STATE OF NEW YORK

DIVISION OF TAX APPEALS

In the Matter of the Petition of WARREN H. JOHNSON for Redetermination of a Deficiency or for Refund of New York State Personal Income Tax under Article 22 of the Tax Law for the Year 1984.	:	
In the Matter of the Petition of AUBREY AND ELSIE R. FARISS for Redetermination of a Deficiency or for Refund of New York State Personal Income Tax under Article 22 of the Tax Law for the Years 1982 through 1986.	:	DETERMINATION DTA NOS. 808383, 810732 AND 810733
In the Matter of the Petition of ROBERT W. AND HARRIET A. REDLIN for Redetermination of a Deficiency or for Refund of New York State Personal Income Tax under Article 22 of the Tax Law for the Years 1982 through 1985.	:	

Petitioner Warren H. Johnson, 157 Southcote Road, Riverside, Illinois 60546, filed a petition for redetermination of a deficiency or for refund of New York State personal income tax under Article 22 of the Tax Law for the year 1984.

Petitioners Aubrey and Elsie Fariss, 3707 Olympia, Houston, Texas 77019, filed a petition for redetermination of a deficiency or for refund ofNew York State personal income tax under Article 22 of the Tax Law for the years 1982 through 1986.

Petitioners Robert W. and Harriet A. Redlin, 83 Blairmoor Court, Grosse Pointe, Michigan 48236, filed a petition for redetermination of a deficiency or for refund of New York State personal income tax under Article 22 of the Tax Law for the years 1982 through 1985.

A consolidated hearing was held before Carroll R. Jenkins, Administrative Law Judge, at the offices of the Division of Tax Appeals, Riverfront Professional Tower, 500 Federal Street, Troy, New York, on March 29, 1994 at 9:15 A.M., and continued on March 30, 1994 at 9:15 A.M., and on March 31, 1994 at 9:15 A.M. The parties were granted until August 30, 1994 to file their respective briefs. All briefs were filed by the prescribed date. Petitioners appeared by E. Parker Brown, II, Esq., and Hancock & Estabrook (Gerald F. Stack, Esq., of counsel). The Division of Taxation appeared by William F. Collins, Esq. (Andrew J. Zalewski, Esq., of counsel).

ISSUES

I. Whether the retirement allowances made to petitioners constitute distributive shares of partnership income a portion of which had a source in New York, taxable under Tax Law former §§ 632(a) and 637(a)(1).

II. Whether such payments, even if distributions of partnership income, are not taxable in New York because they constitute an "annuity" within the meaning of 20 NYCRR 131.4(d) (renum 132.4[d]).

FINDINGS OF FACT

Petitioners' brief includes proposed findings of fact which, to the extent relevant and supported by the record, have been adopted.

Warren H. Johnson

Warren Johnson ("Johnson") resides at 157 Southcote Road, Riverside, Illinois. Johnson appeared and testified at this proceeding.

Johnson was born in Chicago in 1922. He attended school in Illinois and, after serving in the Navy during World War II, he attended the University of Chicago School of Business where, in 1948, he earned a Masters Degree in accounting. He joined the audit staff of Peat,

Marwick, Mitchell & Co.'s ("PMM") Chicago office that same year. In 1958, Johnson was admitted as a partner in PMM's Chicago office. Johnson's specialty was Securities and Exchange Commission matters, not tax accounting. At the time of Johnson's retirement the rights and obligations of the partners were governed by the Articles of Partnership of Peat, Marwick, Mitchell & Co. (United States) dated July 1, 1975, as amended October 4, 1978 (the "1975 Partnership Agreement") (Ex. "3").

The 1975 Partnership Agreement defined a partner as an individual who held an interest in the goodwill and the name of the firm and who shared in the profits and losses of the firm. The 1975 Partnership Agreement provided that a partner's interest in the partnership was represented by "units of interest" allotted to him/her by the partnership. The "units of interest" were the mechanism by which voting rights and the profits and losses of PMM were allocated. Pursuant to the 1975 Partnership Agreement a retiring partner was entitled to a "retirement allowance" explained in the firm's "Retirement Allowance Plan" (Ex. "3", Art. III, Sec 4).

Under the 1975 Partnership Agreement, a partner's units of interest entitled him/her to exercise certain rights including, but not limited to, the right to share in distributions of partnership income, the right to vote on management decisions, to vote on admission of new partners and appointments to the board of directors, and the right to inspect the books and records of PMM (hereinafter, collectively "partnership rights").[1]

Johnson testified that at the time immediately prior to his retirement, his interest in the partnership was represented by 1000 allocated "units of interest", his drawing account, his capital account, his interest in unrealized receivables ("IUR") account and his accelerated cost recovery system ("ACRS") account.

The capital account was an account established by PMM to keep track of a partner's capital contributions to the firm under the 1975 Partnership Agreement. This was fixed at $75.00 per unit.

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[1]Redlin and Fariss also had these "partnership rights".

The drawing account was the partner's banking account. Each partner's drawing account was credited yearly with the partner's share of the cash basis income of PMM. PMM would debit this account as a partner made withdrawals.

When PMM changed for tax purposes from an accrual basis of reporting income to the government to a cash basis, Johnson received an IUR account, which he describes as the partners' equity account in receivables that were unbilled or that had been billed, but were not yet collected. Put another way, the IUR account was designed to track a partner's share of the difference between PMM's income computed on an accrual basis and its income computed on a cash basis.

Johnson's ACRS account was intended to recognize the difference between an accelerated method of depreciation and a straight line method, and was designed so as not to understate a partner's interest in PMM (tr., p. 300). PMM began to keep track of this difference through the use of the ACRS account when the accelerated cost recovery system of depreciation was added to the Internal Revenue Code in 1981.

W. Michael Lynskey, Director of Retirement Benefits and Partner Services for PMM, testified for petitioners. Mr. Lynskey testified that PMM's operating procedures provided for the payment of interest on unrealized receivables and ACRS accounts to retired partners[2] in addition to the retirement allowance benefits received under the 1976 retirement allowance plan. Other than the settlement of their drawing and capital accounts, no other payments were permitted by PMM's operating procedures to retired partners.

In addition to being a partner in PMM, Johnson was also a partner in other partnerships known as the "Greenbriar" partnerships and "Copem 72". Greenbriar and Copem 72 were not formally connected to PMM, although only partners of PMM could be partners in Greenbriar

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[2]For some periods PMM had different classes of partners. Some were CPAs and some were not. Whenever used in this determination, retired "partners" refers to retired partners who were certified public accountants.

and Copem 72. The Greenbriar and Copem 72 partnerships operated out of offices in Manhattan.

The distributive share of income or losses derived from a series of limited partnerships known as Copem 71, Copem 72, Copem Marts and Copem 73 ("the Copem partnerships") has already been litigated up through the Court of Appeals in Matter of Ausbrooks v. Chu (66 NY2d 281, 496 NYS2d 969 [1985]). The facts in that case apply equally to Mr. Johnson. Based on the Court's decision in Ausbrooks, amounts paid to Johnson by Copem 72 are not taxable in New York.

As noted earlier, at the time of Johnson's retirement in 1983, the partnership affairs of PMM were governed by the 1975 Partnership Agreement. PMM was also governed by the operating procedures of Peat, Marwick, Mitchell & Co. (United States) dated July 1, 1975, as amended October 26, 1977 ("the 1975 Operating Procedures") (Ex. "4").

Johnson retired from PMM on June 30, 1983 at the mandatory retirement age of 60, at which point he surrendered all remaining units representing his allocated interest in the partnership. The balances in Johnson's drawing account and capital account were fixed on the date of his retirement. The $3,000.00 balance in Johnson's capital account was transferred to his drawing account, but the combined balance, pursuant to PMM's 1975 Operating Procedures, was not paid to him until one year later, i.e., June 29, 1984.

Johnson views the amounts paid to him from the capital account, drawing account, ACRS and IUR accounts as repayment of a debt owed to him by PMM. Other than the payments from these accounts and the payments from PMM's retirement plan Johnson received no other payments from PMM during fiscal year 1984.

PMM's retirement plan actually consisted of two separate plans. PMM had the "PMM & Co. Pension Plan for Partners" ("the qualified pension plan"),[3] and the "Partners Retirement

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[3]A "qualified plan" refers to a plan qualified under the Internal Revenue Service ("IRS") rules and regulations subject to the employees Retirement Income Securities Act ("ERISA"), and the partnership receives a deduction when it makes a contribution to the plan. An "unqualified" plan is not subject to ERISA and is not qualified under the IRS rules and regulations.

Allowance Plan", effective July 1, 1976 (variously referred to as "the 1976 Plan", the "unqualified retirement allowance" or "the unqualified plan"), as revised through May 15, 1982 (Ex. "5"). The benefit payments made under the qualified plan are not an issue in this proceeding. The focus of this determination is on the payments made under the unqualified plan.[4] The Partners Retirement Allowance Plan is included by reference in the 1975 Partnership Agreement. The 1975 Partnership Agreement and the Partners Retirement Allowance Plan governed Johnson's rights as a partner and his rights upon retirement.

