STATE OF NEW YORK

DIVISION OF TAX APPEALS

In the Matter of the Petition	:	
of	:	DETERMINATION DTA NO. 812976
SASH A. and MARY M. SPENCER	:	
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 1989.	:	

Petitioners, Sash and Mary Spencer, 251 Crandon Boulevard, Unit 164, Key Biscayne, Florida 33149-1506, 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 1989.

On June 12, 1995 and June 21, 1995, respectively, petitioners by their representative, Alan P. Raines, Esq., and the Division of Taxation by Steven U. Teitelbaum, Esq. (Craig Gallagher, Esq., of counsel) executed a consent to have the controversy determined on submission without hearing. In a letter dated October 12, 1995, petitioners were given until November 24, 1995 to serve and file a reply brief, which date began the six-month period for the issuance of this determination. Petitioners filed briefs on September 6, 1995 and November 24, 1995. The Division of Taxation filed a brief on November 10, 1995. After due consideration of the record, Arthur S. Bray, Administrative Law Judge, renders the following determination.

ISSUE

Whether the Division erred in treating the amount reported as a guaranteed payment on petitioners' nonresident income tax return as income subject to New York State personal income tax.

FINDINGS OF FACT

1. Petitioners, Sash and Mary Spencer, filed a U.S. Individual Income Tax Return for the year 1989 on which they listed their address as Unit 164 251 Crandon Blvd., Key Biscayne, Florida 33149. On this return, petitioners reported a long-term capital gain of $10,657,929.00 arising from the disposition of an interest in Coinmach Industries Co. ("Coinmach"). They also included, as an item of other income on line 22 of their return, $1,349,832.00. This item was described on an attached statement as "SALE OF PARTNERSHIP INTEREST - DEPRECIATION RECAPTURE". Mr. Spencer's Schedule K-1, entitled Partner's Share of Income, Credits, Deductions, Etc., from Coinmach reported a guaranteed payment to partner of $1,349,832.00. An asterisk adjacent to this amount corresponded to a notation at the bottom of the form which stated "[t]his represents depreciation recapture due to . . . [illegible]." The Schedule D to petitioners' return, which concerned long-term capital gains and losses, reported that Mr. Spencer's interest in Coinmach was acquired on February 15, 1984 and that the interest was sold on October 28, 1989 for a sales price of $10,657,929.00. Petitioners reported a gain of $10,657,929.00.

2. Petitioners filed a New York State Nonresident and Part-Year Resident Income Tax Return for the year 1989. On this return they listed their address as Unit 164, 251 Crandon Blvd., Key Biscayne, Florida 33149. Petitioners allocated their items of income to sources within and without the State of New York. They did not include as an item of New York income either the long-term capital gain from the disposition of Coinmach or the item reported as a guaranteed payment on their Federal return.

3. Coinmach filed a U.S. Partnership Return of Income (Form 1065) for the period October 21, 1989 through December 31, 1989. On the return, the partnership stated that its principal business activity was a coin operated laundry. The partnership reported, as income, on

the line for listing "[n]et gain (loss) (Form 4797, Part II, line 18)"[1] the amount of $2,005,154.00. It also reported, as a deduction, guaranteed payments to partners of $2,005,154.00. In a statement attached to the return, the partnership explained the following:

> "Due to a deemed termination under Section 708(b)(1)(B) occurring on October 20, 1989, the partnership is filing a return for the short period October 21, 1989 through December 31, 1989. As detailed in the return for the final period ended October 20, 1989, a Section 754 election was made prior to the termination of the partnership.
>
> "Just after the deemed termination occurred, John Sussman and Sash Spencer had their partnership interests liquidated under Section 736. The Section 754 election as attached hereto applies to CIC I, CIC II and Cointrol Associates. Therefore, the bases of the partnership assets must be adjusted as allowed by Section 734(b) pursuant to Section 755, Reg. Sec. 1.755-1 and 1.755-2T.
>
> "The attached computation details this step-up. Columns A & B agree to the 10-20-89 return step-up. Col. E shows the beginning 10-21-89 balances after the deemed termination and recontribution [sic]. Finally, Col. F shows the balance sheet after the step-up due to the 736(b) payments."

