum Amount" means in any year, with respect to a Former Partner, the product of (i) the Partner's Applicable Percentage, (ii) $150,000 and (iii), if greater than 1, the fraction of which the average Net Compensation received from the firm by the ten Partners receiving the highest Net Compensation from the firm in such year is the numerator and the average Net Compensation received from the firm by the ten Partners receiving the highest Net Compensation from the firm in 1980 is the denominator.

"Applicable Percentage" means, with respect to a Retired Partner, 42.5% unless the Partner has not obtained age 65 at the time of retirement, in which event the Applicable Percentage shall be the product of 42.5% times the fraction of which the numerator is 100 less 0.5% for each full calendar month between such time of retirement and the end of the calendar quarter in which the 65th anniversary of the Partner's birth shall occur and of which the denominator is 100; and means, with respect to a Former Partner who has died without becoming a Retired Partner, the greater of 30% and the Applicable Percentage which such Former Partner would have had if he had retired at the end of the calendar quarter in which he died.

"Five-Year Participating Interest" means, with respect to any Partner, (i) the product obtained by multiplying (A) the Participating Interest in the Net Profits for Participating Partners to which such Partner was entitled on the date five years before the end of the calendar quarter in which he died, withdrew or retired (or is deemed to have retired) by (B) a fraction of which the numerator is the average of the Participating Interests of the 10 Participating Partners having the highest Participating Interests during the calendar quarter in which such Partner died, withdrew or retired (or is deemed to have retired) and the denominator of which is the average of the Participating Interests of the 10 Participating Partners having the highest Participating Interests on the date five years before the end of such calendar quarter, or (ii) any higher product obtained by multiplying (A) the Participating Interest in the Net Profits for Participating Partners to which such Partner was entitled at any time subsequent to the date five years before the end of the calendar quarter in which he died, withdrew or retired (or is deemed to have retired) by (B) a fraction of which the numerator is the average of the Participating Interests of the 10 Participating Partners having the highest Participating Interests during the calendar quarter in which such Partner died, withdrew or retired (or is deemed to have retired) and the denominator of which is the average of the Participating Interests of the 10 Participating Partners having the highest Participating Interests at such subsequent time; provided, however, that if such Partner shall have received Net Stated Compensation during any portion of such five-year period, his Participating Interest shall be deemed, solely for the purpose of making the determination of the Five-Year Participating Interest, to have been the Participating Interest which the Partners' Committee shall determine to be appropriate to reflect the compensation such Partner would have received had his compensation been based solely on a Participating Interest, given the actual Participating Interests of Participating Partners.

"HR-10 Plan Offset" means, with respect to a Retired Partner, during any year or portion thereof 100% of the annual annuity (or applicable portion thereof if the HR-10 Plan Offset is being determined with respect to a portion of a year) which would be receivable, as determined by the Partners' Committee, during such year or portion thereof, had such Partner elected to receive an annuity for the Retirement Pay Period in lieu of the lump sum payment which would have been payable to such Partner under the HR-10 Plan at the time of his retirement, determined on the assumption that such Partner had elected, with respect to the options as to investment of his account in the HR-10 Plan during the period of such investment, those options which were determined by the firm from time to time during such period to be applicable in the absence of an election by a Partner (or had elected to purchase an annuity for the Retirement Pay Period with such lump sum payment if no such election to receive an annuity were then available under the HR-10 Plan); provided, however, that there shall be excluded from such lump sum and annuity any portion thereof which is attributable to contributions made by such Partner to the HR-10 Plan or by the firm on his behalf (i) prior to January 1, 1974 or (ii) thereafter in excess of the amount allowable by the Internal Revenue Code as from time to time amended, as a deductible expense for the purpose of computing such Partner's Federal income tax liability. The manner of determining of the HR-10 Plan Offset shall not effect the right of each Partner to designate the beneficiary of the interest of such Partner in the HR-10 Plan upon his retirement or death and to elect among the options which may be available at any time as to investment of his account.

"Net Profits for Participating Partners" in any year or portion thereof means the net profits of the firm for such year or portion thereof reduced by Priority Payments (not already deducted in determining such net profits) for such year or portion thereof.

"Retirement Floor Amount" means, with respect to any Former Partner, the product of the Applicable Percentage with respect to such Partner, times his Five-Year Participating Interest, times the Net Profits for Participating Partners during the year in which such Partner retired; provided, that, the Partners' Committee shall have the right to adjust such net Profits for Participating Partners, for the purpose of this definition, if and to the extent that the Partners' Committee determines, at any time within three years after the date of the Partner's retirement, that the net profits for the year in which such Partner retired are nonrepresentative because of such factors as extraordinary and nonrecurring items of expense or income.