The unqualified plan was established to work in tandem with the qualified pension plan to provide PMM's partners with what was considered a "suitable" retirement allowance (tr., p. 310). The pension rights that a partner accumulated under the qualified plan were offset or deducted from a partner's rights under the unqualified plan.

Mr. Lynskey administers PMM's qualified and unqualified pension plans. In his capacity as director, Mr. Lynskey is also involved with the out-processing of retiring partners. That includes counseling a retiree concerning his/her rights under the particular partnership agreement governing his retirement for the purposes of helping him/her understand their pension (and other) benefits. Mr. Lynskey explains to retiring partners the timing of the settlement of their accounts with the firm, their rights with regard to receiving their interest in unrealized receivables and the retirement benefits they are entitled to receive.

Mr. Lynskey testified that it is possible to compute and advise a partner, at the time of retirement, as to the amount of the retirement allowance benefit he will actually be paid, subject to cost of living adjustments. The 1976 retirement allowance plan allowed for cost of living adjustments ("COLA"), which were granted in the discretion of the Board of Directors. Cost of living adjustments, he said, are a typical, traditional, defined benefit plan mechanism for adjusting benefits. He testified further that it is not uncommon to have such adjustments in a

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[4]The "unqualified plan", as used infra, refers to the retirement allowances paid under both the 1960 Partnership Agreement and 1976 Retirement Allowance Plan.

pension plan left to the discretion of the board of directors. The record shows only one year when COLAs were not granted.

In 1983, the mandatory retirement age of partners at PMM was age 60. Johnson retired at age 60 on June 30, 1983, one month short of his 61st birthday. Lynskey testified that Johnson, at retirement, relinquished all of his units of interest in the partnership and gave up all of his partnership rights pursuant to PMM's operating procedures and the 1975 Partnership Agreement.

Mr. Lynskey stated that after Johnson retired he provided no services to PMM, maintained no office at PMM, and no longer had access to PMM's secretarial staff. However, Lynskey said, Johnson was entitled to retirement benefits from PMM's qualified and unqualified plans upon his retirement. Under the unqualified plan of 1976, the amount of a partner's retirement allowance was based, Mr. Lynskey stated, upon a typical defined benefit formula which is a function of the partner's years of service with the firm and his final average salary over five years. Once the retirement allowance is calculated at the time of retirement, it is fixed and final except for possible increases due to cost of living adjustments.

The benefit that Johnson was entitled to under the "unqualified" Retirement Allowance Plan was determined in accordance with the following formula:

(i) 1.8% of a partner's retirement income base multiplied by the partner's years of service not in excess of 25 years; plus

(ii) 1% of a partner's retirement income base multiplied by years of service in excess of 25 years, but not in excess of 40 years.

A partner's retirement income base was defined as the partner's highest earnings in the five-year period preceding retirement, but limited to $40,000.00 plus 35% of his/her earnings in excess of $40,000.00. A partner's retirement allowance under the unqualified plan was not based on a partner's interest in the assets of PMM nor were such payments designed to compensate the partner for his interest in PMM.

Lynskey testified that the 1976 Retirement Allowance Plan included a limitation or cap of 15%, i.e., the benefits of all retired partners may not exceed 15% of the firm's distributive income (Ex. "5"). The 1960 Partnership Agreement had the same 15% limitation (Ex. "19").

With regard to the 15% limitation on total retirement allowances, Lynskey testified that it was ineffective as a limitation because it was unlikely to be imposed in petitioners' lifetime. This testimony he said is based on calculations and projections taking into account the total payments, the amounts of future benefit payments based upon the number of partners, their ages and their earnings, and based on historical experience. Lynskey stated that these calculations develop projected cash flows based upon conservative estimates of earnings and, on that basis, he concludes that the total retirement allowance payments do not approach the 15% limitation in any reasonable time frame. None of the partnership agreements in this case, nor the retirement allowance plan, provide for paying in later years amounts that have been deferred in a given year due to the 15% limitation.

The 1975 Partnership Agreement and the 1976 Retirement Allowance Plan also contain a forfeiture provision. Under this provision, if a retired partner engages in the practice of accounting subsequent to leaving PMM without PMM's consent, he would forfeit his retirement allowance. According to Lynskey, this provision has never been enforced and PMM's consented is routinely granted. Aubrey Fariss is an example of a retired partner who requested and received permission to practice accounting after leaving PMM.

Using the factors testified to earlier, Mr. Lynskey testified that, for Warren Johnson, he determined a retirement income base of $110,390.38 which, based on 34.916 years of service, resulted in a gross retirement allowance of $60,622.75. This total retirement benefit was reduced or offset by the allowance of $11,963.76 which Johnson received from PMM's qualified pension plan. The $48,659.00 annual retirement benefit remaining after the offset was paid by the Partners' Retirement Allowance Plan (the unqualified plan) (Ex. "8", "9").

Johnson elected under the Partners' Retirement Allowance Plan to take his retirement benefit in the form of a straight life annuity with a "five year certain period." Under that

election, even if he were to die before the expiration of that first five years, his estate would continue to receive retirement benefit payments at regular intervals for the full five years (20 quarters). If he died in the sixth year after retirement the payments would cease.

In addition to the amounts Johnson received in 1984 under the unqualified retirement plan, he was paid interest on the amounts in his drawing account, capital account, ACRS account and unrealized receivables account. Mr. Lynskey summarized the 1984 payments Johnson received as follows:

Source	FYE 6/30/84
a) Non-qualified plan:	$ 48,659.00
b) Interest on Drawing Account balance:	$ 37,719.07
c) Payment on IUR Account	$ 34,186.29
d) Payment on ACRS deferral	$ 1,008.59
Total from PMM:	$121,572.95
Final Payment on PMM's interest in PMM General Partnership:[5]	$ 1,790.00
	$123,362.95
Payments from partnerships unrelated to PMM:	
a) Greenbriar 64, 69 & 72:	$ 3,443.00
b) Copem 72	$ 3,399.00
Total All Sources:	$130,204.95

The interest on Johnson's drawing account was paid to him on June 29, 1984 when his drawing account was closed (tr., pp. 98-99; Ex. "12", "15"). As noted earlier, the Greenbriar and Copem partnerships are unrelated to PMM.

As of the date of Johnson's retirement, the amounts in his ACRS account and IUR account were frozen. Johnson elected, pursuant to section 3 of the 1975 Operating Procedures, to have the balance in these two accounts, plus interest, paid to him over the five-year period subsequent to his retirement. The combined balances of these two accounts was $175,974.42. The first installment of $35,194.88 was paid to Johnson on June 29, 1984.

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[5] PMM General Partnership and PMM are two separate entities.

Tax on amounts petitioner received from the Greenbriar partnership is not an issue in this proceeding (tr., p. 104).

As noted, Johnson also received $1,790.00 from the PMM-General Partnership in 1984 (Ex. "12"). That payment is not taxable in New York and is not an issue in this proceeding (tr., p. 103).

A letter dated February 27, 1985 from R.C. Lurie, Executive Officer of PMM, and addressed to all "Nonresident Partners" provided instructions on preparation of New York's 1984 nonresident income tax returns ("IT-203" or "the returns"). It appears that this letter was also sent to PMM's retired nonresident partners, including Mr. Johnson. Mr. Johnson filled in the forms which were used to prepare his 1984 returns based on the instructions in Lurie's letter (Ex. "46"). Johnson testified that he never questioned the virtue of PMM's tax advice or the contents of Lurie's letter. Johnson just assumed that the PMM tax department knew what it was doing. This was especially so, since Johnson never practiced tax accounting, his specialty being the Securities and Exchange Commission. In following Lurie's instructions, Johnson referred to himself as a "partner" in PMM on his 1984 nonresident New York return. As will be seen, Redlin and Fariss used similar language on their tax returns.

The sum of (i) the retirement payments under the Partners' Retirement Allowance Plan ($48,659.00); (ii) the interest payments credited to Johnson's drawing account ($37,719.07); and (iii) the payment of the first installment of the combined balance in Johnson's IUR account and ACRS account ($35,194.88), or a total of $121,572.95, was reported to Johnson on a K-1 issued by PMM (Ex. "12", "16"). The total amount reported on the K-1 issued to Johnson was characterized by PMM as "Retirement Paymts-736(a)-IRC". Johnson testified that while he was aware that PMM had characterized the total as "Section 736A" payments, he did not know why.