The attached computation, which consists of the balance sheet of Coinmach, as of October 21, 1989, contains the columns described in the above statement. Column D, labeled redemption, reports capital in the amount of $18,237,164.00. Column E, labeled "10-21-89 BEGINNING" reports capital in the amount of $20,419,467.00 and Column F entitled "10/21/89 FINAL STEP-UP ON REDEMPTION" reports capital in the amount of $38,625,891.00.

4. On or about October 15, 1991, the Division of Taxation ("Division") commenced an audit of petitioners' returns. Initially, the Division was interested in issues involving petitioners' domicile, residency and allocation of income. However, as the audit progressed, the matter which principally concerned the Division was the item reported as depreciation recapture which was characterized as a guaranteed payment on the Schedule K-1. The Division concluded that the amount characterized as a guaranteed payment was ordinary income from the sale of a New York partnership and was taxable to a nonresident.

5. On the basis of the foregoing conclusion, the Division issued a Notice of Deficiency, dated March 8, 1993, which asserted a deficiency of personal income tax in the amount of

---

[1]Form 4797 is used to report sales of business property as well as recapture amounts.

$73,402.23 plus interest in the amount of $19,848.87. This amount was reduced by payments or credits of $93,251.10 for a balance due of $0.00. The Statement of Personal Income Tax Audit Changes, which was dated January 22, 1993, explained that petitioners had additional New York income of $1,360,097.00 arising from two sources - additional New York source taxable interest of $10,265.00 and depreciation recapture of $1,349,832.00.

6. A worksheet, offered by petitioners, entitled "Jack/Sash, Recapture Calculation, 10-20-89" reported the following:

	Jack	Sash
Purchase Price	5,829,574	12,007,761
Reimb	130,671	269,158
Expenses of Sale	(130,671)	(269,158)
Net	5,829,574	12,007,761
	* * *	
Net Gain on Fixed Assets § 1245 Recap 2,005,154	655,322	1,349,832

7. The record does not contain any agreements pertaining to the termination of Mr. Spencer's interest in Coinmach.

8. In accordance with State Administrative Procedure Act § 307(1), it is noted that the Division's proposed Findings of Fact do not comply with 20 NYCRR 3000.15(d)(6) since, with the exception of proposed Finding of Fact "3", they do not refer, wherever possible, to the relevant exhibits. Nevertheless, the substance of the Division's proposed Findings of Fact have been generally accepted and included in the determination.

SUMMARY OF THE PARTIES' POSITIONS

9. It is petitioners' position that the entire redemption should be considered as a sale for New York State purposes. Petitioners state that the new partners contributed $18,237,164.00 to the new Coinmach which is the same as the amount paid to petitioner and one other partner in redemption of their interest in the partnership. According to petitioners, the beginning capital in the partnership on October 21, 1989, in the amount of $20,419,467.00, represents the stepped-up basis of new partners, CIC I and CIC II, upon the purchase of the majority of Cointrol's

partnership interest in the partnership plus the beginning book capital of the interests of another partner and petitioner in the amount of $30,540.00. Petitioners note that the sum of $18,237,164.00 and $20,419,467.00 less the $30,540.00 in the beginning book capital represents the $38,626,091.00 stepped-up basis in the assets of the new partnership. Petitioners submit that it is clear that the new capital infused by the new partners was used to redeem petitioner and the other partners as if a sale of partnership interests had occurred.

Petitioners acknowledge that the partnership tax returns and some of the legal documentation concerning the acquisition of Coinmach state that the liquidation of Mr. Spencer's interest was a redemption. However, petitioners submit that under IRC § 707(a)(2)(B), if new partners infuse capital into a partnership and at the same time also redeem the interest of other partners, the transactions are viewed together and treated as a sale.

