STATE OF NEW YORK

DIVISION OF TAX APPEALS

In the Matter of the Petition	:	
of	:	
WARREN R. and ROSEMARY B. HAAS	:	DETERMINATION DTA NO. 812971
for Redetermination of a Deficiency or for Refund of Personal Income Tax under Article 22 of the Tax Law for the Year 1988.	:	

Petitioners, Warren R. and Rosemary B. Haas, 38 Pocono Road, Denville, New Jersey 07834-2922, filed a petition for redetermination of a deficiency or for refund of personal income tax under Article 22 of the Tax Law for the year 1988.

A hearing was held before Catherine M. Bennett, Administrative Law Judge, at the offices of the Division of Tax Appeals, 500 Federal Street, Troy, New York, on March 1, 1995, at 9:30 A.M., with all briefs to be submitted by August 4, 1995, which date began the six-month period for the issuance of this determination. Petitioner appeared by Lipman & Biltekoff (Allan R. Lipman, Esq., of counsel). The Division of Taxation appeared by Steven U. Teitelbaum, Esq. (Kenneth Schultz, Esq., of counsel).

ISSUE

I. Whether payment for a covenant not to compete is income from intangible personal property.

II. Whether payment for a covenant not to compete is income derived from or connected with New York sources.

III. Whether the payment for the covenant was limited to services to be rendered by Mr. Haas in New York State, and should thus be treated as New York based income.

FINDINGS OF FACT

Petitioners submitted 31 Proposed Findings of Fact. Those facts to which the Division of Taxation ("Division") did not object and those requiring a minor clarification are incorporated below as proposed (Proposed Findings 1-4, 8, 9, and 17-19).

Those Proposed Findings which the Division agreed were reflected by the record, but not relevant to the issues of the case are included below to supplement the facts of the case. Such findings provide a broader explanation of the factual setting in which the issues arose (Proposed Findings 5-7, 10-12, and 22).

With respect to Proposed Findings to which the Division objected primarily on the basis of violation of the parol evidence rule, a discussion of the rule is set forth in the Conclusions of Law. Proposed Findings 13-16, established by the record, do not violate the parol evidence rule. Regarding Proposed Findings of Fact 20-21 and 23-31, and the Division's objections thereto, a discussion of the principles of the parol evidence rule and application to this matter is contained in the Conclusions of Law.

The Division submitted 8 Proposed Findings of Fact. Petitioner objected to 6 of the 8 on the basis that, while established by the record, such facts are not relevant to, or dispositive of the issues. All of the Division's Proposed Findings are set forth below, either separately or incorporated into other related facts. Such findings provide a broader view of the facts of this matter and are based upon evidence in the record.

Additional Findings of Fact set forth by the Administrative Law Judge are also incorporated below to complete the record. Other findings have been modified in form only.

1. The Division issued to petitioners[1] a Notice of Deficiency dated March 19, 1993, asserting additional tax due under Article 22 for the tax year 1988 in the amount of $154,031.59, plus interest in the amount of $60,333.45, for a total amount due of $214,365.04.

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[1]Rosemary Haas is a petitioner only by reason of having filed a joint return with Mr. Haas. Therefore, references to "petitioner" will refer to Mr. Haas.

2. Preceding the issuance of the Notice of Deficiency, the Division notified petitioners of its findings in a Statement of Personal Income Tax Audit Changes pertaining to this matter dated November 16, 1992. The following explanation was provided:

> "It has been determined through audit that the Covenant Not to Compete amount of $1,880,000 paid to Warren R. Haas by Merrill Lynch Specialists Inc. as shown on the 1988 IT-203 Return is taxable to New York State."

3. A Consent Extending the Period of Limitation for Assessment of Personal Income Taxes under Article 22 was executed by petitioner and the Division on December 13 and 23, 1991, respectively, for the purpose of extending the period of assessment for the 1988 year to April 15, 1993.

4. Petitioner, Warren Haas, was born on July 2, 1927 in New York City. His family moved to New Jersey in 1938. He resided in Mountain Lakes, New Jersey from 1938 to 1962 and was active in that community as Scoutmaster, Fire Chief, Police Commissioner, Civil Air Patrol and fund raising drives. During the tax year in issue, and currently, Mr. Haas resides in Denville, New Jersey.

5. Mr. Haas entered the Marine Corps in 1945. In 1947, he left the regular Marine Corps to join the Reserves. In 1950, he was recalled for the Korean War and spent two years on active duty overseas. Petitioner returned to civilian life in 1951.

While serving in the Marine Corps Mr. Haas met a Mr. Tompane. Mr. Tompane suggested that Mr. Haas work with him on the New York Stock Exchange. During their military career, the two gentlemen later joined the same Marine Reserve unit and Mr. Tompane further encouraged Mr. Haas to come to the Stock Exchange.

6. In 1947, at age 20, Mr. Haas went to work for Mr. Tompane as a specialist clerk on the trading floor of the New York Stock Exchange. As a specialist clerk, Mr. Haas recorded numerous entries of buy and sell orders. He executed orders, reported orders and performed many administrative chores on the floor of the stock exchange until October 1958, when he was 31 years old. At that time, Mr. Tompane gave Mr. Haas sufficient funds to become a member of the New York Stock Exchange and partner in Mr. Tompane's brokerage firm with a 2%

interest. Except for two years of active duty with the Marine Corps in Korea, Mr. Haas worked continuously in New York City from October 6, 1947 to May 31, 1990.

7. As a member of the exchange, or as a specialist broker, his position differed in that a specialist clerk is behind the counter whereas a specialist broker stands out in front of the counter on the block of the exchange and makes trades with other brokers. Every security listed is assigned to a location in the exchange. A broker stands at the specific location on the stock exchange floor, with a specialist clerk standing behind him, and he executes orders in a specialty stock assigned by the stock exchange.

