STATE OF NEW YORK

TAX APPEALS TRIBUNAL

In the Matter of the Petition of **WILLIAM AND IPEK TECHAR** 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 2017.	:	DECISION DTA NOS. 830479 AND 830481
In the Matter of the Petition of **ANTHONY AND JENNIFER FRASCELLA** 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 2017.	:	

Petitioners, William and Ipek Techar and Anthony and Jennifer Frascella, filed an exception to the determination of the Administrative Law Judge issued on September 7, 2023. Petitioners appeared by Hodgson Russ LLP (K. Craig Reilly, Esq. and Christopher L. Doyle, Esq.). The Division of Taxation appeared by Amanda Hiller, Esq. (Linda Farrington, Esq., of counsel).

Petitioners filed a brief in support of the exception. The Division of Taxation filed a brief in opposition. Petitioners filed a reply brief. Oral argument was heard on June 27, 2024, in Albany, New York, which date began the six-month period for issuance of this decision.

After reviewing the entire record in this matter, the Tax Appeals Tribunal renders the following decision.

ISSUES

I. Whether the Division of Taxation properly allocated petitioners' distributive shares of nonqualified deferred compensation to New York State.

II. Whether petitioners have established reasonable cause to abate negligence and substantial understatement penalties.

FINDINGS OF FACT

We find the findings of fact as determined by the Administrative Law Judge except for finding of fact 68, which we have not restated as it discussed the treatment of the parties' proposed findings of fact as submitted below. As so modified, the findings of fact appear below.

1. In 2017, petitioners, William Techar and Anthony Frascella, were nonresident partners of Aristeia Holdings, LP (Aristeia), which was treated as a partnership for federal and state income tax purposes.[1]

2. Aristeia was formed as a limited partnership in Delaware in 2008.

3. In 2017, Aristeia owned 100% of Aristeia Capital LLC (Aristeia Capital), a disregarded Delaware limited liability company that was formed in Delaware in 1997.

4. Petitioners were not employees of Aristeia or Aristeia Capital.

5. Aristeia Capital operates as a registered investment advisor, providing investment management services to private investment funds.

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[1] While Ipek Techar and Jennifer Frascella are petitioners in this matter, only William Techar and Anthony Frascella were partners in Aristeia, the entity that generated the income at issue. Mrs. Techar and Mrs. Frascella are petitioners in this matter solely because they filed forms IT-203, nonresident and part-year resident income tax returns, jointly with their spouses. Accordingly, unless otherwise indicated, all references to "petitioners" shall refer to Mr. Frascella and Mr. Techar.

6. Aristeia Capital has provided investment management services to various investment funds, including Aristeia International Limited (AIL).

7. AIL was incorporated in the Cayman Islands in 1997 in accordance with the Companies Law (Revised).

8. Aristeia Capital continuously provided investment management services to AIL from the time of AIL's incorporation in 1997 through and beyond the end of the 2017 tax year.

9. Robert Lynch, a founder and managing partner of Aristeia, testified that Aristeia Capital's investment management services provided to AIL consisted of attracting foreign investors and U.S. tax exempt investors, identifying, and researching investment strategies, and executing those investment strategies by purchasing and selling securities.

10. AIL and Aristeia Capital entered into various written investment management agreements that authorized Aristeia Capital to operate as AIL's "agent and attorney-in-fact with full power, discretion and authority to make all investment decisions concerning [AIL's investment portfolio], to enter into agreements and commitments on behalf of and in the name of [AIL], to open and close bank and brokerage accounts, to transfer assets to and from such accounts, and to effect transactions on behalf of [AIL's investment portfolio]."

11. The investment authority granted to Aristeia Capital under its investment management agreements with AIL included "the authority to exercise whatever powers [AIL] may possess with respect to any of its assets held in [AIL's investment portfolio] including, but not limited to, the right to pledge assets, the right to borrow and lend, the right to vote, the power to exercise rights, options, warrants, conversion privileges, redemption privileges, and to tender securities pursuant to a tender offer."

12. During the period covering 1998 through 2003, Aristeia Capital maintained its only office location within New York State.

13. Aristeia Capital became wholly owned by Aristeia in 2009.

14. In 2009, Aristeia Capital opened an office location in Connecticut.

15. In 2015, Aristeia Capital relocated its principal office from New York, New York, to Greenwich, Connecticut.

16. In exchange for providing investment management services to AIL, and in accordance with its investment management agreements, Aristeia Capital received both (i) management fees based on the total net assets of AIL and (ii) performance fees based on any increase or appreciation in the net asset value per share of AIL.

17. For the years ending December 31, 1998, December 31, 1999, December 31, 2000, December 31, 2001, December 31, 2002, and December 31, 2003, Aristeia Capital made irrevocable elections to defer certain percentages of the management and performance fees that it secured from AIL (Deferred Fees).

18. The combined value of the Deferred Fees totaled $29,013,693.00.

19. Aristeia International reinvested the Deferred Fees abroad.

20. The Deferred Fees were treated as though they were reinvested in Class B common shares of AIL.

21. The value of the reinvested Deferred Fees fluctuated based on the performance of AIL's Class B common shares during the relevant deferral periods. The Deferred Fees were subject to the same investment risks as other Class B common shareholders of AIL.

22. Aristeia Capital's right to receive payment of the Deferred Fees from AIL was no greater than, nor had any priority over, the right of any other unsecured general creditor of AIL.

23. Aristeia Capital did not use its potential right to receive payment of the Deferred Fees in any other business activities.

24. In 2017, when Aristeia recognized the Deferred Fees, the appreciation on the Deferred Fees totaled $97,194,568.00 (Appreciation). The collective nonqualified deferred compensation for both the Deferred Fees and Appreciation amounted to $126,208,261.00.