The amounts received by Johnson from PMM ($121,572.95), PMM-General ($1,790.00), the Greenbriar partnerships ($3,443.00) and the Copem 72 partnership ($3,399.00), totalling $130,204.95 (Ex. "12"), were included on the supplemental computation of income or loss from partnerships on Johnson's Federal income tax return (Form 1040), Schedule E, Part II,

Statement 5, attached to Johnson's New York nonresident income tax return for 1984, dated August 4, 1985 ("IT-203").[6] After the addition and subtraction of amounts from partnerships not at issue here, the resulting figure of $112,857.00 was carried over from Schedule E to the Federal column on Form IT-203 at line 13 as net income from partnerships (Ex. "KK").

Of the $112,857.00 received from PMM, PMM and Johnson allocated a total of $21,983.00 to New York source income on his 1984 IT-203. This reported New York source amount came off of a form provided to Johnson by PMM entitled "Partner-Peat, Marwick , Mitchell & Co. 1984 New York State Supplemental Tax Information". This form is attached to Johnson's 1984 IT-203 and states that $21,983.00 represents Johnson's "share of New York income with depreciation calculated using ACRS." This figure is based on PMM's income percentage allocated to New York. Johnson testified that he did not know how PMM arrived at that figure, or why it was reported as income from "Partnerships, estates, trusts and S-corporations" on page one of his 1984 IT-203. He stated, "I think that Peat Marwick was doing it the way they thought it should be handled for income tax, whether it's Federal or state, and I just followed this" (tr., p. 323; Ex. "46"), referring to Lurie's letter of instructions. After adjustments and itemized deductions, Johnson's 1984 IT-203 showed taxable New York income of $16,764.77, and resulted in total New York tax of $1,036.48, which was paid (Ex. "KK").

PMM's New York State partnership return ("IT-204") filed for fiscal year ending June 30, 1985 allocated, under the category "Partners Share of Income", $19,676.00 of the amounts paid to Warren H. Johnson out of the partnership's "net income" as New York income (Ex. "L").

Johnson filed a claim for credit or refund dated May 19, 1986 with the Division of Taxation ("Division") seeking a refund of $1,036.48. This refund claim was based on the Appellate Division's decision in Pidot v. State Tax Commission (118 AD2d 915, 499 NYS2d 482, affd without opin 69 NY2d 837, 513 NYS2d 965).

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[6]It will be recalled that when Johnson retired in 1983, he elected to have his IUR and ACRS accounts paid to him over a five-year period.

A Notice of Disallowance dated January 30, 1989 was sent to Warren Johnson denying his refund claim in full. This notice will be addressed in more detail, infra.

Aubrey and Elsie R. Fariss

At the time of Aubrey Fariss' and Robert Redlin's retirement, the affairs of PMM were governed by Peat, Marwick, Mitchell & Co. (United States) Partnership Agreement, dated October 14, 1959 and effective as of July 1, 1960, as amended through October 16, 1963 ("the 1960 Partnership Agreement").[7]

Pursuant to the provisions of the 1960 Partnership Agreement, Redlin and Fariss were voting partners[8] in PMM and allotted a percentage interest in the profits and losses of PMM, its capital and goodwill. As partners, Redlin and Fariss, like Johnson, were required to contribute to the capital of PMM, and if PMM were liquidated, they would have shared in any surplus that remained after all creditors were paid. As partners, Redlin and Fariss had the same partnership rights as Johnson. Under the 1960 Partnership Agreement a partner who surrendered his allotment would cease to be a "goodwill partner" and could become a limited partner, as will be discussed in more detail, infra (Ex. "19").

Redlin's and Fariss' interests as partners in PMM were represented by their capital account, their drawing account and their percentage interests in PMM. Beginning in 1968, Redlin (only) also had an interest as partner in the unrealized receivables of PMM (Ex. "48").

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[7]Petitioners' witness testified that the Articles of Partnership of Peat, Marwick, Mitchell & Co. (United States) dated July 1, 1970 (Ex. "22") also applied to Fariss and Redlin (tr., p. 138). It is unclear why, since both of these partners retired prior to 1970 and testimony shows that their retirement benefits were governed by the 1960 Partnership Agreement.

[8]Partners such as Redlin and Fariss, under the 1960 Partnership Agreement, were referred to as "'B' Partners", "goodwill partners" and "partners having allotments." Partners having no allotments ("'A' Partners") could not vote. Partners who had relinquished their allotments and retired were called "limited partners".

Neither Redlin nor Fariss had an ACRS account. Fariss did not have an IUR account.

Aubrey Farris and Elsie Fariss,[9] husband and wife, reside at 3707 Olympia, Houston, Texas 77019.

Due to his advanced age and infirmity, Fariss was unable to attend this proceeding as a witness. However, Fariss did offer an affidavit, which was admitted into evidence (Ex. "47"). The contents of Fariss' affidavit was also covered in the testimony of W. Michael Lynskey, PMM's Director of Retirement Services and Partner Benefits. Mr. Lynskey substantiated the contents of Mr. Fariss' affidavit.

Fariss deposes that he graduated from college in 1925 and was licensed by Texas in 1928 as a certified public accountant. In 1940, he founded the accounting firm of Aubrey Fariss Company located in Houston, Texas. Fariss' specialty was tax accounting for the oil and gas industry. In 1950, his accounting firm was purchased by PMM and Fariss joined PMM as a special partner. In 1953, Fariss was admitted as a general partner of PMM. He retired from PMM on June 30, 1965 at the age of 62, which was PMM's mandatory retirement age for partners at that time.

As a partner in PMM, Fariss' share in the profits and losses of PMM was determined based upon his percentage of interest in the partnership. That percentage was fixed on an annual basis by two-thirds vote of the voting partners. In 1965 when he retired, Fariss owned an allotted 1.20% interest (600 units) in the partnership.

At his retirement on June 30, 1965, Fariss surrendered his percentage interest in PMM and partnership rights. At that time he was repaid the balance in his drawing account and 90% of his capital account. Fariss was also paid an amount representing his interest in the goodwill of PMM.

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[9]Elsie Fariss is involved in this proceeding solely because she filed joint returns with her husband. References to "Fariss" in this determination refer to Aubrey Fariss alone.

Upon retirement as a voting partner, Fariss became a "limited partner". The term "limited partner" was a title assigned to PMM's retired partners in the 1960 Partnership Agreement.

The 1960 Partnership Agreement provided that a limited partner had no interest in the goodwill of the partnership or in the firm name, no vote and no voice in PMM's management or direction and could not participate in its practice (Ex. "19", ¶ 10). Paragraph 12 required each limited partner participating in the profits of PMM to retain a percentage of his original capital contribution with the firm. If a limited partner decided to cease being a limited partner, his capital contribution would be repaid to him within three months after the date he ceased to be a limited partner (id., ¶ 12[e]).

The 1960 Partnership Agreement also provides, in relevant part, that a limited partner would participate in the profits of the firm for each fiscal year for which he was a limited partner in an amount computed in accordance with a formula based on: (i) 1% of the annual salary he received at the date he surrendered his interest in the partnership multiplied by his years of service; plus (ii) one-tenth of the profits for the fiscal year applicable to the maximum percentage of interest held by him in PMM at any time during the five-year period ending on the date he surrendered the first portion of his interest (referred to as an "allotment") in the partnership. It is clear from this agreement that to be a limited partner, a retired partner must maintain a capital contribution with PMM, and further, in order to continue to participate in the profits of the firm after retirement, one had to be a limited partner. Limited partners could resign and withdraw their capital contributions at any time, at which point they would no longer share in PMM's profit distributions (Ex. "19", ¶¶ 10, 11, 12). The participation of retired (or limited) partners in the profits of PMM are referred to infra, as their "retirement allowance", "retirement benefits", or "pension benefits".

Fariss' contribution to capital and the extent of his participation in the profits of PMM as a "limited partner" was computed as follows:

PMM (United States)
10% of capital contribution applicable to highest % of interest at any time with PMM.

Fariss' Highest % interest: 1.20%
Highest Amount of capital: $60,000.00
10% of $60,000.00: $ 6,000.00

PMM (General)[10]
Highest % in PMM: 1.20%--600 units
600 units at $15.00 per unit: $ 9,000.00
Capital in PMM (General)
10% of $9,000.00: $ 900.00

Fariss total limited partner capital contribution: $ 6,900.00

Fariss' Participation in profits (retirement allowance) as a limited partner:
1% of annual salary of $15,000. or
150 times 14 years of service: $ 2,100.00

plus .12% of profits.

Mr. Fariss total capital contribution as a limited partner was $6,900.00, $6,000.00 of which was attributable to PMM (United States) and the remainder to PMM (General) (Ex. "21"; tr., pp. 123-124). The $6,900.00 in Fariss' capital account was repaid to him in 1968 when PMM changed its policy and returned the capital contributions to all of its limited partners. After 1968, "limited partners" were no longer required to maintain a capital contribution with PMM as a condition of receiving a retirement allowance.