8. After Mr. Haas had been a partner for 16 or 17 years, Mr. Tompane decided to leave the firm. In 1974 or 1975, he made Mr. Haas the senior partner of the firm. At that time, the firm had 25 or 30 securities with respect to which it was registered as the sole specialist. This included the Allen Group, Williams Company, Sterling Drug, United States Steel, Royal Dutch Petroleum and other stocks, and Mr. Haas developed expertise in these stocks and was responsible to make a market in the stocks on behalf of the brokerage firm. Mr. Haas's prime expertise was with Williams Brothers, the Allen Group, United States Steel and three or four stocks issued by United States Steel.

9. The purpose of the New York Stock Exchange is to provide an auction market where buyers and sellers meet and are exposed to the best possible market. The New York Stock Exchange is a city block square with about 3,500 people working in one room. There are about 1,800 securities that are listed and each security listed is assigned to a specialist. There is only one specialist firm that is assigned to a given security. There were no other specialists on the New York Stock Exchange that dealt in the stock in which Mr. Haas traded. When Mr. Haas began working at the New York Stock Exchange, there were about 140 specialists. In 1990, there existed between 45 and 50 firms.

10. On October 19, 1987, also referred to as "Black Monday", the market suffered substantial losses. The previous Friday, October 16, 1987, was a very bad day on the New York Stock Exchange, with the market down 120 points. This represented a huge loss. The market

seemed to go down without any apparent reason. It was anticipated that Monday was going to be a good day because the market had gone down on Friday without any special reason, but on Monday the market plummeted 500 points. Despite the precipitously declining market, the specialists had to continue to buy and sell and "make a market". This was because the specialist has the privilege of being the market maker. In a declining market, the specialist has to buy a certain number of shares at every eighth or quarter of a point and must do the same thing on the "upside". If there are no public orders, the specialist has to insert himself to stabilize the market. The basic function of the specialist is to execute orders for the brokers, while working to stabilize the market and minimize disparity between supply and demand.

11. On Black Monday, the stock market came down for reasons which were not apparent. During that day the specialists continued to trade stock to the best of their ability. Nevertheless, the Tompane firm lost $7 million that day.

Because of how the system worked, the Tompane firm was required to trade Black Monday and early the next morning on orders that were still coming into the stock exchange. These orders were entered from around the country during trading hours of 9:30 A.M. to 4:00 P.M. Because there was such a mass of orders, the stock exchange required the specialists to stay open and trade every stock that was entered between 9:30 A.M. and 4:00 P.M. according to the time of the order and the time on the floor of the stock exchange.

12. The specialist has the "book" where the 400 or 500 member firms come when they want to buy shares. They send their order via paper or they communicate electronically to the floor of the stock exchange to the specialist, and that order is protected when the stock sells at the price the customer wishes to buy or sell.

The "market" means that, when the order gets to the floor of the exchange and is a "buy" order, it is immediately executed against the lowest seller. The orders are handled by the specialist. If there is a void of public interest, either up or down, the specialist has to buy stock to stabilize the market. He does this with his own buying power, and this is developed by the

partners' contributing capital to the partnership. The specialist has to "trade even though 50% of the time you don't want to trade".

The so-called "book" for many years was just a loose-leaf book and the specialist entered the orders according to the priority of the time received. When a stock sold down to that price the orders were executed in the order of the time entry in the book. With the new direct order turnaround system the orders were electronically entered in the specialist's book, which is now an electronic book. The orders come in electronically and the electronic book is at the specialist's station for the stock in which that specialist deals. The electronic book shows the best bid (meaning the best buyer) and the best offer (which is the best seller). The information is available on a screen located above the specialist's head on the floor of the stock exchange so that a broker walking in who represents a member firm can see what the best bid and offer is, how many shares are offered at the best bid and how many shares are offered at the best selling price.

13. The same information is displayed on the Philadelphia, Baltimore, Boston Exchange, the Midwest Exchange and Chicago and the Pacific Exchange. The Pacific Exchange consists of two trading floors; one in Los Angeles and one in San Francisco. The input on the screen is done electronically by specialists on all of the stock exchanges. When there is input on the screen from one of the other stock exchanges it is indicated by a symbol such as "M" for the Midwest stock exchange, "P" for the Pacific stock exchange, "B" for the Boston exchange, etc.

14. The Intermarket Trading System requires that the public on the New York Stock Exchange receives the best possible execution. If he is a buyer, the specialist meets the lowest seller through the electronic system or the specialist standing there, and the same thing happens with the seller.

15. If a specialist on the New York Stock Exchange is not bidding a "half" but is bidding "three-eighths", then he may have to execute the order based on the "half" from the Midwest exchange. He cannot sell down to "three-eighths". Therefore, it is very important to always

watch what the other markets are doing as to the best bid and offer on the screen at that time because the specialist on the New York Stock Exchange has to execute the order given by the other stock exchanges if they do a better job.

16. Specialists on each of the other stock exchanges were in competition with Mr. Haas when he was a specialist on the New York Stock Exchange. This is because specialists on the other stock exchanges could execute orders on the New York Stock Exchange and top the bid of the specialists on the New York Stock Exchange. This meant that they could pay more than a specialist such as Mr. Haas was willing to pay or they could sell for less than Mr. Haas, as a specialist, was willing to sell. Most of the business on the other stock exchanges is done against the New York Stock Exchange because it is the largest market.

17. Prior to October 1987, brokerage firms could not be specialists because of the obvious competition with being a market-maker on the exchange and also being an upstairs broker or an insurance company. The stock exchange did not want to have brokerage firms that dealt with the public as specialists on the floor of the exchange. Prior to Black Monday, Merrill Lynch and other large brokerage firms could not directly or indirectly through subsidiaries have firms that were specialists on the New York Stock Exchange.