25. In tax years prior to 2017, Aristeia had also previously recognized portions of the Deferred Fees and Appreciation, but the majority of the Deferred Fees and Appreciation were recognized during tax year 2017 in conformity with section 457A of the Internal Revenue Code (IRC or Code), which was added to the Code in 2008 pursuant to Public Law 110-343.

26. During the 1998 through 2017 deferral periods, Aristeia Capital continued to perform ongoing investment management services on behalf of AIL. These services were performed from office locations both within and without New York State.

27. Aristeia Capital's ongoing investment management services resulted in a substantial increase in the value of the original Deferred Fees.

28. On August 31, 2010, the Division of Taxation (Division) published a Technical Services Bureau Memorandum (TSB-M), as TSB-M-10(9)I, Income Received by a Nonresident Related to a Business, Trade, Profession, or Occupation Previously Carried on Within New York State (the 2010 TSB-M). This guidance provided, in relevant part, that pursuant to Tax Law § 631 (b) (1) (F), an individual who receives income related to a business that was previously carried on partly within and partly without New York State must determine the New York business allocation percentage (BAP) "for the year the contract or other agreement was entered into that result[ed] in the federal income," and multiply the federal income by that New York BAP to determine the New York source income.

29. On April 6, 2018, the Division published Technical Memorandum TSB-M-18(2)C, 3(I), New York State Tax Treatment of Nonqualified Deferred Compensation (the 2018 TSB-M). The 2018 TSB-M states that for services performed before January 1, 2009, where the business, trade, profession, or occupation was carried on only in New York State in the year the services were performed, the entire amount of nonqualified deferred compensation must be included in New York source income. The 2018 TSB-M also provides that if the business, trade, profession, or occupation was carried on partly in and partly outside of New York State during the tax year the services were performed, the amount of nonqualified deferred compensation included in New York source income is determined using either the books and records of the partnership or the three factor formula described in 20 NYCRR 132.15 (c), calculated by the partnership for the tax year the services were performed.

30. The deadlines for partnerships and nonresident individuals to make 2017 estimated tax payments were April 18, 2017; June 15, 2017; September 15, 2017; and January 16, 2018, all dates that occurred prior to the release of the 2018 TSB-M.

31. After the Division's April 6, 2018 release of the 2018 TSB-M, and prior to filing its 2017 partnership tax returns, Aristeia and Aristeia Capital received written tax advice on the proper allocation of the Deferred Fees and Appreciation from Price Waterhouse Coopers LLP ("PwC"), an international accounting firm.

32. PwC initially provided Aristeia with a written memorandum, dated May 18, 2018, which included the following statement regarding the proper allocation of the Deferred Fees and Appreciation:

> "While further analysis would be required to determine the merits of any alternative apportionment methodology, the most conservative approach would be to include one hundred percent (100%) of the deferred fees and all

appreciation and earnings thereon, in the numerator of the New York gross income percentage."

33. Aristeia relied upon and utilized the 2017 allocation methodology that was described by PwC in its May 18, 2018 written memorandum as the "most conservative approach." This approach was to include the full value of both the Deferred Fees and the Appreciation in the numerator and the denominator of its 2017 gross income percentage.

34. Subsequent to the Division's audit of Aristeia's 2017 tax year, Aristeia obtained a second piece of written tax advice from PwC on the proper allocation of the Deferred Fees and Appreciation. The second piece of written tax advice was a 2019 written opinion letter, which included the following statements regarding the proper allocation of the Deferred Fees and Appreciation:

> "As discussed below, we do not think that the 2018 TSB-M is correct that nonqualified deferred compensation should be sourced by reference to historical business allocation percentages. However, if a partnership were to conservatively follow the 2018 TSB-M and use its historical business allocation percentages, it still has to determine how, as a mechanical matter, the historical business allocation percentage should be applied to determine NYS source income- an issue that the 2018 TSB-M does not even analyze. The approach that is most consistent with applicable law would be for the partnership to use such historical business allocation percentages to apportion its deferred fees to NYS (i.e.,
>
> 1. Multiply the deferred fees by the prior year three-factor formula,
>
> 2. Include such amount in the numerator of the 2017 three-factor formula, and then
>
> 3. Multiply the deferred fees by the 2017 three-factor formula (the Apportionment Approach") (emphasis in original).
>
> "It is our opinion that Aristeia should follow the Apportionment Approach, not the Allocation Approach, insofar as it uses its prior year three-factor formula.
>
> We note at the outset that Aristeia should actually have sourced the *appreciation* earned on its deferred performance fees using the three-factor formula from ***the year of receipt*** since the appreciation was subject to substantial risk of forfeiture until 2017 and was not readily ascertainable in prior years" (emphasis in original).

> "Moreover, it is more likely than not that *the deferred performance fees themselves* should have been sourced using the three-factor formula from the year of receipt as well since they were not readily ascertainable at the time of deferral and were fully subject to investment risk-just like the capital of any other AIL investor" (emphasis in original).
>
> "In the alternative, there is also substantial authority to treat the appreciation earned on deferred performance fees as income from intangible personal property and therefore as entirely income from non-NYS sources."

35. Aristeia reported the full $126,208,261.00 value of the Deferred Fees and the Appreciation as "Other income" on its 2017 tax returns, including its form IT-204, Partnership Return.

36. Aristeia and petitioners disclosed the recognition of the Deferred Fees and the Appreciation on their 2017 New York State tax returns by affirmatively answering the listed questions related to the reporting of nonqualified deferred compensation under Pub L 110-343, Div. C, section 801 (d) (2), 122 Stat 3765.

37. New York State's 2017 form IT-204 includes a New York allocation schedule on which partnerships compute and report their formula-based apportionment of income (i.e., BAP).

38. In 2017, Aristeia maintained 42.2668% of its real and tangible personal property within New York State and reported this percentage on the New York allocation schedule contained within its 2017 form IT-204.

39. In 2017, Aristeia maintained 56.4762% of its payroll within New York State and reported this percentage on the New York allocation schedule contained within its 2017 form IT-204.

