

When Is a Partner a Partner For New York Tax Purposes?

by Peter L. Faber

Peter L. Faber is a partner with McDermott Will & Emery LLP, New York.

A New York administrative law judge has held that a lawyer resident in New Jersey who was nominally designated as a “partner” in a New York law firm was taxable on his share of the partnership’s income from New York sources even though he had no economic interest in the partnership.¹ Except for the title of partner, the taxpayer was in all respects an employee of the firm. The decision elevates form over substance and ignores the economic realities of the taxpayer’s relationship with the partnership.

The Tosti decision elevates form over substance and ignores the economic realities of the taxpayer’s relationship with the partnership.

The decision is important because many law firms and other professional partnerships have nonequity partners. Although they are designated as partners, typically sign the partnership agreement, and undoubtedly can be held liable for partnership debts because they are held out to the world as partners, they have no economic interest in the firm. Typically, they have no capital interest and do not share in the firm’s profits or losses. Their compensation consists of salary, the normal fringe benefits, and perhaps, a bonus. Although the bonus may be affected by the firm’s performance, it is typically not a percentage of profits and, if the firm has a good year but needs cash to invest in new computer equipment or a new

lease, the bonuses paid to the nonequity partners may be reduced or eliminated. The nonequity partners usually have no right to vote on partnership matters or to inspect the partnership’s books and records.

Although nonequity partners are partners for some purposes (for example, liability) and have the external prestige of being partners, they do not have an economic interest in the firm. In a tax regime like New York’s, in which a nonresident partner is taxed on his or her share of the partnership’s income from New York sources, it makes no sense to treat a nonresident as if he or she was sharing in the firm’s income from New York sources when the individual clearly is not. In *Tosti*, the taxpayer’s income was not affected by the amount of the firm’s New York-source income and he should not have been taxed as if it was.

One could dismiss *Tosti* as being an aberration, and under New York law, ALJ decisions have no precedential value, but the opinion was based on decisions of the New York courts that ignored the economic realities of the relationships in question, and it is likely to be upheld on appeal unless the New York courts can be persuaded that their prior decisions were incorrect.

Tosti

Robert Tosti was a resident of New Jersey and practiced law for the law firm of Wilson Elser, Moskowitz, Edelman & Dicker LLP. The firm had offices in many locations, including three offices in New York state. Tosti practiced exclusively in New Jersey and did not work at the New York offices.

Tosti had been a partner in a small New Jersey law firm for about 20 years. He joined Wilson Elser in 2003 and his arrangement with the firm was reflected in a letter agreement. The agreement indicated that he would be a “non-equity or limited partner as opposed to a general or capital partner.” The agreement provided that he would not be liable for the firm’s liabilities and would not have any interest in its “assets, income or files.” He had no right to demand an accounting or a dissolution of the firm. His compensation was determined by the

¹*Petition of Robert and Frances Tosti*, NYS Division of Tax Appeals, DTA No. 822915 (2010). (For the decision, see *Doc 2010-15164* or *2010 STT 134-24*.)

firm's executive committee and he had no interest in the firm's profits. He had no right to vote on firm matters. He could make recommendations, but the firm was not obligated to follow or even consider them. The firm assigned associates to work with him and the firm determined their compensation. Tosti could make recommendations about their compensation, but the firm was not obligated to follow them. Tosti did not see or have access to Wilson Elser's partnership agreement, nor did he sign it.

The firm sent Tosti a K-1 form indicating his income and describing it as "guaranteed payments." In other words, the firm for tax reporting purposes treated Tosti as a partner. Income taxes were not withheld from his compensation and the firm did not pay employment taxes regarding his compensation.

Tosti received bonuses from time to time, but they were not linked to firm profits.

The lesson to be drawn from the case is that form controls and that the tax treatment of a person by the partnership will determine his tax status regardless of the economic realities.

In holding that Tosti was a partner for tax purposes and, hence, was taxable on his share of the firm's income from New York sources, the ALJ focused entirely on the arrangement's form and ignored its economic substance. The decision rests entirely on the partnership's decision to treat Tosti as a partner for tax reporting purposes. The ALJ focused on the facts that Tosti received K-1 forms in which he was described as a partner, that taxes were not withheld from his compensation, and that the payments to him were described as "guaranteed payments." In response to Tosti's argument that he had no interest in firm profits, the ALJ said that there was nothing in the record on how the amount of his compensation was calculated and that in view of that lack of information, "it cannot be concluded that the same bore no relationship to WEMED's profits." Because Tosti's compensation was paid to him in a biweekly draw beginning at the start of the year, it would seem obvious that those amounts were not based on firm profits; the profits for the year could not have been known at the beginning of the year when the draw was established. Thus, the ALJ's economic argument does not stand up. The lesson to be drawn from the case is that form controls and that the tax treatment of a person by the partnership (a decision that the partner had nothing to say about) will determine his tax status regardless of the economic realities.