The 1960 Partnership Agreement also provided that the aggregate participations of all limited partners in the profits of the firm for any fiscal year could not exceed 15% of the net profits of the firm for fiscal year. "In the event that the aggregate amounts otherwise determined in accordance with the provision of this Paragraph ELEVENTH shall exceed said fifteen per cent (15%)", such amounts were to be reduced pro rata, so that in the aggregate they would equal the 15% cap (Ex. "19", ¶ 11[e]). Put another way, Lynskey stated that, to the

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[10] PMM (General) is a separate partnership from PMM (United States).

extent that the aggregate retirement allowance calculation exceeded the cap, the cap was substituted. Because the cap was substituted, in these instances, in Mr. Lynskey's opinion, petitioners' benefits were not based on the profits of PMM, because the linkage between the benefits and PMM's profits was lost.

The 1960 Partnership Agreement also provided, in relevant part, that "[t]he participation of a limited partner . . . shall not be less than Four Thousand Dollars ($4,000.00) per annum nor more than Twelve Thousand Dollars ($12,000.00) per annum" (Ex. "19", ¶ 11[b][1]), plus cost of living adjustments (Ex. "19", ¶ 11[b][4]). The 1960 Partnership Agreement was amended October 16, 1963 to increase these amounts to "not be less than Six Thousand Dollars ($6,000.00) per annum or more than Eighteen Thousand Dollars ($18,000.00) per annum" (Ex. "19", ¶ 11[b][1]).

While Mr. Lynskey testified that limited partners did not maintain any investment in PMM, that was only true after 1968. Up until 1968, limited partners were required, as a condition of their status and as a condition of participating in PMM's profit distributions, to keep a portion of their original capital contributions with PMM. The concept of PMM's "limited partners" was formally abandoned in 1970 when the Articles of Partnership, effective July 1, 1970 ("the 1970 Partnership Agreement"), were adopted and eliminated the designation (tr., p. 135). However, retired partners that had been receiving retirement allowances under the 1960 partnership agreements, et al, continued to do so.

As noted above, Fariss was repaid his capital contribution in 1968, when PMM decided to repay the capital contributions of all its limited partners. After 1968, Mr. Fariss had no capital contribution in PMM. After 1968, a contribution to capital was not a condition of being a limited partner.

The record shows that the annual retirement allowance paid to Mr. Fariss from 1971 through 1991, as with Johnson, was equal to the ceiling (cap) amounts. Lynskey stated that because of this cap, in practice, the amounts paid as pension benefits lost their linkage to the firm's profits (tr., p. 141; Ex. "23").

The following shows the amounts actually paid to Mr. Fariss on a fiscal year basis compared to what he would have received without PMM's cap:

FISCAL YEAR	MAXIMUM BENEFIT WITHOUT 15% CAP	ACTUALLY PAID FISCAL YEAR
1982	$254,413.00	$46,653.00
1983	286,032.00	48,985.00
1984	319,166.00	50,945.00
1985	347,241.00	51,953.00
1986	362,594.00	51,557.00

Fariss reported his income from PMM on a fiscal year basis. The Schedule K-1's prepared by PMM and provided to Fariss reported the above fiscal year amounts for each year 1982 through 1986. The amounts on each K-1 are referred to as "Guaranteed payments-Retirement Paymts-736(a)--IRC" (Ex. "26").

The following shows the retirement allowance paid to Aubrey Fariss by PMM and the amounts PMM and Fariss reported as New York source income during the years 1982 through 1986 using PMM's allocation percentage of 16.88%:

FISCAL YEAR	RETIREMENT ALLOWANCE	PORTION ALLOCATED BY PMM TO NY
1982	$46,653.00	$8,076.00
1983	$48,985.00	$7,985.00
1984	$50,945.00	$9,332.00
1985	$51,953.00	$9,640.00
1986	$51,557.00	$8,034.00

Aubrey and Elsie Fariss filed New York nonresident income tax returns ("IT-203") separately on one return for 1982, 1983, 1984, 1985 and 1986. They claim these returns were filed under the mistaken belief that they had received income attributable to a New York source. In filing the returns for each of the subject years, Aubrey and Elsie Fariss entered a portion of the amounts received from PMM in the New York column on said returns as net income from partnership attributable to New York and, after adjustments and deductions, paid New York income tax in the following amounts in the years specified:

YEAR	TAXABLE NY INCOME	TAX PAID
1982	$6,031.00	$121.23
1983	$5,959.00	$118.77
1984	$7,368.00	$174.74
1985	$9,414.00	$296.54
1986	$6,419.00	$176.76

Aubrey and Elsie Fariss filed claims for credit or refund dated April 11, 1986 for the years 1982, 1983, 1984 and 1985 and seeking a refund of income tax paid in the amount of $753.50. A subsequent claim for credit or refund dated April 15, 1988 was filed for 1986 seeking a refund of $176.76. The Farisses, like the other petitioners, based these refund claims on the Appellate Division's decision in Pidot v. State Tax Commission (supra).

Two notices of disallowance, both dated April 18, 1990, were sent to Aubrey and Elsie Fariss denying their refund claims in full. These notices will be discussed in more detail, infra.

Robert W. and Harriet A. Redlin

Robert W. Redlin and Harriet Redlin,[11] husband and wife, reside at 83 Blairmoor Court, Grosse Pointe, Michigan.

Redlin did not appear as a witness in this proceeding due to ill health, but did provide an affidavit, which was admitted into evidence. The substance of Redlin's affidavit was also covered in the testimony of W. Michael Lynskey. Mr. Lynskey's testimony served to substantiate Mr. Redlin's affidavit.

Redlin states that he was born in Cleveland, Ohio in 1918 and graduated from Miami University, Oxford, Ohio in 1939. Following graduation from college, Redlin was employed as an accountant in the Detroit, Michigan office of PMM. In 1941, he was licensed in Michigan as a certified public accountant. Redlin took a leave of absence in 1942 to go into the Navy, and in 1945 he resumed his career with PMM at its Detroit, Michigan office.

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[11]Harriet Redlin is a named party to this proceeding solely by reason of filing joint income tax returns with her husband. Accordingly, the terms "petitioner-Redlin" or "Redlin" refer only to Robert Redlin.

In 1951, Redlin states that he became a general partner of PMM. He took early retirement from PMM on June 30, 1969 at the age of 50. Redlin states that, since 1939, he has always lived and spent his entire working career in the State of Michigan. When Redlin retired on June 30, 1969, he relinquished his entire percentage interest in the partnership and lost his "partnership rights", including, but not limited to, his right to vote on the admission of new partners, and his right to inspect the books and records of the firm. At his retirement, Redlin surrendered his percentage interest in PMM and was repaid the balances in his drawing account and capital account. Additionally, Redlin elected to have the balance in his unrealized receivables account repaid to him over a ten-year period. The unrealized receivables account was completely repaid to Redlin by the end of fiscal year 1979 (tr., pp. 172-173). Like Fariss, Redlin became a "limited partner" of PMM upon retirement. However, unlike Fariss, Redlin was not required to leave a capital contribution with the firm as a condition of being a limited partner since, by 1969, it was no longer required. Pursuant to PMM's operating procedures, Redlin was repaid his partner's capital contribution one year following his retirement, i.e. June 30, 1970. Redlin's retirement benefits were computed pursuant to the 1960 Partnership Agreement.[12]

A memo is in the record from W. E. Hanson to all B-Partners, dated May 14, 1969 (Ex. "29"), which advised Mr. Redlin as to his retirement benefits as a B-Partner,[13] and states, in pertinent part:

> "A 'B' partner shall be entitled to a retirement allowance equal to the sum of:
>
> "1. 1% of basic compensation he was receiving at the date of retirement multiplied by the number of years of service prior thereto and 1/10 of the profits for each fiscal year applicable to the maximum percentage of interest he held at any time in

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[12]As were the benefits of Farris.

[13]At the time, "B" Partners were partners such as Redlin and Fariss who had all of the rights of general partners.

> the overall profits of PMM & Co., United States. The retirement allowance shall not be less than $6,000 per annum or more than $18,000 per annum.
>
> "2. In the event official statistics of the United States Government should indicate that the cost of living has increased . . . consideration shall be given to an appropriate increase in the maximum and minimum allowance referred to above . . . .
>
> "3. A 'B' partner who shall have completed 25 years of continuous service and surrendered his units after attaining the age of 50 years, and has been a 'B' partner for 10 years, may take early retirement, and if he does, his retirement allowance shall be a percentage of what his annual retirement would have been in accordance with the formula above . . . .
>
> * * *
>
> "5. In no event, shall the aggregate retirement allowances of 'B' partners exceed 10% of the overall profits of the Firm for such fiscal year. In the event that the aggregate amount exceed said 10%, then the amounts shall be reduced pro rata so that in the aggregate, they shall equal 10%."[14]

A computation taken from Redlin's personnel file and obtained for the hearing by Mr. Lynskey shows Mr. Redlin's estimated pension payments under the "Old 'B' Agreement"[15] (Ex. "30") shows a computed maximum benefit of $31,000.00 subject to a 49% discount due to his early retirement at age 51.