40. In 2017, Aristeia sourced 88.0713% of its receipts to New York State and reported this percentage on the New York allocation schedule contained within its 2017 form IT-204.

This calculation included adding all Deferred Fees and the Appreciation as receipts sourced within New York State.

41. Aristeia, therefore, included the full value of the Deferred Fees and the Appreciation (collectively, $126,208,261.00) in the numerator and the denominator of its 2017 gross income percentage.

42. New York State's 2017 form IT-204 includes only one New York allocation schedule. The 2017 form IT-204 does not include a separate allocation schedule for reporting nonqualified deferred compensation.

43. On its 2017 form IT-204, Aristeia used the same allocation methodology for sourcing the Deferred Fees and Appreciation it received in 2017 as it used in tax years prior to 2017. In other words, Aristeia allocated Deferred Fees and Appreciation recognized prior to tax year 2017 using the property and payroll factors from the income recognition year and placing all of the Deferred Fees and Appreciation in both the numerator and denominator of the gross income factor in the income recognition year.

44. The amounts Aristeia recognized in 2017 for the Deferred Fees and Appreciation flowed through to petitioners as proportionate shares of partnership income. Petitioners reported their proportionate shares of the Deferred Fees and Appreciation on their 2017 forms IT-203, Nonresident and Part-Year Resident Income Tax Returns.

45. Petitioners computed their 2017 New York State estimated personal income tax payments utilizing the allocation methodology selected by Aristeia.

46. Aristeia computed the amounts listed on its 2017 New York Partner's schedules K-1 using the same income allocation methodology that was used on its 2017 form IT-204, i.e., Aristeia's 2017 New York Partner's schedules K-1 reported a BAP based on Aristeia's current

year property and payroll factors and included 100% of the Deferred Fees and Appreciation in both the numerator and the denominator of the gross income factor.

47. Petitioners reported their income from Aristeia on their 2017 forms IT-203 in accordance with the information provided on Aristeia's New York Partner's schedules K-1.

48. The Division performed audits of Aristeia and of petitioners' personal income tax returns for the tax year January 1, 2017 through December 31, 2017 (audit period).

49. The Division's audits of petitioners were initiated on April 29, 2019. The Division's audit of Aristeia was initiated on August 14, 2019. Although petitioners' 2016 tax returns were still eligible for audit under the applicable period of limitations, the Division did not audit them.

50. The Division did not make any adjustments to Aristeia's 2017 New York State BAP property or payroll percentages, and those percentages were accepted as filed.

51. During the audit, the Division determined that Aristeia failed to properly source the Deferred Fees and Appreciation it was required to report in 2017.

52. As its audit adjustments, the Division removed the Deferred Fees and the Appreciation from the numerator and denominator of the gross income factor of Aristeia's 2017 New York State BAP.

53. After removing the Deferred Fees and the Appreciation from the numerator and denominator of Aristeia's 2017 gross income factor, the Division separately allocated all of the income from the Deferred Fees and the Appreciation to New York State.

54. In removing the Deferred Fees and Appreciation from the numerator and denominator of Aristeia's 2017 gross income factor and separately allocating that income entirely to New York State, the Division relied on the guidance contained within the 2018 TSBM, the legal advice from its Office of Counsel, and the work papers provided by Aristeia.

55. The Division made no other audit adjustments beyond the reallocation of the 2017 Deferred Fees and Appreciation.

56. The Division's audit reports indicate that, following its audits, "[t]he Department issued [audited adjustments] to reflect the deferred income being allocated to New York State utilizing the business allocation percentage of Aristeia Holdings LP for each of the tax years the services were performed as described in 20 NYCRR 132.15."

57. The computational basis for the Division separately allocating 100% of the income from the Deferred Fees and Appreciation to New York State was Aristeia's prior reporting of a 100% New York State BAP throughout the tax years 1998 through 2003.

58. The Division's auditor testified that New York State's partnership BAP schedule is "what a partnership would use to determine how much of their business activities are taking place in the State of New York" and that "traditionally," the BAP uses current year apportionment factors.

59. The Division's 2013 Nonresident Allocation Guidelines describe the "property percentage" of the three-factor allocation method as:

> "[C]omputed by dividing (i) the average of the values, at the beginning and the end of the taxable year, of real and tangible personal property connected with the business and located within New York State, by (ii) the average of the values, at the beginning and end of the taxable year, of all real and tangible personal property connected with the business and located both within and without New York State."

60. The Division's 2013 Nonresident Allocation Guidelines describe the "payroll percentage" of the three-factor allocation method as:

> "[C]omputed by dividing (1) the total wages, salaries and other personal service compensation paid or incurred during the taxable year to employees, in connection with business carried on within New York State, by (2) the total of all wages, salaries and other personal service compensation paid or incurred

> during the taxable year to employees in connection with the business carried on both within and without New York State."

61. The Division's Nonresident Allocation Guidelines were revised in 2013, approximately five years after the 2008 enactment of IRC (26 USC) § 457A.

62. The Division's auditor testified that the Nonresident Allocation Guidelines remained applicable to Aristeia's 2017 recognition of nonqualified deferred compensation.

63. During the audit, the Division issued to petitioners each a consent to field audit adjustment, dated January 15, 2021. In the Consent to Field Audit Adjustment issued to petitioners Anthony and Jennifer Frascella, the additional tax due was $1,258,375.00, plus interest and penalties. In the remarks section of this document, it stated as follows:

> "The audit adjustment reflects the sourcing of income related to nonqualified deferred compensation as defined under IRC 457A following Technical Memorandum TSB-M-18(2)C, (3) I which addresses the treatment of nonqualified deferred compensation by nonresident individuals. The deferred income has been allocated to New York State utilizing the business allocation percentage for each of the tax years the services were performed as described in 20 NYCRR 132.15."