Petitioners also argue that the Revenue Reconciliation Act of 1993 added Internal Revenue Code § 736(b)(3) which stated that Internal Revenue Code § 736(b)(2), which requires a retiring partner to treat the recapture portion of his gain as a guaranteed payment, will not apply if either capital is a material income producing factor for the partnership or the retiring partner is a limited partner. Petitioners contend that in this case capital is a material income producing factor for the partnership and that Mr. Spencer was a limited partner. According to petitioners, if this section had been in effect in 1989, even if the transaction had been a retirement of Mr. Spencer's interest in Coinmach, the entire gain would have been treated as a capital gain and no portion would have been subject to New York taxation.

On the basis of the foregoing, petitioners submit that there are three reasons why they should prevail. First, the entire transaction was a sale of Mr. Spencer's partnership interest in Coinmach and therefore not subject to tax. Second, the guaranteed portion of the gain should not be subject to New York State taxation because the partnership did not receive a benefit for the deduction and no portion of the gain represented a distributive share of the partnership profits. Lastly, petitioners argue that, in light of the Revenue Reconciliation Act of 1993, the fair result would be to treat this transaction, regardless of its classification as a sale or

retirement, as a disposition of an intangible asset which is not subject to New York State taxation.

10. In response to the foregoing, the Division contends that Mr. Spencer's receipt of guaranteed payments made in connection with the redemption of a New York State partnership interest was properly subject to New York State taxation. Citing Matter of Baum v State Tax Commn. (89 AD2d 646, 453 NYS2d 268, lv denied 57 NY2d 607, 455 NYS2d 1026) and Treasury Regulation § 1.707(c), the Division argues that, except for limited purposes not relevant here, guaranteed payments are treated as a partner's distributive share of partnership income. It is further argued that a partner who receives payments in the form of a distributive share of a guaranteed payment under section 736 of the Internal Revenue Code is treated as a partner until the interest is completely liquidated.

The Division posits that when a partnership chooses to liquidate a partner's interest in the form of a guaranteed payment, the partnership may deduct the payments as an ordinary business expense. In turn, the retiring partner is required to treat the guaranteed payments as ordinary income.

It is submitted that IRC § 736 applies because petitioners admit that they received payment from the partnership and not other partners. Further, the payments were characterized as guaranteed payments on the Schedule K-1. The Division posits that under Federal regulations and the Baum decision, the guaranteed payments are properly treated as distributions of partnership income.

The Division proceeds to argue that IRC § 741 is inapplicable because the partnership was liquidated through guaranteed payments to the partnership and not to another partner. It is also submitted that the Revenue Reconciliation Act of 1993 is inapplicable because the sale took place in 1989. The Division further argues that, on its face, Technical Services Bureau memorandum (TSB-M-92[2]I), is inapplicable to this case.

The Division's second argument is that petitioners have failed to meet their burden of proof of establishing that the transaction at issue herein was a capital sale and not a liquidation through guaranteed payments.

11. In their reply brief, petitioners argue that from the beginning of the audit until the present they offered documentation to substantiate their position. Petitioners contend that they made their files available for anyone to review. However, no one from New York State ever bothered to review anything more than the 1989 Schedule K-1 and the front page of the partnership return.

Petitioners proceed to argue that, in this case, for Federal purposes the depreciation recapture is treated as a guaranteed payment to a partner because it is determined without regard to the income of the partnership. Petitioners state that even though the depreciation recapture was treated as a guaranteed payment, the partnership did not receive a deduction for the payment. According to petitioners, "[t]his is evidenced by the fact that the guaranteed payment was reported both as a deduction on Coinmach's 1989 Form 1065 line 10 and as an offsetting gain on line 6 of the same form. . . ." (Petitioners' reply brief, p. 3.) As a result, the partnership received no tax benefit from the guaranteed payment.

Referring to Treasury Regulation § 1.707-1(c), petitioners state that the terms guaranteed payment and distributive share are not synonymous. In addition, the New York source loss was not augmented by the depreciation recapture to the retiring partners.

It is petitioners' position that the Baum case is inapplicable because no deduction was taken in the instant matter for the guaranteed payment to Mr. Spencer, and the other partners of Coinmach did not have their incomes reduced as a result of the same. Petitioners further contend that if the dictates of Matter of Michaelson v State Tax Commn. (67 NY2d 579, 505 NYS2d 585) had been followed, the Division would have concluded that that the guaranteed payment resulted in no deduction at the partnership level and had nothing to do with the distributive share of partnership income.