Mr. Lynskey's testimony and documents show the amounts paid to Mr. Redlin on a fiscal year basis compared to what he would have received without PMM's 15% benefit cap as follows:

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[14] The 10% cap in this paragraph would appear to relate to an old version of the partnership agreement since, by 1969, the cap had been increased to 15% (Ex. "19", ¶ 11[c]).

[15] It is assumed here that the old "B" agreement is the 1960 Partnership Agreement that governed "B" partners and others.

FISCAL YEAR	MAXIMUM BENEFIT WITHOUT 15% CAP	ACTUALLY PAID FISCAL YEAR
1982	$179,202.00	$22,859.00
1983	201,098.00	24,006.00
1984	224,043.00	24,962.00
1985	243,485.00	25,455.00

As with the other petitioners, Mr. Lynskey testified that these amounts received by Mr. Redlin as retirement allowances were not tied to the profits of PMM, because the linkage was lost due to the ceiling or "cap" on the amount of the payments (tr., p. 167). Mr. Lynskey testified that other than the retirement benefits, supra, Redlin received no other amounts from PMM during the years in question, i.e., 1982, 1983, 1984 and 1985.

The following shows the retirement allowance paid to Redlin for fiscal years 1982 through 1985 and the amounts PMM and Redlin reported as New York source income:

YEAR	RETIREMENT ALLOWANCE	ALLOCATED TO NY INCOME BY PMM
1982	$22,855.00	$3,956.00
1983	$23,999.00	$3,912.00
1984	$24,955.00	$4,512.00
1985	$25,455.00	$4,723.00

Robert and Harriet Redlin filed joint New York nonresident income tax returns ("IT-203") for 1982, 1983, 1984 and 1985. Like the other petitioners, they claim these returns were filed under the mistaken belief that they had received income attributable to a New York source. In filing the returns for each of the subject years, Robert and Harriet Redlin entered a portion of the amounts received from PMM in the New York column on said returns as net income from a partnership attributable to New York and, after adjustments and deductions, paid New York income tax in the following amounts for the years specified:

YEAR	INCOME ALLOCATED TO NY	TAX PAID
1982	$3,956.00	$ 47.00
1983	$3,912.00	$ 45.00
1984	$4,512.00	$ 64.00
1985	$4,723.00	$142.00

Robert and Harriet Redlin filed separate claims for credit or refund, all dated April 13, 1986, for years 1982, 1983, 1984 and 1985 and seeking a total refund of income tax paid in the amount of $298.00. The Redlins, like the other petitioners, based these refund claims on the Appellate Division's decision in Pidot v. State Tax Commission (supra).

A notice of disallowance dated April 18, 1990 was sent to Robert and Harriet Redlin denying their refund claims in full. This notice will be discussed in more detail, infra.

Each of the petitioners receive the maximum amount allowed under the retirement provisions of the 1960 or 1975 Partnership Agreements. Such payment amounts do not fluctuate. The retirement allowances each petitioner received were fixed at retirement. Any variations since that time have been due solely to cost of living adjustments.

In each of the subject years, the partnership returns filed by PMM with the State of New York included a list of each of its partners, their state of residence, social security number, and the amount paid by PMM to each partner as their share of partnership income for the year (Ex. "L"). Johnson, Fariss and Redlin and their respective shares of PMM's profits allocated to New York appear on each of these partnership returns.

Up until 1970, the question of whether to grant a COLA in the retirement allowance of retired partners was decided by those partners having a right to vote. Since 1970, resolution of that question has been in the sole discretion of PMM's board of directors (tr., pp. 190-192). Mr. Lynskey testified that the increases in benefits actually paid to petitioners over the years were solely attributable to the COLAs (tr. 193). Lynskey also testified, and the other evidence supports, that there has never been a decrease in the retirement benefit payments from one year to the next.[16]

There was no linkage between Johnson's, Fariss', or Redlin's retirement benefits and the assets of the firm, or the percentage interest each held as partner in the assets of the firm (tr., p. 164).

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[16]Under either the 1960 Partnership Agreement or the 1976 Retirement Allowance Plan.

Redlin and Fariss were given an opportunity to switch from the retirement benefit arrangement in the 1960 Partnership Agreement to the plan which applied to Mr. Johnson. They declined to do so, because it would have resulted in less benefits.

Lynskey testified that the retirement allowances were processed by PMM in the following manner. The "partner's accounts" of Johnson, Redlin and Fariss would be credited at the beginning of each fiscal year with the amounts representing their respective retirement allowance for the year. As quarterly distributions were made to the retired partners during the year, their respective accounts were debited until at the end of the year there would be a zero balance (tr., p. 148). After 1984, the payments to retired partners of amounts representing their participation in the profits of PMM were no longer processed or passed through the "partner's account" (tr., pp. 147, 176-180; Ex. "24", "33").

Redlin, Fariss and Johnson reported their income from PMM on a fiscal year basis as required. The Schedule K-1's prepared by PMM and provided to the three petitioners reflected the fiscal year retirement allowance payments on each K-1 as "Guaranteed payments-Retirement Paymts-736(a)--IRC" (Ex."16", "26", "35").

Johnson, Redlin and Fariss were never licensed as CPAs by the State of New York, were never employed in the State of New York, and never lived in the State of New York. The sole connection of Johnson, Redlin and Fariss with New York is that they each were at one time nonresident partners of PMM, a New York partnership.

The evidence with respect to Redlin, Fariss and Johnson is that, as of the dates of their retirement, they surrendered all of their "partnership rights". After their respective retirement dates, Redlin, Fariss and Johnson no longer had the right to vote on any matter submitted to the partners for a vote, no longer had the right to participate in the management of PMM, no longer had the right to inspect the books and records of PMM and no longer were entitled to receive financial information from PMM. After their respective retirement dates, the amounts each received as a retirement allowance was the only contact they had with PMM. The amounts

received by Johnson, Fariss and Redlin did not depend on the extent of their respective interests in the partnership while they were partners.

As noted earlier, each of the petitioners applied for refunds of the New York income tax paid on their retirement allowances. Each of these refund claims were disallowed with notices of disallowance which, except for taxpayer specific information, were identical. Each of the notices of disallowance that were sent to the respective petitioners stated that upon review of that part of PMM's "partnership agreement which covers payments made to retired partners (in particular the paragraphs entitled 'Limitation of Total Retirement Allowance,' 'Forfeiture of Allowance' and 'Unrealized Receivables, Accelerated Cost Recovery System Deferred, and/or Deferred Compensation'), it has been determined that the payments received by you from the partnership as a retired partner do not qualify as an annuity" under 20 NYCRR 131.4(d) for the following reasons:

> "1. An overall limitation on payments in any year to retired partners applies. However, there is no provision for the payment of the reduced amount in a subsequent year as was the case in the decision Pidot v State Tax Commission, 118 AD 2nd 1915, aff. without opinion 69 NY 2nd 837. As a result, the payment plan would not satisfy the uniform rate test nor would it be possible to determine the total of the amounts payable at the annuity starting date.
>
> "2. A restrictive covenant condition exists which results in forfeiture of retirement allowances, if violated.
>
> "3. Retirement allowance includes payments attributable to a partner's share of unrealized receivables which are payable over a period of time. The partner would be considered a retiring partner receiving payments in liquidation of his interest in the partnership during this period. Therefore, the retiring partner's interest in the partnership would not be fully liquidated until all shares of unrealized receivables are paid to him. Full liquidation of the partner's interest in the partnership prior to receipt of retirement allowances was vital to the Court's decision in Pidot."

Kraig M. Kummer, an enrolled actuary[17] and pension and asset planning consultant with William M. Mercer, Inc., testified as an expert for Mr. Johnson. In his capacity as consultant, Mr. Kummer provides advice to corporations, non-profit agencies, hospitals, universities, and unions, etc., on the design, funding and administration of pension plans and other employment

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[17]The term "enrolled actuary" is a term of recognition conferred by the Joint Board for the Enrollment of Actuaries.

benefit plans. He also assists retirement plan sponsors in establishing investment policies and objectives. In forming his expert opinion testified to at hearing, Mr. Kummer reviewed and analyzed the Partners' Retirement Allowance Plan which became effective July 1, 1976.

As part of his duties as consultant, Mr. Kummer performs actuarial evaluations for clients to determine the minimum required and maximum deductible contributions required of the plan sponsor for the plan year. A pension plan is a promise made by the employer to provide certain benefits to employees upon retirement, and those benefits are typically due many years in the future. Mr. Kummer stated that it was his job to place a value on those promises. In doing that, he takes into account certain future contingent events such as the employee's salary just before retirement, the length of service and the continued survival of the employee.