Unfortunately, New York case law supports this formalistic approach.

In support of its position, the *Tosti* opinion cites the decision of the New York State Supreme Court, Appellate Division (not the state's highest court), in *Heller v. New York State Tax Commission*.² That case also involved a nonresident partner of a New York law firm. The taxpayer had no capital interest, had no interest in partnership assets, did not participate in management decisions, did not receive a share of profits, and was not liable for partnership losses. Although the court acknowledged that those facts pointed toward nonpartner status, it held that the commissioner of taxation and finance's decision to treat the taxpayer as a partner was not unreasonable because the taxpayer was described as a partner in the partnership's tax returns and the partnership did not deduct Social Security or withholding taxes from his compensation. Here, too, the court held that the partnership's description of the relationship was more important than the facts of the relationship. A stinging dissent argued that the taxpayer had none of the rights that partners generally have, arguing that "all of the evidence clearly negated the existence of [a] relationship."

Another case cited by the ALJ in *Tosti* is *Heffron v. Chu*.³ That case also involved a nonresident attorney who was a nominal partner in a law firm doing business in New York state. The taxpayer had a two-year agreement with the firm in which he was "admitted to partnership" but his compensation was fixed at \$50,000 a year regardless of the firm's profits or losses and he had no capital account or share in the firm's assets. He had no right to participate in management. When the two years ended, he left the firm and opened his own law office. The taxpayer argued that the only reason for making him a partner was to enable him to sign litigation papers for filing in the federal courts and that he had no economic interest in the firm. The court, relying on *Heller*, rejected that argument and held that the controlling facts were that the taxpayer and the firm reported his income as income from the partnership and that taxes were not withheld from his compensation. Those facts were held to be sufficient to make him a partner for purposes of taxing him on his share of the firm's New York income. Interestingly, the judge who wrote the dissent in *Heller* wrote the court's opinion in *Heffron*. Here, too, the decision rested entirely on the arrangement's form and the manner in which the parties treated it for tax filing purposes. The arrangement's economic realities were ignored.

Another case cited by the ALJ was *Weinflash v. Tully*.⁴ In *Weinflash* the taxpayer was a partner of a

²16 A.D.2d 901, 498 NYS 2d 211 (3rd Dep't 1986).

³144 A.D. 2d 729, 535 NYS 2d 141 (3rd Dep't 1988).

⁴93 A.D. 2d 369, 463 NYS 2d 94 (3rd Dep't 1983).

stock brokerage firm and was entitled to receive 1 percent of the partnership's profits and 45 percent of the commissions earned by his efforts as a stock broker. The court rejected the taxpayer's argument that he was not a partner of the firm because his profits interest was only 1 percent and he did not participate in management. The court said that the taxpayer had made a decision to be described to the world as a partner in the firm and that he must live with the consequences of that decision. Once again, form was deemed to be paramount, although obviously the existence of a 1 percent profits interest distinguishes *Weinflash* from *Tosti*.

The New York cases cited by the ALJ and the ALJ's decision itself confuse the decision to be described as a partner with a decision to actually be a partner. If a taxpayer wanted to be treated as a partner in a partnership for tax purposes and argued that the label attached to his status was controlling for tax purposes, despite the absence of an interest in capital, profits, or management, there is no doubt that the Department of Taxation and Finance would argue that the economic substance of the arrangement should control. The same principle should apply when the shoe is on the other foot.

Analysis of *Tosti* Facts

An entity can be treated as a partnership for some purposes and not for others, and the status of an individual as a partner may depend on the context in which the issue arises. It seems clear, for example, that a person who is held out to the public as being a general partner in a partnership should be liable to the partnership's creditors for partnership obligations because the creditors were led to assume that the person would be personally liable for partnership debts.