Relying upon the Amended and Restated Agreement of Limited Partnership of Coinmach Industries Co., petitioners submit that the partnership was used as a vehicle in order to transfer Mr. Spencer's, Mr. Sussman's and a majority of Cointrol Associates' interests to CIC I and CIC II. Petitioners state that the steps set forth in said document show one transaction which is the sale of partnership interests.

In response to the Division's claim that the transaction took the form of a redemption, petitioners argue that the substance of the transaction should be considered a sale because "95 % of the partnership interests were transferred in the transaction . . . [t]he new partners receiving 95% ownership, CIC I and CIC II, used funds secured from outside sources to purchase the partnership interest of Cointrol Associates . . . [and] [o]n the same date, CIC I and CIC II contributed funds to the partnership and those same funds were utilized to redeem, and in effect, acquire, the partnership interests of Messrs. Sussman and Spencer." (Petitioners' reply brief, p.5.) Petitioners stress that, since TSB-M-92(2)I applies only in the case of a sale, it is important that this transaction be recognized as a sale. It is further submitted that the Division's reliance upon IRC § 741 is misplaced because "the same portion of unrealized receivables would have been recharacterized [sic] as ordinary income whether the transaction was classified as a sale or a redemption . . . . [and] there was no deduction taken at the partnership level for the depreciation recapture amount which was completely offset by an equal amount of income." (Petitioners' reply brief p.5.)

Petitioners submit that the Congressional intent of the Revenue Reconciliation Act of 1993 was to eliminate the possibility that taxpayers would receive a deduction for guaranteed payments resulting from depreciation recapture when a partnership interest was redeemed. According to petitioner, Coinmach followed Congress's goal in 1989 by not taking a deduction for a guaranteed payment resulting from the depreciation recapture. Petitioners contend that they cited the change in the law in order to demonstrate that the reclassification of the depreciation recapture was a fiction of the Internal Revenue Code that was subsequently clarified and corrected.

Petitioners next note that the Division recognizes the relevance of TSB-M-92(2)I even though it was issued in 1992. Petitioners submit that allowing this rule, which benefits the Division, although it was promulgated after the transaction in issue, while disavowing a second rule similarly legislated which goes against the Division, would be the height of hypocrisy.

Petitioners conclude that there are three reasons why they should prevail. First, the guaranteed payment did not provide a tax deduction to the partnership and the gain realized by Mr. Spencer did not represent a distributive share of partnership profits. Second, this transaction was really a sale of a partnership interest and none of the income is considered New York income. Lastly, subsequent law changes eliminated the treatment of any portion of the gain on the retirement of a partner as ordinary income.

CONCLUSIONS OF LAW

A. Tax Law § 631(former [a]) defines New York source income of a nonresident individual, in pertinent part, as:

> "the sum of 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:
>
> "(1) his distributive share of partnership income, gain, loss and deduction, determined under section six hundred thirty-two . . . ."

B. Tax Law § 632(a)(1) provides, in pertinent part:

> "In determining New York source 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 partner's 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-one."

C. In the present matter, petitioners cited Memorandum TSB-M-92(2)I as supporting their position. This memorandum provides, in pertinent part as follows:

> "It has been the position of the Department that an interest in a New York partnership represented an interest in real or tangible personal property in this State, or constituted an intangible employed in a business, trade, profession or occupation carried on in this state. Accordingly, any gain or loss realized upon its sale was held to be gain or loss derived from or connected with New York sources pursuant to sections 631(b)(1) and (2) of the New York State Tax Law.

> Upon reviewing the matter, the Department has decided that a gain or loss (whether treated as capital or ordinary for federal income tax purposes) from the sale of an interest in a New York partnership, except in the situation described below, does not constitute gain or loss derived from or connected with New York sources and is not includible in the New York source income (the numerator of the tax allocation fraction) of a nonresident individual, estate or trust. . . .
>
> * * *
>
> "This new policy applies to all open tax years, and will apply regardless of the type of activity (e.g. real estate, business, etc.) that the partnership is engaged in. . . .
>
> * * *
>
> "This new policy does not in any way affect the tax treatment of a partner's distributive share (including guaranteed payments) of partnership income, gain, loss, or deduction from a New York partnership. Such amounts remain taxable to the extent the partnership's income is derived from or connected with New York sources. . . ."