Kummer's testimony was limited to the 1976 Partners' Retirement Allowance Plan as it affected Mr. Johnson. Kummer testified that the 1976 Partners' Retirement Allowance Plan ("1976 plan") is an unqualified defined benefit pension plan. Under this plan, Kummer states, benefits are calculated on the retiree's length of service with the company and based on the highest earnings in any year out of the last five years of employment. These benefits are subject to a "maximum limit which is 15 percent of the cash basis net income or the pro rata share of the partner's pro rata share of the cash basis in the income of the firm" (tr. pp. 230-231). Under this plan, benefits are payable periodically under one of several optional forms of payment, but each form extends over at least the life expectancy of the retiree.

Mr. Kummer reviewed the Division's annuity rules in 20 NYCRR 132.4(d) (formerly 20 NYCRR 131.4[d]). Kummer addressed the Division's claim that, under its rules, the payments received by Mr. Johnson under the 1976 plan did not qualify as an annuity because it was not possible to determine the total amounts payable at the annuity starting date, either directly or indirectly, in accordance with sound actuarial theory. Kummer did not agree.

In setting the background for his reasoning, Mr. Kummer stated that the American Academy of Actuaries established a standard setting board in 1985 known as the Actuarial

Standards Board ("the board"). The board has produced publications, including a "Preface to Actuarial Standards of Practice" (hereinafter "Standards of Practice") and the "Fundamental Concepts of Actuarial Science" (Ex. "36"), portions of which were made part of the record. "Fundamental Concepts of Actuarial Science" (hereinafter "Fundamental Concepts"), at page 23, states:

> "Probability and statistics, the study of random variables is clearly one of the foundations upon which actuarial science is built. The impossibility of certainty is one of the facts with which all humans contend. In many situations the actuary's role is to help society, via financial security systems, to deal with uncertainty. Probability and statistics provide many of the tools on which such systems depend."

Kummer stated that a "financial security system" is any economic system that transfers risk from an individual to a collective of individuals, e.g., pension plans. Pension plans transfer the risk of a person outliving his means from the individual to the pension plan. The Board in Fundamental Concepts developed a generalized model to describe interaction between a financial security system, its individual members and the time concept of money.

Kummer stated that the cash flow from a financial security system is a time-related complex of payments. Every payment has three distinguishing elements: (i) the time when the payment is made; (ii) the amount; and (iii) the probability that the payment will be made. For example, assume a person is 55 years old and his employer promises to pay him $10,000.00 when he is 65, if he is still alive. There are three elements. There is a time of payment, an amount of payment and a probability that the payment will be made, which is the probability that the individual will survive for 10 years.

If probability of payment is assigned a zero, that denotes certainty that the payment will not be made. If the probability of payment is assigned the number "1", it denotes certainty that a payment will be made. Once cash flow from a financial security system is established, its value is determined by multiplying each expected payment by the probability that it is going to be made and then, further, by a factor which takes into account the time value of money, a discount factor. Therefore, Mr. Kummer stated, in the example, supra, if the $10,000.00

payment was assured of being made 10 years from now, the present value of that payment would still be something less than $10,000.00 because of the time value of money.

Mr. Kummer testified that as a matter of "sound actuarial theory", the total of the amounts payable to a retiree under the 1976 partners' retirement plan is determinable at the annuity starting date from the plan itself by use of mortality tables and compound interest computations. This is so, he said, because the three distinguishing elements are present.

> "You can determine the time that each payment is to be made; you can determine the probability that it's going to be made; and you can determine the expected amount of each payment" (tr., p. 246).

Kummer stated that you could determine the expected future payments by observing the actual plan payments that have been made over a period of time. By doing so, you can determine what the underlying trend is in payments, and that can be used to determine the likelihood that the payment will be reduced at any point in the future because of the plan's 15% limit. By using "Time Series Analysis", Kummer stated that it was possible to determine the extent that Johnson's future payments would be reduced.

Using data provided by PMM, Kummer prepared an analysis which showed, for each year from 1971 through 1991, the retirement plan payments made to partners and the adjusted cash basis income of PMM (Ex. "6").[18] The figures for each year represent a time series; for example, the retirement plan payments from 1971 to 1991 is a time series. Time series analysis can help to determine the probability that Johnson's payments will be reduced in the future because of the 1976 retirement plan's 15% limit. This is done by comparing plan payments in the past to PMM's adjusted cash basis income over the same period and extending the trend lines of these previous years into the future by using "least squares analysis." "Least squares analysis" is a technique of plotting each time series on a graph and making a visual observation as to the nature of the progression to see whether the retirement plan payments, for example, strike a relatively straight line that is increasing over a curved line.

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[18]Each of the calculations done by Mr. Kummer and referred to in his testimony implicitly include COLAs made for the periods covered in his testimony.

Based on information contained in Exhibit "6", Kummer plotted the observed values from 1971 to 1991 for the annual retirement payments to partners and annual plan limits under the 1976 retirement plan (Ex. "37"). Kummer stated that his graph shows that for each time series (retirement plan payments and adjusted cash basis income) there was an upward sloping curve which suggested to Kummer that he should use an application called the "Logarithmic Least Squares Application." This application is characterized by a line that slopes upward implying a constant percentage increase in the variable. Kummer stated that this analysis is completely objective in that anyone applying the same formulas would obtain the same results. A least squares analysis results in a "least squares equation" (Ex. "38").

From these various analyses, Mr. Kummer prepared a document entitled "Trended Benefits vs. Trended Limits" (Ex. "39"). This graph shows that from 1971 to 1991 the annual amounts representing the 15% limit has increased at a much faster rate than the annual increases in actual benefit payments. Kummer extended the trends demonstrated by this graph into the future in preparing a graph entitled "Projected Benefits vs. Limit" (Ex. "40").

Exhibit "40" projects the trend for both the retirement plan payments and the 15% plan limit through the year 2021. According to the projected trend lines, the benefit payments are not expected to exceed the 15% limit until the year 2019. That means that in trying to determine the actuarial present value of this income stream, the payments due to Mr. Johnson after the year 2019 would be less than what he is currently receiving. For example, in the year 2020, the expected benefit payments in total are $2,400,248,000.00 and the plan limit is $2,000,282,039.00. The ratio of the plan limit to the benefit payments is 93.1%. So, the plan payments to Mr. Johnson in the year 2020 would be 93.1% of the amount he is currently receiving. Kummer states that similar projections can be made for any date in the future (tr., p. 258-259).

Similarly, Kummer states that, as of the annuity starting date, the amounts payable can be determined using the 1976 plan itself, mortality tables and compound interest as specified in the Division's annuity regulations, because the three basic elements necessary to value a cash

flow are capable of being determined, i.e., probability that the payment will be made, the time that the payment will be made and the expected amount of each payment. According to Kummer, it is not necessary in order to value a cash flow in accordance with sound actuarial theory to know with certainty what each future payment is going to be. Rather, he said, you need to know what the expected future payments are to be. And, in addition, you need the other key elements, the time each payment is to be made and the probability that it will be made.

The Division's regulations have a "uniform rate test" which provides that payments will qualify as an annuity if they remain uniform during the individual's lifetime or over a shorter period not less than half of said individual's life expectancy as of the date payments begin. In determining a person's life expectancy, the Division's regulations specify "Appendix A, Annuity Tables, Table "I", "Ordinary Life Annuities--One Life--Expected Return Multiples" in the Internal Revenue Code regulations (Ex. "41"). Mr. Kummer testified that since Mr. Johnson retired at age 61, his expected return multiple or life expectancy would have been 17.5 years. The projection in petitioners' Exhibit "40" indicates that the 1976 plan limit will not be reached until 2019, or 36 years after his retirement. From this, Kummer concluded on the basis of sound actuarial theory, that Mr. Johnson's retirement benefit payments would remain the same during his life expectancy.

Kummer testified that there is a high degree of likelihood that the plan limit will never be reached because of the typical growth pattern that most companies exhibit, i.e., one that is usually characterized by slow initial growth, then rapid expansion, then a leveling off as market saturation occurs. The effect of a leveling off in revenue growth is a leveling off in terms of the number of employees and, in this case, the number of partners in PMM. Exhibit "42", states Kummer, reflects the implications for PMM in terms of the 1976 retirement plan. Over time, after a period of expansion, a company's sales, revenues and profits will level off. This would result in a reduction in the number of partners which, in turn, would result in a leveling off of the retirement plan payments. A graph prepared by Mr. Kummer demonstrates that the number of partners in PMM will ultimately level off long before the year 2019 (Ex. "45"). The

significance of this, says Mr. Kummer, is that if, in fact, the number of partners and principals and, therefore, the retirement payments to be made to partners levels off long before the plan limit is expected to be reached, then the Uniform Rate Test would be satisfied, because the payments to Johnson would remain uniform during his lifetime. Taking this one step further, Kummer states that if the number of partners levels off and the plan payments to the retired partners levels off, that in fact, the 15% limit will never be reached and the Uniform Rate Test is satisfied. From this, Kummer concludes that one can assign a zero probability that the the retirement benefits would ever exceed the 15% plan limit.