The last few pages of the document showed the reallocation of the Deferred Fees and Appreciation by removing them from the numerator and denominator of the gross income percentage of the BAP for tax year 2017 and finding that it was separately fully taxable as New York State income. The Consent to Field Audit Adjustment issued to William and Ipek Techar was the same as the consent issued to Mr. and Mrs. Frascella, except that their additional tax due was $402,715.00, plus interest and penalties, according to their proportionate share of Aristeia.

64. On April 13, 2021, following the audit, the Division issued to petitioners, Anthony and Jennifer Frascella, notice of deficiency L-053133059, which asserted additional tax due for the tax year 2017 in the amount of $1,258,375.00 plus penalty and interest. On the same date, the Division issued to petitioners, William and Ipek Techar, notice of deficiency L-053133062,

which asserted additional tax due for the year 2017 in the amount of $402,715.00, plus interest and penalty.

65. The Division assessed negligence and substantial understatement penalties against petitioners under sections 685 (b) (1), 685 (b) (2), and 685 (p) of the Tax Law.

66. The Division's auditor testified that the basis for imposing negligence penalties was petitioners' disregard of "clear guidance and clear tax law."

67. On May 28, 2021, petitioners each timely filed petitions asserting that the Division erred in issuing the assessments because the notices of deficiency were based on a nonbinding Technical Memorandum that was not consistent with the New York State Tax Law and the Division's own regulations. Petitioners also alleged that the Division's assessment of penalties against the petitioners was improper as any delinquency was due to reasonable cause and not negligence, intentional disregard, or willful neglect within the meaning of Tax Law § 685 (b) and (p).

THE DETERMINATION OF THE ADMINISTRATIVE LAW JUDGE

At the outset of the determination, the Administrative Law Judge cited IRC (26 USC) § 457A which provides that any compensation that is deferred under a nonqualified deferred compensation plan of a nonqualified entity is includible in the service provider's gross income when there is no substantial risk of forfeiture of the rights to the compensation. Next, the Administrative Law Judge noted that IRC (26 USC) § 457A generally applies to deferred amounts that are attributable to services performed after December 31, 2008. However, if IRC (26 USC) § 457A does not apply to a deferred amount solely because the amount is attributable to services performed before 2009, section 801 (d) (2) of Tax Extenders and Alternative Minimum Tax Relief Act of 2008 (TEAMTRA) provides that the amount is includible in gross

income in the later of the last taxable year beginning before 2018 or the taxable year of vesting (***see*** section 801 (a) of the Pub L 110-343 [Div C], Title VIII, § 801 [a] 122 Stat 3929 [October 3, 2008] [TEAMTRA]; ***see generally***, Internal Revenue Service Notice 2009-8, Interim Guidance Under § 457A).

The Administrative Law Judge found that in the instant matter the compensation was deferred under a nonqualified deferred compensation plan for a nonqualified entity and that it was included in gross income in 2017, the last taxable year before 2018. Additionally, both the Division and petitioners allocated all of the Deferred Fees and Appreciation to New York.

The Administrative Law Judge noted that pursuant to Tax Law § 631 (a) (1), New York State imposes personal income tax on the income of a nonresident that is derived from New York sources and such income includes a nonresident's distributive share of all items of partnership income, gain, loss and deduction entering into his federal adjusted gross income to the extent such items are derived from or connected with New York sources (***see*** Tax Law § 632 [a] [1]).

The Administrative Law Judge observed that where a business is carried on partly within and partly without New York State, the income, gain, loss, and deduction derived from New York sources shall be determined by apportionment and allocation under such regulations (***see*** Tax Law § 631 [c]). Where personal services are performed both within and without New York State, the portion of the compensation attributable to the services performed within New York State must be determined in accordance with section 132.15 of the regulations (***see*** 20 NYCRR 132.15). Additionally, the Administrative Law Judge noted that if personal services are performed within New York State, the compensation for such services that is includible in FAGI constitutes income from New York sources (***see*** 20 NYCRR 132.4 [c]).

The Administrative Law Judge found that the Deferred Fees were taxable at the time they were received but for petitioners' election to defer. Accordingly, the Administrative Law Judge agreed with the Division's separate allocation of the Deferred Fees and Appreciation using the BAP from the time the services were performed pursuant to Tax Law § 631 (b) (1) (F) and 20 NYCRR 132.4 (c).

The Administrative Law Judge rejected petitioners' argument that utilizing the BAP applicable to 2017 was the only proper method for apportioning the Deferred Fees and Appreciation because during that year business was performed both within and without New York. The Administrative Law Judge found that regardless of the business income earned within and without New York during the years between 2003 and 2017, and the New York BAPs that were calculated for those years, the New York BAP that petitioners assert should be used is determined solely by the income, property and payroll percentages calculated for 2017. Therefore, according to the Administrative Law Judge, petitioners' argument about business performed in the years in between is irrelevant.

The Administrative Law Judge also rejected petitioners' contention that the Division improperly treated the Appreciation as income from intangible property that does not qualify as New York State-source income, even if the Deferred Fees were determined to have been earned entirely within New York State. The Administrative Law Judge noted that for tax reporting purposes recognition of appreciation on Deferred Fees must be treated as ordinary income as compensation for services. The Administrative Law Judge observed that petitioners allocated all the Appreciation on the Deferred Fees to New York and found that petitioners failed to offer any legal authority for their assertion that a different BAP should be used for the Appreciation than

for the Deferred Fees because the Appreciation related to ongoing business activities that occurred both within and without New York.

The Administrative Law Judge determined that after Tax Law § 631 (b) (1) (F) was enacted, the Division issued guidance explicitly instructing taxpayers how to apply that provision on August 31, 2010 (***see*** 2010 TSB-M). The 2010 TSB-M instructed taxpayers that the BAP used to determine how income should be sourced to New York was the BAP for the year the contract or other agreement was entered into that resulted in the income (***see id.***).