D. In essence, it is petitioners' position that the substance of the transaction is controlling and that the evidence shows that the substance of this transaction was a sale of Mr. Spencer's partnership interest. Since there was a sale of Mr. Spencer's interest, the foregoing memorandum excludes the receipts in issue from New York tax.

E. The tax consequences of a sale of a partnership interest may be quite different from a liquidation of the same interest (see generally, 2 McKee, Nelson and Whitmire, Federal Taxation of Partnerships and Partners ¶ 15.02[2] [2d ed 1990] [which discusses several major differences in the treatment of liquidations and sales]). In general, IRC § 736 applies to "payments made to a retiring partner or to a deceased partner's successor in interest in liquidation of such partner's entire interest in the partnership (Treas Reg § 1.736-1[a]). In addition, this section "applies only to payments made by the partnership and not to transactions between the partners" (Treas Reg § 1.736-1[a]). To the extent that a payment is considered a guaranteed payment under IRC § 736(a)(2), it is deductible by the partnership under IRC § 162(a) and is taxable to the recipient under IRC § 61(a) (Treas Reg § 1.736-1[a][4]).

The sale or exchange of an interest in a partnership is governed by IRC § 741. The pertinent regulation provides:

> "The sale or exchange of an interest in a partnership shall, except to the extent section 751(a) applies, be treated as the sale or exchange of a capital asset, resulting in a capital gain or loss measured by the difference between the amount realized and the adjusted basis of the partnership interest, as determined under section 705." (Treas Reg § 1.741-1.)

Section 741 of the Internal Revenue Code applies whether the partnership interest is sold to members of the partnership or to individuals who are not members of the partnership. This section also applies when the sale of the partnership results in a termination of the partnership under IRC § 708(b) (Treas Reg § 1.741-1[b]).

F. In Spector v. Commr. (641 F2d 376, cert denied 454 US 868, 70 L Ed 2d 171) the taxpayer presented a similar argument to that which is at issue here. Specifically, the question in Spector was whether the transaction wherein the taxpayer gave up his partnership interest was a "sale" resulting in a long-term capital gain under IRC § 741 or whether the transaction was a "liquidation" under IRC § 707(c) resulting in ordinary income under IRC § 736(a)(2). As here, the taxpayer argued that the form of the transaction was not controlling and that the substance of the transaction was a sale and not a liquidation of the interest in the partnership. The Tax Court found that there was "strong proof" that the agreements that the taxpayer signed did not reflect reality as far as his status in the partnership was concerned and that the substance of the transaction was a sale and not a liquidation. The Tax Court concluded that, except for certain payments which were allocated to a covenant not to compete, the transaction resulted in a long-term capital gain pursuant to IRC § 741 and and not ordinary income pursuant to IRC § 736(b)(2)(B).

On appeal, the court held that the proper standard to apply was that adopted by the Third Circuit in Commissioner v. Danielson (378 F2d 771, cert denied 389 US 858, 19 L Ed 2d 123). The court quoted the portion of the decision in Danielson wherein it was stated:

> "'a party can challenge the tax consequences of his agreement as construed by the Commissioner only by adducing proof which in an action between the parties would be admissible to alter that construction or to show its unenforceability because of mistake, undue influence, fraud, duress, etc.'" (Spector v. Commn, supra, 641 F2d at 380 quoting Commissioner v. Danielson, supra, 378 F2d at 775.)

The court in Spector noted that one difficulty with the Tax Court's approach was that from the perspective of "economic reality" a substantial difference did not exist between a section 736 liquidation and a section 741 sale of a partnership interest. After reviewing several policy considerations, the court concluded that the Danielson rule appropriately balances the interests of the Commissioner in the proper administration of the tax laws and the need for flexibility and fairness in a particular case. As a result, the decision of the Tax Court was reversed for a determination of whether the taxpayer presented proof of mistake, fraud, undue influence or other ground that, in the event of an action between the parties, would warrant setting the agreement aside or altering its construction.