There was activity which attempted to change that rule, and in 1985 there was some indication that Merrill Lynch might be interested in purchasing Tompane if the rule was changed. There was some communication by Merrill Lynch to Mr. Haas on October 10, 1987 that the rule might be changed on October 23rd or 24th at the upcoming board meeting of the New York Stock Exchange. Some interest was shown by Mr. Haas.

After Black Monday, there was some renewed interest by Merrill Lynch to pursue such purchase. It became necessary for Mr. Haas's firm to obtain extra capital because all of the partners were former clerks and did not have the requisite funds. They needed to raise additional capital or be forced to sell out.

18. Meetings were held with Merrill Lynch and its attorneys and the attorney and accountant for the Tompane firm. A deal was negotiated, subject to permission from the New

York Stock Exchange, which was obtained. The agreement was entered into as of October 23, 1987, and set forth the purchase price in Section 1.3. Mr. Haas provided testimony that Merrill Lynch explained to him very explicitly that Mr. Haas was going to work for Merrill Lynch and "that's it", and other than in another capacity, that he could not go anywhere else as a specialist.

19. Portions of the October 23, 1987 Agreement between A.B. Tompane ("ABT"), its General and Limited Partners and Merrill Lynch Specialists Inc. ("MLSI") provide as follows:

> "1.1. Allocated and Assigned Securities. Five of the General Partners are registered with the NYSE as specialists in the equities and warrants set forth on Schedule 1.1(a) hereto (the 'ABT Specialist Book'), such securities (the 'Securities') having been allocated and assigned by the NYSE to ABT as a specialist unit, and each General Partner agrees to join MLSI. ABT and the General Partners agree to use their best efforts to have the NYSE allocate or assign the Securities to MLSI as a specialist unit.
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> "2.2. Use of and/or Lease of Membership. Warren R. Haas, Frank A. Delaney, John P. Moran, Roland J. Cadotte and Thomas M. Schwalenberg are each a member in good standing of the NYSE. So long as they remain employees of MLSI, each of the foregoing Partners agrees to remain a member in good standing of the NYSE and to use his membership solely and exclusively for the benefit of MLSI, or, at the request of MLSI, to enter into a Lease Agreement in the form attached hereto as Exhibit C to lease his membership at no cost to a designee of MLSI.
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> * * *
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> "5.1. Agreement Not to Compete. ABT and each of the General Partners severally agrees that for a period of five (5) years after the date of this Agreement, they will not engage, and will not permit any partnership of which any of the General Partners may be a partner or any corporation of which any of the General Partners may be an officer, director or owner of 5% or more of the voting securities to engage, or assist, directly or indirectly, financially or otherwise, any party other than MLSI to engage in the business of acting as a competing specialist or as a registered competitive market maker (except to the extent called upon under the NYSE rules to do so) on the NYSE in securities allocated to ABT or then allocated to MLSI. MLSI shall be entitled, if it so elects, to institute and prosecute proceedings in any court of competent jurisdiction, either at law or in equity, to obtain damages for any breach of this Section 5.1 and/or to seek immediate injunctive relief against ABT and/or the General Partners.
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> "7.11. Entire Agreement. This Agreement, together with the exhibits, schedules, lists, certificates, agreements and other instruments delivered pursuant to this Agreement, and any amendments hereafter executed and delivered in accordance with Section 7.2 of this Agreement, constitutes the entire agreement of ABT, the General Partners and MLSI, and supersedes any and all prior written or oral

> agreements or understandings between and among ABT, the General Partners and MLSI, pertaining to the matters contemplated under this Agreement, including, without limitation, the letter from MLSI to ABT dated October 21, 1987."

20. Mr. Haas and his partners agreed that they would not compete in any way, shape or form with any partnership, directly or indirectly, with Merrill Lynch in any of the stocks that the firm had when the agreement was signed or stocks which Merrill Lynch Specialists would subsequently add to their portfolio of specialty stocks. It was Mr. Haas's understanding that the covenant not to compete prohibited him from being a specialist on any of the stock exchanges that participated in the Intermarket Trading System. To Mr. Haas it meant that for five years he could not be a specialist, broker, dealer, partner or a capital partner of any member firm that had anything to do with being the corporation's broker or banker of any of the stock that the firm had or whatever Merrill Lynch would acquire in the next five years.

21. Merrill Lynch told Mr. Haas that it thought it would be a specialist in a hundred or more companies. As a result, it believed ABT was too small, and it inquired about other firms.

22. Petitioner provided testimony that the noncompetition agreement restricted him from going to another of the five stock exchanges if he went with a specialist firm on that exchange who was a specialist in one or more of the stocks in which Merrill Lynch was a specialist. If the specialist on the other stock exchange was not a specialist in any one of the 20 some odd stocks in which Merrill Lynch was a specialist at the time Mr. Haas could join that firm, but subsequently, if Merrill Lynch and the Midwest specialist became specialists in the same stock, Mr. Haas would have to leave that firm because he would have money or capital or be a participant in violation of the agreement. In a sense, Mr. Haas would be competing by being a general or even a limited partner of another firm (that subsequent to that date, based on the anticipated growth of new listings and/or Merrill Lynch's acquiring other specialist units, which they did, and well over 100 stocks) and he would be "knocked out".

Petitioner's belief was that he could not compete by working with Chase Bank or being in its trading department. He could not compete by initiating orders on his own (not directly with the public) or by taking a position in any of the stocks. In Mr. Haas's opinion, he was paid just

to stay home and he did so. He did not initially stay at home, but stayed home until Merrill Lynch suggested he was too old to work.

Along these same lines, Mr. Haas further explained that if a person sends an order to the Pacific Exchange, it is electronically routed to the floor of either the Los Angeles Exchange or the San Francisco Exchange. Although petitioner and his wife loved San Francisco and had friends there, Mr. Haas believed he could only go there if he retired. In other words, he was prevented from going there prior to October 24, 1992 as, for example, a stockbroker. He believed himself to be out of the job market except to be a specialist.