Consequently, the Administrative Law Judge found that the only reasonable interpretation of Tax Law § 631 (b) (1) (F) is that the BAP to be utilized is from the year the services generating the income were performed. Additionally, the Administrative Law Judge found that the term "taxable year" as used in 20 NYCRR 132.15 does not mean "current taxable year," as petitioners would suggest, and instead merely represents an accounting period (***see*** IRC [26 USC] § 441 [b]).

The Administrative Law Judge found that petitioners' argument that the Division's reliance on the 2018 TSB-M violated the New York State Constitution and State Administrative Procedures Act (SAPA) lacked merit. The Administrative Law Judge stated that because the directions given in the 2018 TSB-M are advisory in nature and have no legal force or effect, no new rules were created, and thus the guidance given therein does not violate the New York State Constitution or SAPA.

Next, the Administrative Law Judge addressed the Division's imposition of penalties pursuant to Tax Law § 685 (b) and (p). The Administrative Law Judge rejected petitioners' argument that they did not act negligently in reporting the Deferred Fees and Appreciation as they did, since they sought out legal advice and disclosed their reporting positions on their

returns. In support of their argument, petitioners claimed to have an honest and reasonable misunderstanding of the law and facts. The Administrative Law Judge noted that petitioners chose to ignore published guidance, statutes, and regulations on the subject. The Administrative Law Judge also rejected petitioners' argument that reliance on the advice of their tax advisors was reasonable, noting the existence of official guidance and that the advice purportedly relied on was contradictory to such guidance. Accordingly, the Administrative Law Judge upheld the penalties in full.

ARGUMENTS ON EXCEPTION

On exception, petitioners argue, as they did below, that the Tax Law mandates that petitioners' 2017 New York State source distributive shares of partnership income be determined according to 20 NYCRR 132.15. Petitioners contend that Tax Law §§ 631 (a) (1) (A), 632 (a) (1), and 631 (b) (1) (F) require the use of sourcing rules found at 20 NYCRR 132.15. Petitioners assert that during the relevant periods from 1998 through 2017, Aristeia Capital, which was wholly owned by Aristeia, performed ongoing investment management services from locations both within and without New York State. Petitioners argue that petitioners' 2017 income from Aristeia is not akin to the income addressed in Tax Law § 631 (b) (1) (F) because during the relevant period Aristeia was an active partnership with ongoing business activities both within and without New York State.

Petitioners also argue that the Division based its audit adjustments on the partnership sourcing rules found at 20 NYCRR 132.5. Petitioners assert that the Administrative Law Judge's reliance on 20 NYCRR 132.4 (c) is misplaced. Petitioners contend that the language of 20 NYCRR 132.4 (c) cannot be read to alter existing income allocation periods. In addition,

petitioners argue that the 2018 TSB-M also makes no reference to 20 NYCRR 132.4 (c), and thus is inapplicable.

Petitioners also assert that the three-factor allocation method from 20 NYCRR 132.15 mandates use of a single BAP calculated using a property percentage from the "taxable year" and a payroll percentage from the "taxable year." Specifically, petitioners disagree with the Administrative Law Judge's interpretation of the "taxable year" as simply meaning an accounting period. Petitioners assert that the 2018 TSB-M contradicts the Tax Law and partnership income allocation rules. Specifically, petitioners point to the language contained therein that sets forth that that the BAP shall be the same as that ". . . [c]alculated by the sole proprietorship or partnership ***for the tax year the services were performed*** . . ." Petitioners claim that the above language directly contradicts the term "taxable year" found in paragraphs (d) and (e) of 20 NYCRR 132.15 that partnerships calculate and apply a single BAP for the taxable year. Further, petitioners argue that the Tax Appeals Tribunal has rejected the Division's prior attempts to contradict or expand existing income allocation periods through improper technical guidance.

Petitioners claim that the Division's application of the 2018 TSB-M to nonresident partners violates the New York State Constitution and SAPA. Both the New York State Constitution and SAPA require that all agencies follow minimum procedures before enacting and enforcing new rules. According to petitioners, here the Division attempted to apply a conflicting memorandum in a manner that violates both. Petitioners argue that blanket requirements and fixed standards that are to be generally applied are subject to procedures provided under SAPA.

Lastly, petitioners contend that they have established a reasonable cause for the abatement of penalties. Petitioners argue that the Division did not prepare or release a separate

multi-year allocation form similar to what the Division has released for other allocation scenarios. Petitioners assert that the conflicting guidance contained within the 2018 TSB-M is not found within the relevant provisions of the Tax Law and directly conflicts with the term "taxable year." According to petitioners, Aristeia not only disclosed the relevant facts affecting the tax treatment of the Deferred Fees and Appreciation but took a further step by obtaining professional tax guidance.

The Division, in their brief in opposition to petitioners' exception, states that the Administrative Law Judge correctly determined the source and character of the nonqualified deferred compensation. The Division argues that Tax Law § 631(b) (1) (F) was clear that the repatriated income of Aristeia must be sourced solely to New York based on the activities that generated the income in the years it was earned, regardless of when the income was recognized. The Division contends that despite the record clearly reflecting that the income at issue was earned by activities of Aristeia Capital at a time when Aristeia Capital operated solely within New York, petitioners continue to argue that they do not have to pay tax on the entire amount of repatriated income to New York and attempt to avoid this by diluting their apportionment of this income based on activities occurring two decades after the income was earned.

The Division asserts that federal law mandates that Deferred Fees, despite being recognized for tax purposes much later, are attributable to services performed in the specific period of service. The Division contends that these amounts were properly considered compensation for services earned during the years 1998 through 2003 pursuant to IRC (26 USC) § 457A.