The 1960 Partnership Agreement and the 1976 Retirement Allowance Plan both have in common that: (i) benefits to retired partners are calculated as a function of the partners' years of service with PMM and their highest annual salary during certain years; (ii) are subject to the same 15% cap on payments to retired partners; (iii) have similar forfeiture provisions for retired partners who engage in the practice of accounting without obtaining the consent of PMM; and (iv) provide that retirement allowance payments to a retired (limited) partner are distributions of profits, e.g., "[e]ach partner who shall have become a limited partner . . . shall participate in the profits of the firm for each fiscal year for which he shall continue to be a limited partner. . ." (Ex. "19", ¶ 11[a][1]). "The Partners' Retirement Allowance Plan (effective July 1976) is a defined benefit pension plan . . . whereunder quarterly payments are made from the Firm's current income to eligible retired partners" (Ex. "5", p. 1). Since the two plans share these common features, Mr. Kummer's testimony regarding the 1976 Retirement Allowance Plan is deemed equally applicable to the payments computed and paid under the 1960 Partnership Agreements.[19]

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[19]Actually we are only dealing with the benefits computed under the 1960 Partnership Agreement (for Fariss and Redlin) and under the 1975 Partnership Agreement and the 1976 Retirement Allowance Plan (for Johnson). Although the 1970 Agreement is in evidence, it is not germane to this discussion.

SUMMARY OF THE PARTIES' POSITIONS

Petitioners argue that PMM's retirement allowance payments are not tied to the partnership's profits and that, as nonresidents of New York State, the retirement benefits they receive in the form of annuity payments from PMM, a New York partnership, are not subject to New York tax.

With respect to Johnson only, it is argued that the payments he received from PMM in 1984, which were in addition to his retirement allowance, were not guaranteed payments subject to New York tax.

The Division disagrees with each of the above arguments.

The Division does not dispute that PMM used the correct allocation percentage for its New York income in each of the subject years or that petitioners each used the same correct percentages when filing their nonresident New York income tax returns for each of the years in question. Accordingly, the accuracy of the allocation and the calculations of tax on petitioners' returns is not an issue.

CONCLUSIONS OF LAW

A. Tax Law former § 632(a)(1)[20] defines the adjusted gross income of a nonresident individual, in pertinent part, as:

> "(1) the net amount of items of income, gain, loss and deduction entering into his federal adjusted gross income, as defined in the laws of the United States for the taxable year, derived from or connected with New York sources, including:
>
> (A) his distributive share of partnership income, gain, loss and deduction, determined under section six hundred thirty-seven. . . ."

Tax Law former § 637(a)(1) provided in pertinent part that:

> "In determining New York adjusted gross income of a nonresident partner of any partnership, there shall be included only the portion derived from or connected with New York sources of such partners distributive share of items of partnership income, gain, loss and deduction entering into his federal adjusted gross income, as such portion shall be determined under regulations of the tax commission consistent with the applicable rules of section six hundred thirty-two" (emphasis added).

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[20]Section 77 of Laws of 1987 (ch 28) repealed former section 632 as section 631, effective January 1, 1988.

B. Petitioners argue that the retirement benefits on which the tax was paid do not have a New York source and, therefore, no tax was due. Petitioners argue that the retirement allowance payments they receive cannot be distributive shares of partnership income because they were no longer partners in PMM during the subject years. When they retired, they relinquished their partnership rights, e.g., to vote on new partners, to take part in managing the business, etc. That being the case, say petitioners, no tax is due the State of New York based on the Court's decision in Pidot v. State Tax Commission (118 AD2d 915, 499 NYS2d 482, supra).

Pidot involved an attorney who, in 1977, retired from his law partnership in New York City and moved to Florida to live. Upon his retirement, the law firm paid him in full for his share of the firm's capital. Thereafter, he received annual retirement benefits from the firm pursuant to a formula set forth in the partnership agreement. On his 1981 New York nonresident income tax return, Pidot reported income of $172,186.00, of which $136,324.00 was listed as income from the partnership and $35,862.00 was listed as other income. Pidot filed a claim for a refund, asserting that his retirement income was a nontaxable annuity. The State Tax Commission denied his claim and he appealed. Pidot, like these petitioners, claimed that he was a nonresident receiving a pension which constitutes an annuity and that, therefore, pursuant to 20 NYCRR former 131.4(d) (now 20 NYCRR 132.4[d]), the income is nontaxable by New York. The Tax Commission argued that 20 NYCRR former 131.4(d) only applied to employees, not to former partners, and that the law firm's payments to the petitioner were properly considered a guaranteed payment under 26 USC § 736(a), so that Pidot, for tax purposes, was still considered a partner. In addition, the State Tax Commission noted that there was no guarantee, as required by its annuity rule, that Pidot's retirement benefit would always be paid at a uniform rate, because the partnership agreement provided that a retired partner's pension would be reduced if all annual retirement payments made by the law firm exceeded an amount equal to 20% of the law firm's net income. In the event of such reduction in payments, the partnership agreement provided that the unpaid amounts remained due and would be paid in subsequent years.

The Appellate Division modified the State Tax Commission and held that 20 NYCRR former 131.4 was not limited in application to former employees. In addition, the Court held, as it did in Matter of Kestenbaum v. State Tax Commn. (107 AD2d 955, 484 NYS2d 371),[21] that since the petitioner retired from the law firm and received a payment fully liquidating his interest in the partnership in 1977, the payments to Pidot by the firm in 1981 were not guaranteed payments pursuant to 26 USC § 736(a). The Court stated:

> "It is undisputed that upon his retirement in 1977, petitioner retained no interest in the partnership; he could not participate in partnership profits, nor was he liable for partnership losses. Pursuant to the partnership agreement, petitioner was entitled to an annual payment by the partnership of an amount fixed at the time of his retirement, using a formula based on petitioner's five highest earning years as a partner.
>
> Although the agreement provided that all payments to retired partners would be reduced in any year in which the partnership's net income failed to exceed certain criteria, the unpaid amounts remained due and owing, to be paid in subsequent years when the limitation did not apply. Such a potential deferral of a portion of the payment does not provide a rational basis for concluding that the payment is a distributive share of partnership income" (118 AD2d 915, 916, 499 NYS2d 482, 483 [emphasis added]).

Pidot is very similar to the facts here. Johnson, Redlin and Fariss are all nonresidents and former partners of a New York partnership. Like Pidot, by the years in question, Johnson, Redlin and Fariss had retired as partners and relinquished their interests in the partnership. Redlin and Fariss had been paid back their capital contributions, drawing accounts etc., and their only contact with PMM was as recipients of their respective retirement allowances. As of 1984, only Johnson had not yet been fully paid all of his accounts.[22] Like Pidot, the amounts in petitioners' accounts were fixed at the dates of their retirement. As in Pidot, the amounts received by petitioners as retirement benefits were determined at the time of their retirement, using a formula based upon their salary and years of service with PMM. Like PMM, Pidot's former partnership issued Schedule K-1's, "Partners Share of Income, Credits, Deductions, etc.",

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[21]A case having similar facts and reasoning.

[22]It will be recalled that when Johnson retired in 1983, he elected to have his IUR and ACRS accounts paid to him over a five-year period.

designating the amounts paid to Pidot as "Guaranteed Payments" deductible by the partnership. The fact that Pidot's partnership referred to these amounts as "guaranteed payments" was not dispositive. Similarly, the manner in which PMM referred to petitioners on its books and tax forms while relevant, is not dispositive. The overwhelming evidence in this case is that during the subject years, all of the petitioners had retired and had relinquished all but one of their partnership rights. This one exception will be discussed, infra.

C. While the facts in this case are similar to Pidot, there are also differences. The Schedule K-1 in Pidot expressly noted that Pidot no longer shared in the firm's profits.[23] In Pidot, the Court found that Pidot had given up all of his partnership rights, including the right to "participate in partnership profits" (id.; emphasis added). While it is true that Johnson, Redlin and Fariss gave up their interests in the partnership when they retired, no longer had a say in the management, were no longer liable for partnership losses and could not exercise the partnership rights they previously enjoyed, there is one crucial right that each of these petitioners retained, i.e., the right to continued participation in PMM's profit distributions. Petitioners' argument to the contrary on this point is not persuasive. It is true, as petitioners suggest, that a retired partner generally may not share in the profit distributions of his former partnership. However, the rights of partners and former partners, so long as otherwise consistent with the law, are a function of what the partners decide in their partnership agreement. In this case, the partners of PMM expressly agreed in their partnership agreements, at least since 1960, that former partners may continue to receive distributive shares of the firm's profits by way of the firm's retirement allowance benefit payments (Ex. "5", "19", "22"; Ex. "L").

D. The Division's regulations (20 NYCRR 132.4(d)(2) [formerly 131.4(d)(2)]) provide, in pertinent part, that in order to qualify as a nontaxable annuity, a pension or other retirement benefit must meet the following requirements:

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[23]This is reflected in the decision below, but not in the Appellate Division record. (See, Matter of Pidot, State Tax Commn., January 18, 1985.)