The issue in *Tosti* was whether *Tosti* should be taxed on a share of the partnership's income from New York sources. Did he share in that income? Was his income increased when a firm client paid the partnership a fee for legal work done in New York state? The answer clearly seems to be no. He was a creditor of the partnership. His compensation was an item of partnership overhead. It was a cost of the partnership that was incurred regardless of whether the partnership made or lost money. It was not a distribution of partnership profits.

The essence of a partnership relationship is a sharing of risks and benefits. In the seminal case of *Commissioner v. Culbertson*, the U.S. Supreme Court said that a partnership exists for federal income tax purposes only when:

considering all the facts — the agreement, the conduct of the parties in execution of its provisions, their statements, the testimony of disinterested persons, the relationship of the parties, their respective abilities and capital contributions, the actual control of income and

the purposes for which it is used, and any other facts throwing light on their true intent — the parties in good faith and acting with a business purpose intended to join together in the present conduct of the enterprise.⁵

The elements that are typically considered in determining whether the requisite sharing exists are interests in capital, profits, and management. No one factor is controlling. For example, the existence of a capital interest may not be as important in a professional service partnership in which capital is generally regarded as not being a material income-producing factor as it would be in a real estate investment partnership. Nevertheless, there must be some significant sharing of economics for a partnership to exist and for a person to be a partner.

The sharing of something seems totally absent in *Tosti's* case. He had no interest in capital, no interest in profits, and no right to participate in partnership management. Although the ALJ said the record did not show that his compensation was not fixed regarding profits, the fact that his draw was determined at the beginning of the year and remained constant throughout the year regardless of the firm's performance seems adequate proof that it was not related to profits. It is hard to distinguish *Tosti's* situation from that of a typical law firm associate, who gets a regular salary, has no capital interest in the firm, and may get a bonus at the end of the year that may depend in part on how well the firm does economically but that is not linked to firm profits.

The only respect in which *Tosti's* situation was different from that of a typical law firm associate is that he was described as a partner on the partnership's tax returns. The question thus becomes one of whether a person who is not a partner, if you apply the standard criteria for determining the existence of a partnership interest, should be treated as a partner for determining whether a portion of his fixed compensation should be viewed as being attributable to the firm's activities in one location just because the firm, without consulting him, described him as a partner on its income tax returns. The firm's characterization of him on its income tax returns did not affect the economics of his arrangement. It did not make him any more or less a sharer of the firm's economic success. It may be that the firm should be estopped from claiming that he was a partner if doing so would serve the firm's interests, but that should not affect the manner in which *Tosti* was taxed. In determining whether a partnership exists, the requisite intension is whether there is an intent to jointly carry on a business venture, not

⁵337 U.S. 733, 742 (1949).

whether that venture should be treated as a partnership for state law or tax purposes.⁶ Whether a person is a partner should depend on his economic relationship with the partnership and not whether the partnership for its own purposes chose to describe him as a partner on its income tax returns.

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It is irrelevant that guaranteed payments to a partner (that is, payments that are determined without regard to partnership profits) are treated as distributions of partnership income for federal income tax purposes. Persons who are genuine partners, having an interest in partnership profits, often are entitled to receive other payments determined without regard to partnership profits. For example, a partner might be entitled to receive an annual salary of \$100,000 and also to receive 5 percent of the partnership's profits determined after subtracting the guaranteed salaries paid to all partners. The purpose of the guaranteed payment rule in the Internal Revenue Code is to ensure that the fixed payments will be treated as distributions of partnership income as will the percentage payments. That does not mean that a person who gets only guaranteed payments and who has no interest in capital, management, or profits is a partner.

In short, an analysis of Tosti's economic relationship with the partnership makes it clear that he had no economic interest in the partnership, that his relationship to the partnership was the same as that of the typical law firm associate, and that he should not have been viewed as sharing in the partnership's income. An associate who lived in New Jersey and worked entirely in New Jersey for the same firm would not be taxed by New York on any of his income, and the treatment of Tosti should be the same.

Authorities in Other Areas

The treatment of law firm "partners" has attracted attention in other areas of the law in recent years. The issue has arisen often in the context of age discrimination. Many law firms have mandatory retirement ages for capital partners, and in several cases they have been sued by partners who were forced to retire or give up their equity status, alleg-

ing age discrimination. The allegations typically include assertions that even though the individuals may have been full equity partners they should not be treated as partners for purposes of the age discrimination rules.

The courts in responding to those allegations have taken a functional approach in examining the realities of the relationships between the plaintiffs and the partnerships.