For clarification, Mr. Haas explained that a "specialist" has to try to guess what the management of U.S. Steel (or any other company) could do to make more money because a specialist has to anticipate buying stock. The specialist must prognosticate whether the stock will go up based on management decision or product quality. Mr. Haas testified that "it's a learning experience. . .very few people. . .last 43 years. . . . It's an extremely tough job. . . . If you don't learn you are not going to make any money if you don't watch anything." (Tr., p. 66.)

23. In 1987 and 1988 Mr. Haas had opportunities to work on other stock exchanges but he believed the covenant prevented him from doing so. Mr. Haas could have gone to the Midwest Exchange, the largest market-maker of listed stock on the New York Stock Exchange. Mr. Haas could have gone to Philadelphia since it wanted someone to make a market in U.S. Steel.

24. In response to questioning by the Administrative Law Judge, Mr. Haas explained that he could not have left Merrill Lynch and gone into business for himself working for member firms as a specialist on the floor because if those firms ever did anything that Merrill Lynch engaged in over the years and Mr. Haas invested capital, it might be used to compete with Merrill Lynch. For example, Solomon competes with Merrill Lynch every day to try to become underwriters, and that is direct competition. Mr. Haas could work as an employee, but Mr. Haas could not be a specialist or member of the Exchange. He could have obtained a job in

the business but not in any way that related to the name of any security in which Merrill Lynch was a specialist for five years.

25. In a less than common occurrence, Mr. Haas had a partner who decided to leave his firm and compete with the firm as a market-maker specialist in four stocks in which the firm was a specialist. This person had a specialist's book, a long loose-leaf notebook and access to the screens. He could see what other specialists were doing on the other stock exchanges. He would attempt to entice other brokers to give him the order and maybe do it for less commission.

Mr. Haas recalled a similar occurrence happening 5 times in his 43 years of experience, where an individual thought that he could make more money by not splitting with other partners. He could pick the stock that he wanted but could not get further than four feet away from the specialist's location. If the person was resourceful enough, he could compete. Mr. Haas's firm could have been resourceful enough when the partner left to compete against the firm to require him to agree not to do so by signing a covenant. This is an example where there are other specialists that can operate in the same exchange in the same stock. They have to have the capital and the administrative ability to do it and they have to stand right at the place where the specialist who deals in the stock is located. He would also have to have a partner to give him relief. Mr. Haas indicated that although the constitution governing the trading system allowed such competition, it virtually never takes place because it is administratively and financially impossible. The concept of such competition exists to afford specialists protection from a charge of monopoly.

26. When Mr. Haas was terminated by Merrill Lynch, he had to go home. He could not work on Wall Street except as a clerk. He had opportunities in San Francisco and could have teamed up with very capable people there, but believed that he could not do so until after the covenant expired in October 1992.

27. Petitioner filed a New York State Nonresident and Part-Year Resident Income Tax Return, Form IT-203, for each of the 1988 and 1989 calendar years, both of which were

submitted into evidence. In both tax years, Mr. Haas's W-2's were issued by Merrill Lynch Specialists, Inc., the company which purchased Mr. Haas's former firm, A.B. Tompane & Co. For 1988 and 1989 respectively, petitioner reported wage income in the amounts of $399,173.00 and $217,015.00, and allocated 100% of such wage income to New York State.

The 1988 return indicated that income received from a "covenant not to compete by Merrill Lynch" in the amount of $1,880,000.00 was reported on petitioner's Federal return. No portion of that amount was reported in the New York column which depicted petitioner's nonresident income taxable to New York.

Petitioner filed a State of New Jersey Income Tax Resident Return for the tax year 1988, on which he included in "other income" the covenant not to compete by Merrill Lynch in the amount of $1,880,000.00. New Jersey State tax was accordingly paid on such income.

SUMMARY OF THE PARTIES' POSITIONS

28. Petitioner takes the position that the covenant not to compete is an intangible asset which is not employed in carrying out petitioner's business in New York State. Since it is not used in such capacity, and is an intangible, income therefrom should be taxable by the situs of petitioner's domicile (New Jersey) and not New York.

Petitioner alternatively asserts that if it is determined that the covenant is not an intangible asset, it would still not be subject to New York taxation, on the basis that general rules of taxation governing nonresidents dictate that the payment would constitute New York income only if it was attributable to a business, trade, profession or occupation carried on in New York State, or was compensation for services.

Petitioner argues that the geographic scope of the covenant is irrelevant to the issue as to whether or not the payment to a nonresident is subject to New York tax. Petitioner maintains that if the geographic scope must be taken into account, since payment for the covenant was not limited to services to be rendered by Mr. Haas in New York State, it should not be subject to tax by New York.

29. It is the Division's position that the payment for the covenant not to compete to petitioner was properly sourced to New York and thus, subject to New York taxation.

The Division also relies upon 20 NYCRR 131.4(d) which pertains to taxation of pension and related retirement benefits of nonresidents of New York.

As a corollary issue, the Division objects to petitioner's attempt to expand the geographic scope of the covenant not to compete to states other than New York, on the basis that the portion of petitioner's testimony which is being used to explain, supplement, contradict or create an ambiguity in the covenant is barred by the parol evidence rule.

CONCLUSIONS OF LAW

A. The effect of the Division's objection to certain proposed Findings of Fact on the basis of the parol evidence rule will be discussed first.