"(i) It must be paid in money only . . . .

"(ii) It must be payable at regular intervals, at least annually, for the life of the individual receiving it, or over a period not less than half of such individual's life expectancy as of the date payments begin . . . .

"(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. . .

"c) in such a manner that the total of the amounts payable is determinable at the annuity starting date either directly from the terms of the contract or indirectly by the use of either mortality tables or compound interest computations, or both . . ." (emphasis added).

E. "In no event shall the aggregate participations of all limited partners in the profits of the firm for any fiscal year exceed fifteen per cent" (Ex. "19", ¶ 11[c]). Despite this sort of language in petitioners' own exhibits, they argue that their retirement allowance benefits are not tied to PMM's profits. According to petitioners' expert, any linkage with PMM's profits is lost because of the 15% cap on payments. This argument is not persuasive. This is especially so since petitioners' own exhibits repeatedly refer to the right of PMM's former partners to participate in the profits of the firm (Ex. "L"; Ex. "5", "19", "22"). Having said that, however, there is nothing in the Division's annuity rule, supra, which prescribes or requires a particular funding mechanism for annuities. Therefore, if PMM's unqualified retirement plans otherwise satisfy the requirements of 20 NYCRR former 131.4(d)(2), the retirement payments to petitioners would nevertheless be nontaxable (20 NYCRR former 131.4[d][1]).

F. The testimony of Mr. Kummer and the other evidence in this case establishes that PMM's retirement allowance payments under its nonqualified plans are payable in money at regular intervals, at least annually, for the life of the petitioners, satisfying (i) and (ii) of 20 NYCRR former 131.4(d)(2).

G. The remaining question is whether the 15% cap prevents PMM's retirement allowance payments to petitioners from being paid in a "uniform" manner. In this case, unlike Pidot, the 1976 Retirement Allowance Plan and the relevant partnership agreements provide that retirement allowance payments cannot exceed 15% of net profits. While in Pidot, the partnership agreement provided that retirement payments would be reduced if they exceeded 20% of profits. The Pidot Court held that "a potential deferral" of a portion of a retiree's payments was not sufficient to disqualify them as an annuity.

In this case, the facts are slightly different. The partnership agreements and the 1976 Retirement Allowance Plan do not speak in terms of reducing or deferring payments. The partnership agreements and the 1976 Retirement Allowance Plan in this case merely place an outside limit or cap above which the payments cannot go. That is not the same thing as saying that a retiree's payments will be decreased if they exceed 20% of profits. As noted in the facts, the evidence shows that payments to PMM's retirees have never been reduced based on this cap. To say that a retiree might have received higher benefits if the cap did not exist might be true, but that is not the same thing as saying that a retiree's retirement payments will be reduced because of the cap. The cap has been in existence since the plan's inception. The very first payment to petitioners, based on this record, was subject to the cap. Nevertheless, petitioners' retirement benefits have always increased, not decreased. The record in this case supports the conclusion that, during the life expectancy of petitioners, this cap will not result in the retirement payments being paid at other than a uniform rate as required by the Division's annuity regulation (20 NYCRR former 131.4[d][2][iii][a]) and that the payments only fluctuate based on cost of living increases (20 NYCRR former 131.4[d][2][iii][b]).

H. Even if it were concluded that the 15% cap would result in petitioners' retirement payments being paid at other than a "uniform" rate, petitioners' retirement allowance benefits could still qualify as a nontaxable annuity if they are payable:

> "in such a manner that the total of the amounts payable is determinable at the annuity starting date either directly from the terms of the contract or indirectly by the use of either mortality tables or compound interest computations, or both, in

> conjunction with such terms and in accordance with sound actuarial theory" (20 NYCRR former 131.4[d][2][iii][c]).

The unrebutted evidence of Mr. Kummer establishes that the total amounts payable to petitioners in retirement benefits under the PMM's unqualified retirement plans could be determined indirectly by the use of mortality tables or compound interest computations in conjunction with sound actuarial theory. Accordingly, it is concluded that the payments to petitioners constitute nontaxable annuities under New York's regulations.

I. The fact that there is a provision in the subject retirement plans that provides for forfeiture of retired partners' benefits if they engage in the practice of accounting without the consent of PMM is not sufficient to negative this result. The evidence establishes that this provision has never been enforced and that, when asked, PMM's permission is routinely granted.

J. The only payments at issue with regard to Redlin and Fariss are the retirement allowance payments discussed above. Johnson, however, received other payments during 1984 (the only year in dispute for him) in addition to his retirement allowance. Johnson, like Redlin and Fariss, was a fiscal year taxpayer. In fiscal year ending June 30 1984, Johnson received the following amounts from PMM:

a) Non-qualified plan	$ 48,659.00
b) Interest on Drawing Account Balance	37,719.07
c) Payment on IUR Account	34,186.29
d) Payment on ACRS Deferral	1,008.59
Total from PMM	$121,572.95

Of the $121,572.95 received from PMM, Johnson, using PMM's allocation percentage, allocated a total of $21,983.00 to New York source income on his 1984 IT-203. The Division argues that these payments represent "guaranteed payments" taxable as Johnson's distributive share of partnership income, as evidenced by PMM's Schedule K-1.

K. Tax Law former § 632, supra, evidences an attempt to conform to Federal law; reference is made to Federal income tax treatment of payments to retired partners (Matter of Michaelson v. State Tax Commission, 67 NY2d 579, 583, 505 NYS2d 585 [1986]; Tax Law § 607[a]). Under the code, a partnership may make payments to a retired partner to liquidate his

interest in the form of distributive shares, i.e., payments computed with regard to partnership income (Internal Revenue Code ["IRC"] § 736[a][1]), or guaranteed payments, i.e., fixed payments computed without regard to partnership income (IRC § 736[a][2]). Distributive shares are taxed as ordinary income to the retired partner to the extent such payments do not reflect that partner's capital contribution and interest in partnership goodwill provided for by the partnership agreement (IRC § 702; Treas Reg § 1.736-1[a][3][i]). The taxable income of the other partners is correspondingly reduced when the retired partner's non-capital assets are liquidated in the form of a distributive share of net income.

Guaranteed payments to a retired partner are also taxable as ordinary income (IRC §§ 61[a]; 707[c]). By choosing to liquidate a retired partner's interest in the form of guaranteed payments, the partnership may deduct such payments from partnership income as an ordinary business expense (IRC § 162[a]; Treas Reg § 1.736-1[a][4]). Guaranteed payments are regarded as a partner's distributive share of partnership income[24](Treas Reg § 1.707-1[c]).

A partner receiving payments in the form of a distributive share of partnership income or guaranteed payments under IRC § 736(a) is treated as a partner for tax purposes until his interest in the partnership has been completely liquidated (Treas Reg § 1.736-1[a][1][ii]). In 1984, Johnson had not yet completely liquidated his interest in the partnership, since he would continue to receive payments through 1988. For tax purposes, Johnson was still considered a partner of PMM in 1984.

Accordingly, the interest and principal payments on Johnson's drawing account, his ACRS deferral and unrealized receivable accounts constitute guaranteed payments, subject to tax. In determining the New York adjusted gross income of a nonresident partner of any partnership, only that portion of the distributive share of partnership income which is derived from New York sources is to be included (Tax Law former § 637[a][1]). Therefore, of the amounts paid to Johnson by PMM in 1984, $63,439.73 was income derived from a New York partnership, and constituted his distributive share of partnership income under Internal Revenue

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[24]Except for limited purposes not relevant to this discussion.

Code § 736(a). These payments must be allocated to New York State in the same proportion[25] as PMM allocated partnership income to sources within and without New York State (Matter of Rosenberg, State Tax Commn., April 6, 1983 [TSB-H-83-(75)-I]; Matter of Lowenfels, State Tax Commn., December 29, 1982 [TSB-H-82-(383)-I]).

L. The amounts Johnson received from the Greenbriar partnership remain subject to tax, since it has not been disputed.

M. No tax was paid on the amounts received by Johnson from Copem 72, such payments are not subject to tax in New York based on the Ausbrooks decision, supra.

N. The retirement allowance benefits paid to Johnson, Redlin and Fariss during the subject years, although funded from PMM's profits, nevertheless satisfy the Division annuity rules and are not subject to New York tax (20 NYCRR former 131.4[d][2]).

O. The petitions of Aubrey and Elsie Fariss and Robert W. and Harriet A. Redlin are granted, and the Division is directed to refund the amounts paid for the years in issue, plus interest.

P. The petition of Warren H. Johnson is denied to the extent provided in Conclusions of Law "K" and "L", but is otherwise granted, and the Division is directed to recompute the tax due and refund the appropriate amount plus interest.

DATED: Troy, New York
February 27, 1995

/s/ Carroll R. Jenkins
ADMINISTRATIVE LAW JUDGE

[25]16.88% according to Johnson's petition.