G. On the basis of Spector, petitioners' argument, which focuses on the "economic reality" of the transaction, is rejected. As pointed out in Spector, there is no substantial difference between a section 736 liquidation and a section 741 sale of a partnership interest. Therefore, it is more productive to examine how the parties structured Mr. Spencer's separation from the partnership.

Petitioners did not present any evidence of Mr. Spencer's separation agreement from the partnership.[2] However, the documents in the record support the inference that the parties to the severance of Mr. Spencer's interest in the partnership agreed to proceed by a liquidation pursuant to IRC § 736. This conclusion is directly supported by the statement attached to the partnership return (Finding of Fact "3"). It is also supported by the partnership's reporting of a deduction for guaranteed payments and Mr. Spencer's corresponding reporting of income from guaranteed payments. Since petitioners have not presented any evidence of mistake, fraud, undue influence or other ground which would warrant setting aside the agreement, Mr. Spencer is bound by the agreement he reached with the partnership. Accordingly, the Division properly treated the transaction as a liquidation. It also properly concluded that the guaranteed payments

[2]Petitioners offered a copy of the Amended and Restated Agreement of Limited Partnership of Coinmach Industries Co. with their reply brief. Since no provision was made for the receipt of this document into the record, it was returned to petitioners' representative (see, Matter of Anzilotti, Tax Appeals Tribunal, February 22, 1996).

were subject to New York State personal income tax (see, Matter of Baum v State Tax Commn., supra).

H. Petitioners argue that the partnership never received a benefit for the deduction of the guaranteed payments. This argument is also rejected. Since the record contains only the first page of the partnership return and does not include a copy of the Form 4797, the record does not show the source of the net gain on line six. Moreover, in view of the holding in Spector, the result reached herein would be the same even if the partnership did not receive the benefit of the deduction since it was the apparent intent of the parties to proceed by a liquidation.

I. The House Committee Report on the Omnibus Budget Reconciliation Act of 1993 (Pub Law 103-66) explains the function of the Act, in part, as follows:

> "The bill generally repeals the special treatment of liquidation payments made for goodwill and unrealized receivables. Thus, such payments would be treated as made in exchange for the partner's interest in partnership property, and not as a distributive share or guaranteed payment that could give rise to a deduction or its equivalent. The bill does not change present law with respect to payments made to a general partner in a partnership in which capital is not a material income-producing factor. . . ."

If the transaction at issue had occurred at a later date, then on its face, the section relied upon by petitioner might have a bearing on this matter. However, this question is not presented because the House Committee Report also states that "[t]he provision generally applies to partners retiring or dying on or after January 5, 1993." Therefore, it is clear that Congress did not intend to apply the 1993 amendment to IRC § 736 retroactively and petitioners' reliance upon this amendment is misplaced.

J. Contrary to petitioners' argument, this is not a situation where the Division is applying its memorandum retroactively but not doing the same with a statutory provision which would benefit petitioner. Although TSB-M-92(2)I is dated August 21, 1992, it reflects a long-established line of cases which hold that the income of a nonresident from an intangible arising from the sale of an interest in New York is not subject to New York State personal income tax because the intangible was not used in a business, trade, profession or occupation carried on in New York State (see, Matter of Pastor v. State Tax Commn., 115 AD2d 144; 495 NYS2d 515;

Matter of Delmhorst v State Tax Commn., 92 AD2d 981, 461 NYS2d 499, affd 60 NY2d 628, 467 NYS2d 352; Matter of Epstein v. State Tax Commn., 89 AD2d 256, 456 NYS2d 454). Therefore, unlike the addition of IRC § 736(b)(2), the promulgation of TSB-M-92(2)I represented an acquiescence in the then existing case law rather than a change in the law.

K. The petition of Sash A. Spencer and Mary M. Spencer is denied, and the Notice of Deficiency issued March 8, 1993 is sustained.

DATED: Troy, New York
May 9, 1996

/s/ Arthur S. Bray
ADMINISTRATIVE LAW JUDGE