The general principle, as well as rules governing the application of the "parol evidence rule" follow:

> "where the parties to a contract have deliberately put their entire engagement in writing in such terms as to import a legal obligation without any uncertainty as to the object and extent of such engagement, extrinsic evidence of prior or contemporaneous conversations, statements, or declarations tending to substitute a contract different from that evidenced by the writing is inadmissible, since all agreements which would be shown by such extrinsic evidence are conclusively presumed to have been merged in the writing. Briefly stated in terms of the result of the application of the rule, a valid instrument clear in its terms and purporting to express the entire agreement of the parties cannot be contradicted, varied, or explained by what was communicated between the parties either prior to or at the time of the execution of the instrument.
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> "Whenever the terms of a contract are <u>susceptible of more than one interpretation, or an ambiguity arises</u>, or the extent and object of the contract cannot be ascertained from the language employed, <u>parol evidence may be introduced to show what was in the minds of the parties at the time of making the contract</u>, and to determine the object upon which it was designed to operate. In other words, if a written contract is so ambiguous or obscure in its terms that the contractual intention of the parties cannot be understood from a mere inspection of the instrument, extrinsic evidence of the subject matter of the contract, of the relations of the parties to each other, and of the facts and circumstances surrounding them when they entered into the contract may be received to enable the court to make a proper interpretation of the instrument.
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> * * *

"Evidence to explain an ambiguity, or to show the meaning of technical terms, is not regarded as an exception to the general rule prohibiting parol evidence to vary or contradict the terms of a written instrument, because such evidence does not contradict or vary the written instrument but simply places the court in the position of the parties when they made the contract, and enables it to appreciate the force of the words they used in reducing it to writing. Because the purpose of admitting evidence extrinsic to the writing where doubt arises upon the face of the instrument as to its meaning is not to enable the court to hear what the parties said, but to enable it to understand what they wrote as they understood it at the time, such evidence is explanatory and admissible only as consistent with the terms of the contract. . . .

* * *

"Generally, extrinsic evidence is admissible to explain the terms of a written instrument only where there is an ambiguity or the language is doubtful. In accordance with the general principle that the rules of construction are only to be applied to interpret language of ambiguous or doubtful meaning, the initial or preliminary step in explaining an ambiguity in a written agreement involves the discovery of the ambiguity itself. As a corollary of the view that an agreement which 'appears' to be plain and unambiguous bars the admission of parol evidence, the traditional view that the search for the ambiguity must be conducted within the four corners of the writing, unaided by any reference to external circumstances, has been criticized. But many courts have, almost as a matter of course, considered initially the express terms of the writing to discover any ambiguity. Other decisions have accepted evidence of parties' negotiations and other relevant external circumstances in order to ascertain whether the written contract was ambiguous . . . . The existence of an ambiguity calling for explanation by parol evidence may appear from the words plain in themselves, but uncertain when applied to the subject matter of the contract, or from words which are uncertain in their literal sense. . . .

* * *

"A patent ambiguity is one which appears on the face of the instrument, and arises from defective, obscure, or insensible language used. Parol evidence is admissible to explain such an ambiguity; it is said that the only patent ambiguity not explainable by parol evidence is one which is incapable of resolution. . . .

* * *

"In accordance with the general principle permitting the admission of parol evidence as to custom and usage to explain technical or trade terms in a written agreement, custom and usage may be proved to show the intention of the parties to a written contract or other instrument in the use of phrases of a special technical meaning which when unexplained are susceptible of two or more plain and reasonable constructions. When mercantile or trade usage and custom attaches a special meaning to certain words or terms used in any particular trade or business, it is competent for the parties to a contract in which such words and terms are used to show the peculiar meaning accorded thereto in the business or trade to which the contract relates, not for the purpose of altering, adding to, or contradicting the contract, but for the purpose of expounding and elucidating the language used as a means of enabling the court to construe, interpret, and apply the language of the contract according to the actual intent of the parties. In other words, where it

> appears that words employed have, besides their ordinary and popular sense, a different meaning in a certain business, trade, or profession in which they are used and understood by the class of persons engaging in transactions of the kind in question, parol evidence is admissible to show the usage and explain the meaning, and an intention to use the words in the peculiar sense will be inferred accordingly . . ." (58 NY Jur 2d, Evidence and Witnesses, §§ 555, 575, 577, 578, 580, 586; footnotes omitted and emphasis supplied).

At first glance it appeared that the covenant not to compete was in fact clear and unambiguous on its face. However, in the questioning of Mr. Haas by the Administrative Law Judge (tr., pp. 75-85) it was revealed that an ambiguity in fact exists in what was covered by the covenant. Employing the school of thought which readily allows looking beyond the four corners of the document, such testimony follows to identify the ambiguities:

> ALJ BENNETT: ". . . You clarified for me that you believed the agreement prohibited your accepting a position as a specialist on another exchange that was a specialist in the specific securities in which you traded. Were there other specialists on the New York Stock Exchange that also dealt in the stock in which you traded?"
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> MR. HAAS: "No, Ma'am."
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> ALJ BENNETT: "Then what's not clear to me is why the agreement exists. What the agreement says is that you are prohibited from engaging in the business of acting as a competing specialist or as a registered competitive market maker on the New York Stock Exchange in securities allocated to ABT, Tompane Company, or then allocated to Merrill Lynch Securities. What you are telling me is that there was no place on the New York Stock Exchange where you could compete because no one else dealt in the specific securities?"
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> MR. HAAS: "That is correct."
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> ALJ BENNETT: "Then what does this covenant prohibit?. . ."
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> MR. HAAS: ". . .You could compete by standing there. If you are me and I am the Merrill Lynch surviving broker, I could stand and compete against you. It doesn't happen because, first of all, it's administratively and financially impossible. It's in there in the constitution so no one can say that I, as a specialist, had a monopoly. I didn't. Someone else could stand in the crowd, has to be within five feet, to trade with a stock. I can't trade ten or fifteen feet away. It just doesn't happen. It eliminated the monopoly which has been talked about over the years if the specialist has a monopoly. We don't. Because someone could stand there and the five other exchanges, they are competing with us.
>
> So, it's the Intermarket Trading System that allows you, Judge Bennett, the opportunity to trade in the best possible market at one location. So, by competing I can't stand there and I couldn't go anywhere else in the stock that they then had or in the next five years if they received any more by allocation or merger."
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> ALJ BENNETT: "If Merrill Lynch bought the securities firm Tompane, then what they also bought was the right to be specialists in that particular stock?"