The agreement between Aristeia Capital and AIL authorized Aristeia Capital to make all investment decisions on behalf of AIL (***see*** finding of fact 10). In exchange for providing

investment management services to AIL, Aristeia Capital received both (i) management fees and (ii) performance fees based on any increase or appreciation in the net asset value per share of AIL (***see*** finding of fact 16). The Division argues that Aristeia Capital was permitted to end the service arrangement in any year without jeopardizing its right to compensation for services that it had already performed. Thus, the Division asserts that the fact that Aristeia Capital continued its agreement with AIL did not impact amounts earned in prior years, only amounts earned in later years.

The Division claims that the Administrative Law Judge properly concluded that nonqualified deferred compensation previously earned within New York must be sourced to New York under Tax Law § 631 (b) (1) (F) and that the Deferred Fees in the present instance fall within the scope of Tax Law § 631 (b) (1) (F) and 20 NYCRR 132.4 (c). The Division supports its assertion by pointing to the fact that the documentation provided by Keith James to the Division clearly indicates that 100% of the Deferred Fees were earned in New York in each of the years. Furthermore, in reporting these fees on their 2017 tax return, Aristeia Holdings included 100% of the Deferred Fees in the New York column in its BAP schedule.

Next, the Division asserts that the Administrative Law Judge properly applied the three-factor formula to nonqualified deferred compensation. In support thereof, the Division states that based on Tax Law § 631 (b) (1) (F) income should be allocated based on the activities generating the income that were "previously carried on in this state." According to the Division, the use of the word "previously" in the statute indicates that allocation should look to the time period during which the income was earned.

The Division argues that the Administrative Law Judge correctly concluded that the 2018 TSB-M was consistent with the Tax Law and regulations. The Division states that technical

memoranda are primarily designed to keep taxpayers and other interested persons informed and to ensure consistent understandings throughout the Division.

Finally, the Division asserts that the Administrative Law Judge correctly concluded that petitioners were negligent and that penalties were properly imposed. The Division, in their brief, disagrees with petitioners' argument that since they relied on professional advice, they have established sufficient grounds to abate penalties. The Division contends that petitioners in fact never followed the professional advice. Instead of following the position from their tax advisor, PwC, or waiting for an answer from another advisor, Ernst & Young, petitioners affirmatively chose to improperly allocate their income using their own methodology. The Division further disagrees with petitioners that they made an "honest misunderstanding of fact or law," and states that petitioners made a conscious choice to not only reject the Division's clear guidance, but also ignored the statutory provisions.

OPINION

The first question presented on exception distills to whether the Deferred Fees and Appreciation here at issue should be allocated as New York source income in the gross income percentage and ultimately be reflected in the BAP for 2017, or whether such income should be allocated to New York entirely utilizing the BAP for the years the services were performed, namely 1998 through 2003. "[A]ny compensation which is deferred under a nonqualified deferred compensation plan of a nonqualified entity shall be includible in gross income when there is no substantial risk of forfeiture of the rights to such compensation" (IRC [26 USC] § 457A). That section of the Code was adopted by section 801 (d) (1) of TEAMTRA, which provides that "the amendment made by this section shall apply to the amounts deferred which are attributable to services performed after December 31, 2008." TEAMTRA § 801 (d) (2) provides

a transition rule for deferred amounts that are exempt from IRC (26 USC) § 457A solely because they are attributable to services performed before Jan. 1, 2009. In addition to requiring tax recognition of the original deferred management fees, the grandfathered provision required recognition of the appreciation on these fees to be treated as ordinary income for tax purposes (***see*** IRS Notice 2009-8, Interim Guidance Under § 457A).

Here, the compensation was deferred under a nonqualified deferred compensation plan for a nonqualified entity, and it was included in gross income in 2017, the last taxable year before 2018. At issue is whether the Deferred Fees and Appreciation should be allocated as New York income included in the gross income percentage and ultimately the BAP for 2017 or allocated separately as New York income in its entirety utilizing the BAP for the years the services were performed (1998 through 2003).

Pursuant to Tax Law § 631 (a) (1), New York State imposes personal income tax on the income of a nonresident that is derived from or connected to New York sources (***see*** Tax Law § 601 [e] [1]; ***Matter of Zelinsky v Tax Appeals Trib. of State of N.Y.***, 1 NY3d 85, 89-90 [2003], ***cert denied*** 541 US 1009 [2004]). Such income includes a taxpayer's "distributive share of partnership income, gain, loss and deduction" (Tax Law § 631 [a] [1] [A]; ***see Matter of Murphy***, Tax Appeals Tribunal, December 16, 2016). In relevant part, Tax Law § 632 (a) (1) provides that "[i]n 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 of this part . . . " (Tax Law § 632 [a] [1]; ***see also Matter of Purcell***, Tax Appeals Tribunal, November 14, 2016).

Tax Law § 631 (b) (1) (F) provides that:

> "income received by nonresidents related to a business, trade, profession or occupation previously carried on in this state, whether or not as an employee, including, but not limited to, covenants not to compete and termination agreements. Income received by nonresidents related to a business, trade, profession or occupation previously carried on partly within and partly without the state shall be allocated in accordance with the provisions of subsection (c) of this section."

Pursuant to Tax Law § 631 (c), where a business is carried on partly within and partly without New York State, items of income, gain, loss, and deduction derived from New York sources shall be determined by apportionment and allocation under the regulations.

The applicable regulations at 20 NYCRR 132.15 deal with the apportionment and allocation of income from business carried on partly within and partly without New York State. Subsection (a) provides that a nonresident's items of income, gain, loss, and deduction from business, trade, profession, or occupation both within and without New York State, must be allocated and apportioned according to a fair and equitable method (20 NYCRR 132.15 [a]). If the books of the business disclose the proportion of the net amount of the items of income, gain, loss, and deduction derived from or connected to New York State sources, the books may be used to determine the allocation (***see*** 20 NYCRR 132.15 [b]). However, if the books and records of the business do not disclose the proportion of the net amount of the items of income, gain, loss, and deduction attributable to the activities of the business carried on in New York State, such proportion is determined by multiplying the net amount of income, gain, loss, and deduction of the business by the average of the property percentage, the payroll percentage, and the gross income percentage (***see*** 20 NYCRR 132.15 [c]).