MR. HAAS: "Yes, Ma'am."

ALJ BENNETT: "Could you have quit Merrill Lynch and you don't lose your registered status; is that correct?"

MR. HAAS: "I would then become a registered -- I could become a registered relief specialist, which the constitution allows for a few people that are qualified at the market, which means an individual stock or the market gets extraordinarily busy and someone needs help, that the vice chairman or chairman of the board or senior governor could say, 'Haas, go over to help the Polaroid crowd.' I would be a relief specialist capable of being a specialist in any stock on the floor of the exchange."

ALJ BENNETT: "Not just the ones you were a specialist?"

MR. HAAS: "That is correct. And I would be called upon at a specific time. Could be for an hour until things calmed down. Might be a week. Might be a case where three partners are coming on the same subway, the Lexington Avenue, and don't make it.

The stocks have to open at 9:30. So, if there is no one there, which never happened because you would lose your business, the exchange would come and say, "you, you, you go over there". And you would say, "oh, thank you very much for the opportunity", but you are worried because any trades you made would be for your account. You would have to put up the capital. You are not acting on that firm's behalf. You are just renting the marketplace. The competition is the other five Stock Exchanges. They could go out and solicit. They have less stringent rules than we do. They could compete by getting orders from any member firm they could go execute on their floors or trade against our market in New York."

ALJ BENNETT: "Could you have left Merrill Lynch and go in to business for yourself working for member firms as a specialist on the floor?"

MR. HAAS: "-- people in our business who know what competition is . . . and it related to any stock that Merrill Lynch engaged in over the years, if it had anything to do maybe not as an employee but maybe if I had any capital, my capital would be used to compete with something Merrill Lynch may be doing. They all compete. Solomon competes with Merrill every day to try to get to become the underwriters. That's direct competition.

I could go as an employee. I wouldn't be a specialist or member of the exchange. I would be a clerk because I can do nothing else. I am not putting myself down. It's the only thing I have done. I could have gotten a job for sure in the business, but not in any way that related to the name of any securities that Merrill Lynch was a specialist in for five years. I expected to be employed by them for five years, so, we made a sale and I was getting a salary and that was it.

This is a very difficult thing for Brown and Wood to write -- since they had no idea what a specialist was -- in the matter of hours. At 3:00 or 4:00 in the morning had to be agreed on. As I said before, Merrill could verify to the Stock Exchange there was an agreement and we were going to keep the team together so we are going to be good specialists and do the job. These people do the same job and they wrote that. To me, as was explained to me it was very explicit. 'You are going to work for us. That's it. You can't go any place else except in another position, another capacity, but not a specialist.'"

ALJ BENNETT: "There was never such a thing as two specialists from two different firms?"

MR. HAAS: "Yes."

ALJ BENNETT: "That dealt with the same stock?"

MR. HAAS: "Yes. We were the last one to have that happen. We had a partner . . . and he thought that he could make more money by being a specialist -- standing this close with paraphernalia in his arms -- than splitting it with eight people . . . . Instead of splitting it -- and he didn't have much percentage of the profit and loss. We had not had him as a partner that long. He went out and tried to compete."

ALJ BENNETT: "How did he do that?"

MR. HAAS: "He was a registered specialist with us. He was very well qualified. Told the Stock Exchange on whatever day it was, 'I am going to be a market maker, specialist, in Cuno Press, US Steel, Williams and maybe Allen Group'. I think four stock. And he's competing against me because I happen to have those four . . . . He stood there. This was before a lot of the automated equipment that's there now. He had the specialist book, the long loose-leaf book and access to the screens. He could see what other specialists on other exchanges were doing.

He stood there. And he would entice this broker, 'you leave, give me the order', like the guy with the broken leg, 'and I will charge you two dollars ten cents for every hundred shares you execute'. This gentleman would give the other specialist -- maybe I will do it for two bucks. I never would break price and he did. He got some orders. But then a situation arose in Cuno Press Publishing Company, I forget what it was, disastrous earning report, and he backed away from the requirement to be a market maker, filling a void, buying stock in a declining market. Every quarter of a point, maybe a thousand shares, he backed away. . . . He found out he couldn't stand there from about 9:15 to 4:10. Not going to the bathroom, no breaks, no phone calls, no lunch.

And that had been tried -- since I have been there that was the last one. Maybe five times earlier the same thing happened. Just individuals thought, 'I can make more money than you guys'. Maybe personality problems, I don't know, but why split eight ways if I can do the same thing and not get involved with making a market in Royal Dutch, which is a tough market, or Sterling Drug, a tough market. He could pick what he wanted. He couldn't do too many. He couldn't get farther than four feet away couldn't hear what's going on.

Competition is allowed because it detracts from whatever lawyers know about monopoly, that there is a monopoly, but there is not a monopoly because you can compete."

ALJ BENNETT: "Even though he was unsuccessful at doing it because basically he didn't have enough energy and resources, personal resources, to succeed at doing it on his own, if he was resourceful enough perhaps he could have?"

MR. HAAS: "Yes. But we should have been resourceful enough when he left to tell him not to compete."

ALJ BENNETT: "To make him agree to that; is that what you are saying?"

MR. HAAS: "Yes. But we believe in sort of democracy if he wants a shot at it. We thought about it. He told us he's going to leave the firm. Okay. Gave us no required notice. We have to get someone to replace him, otherwise we would never be able to have vacation. We needed the bodies . . . . There is competition allowed. It has never been successful."

ALJ BENNETT: "So there are other specialists that can operate on the same exchange in the same stock?"

MR. HAAS: "If they have someone standing where the prime specialist is. I am in US Steel. If a firm out by Wall Street, we are down -- way down here. If they want to compete they would have to send a broker down there to stand there and do it. Can't do it here. Has to do it, again, this close. Has to have the capital and administrative ability to do his work. He has to stand right there. He has to have relief. He would have to get sometimes another partner from there." (Tr., pp. 75-85.)

The parties agreed to a finding that there is only one specialist firm assigned to a given security, and that there were no other specialists on the New York Stock Exchange that dealt in the stock in which Mr. Haas traded. Mr. Haas testified at great length in a truthful manner about a very sophisticated business. He exhibited an experienced working knowledge with the industry and his testimony is classified as entirely reliable. Accepting Mr. Haas's testimony as credible, and not contradicted, then the covenant not to compete prevented a situation that could not, or for all practical purposes would not, exist. If that is the case, the covenant must have meant something other than what the words appear to mean. Mr. Haas referenced the fact that what was meant to be drafted was not placed in the terms that technically spelled out the restrictions of the covenant. In this context I believe there is a significant ambiguity that requires clarification. The ambiguity addresses the specific trade terms utilized in the agreement, the understanding between the parties, and the complex business environment in which the agreement arose.

The Division made one final argument pertaining to the testimony of Mr. Haas. The Division stated that his testimony does not and cannot suffice to establish the intent of all parties to the contract, citing Matter of Emery Air Freight Corp. (Tax Appeals Tribunal, October 17, 1991). In Emery, such testimony was rejected because it attempted to vary the meaning of the contract, not explain an ambiguity, as here. Thus, the Tribunal found error in the Administrative Law Judge's reliance "on the oral testimony of the witnesses . . . in

determining the intent of the parties to the lease since the lease was clear and unambiguous" (Matter of Emery Air Freight, supra). Emery is thus distinguishable.

Accordingly, Proposed Findings of Fact 20, 21 and 23 through 31 are not in violation of the parol evidence rule, and have been reflected in this determination.

B. Turning to a determination of whether payment for a covenant not to compete is income from intangible personal property, petitioner notes that the Tax Appeals Tribunal, in Matter of Laurino (May 20, 1993), recognized that contract rights are included within the definition of "general intangibles" in the New York Uniform Commercial Code § 9-106, and that a right to future employment is intangible property. Likewise, the reasoning applied by the Administrative Law Judge in Matter of McSpadden (Division of Tax Appeals, September 9, 1993), whose determination was affirmed by the Tax Appeals Tribunal (Matter of McSpadden, September 15, 1994) classifies similar employment related payments as intangibles. In Matter of McSpadden (Tax Appeals Tribunal, September 15, 1994), petitioner, a resident of Connecticut, was permitted to allocate his compensation within and without New York pursuant to the nonresident allocation rules. The primary issue in McSpadden was whether the treatment of the lump-sum payment received by the petitioner in connection with terminating his employment was proper. In McSpadden, the taxpayer and his employer negotiated a settlement wherein it was agreed that petitioner would relinquish his contractual rights under the employment agreement in exchange for a lump-sum payment. If the taxpayer had remained with the current employer, his employment would have continued to take place within and without New York as had been his prior pattern. The Administrative Law Judge held that petitioner possessed a right to future employment secured by his mere promise to work in the future, and that the lump-sum payment was consideration received in exchange for petitioner's surrender of an item of intangible personal property, i.e., the remaining term value of petitioner's employment contract. Since petitioner's rights under the employment agreement were originally secured by consideration having no connection to New York, i.e., petitioner's promise to work for the company in the future, the lump-sum payment was determined to be

nontaxable. In its affirming decision, citing Donahue v. Chu (104 Ad2d 523, 479 NYS2d 889) the Tax Appeals Tribunal concluded that the consideration for the relinquishment of petitioner's right to future employment, which may or may not have taken place in New York, was not subject to New York taxation.

In this matter, petitioner surrendered the right to engage in an occupation that would conflict with his then current professional commitment. The payment for the covenant not to compete was consideration received in exchange for petitioner's surrender of his right to pursue employment in his chosen field. Critically unlike McSpadden, what he gave up was not a contractual right or entitlement. For similar reasons, petitioner's inclusion of contract rights, such as the right to future employment, in the classification of intangibles, does not answer the question of whether income from the covenant is income from intangible personal property, since there was no contractual right surrendered by petitioner. Accordingly, the authorities relied upon by petitioner do not resolve the question of whether the covenant is an intangible asset.

C. A determination of whether the covenant not to compete is intangible personal property, is however, important to a determination of how to classify the income therefrom vis-a-vis nonresident taxation.

Tax Law § 631 provides that New York source income of a nonresident individual includes income or gain derived from or connected with New York sources including income derived from a business, trade, profession or occupation carried on in New York. The statute also provides that:

> "[i]ncome from intangible personal property, including annuities, dividends, interest, and gains from the disposition of intangible personal property, shall constitute income derived from New York sources only to the extent that such income is from property employed in a business, trade, profession, or occupation carried on in [New York State]" (Tax Law § 631[b][2]; emphasis added).

The Tax Appeals Tribunal has held that, in determining whether income is derived from or connected with New York sources within the meaning of the statute:

> "it is necessary to identify the activity upon which the income was secured or earned . . . [and that] in making this determination, the consideration given by

petitioner in exchange for the right to the income at issue is the controlling factor" (Matter of Laurino, Tax Appeals Tribunal, May 20, 1993).