The regulations further provide that, "[i]f personal services are performed within New York State, whether or not as an employee, the compensation for such services includible in the Federal adjusted gross income constitutes income from New York State sources, regardless of the fact that (1) such compensation is received in a taxable year after the year in which the services were performed . . ." (20 NYCRR 132.4 [c]).

On exception, petitioners contend that the BAP from the year that the Deferred Fees and Appreciation had to be recognized should be used here. Petitioners assert the Deferred Fees and Appreciation should be included in the gross income percentage and ultimately averaged with the property and payroll percentages for 2017 to determine its BAP for 2017. Additionally, petitioners contend that since income was earned both within and without New York, the language of 20 NYCRR 132.4 (c) cannot be read to alter existing income allocation periods. We disagree.

The language of Tax Law § 631 (b) (1) (F) as explained by the 2018 TSB-M and 20 NYCRR 132.4 (c) is clear that the Deferred Fees and Appreciation must be sourced to New York State as ordinary income on the partnership's return. Consequently, the only logical application of Tax Law § 631 (b) (1) (F) would be to look to the BAP in the year the income was earned. The record demonstrates that the Deferred Fees and Appreciation thereon were earned in New York from 1998 through 2003 (***see*** finding of fact 17). The Deferred Fees sourced in New York were taxable once received, but petitioners elected to defer it (***see id.***). Once recognized, the Deferred Fees and Appreciation should be sourced to the origin, i.e., New York.

We agree with the Administrative Law Judge that the Division's separate allocation of the Deferred Fees and Appreciation using the BAP from the time the services were performed pursuant to Tax Law § 631 (b) (1) (F) and 20 NYCRR 132.4 (c) was correct. Additionally, we

agree with the Administrative Law Judge that recognition of appreciation on Deferred Fees generally must be treated as ordinary income for tax purposes (***see*** IRC [26 USC] § 457A [a] [1]; IRS Notice 2009-8, Interim Guidance Under § 457A at A-23).

Petitioners argue that because the property percentage and the gross income percentage provided in 20 NYCRR 132.15 refer to the "taxable year," i.e. 2017, the gross income percentage for 2017 must include the Deferred Fees and Appreciation because that is the taxable year that is being reported and the year petitioners are required by law to repatriate the Deferred Fees and Appreciation. We reject this argument. The Administrative Law Judge correctly noted that the term "taxable year" as used in 20 NYCRR 132.15 does not mean "current taxable year," instead, the term refers to an accounting period (***see*** IRC [26 USC] § 441 [b]). The plain meaning of Tax Law § 631 (b) (1) (F) directs taxpayers to use the property percentage, payroll percentage, and gross income percentage to determine their BAP from the year the services were rendered, utilizing the formula provided by 20 NYCRR 132.15.

Petitioners in their brief cite to ***More v Commr***, 66 TC 27 [1976] ***affd*** 562 F2d 38 (2d Cir 1977), where the term "taxable year" was analyzed as a specific period of time that impacted the taxpayers' eligibility for income averaging under a specific federal tax provision. The Court in ***More*** found that the term "taxable year" was defined under the Code as ". . . the calendar year, or the fiscal year ending during such calendar year, upon the basis of which the taxable income is computed under subtitle A. 'Taxable year' means in the case of [a] return made for a fractional part of a year under the provisions of subtitle A or under regulations prescribed by the Secretary or his delegate, the *period for which such return is made*" (emphasis added) (***see also*** IRC [26 USC] § 7701 [a] [23]). Accordingly, the term "taxable year", for purposes of IRC § 457A, means the year for which the taxpayer is filing the tax return or the year in which the income is

earned. Accordingly, the term "taxable year" means the year in which services were performed.

Petitioners make the same arguments as below and assert that the Division's creation of and reliance on a TSB-M for the authority for the Division's audit methodology was struck down previously in ***Matter of Stuckless*** (Tax Appeals Tribunal, August 17, 2006), and that similar to ***Matter of Stuckless***, the Tax Law and regulations thereunder do not support the Division's sourcing of income in the present matter. The Administrative Law Judge distinguished ***Matter of Stuckless*** from the present instance and we agree with the Administrative Law Judge that the facts and law in ***Matter of Stuckless*** are distinguishable from the instant case.

The Tax Law and regulations are clear and support the Division's apportionment of petitioner's income. The 2018 TSB-M, unlike in ***Matter of Stuckless***, does not articulate new rules of interpretation of the Tax Law. Accordingly, we find that the TSB-M issued by the Division constitutes proper technical guidance and does not contradict the existing law and regulations.

We now address petitioners' contention that the 2018 TSB-M issued by the Division violates the New York State Constitution and SAPA. The New York State Constitution provides that no rule or regulation made by any state department, board, bureau, officer, authority or commission shall be effective until it is filed in the office of the department of state and the Legislature is responsible for the timely publication of these rules and regulations through appropriate laws (***see*** NY Const, art IV, § 8). SAPA outlines the process of rulemaking followed by state agencies. It requires agencies to provide notice of proposed rules, allowing for public comment, and establishes procedures for the adoption of final rules. SAPA aims to ensure transparency and public participation in the regulatory process (***see*** SAPA § 202).

TSB-Ms are "advisory in nature" and "do not have legal force or effect" (20 NYCRR 2375.6 [c]; ***see Matter of Friesch–Groningsche Hypotheek Bank Realty Credit Corp.***, Tax Appeals Tribunal, December 28, 1990, ***confirmed*** 185 AD2d 466, 468 [3d Dept 1992], ***lv denied*** 80 NY2d 761 [1992]; ***see also*** 20 NYCRR 2375.6 [a] [1] [providing that TSB-Ms are "informational statements of the Division of Taxation's policies"]). TSB-Ms are designed with the intent of keeping the taxpayer informed regarding the application of the law (***see Matter of 300 East 74th Owners Corp.***, Tax Appeals Tribunal, July 25, 1996, citing ***Developing and Communicating Interpretations of the Tax Laws: A report to the Governor and the Legislature reviewing the Department of Taxation and Finance Policies and Practices***, March 1989, p 20; ***see also Matter of Garden Way***, Tax Appeals Tribunal, February 24, 1994). As stated above, the 2018 TSB-M did not create any new rules but was merely explanatory in nature. Technical memoranda are primarily designed to keep taxpayers and other interested persons informed and to ensure consistent understandings throughout the Division. Accordingly, the directions contained in the 2018 TSB-M do not violate the New York State Constitution or SAPA.

Next, we address the issue of imposition of penalties. The Division asserted both a negligence penalty, pursuant to Tax Law § 685 (b) (1), (2), and a substantial understatement penalty, pursuant to Tax Law § 685 (p), for tax year 2017. Under Tax Law § 689 (e), petitioners have the burden of proof of showing that the deficiencies asserted against them did not result from negligence or an intentional disregard of the Tax Law (***see*** Tax Law § 685 [b] [1], [2]; ***see also Matter of Wiesen***, Tax Appeals Tribunal, September 13, 2018). Similarly, petitioners bear the burden of proof in showing that any substantial understatement of tax was due to reasonable cause and not willful neglect in order for such penalty to be abated (Tax Law § 685 [e]; 20

NYCRR 2392.1 [g] [1]; ***see also Matter of Campaniello v New York State Div. of Tax Appeals Trib.***, 161 AD3d 1320, 1325 [3d Dept 2018], ***lv denied*** 32 NY3d 913 [2019]).

Petitioners contend that their penalties must be cancelled for the following reasons: (i) they reported recognition of the Deferred Fees and Appreciation on their 2017 returns; (ii) they had a reasonable and honest misunderstanding of fact or law because they used the same allocation methodology for tax year 2017 as they did for reporting tax years prior to 2017; (iii) the 2018 TSB-M conflicted with 20 NYCRR 132.15, and an earlier decision from the Tax Appeals Tribunal stated that Tax Law § 631 (b) (1) (F) "casts no light" on the allocation of distributive shares of partnership income (***see Matter of Murphy***); and (iv) they relied on written tax advice from an international accounting firm. We disagree.

Although petitioners disclosed the full value of the Deferred Fees and Appreciation on their 2017 return, such disclosure does not prove that petitioners acted without negligence or intentional disregard of the Tax Law. Here, petitioners chose to ignore the applicable law and guidance related to treatment of Deferred Fees and Appreciation. Petitioners claim an honest misunderstanding of fact or law for their failure to follow the guidance provided in the 2018 TSB-M pursuant to Tax Law § 631 (b) (1) (F). The 2018 TSB-M was issued pursuant to Tax Law § 631 (b) (1) (F) and 20 NYCRR 132.15 and explained the correct treatment of nonqualified deferred compensation thereunder. TSB-M memoranda are informational in nature, "designed to aid in keeping the taxpayer as informed as possible about the application of the law" (***see Matter of 300 East 74th Owners Corp.; Matter of Garden Way***). Given the availability of official guidance on the treatment of the nonqualified deferred compensation at the time of filing, and considering the sophistication of petitioners' advisors, we agree with the Administrative Law

Judge that petitioners failed to bear their burden of showing that they acted without negligence in reporting the nonqualified deferred compensation as they did.

Petitioners argue that the penalties must be abated as they relied on professional tax advice. We note that reliance on professional advice is not an absolute defense (***see Matter of Wiesen***; ***Matter of Tweed***, Tax Appeals Tribunal, May 23, 1996; ***see also Matter of 1230 Park Assoc. v Commissioner of Taxation & Fin. of State of N.Y.***, 170 AD2d 842 [3d Dept 1991], ***lv denied*** 78 NY2d 859 [1991]; ***see also Plante v Commr***, TC Memo 1985-117 [1985]). When a taxpayer relies on a tax professional, the taxpayer must show that he “acted with ordinary business care and prudence in attempting to ascertain his tax liability,” and thus, must show that his reliance on professional advice was reasonable (***Matter of McGaughey***, Tax Appeals Tribunal, March 19, 1998, ***confirmed*** 268 AD2d 802, 803 [3d Dept 2000]). Notwithstanding the fact that petitioners sought and received professional advice, that advice contradicted the guidance provided in the TSB-M. Something more than merely seeking and relying on professional advice is required to show that such reliance is reasonable (***see Matter of Siegel***, Tax Appeals Tribunal, November 12, 2012, citing ***Matter of CBS Corp. v Tax Appeals Trib. of N.Y.***, 56 AD3d 908, 911 [3d Dept 2008], ***lv denied*** 12 NY3d 703 [2009]).

We conclude that the Administrative Law Judge correctly determined that petitioners’ disregard of the applicable law and guidance constituted negligence, and that imposition of the penalties pursuant to Tax Law §§ 685 (b) (1), (2) and (p) was proper.

Accordingly, it is ORDERED, ADJUDGED and DECREED that:

1. The exception of William and Ipek Techar and Anthony and Jennifer Frascella is denied;

2. The determination of the Administrative Law Judge is affirmed;

3. The petitions of William and Ipek Techar and Anthony and Jennifer Frascella is denied; and

4. The notices of deficiency, dated April 13, 2021, are sustained.

DATED: Albany, New York
December 12, 2024

/s/ Jonathan S. Kaiman__ ___
Jonathan S. Kaiman
President

/s/ Cynthia M. Monaco
Cynthia M. Monaco
Commissioner

/s/ Kevin A. Cahill____ ___
Kevin A. Cahill
Commissioner