Applying the principles of Laurino to the matter herein, the activity upon which petitioner received the payment for the covenant not to compete was petitioner's occupation and profession as a registered specialist, also referred to as a competitive market maker, which was connected to New York State from the inception of his career, and certainly derived from the skills he possessed and employed in his position with ABT. The consideration given by petitioner was the agreement not to perform as a registered specialist in a manner which would compete with Merrill Lynch for a specified period. Although petitioner established that to actually compete he would be acting as a registered specialist on one of the other five regional exchanges, a similar argument was rejected in Laurino. There petitioner contended that because a lump sum payment was intended to compensate him for work that he would have performed in the future, and that such work would have been performed in California, this income should not be taxable in New York. The Tax Appeals Tribunal rejected such argument in favor of identifying "the activity upon which the income was secured or earned" (Matter of Laurino, supra). Although I accept as entirely admissible and credible petitioner's testimony regarding the scope of the covenant in relation to the other exchanges, and accordingly agree with petitioner's assertion that there is no basis to assume that a position competitive with Merrill Lynch would be located in New York, the geographic scope of the covenant, to the extent that it may have been intended to be nationwide in scope is not relevant to a determination of New York taxation under these facts. Thus, the income from the covenant is derived from or connected with New York sources.

D. The next two-part inquiry, however, is (1) whether the income paid to petitioner is from intangible personal property, and if so, (2) whether the intangible is employed in a business, trade, profession, or occupation carried on in New York (Tax Law § 631[b][2]).

Turning to the question of whether the covenant not to compete is intangible personal property, I believe the answer, in the affirmative, is found in well established case law, in addition to a more recent Internal Revenue Code codification (see, United Finance and Thrift

Corp. v. Commissioner, 31 TC 278, affd 282 F2d 919, cert denied 366 US 902, 6 L Ed 2d 202; Internal Revenue Code § 197[d][1][E]).

Having concluded that the covenant is an intangible, a determination must be made as to whether the covenant was employed in a business, trade, profession or occupation carried on in New York. The covenant was certainly an asset of Merrill Lynch's business, particularly the segment which replaced ABT as the registered specialists in certain stocks. In fact, the protection afforded by the covenant gave Merrill Lynch the "standing" to be the competitive market makers in such stocks. I cannot draw a conclusion other than that the covenant was employed, used and relied upon by Merrill Lynch in its business as registered specialists on the NYSE. Accordingly, the income received from the covenant is properly subject to taxation by New York.

E. In order to reach a conclusion that the payment received by petitioner was taxable by New York, the Division additionally argues that 20 NYCRR former 131.4(d) requires petitioner to report as New York income payments received under a covenant not to compete because they are considered compensation for personal services to the extent those services were performed in New York State.

20 NYCRR former 131.4(d) provides that when a nonresident receives a pension or other retirement benefit attributable to his former services in New York State, that benefit is not taxable for New York State income tax purposes if it constitutes an annuity. The regulation further provides that if the pension or retirement benefit does not constitute an annuity, then:

> "it is taxable for New York State personal income tax purposes to the extent that the services were performed in New York State. The term compensation for personal services as used in the foregoing sentence includes, but is not limited to . . . amounts received upon retirement under a covenant not to compete" (emphasis added).

The Division reasons that when petitioner executed the sale agreement, he became an employee of MLSI, and he retired from employment with ABT. Thus, the Division concludes that it would follow that the compensation the petitioner received in exchange for the covenant not to compete was properly taxed as personal service income by New York State.

The Division's reliance on 20 NYCRR former 131.4(d) is misplaced. The Division erroneously concludes petitioner "retired" from ABT, when, in fact, the company effectuated a sale of its assets. There is no evidence in this record to support such a conclusion. From the evidence submitted, this amount can in no way be construed as a pension or retirement benefit to petitioner. The only evidence in the record relating to this issue of whether Mr. Haas retired contradicts such a conclusion, i.e., the W-2's from MLSI for 1988 and 1989. Therefore, there is no basis for applying this regulation to petitioner's situation.

F. In attempting to refute petitioner's argument that the taxable situs for payments received for the covenant (an intangible) would be petitioner's residence in New Jersey, the Division next argues that the taxable situs in such a case is the place where the activity would have occurred but for the covenant (citing, Korfund Co. v. Commissioner, 1 TC 1180 [1943]). The Division's reliance on Korfund Co. v. Commissioner (supra), standing for the proposition that payments of this type are sourced to the jurisdiction where the promisor forfeits his right to act, yields a result favorable to petitioner given my conclusion regarding the geographic scope of the covenant as nationwide. Korfund involved a corporation involved in the manufacturing and selling of foundation material, such as cork plates and vibration absorbers, and a competitor corporation located in Germany. The German corporation was paid by Korfund for its agreement not to compete with Korfund "in the United States or Canada". The court held that the competitor's right to do business in the United States, in competition with Korfund, was an interest in property in the United States and not in Germany. The court stated that what the nonresident corporation received was in lieu of what it might have received; that the situs of the right was the United States and the income that flowed from the privileges was necessarily earned and produced in the United States; and that the rights given up were property of value and the income acquired in exchange for those rights was therefore derived from the use of that property in the United States.

Thus, the reasoning in Korfund does not support the Division's position, but instead supports petitioner's position. Petitioner's agreement not to compete was not limited to a

specific geographic market or location as in Korfund. Petitioner's payment was in exchange for him not to compete with Merrill Lynch on the regional exchanges which spanned across the United States. If the geographic scope played a role in the nonresident taxation scheme as applied to these facts, Korfund would provide additional support to a determination of the source of the payment. However, the New York statutes, regulations and case law dealing with such provisions dictate that New York properly taxed the covenant herein.

G. The petition of Warren R. and Rosemary B. Haas is hereby denied, and the Notice of Deficiency dated March 19, 1993 is sustained.

DATED: Troy, New York
February 1, 1996

/s/ Catherine M. Bennett
ADMINISTRATIVE LAW JUDGE