Although a number of these cases have been settled before going to decision, *Simpson v. Ernst & Young* was decided by summary judgment and is instructive.⁷ LaRue Simpson was a partner in Ernst & Young. Before the merger of Ernst & Whinney and Arthur Young, he was the managing partner for Arthur Young's Cincinnati office. After the merger, Simpson and some other partners in the firm were fired. Simpson brought a claim under the Age Discrimination in Employment Act (ADEA) and other state and federal statutes. He alleged that, although nominally a partner, he should be treated as an employee under the age discrimination statutes.

Simpson had a capital account with E&Y. He was paid an annual salary in an amount determined by the firm's management committee. He did not have a percentage interest in profits. He was also eligible for a bonus based on "performance, level of responsibility, years of service, and other factors." He had the right to vote on some major decisions, such as dissolution of the firm and amendments to the partnership agreement. He did not however, have the right to vote for members of the management committee. Nevertheless, he represented on his federal income tax returns that E&Y was a partnership, that he was a partner, and that his earnings, reported on a K-1 form, were distributions of partnership income.

E&Y argued that Simpson was a partner in the firm and therefore was not protected by the ADEA. Simpson argued that although he had treated himself as a partner he was actually an employee.

Looking at New York law, the court indicated that the factors to be considered in determining whether a person was a partner included a sharing of profits, liability for debts, the existence and terms of a capital interest, and rights in management. The court said the determination of partnership status under the ADEA would depend on the economic realities of the relationship between the individual and the firm and not on how the parties described the relationship. It analyzed in depth the economics of Simpson's relationship with E&Y.

The court concluded that Simpson did not make a true capital contribution to the firm. Although he nominally had a capital account, the amount was

⁶C. *Silberman v. Commissioner*, 47 TCM 778 (1983).

⁷850 F. Supp. 648 (S.D. Ohio 1994).

financed by Citibank and arranged by E&Y. The court viewed the arrangement as being a loan from Simpson to the firm and not an equity contribution, regardless of its form. Although he was liable to the bank for the loan, his “capital account” at the firm was available to satisfy the debt and ultimately it did satisfy the debt.

Simpson’s salary was viewed as not being indicative of partner status. As the court said, it “did not vary based on the rise and fall of firm profits. There was no evidence that Simpson or any other Party were required to return any amount of salary due to declining profits. Nor was there evidence that his salary was calculated as a proportionate share of the firm’s profits.”⁸ Simpson was entitled to receive a bonus that was described as an “allocation” but there was no evidence that the bonus was based on firm profits.

Simpson had little management authority. His rights to vote were limited to some major transactions and he had no right to examine the firm’s books and records.

The court concluded that “Simpson has many qualitative characteristics of an employee and few, if any, attributes of a bona fide partner. Therefore we find Simpson was an employee protected against age discrimination under ADEA.”⁹

Conclusion

The analysis in the *Tosti* opinion is superficial. The opinion ignores the economic realities of Tosti’s relationship with the partnership and focuses solely on the fact that he was described as a partner in some partnership tax filings. It seems clear that Tosti did not share in the firm’s profits and losses and had none of the attributes of ownership in the firm that courts have generally considered in determining whether a person has an ownership interest in property. There may have been benefits to him

and to the firm in holding him out to the public as a partner. Presumably, it enhanced his ability to attract new clients and keep old ones. Nevertheless, those benefits do not indicate that he should be viewed as an owner of the firm for income tax purposes.

The issue presented is whether as a nonresident of New York, working entirely outside New York, Tosti should be subject to New York state income taxes on that part of the firm’s earnings attributable to its New York operations. If he had been a partner with a full profits interest so that his earnings would be directly affected by the firm’s profits attributable to New York activities, that would have been a reasonable conclusion. In fact, he was not. He had no more economic interest in the firm’s New York profits than did an associate attorney or, for that matter, a messenger employed by the firm.

In view of the appellate court decisions in New York state on which the ALJ relied, an appeal by Tosti is unlikely to succeed unless the appellate courts can be persuaded that their prior opinions were incorrect. One hopes that this can be done.

If the law represented by the *Tosti* opinion stands, major problems will be presented for nonresident nonequity partners in law and other professional service firms as well as in all other companies operating as partnerships or limited liability companies that are treated as partnerships for tax purposes.

Another approach would be to attempt to convince the Department of Taxation and Finance that its position is incorrect. It is likely that the department would not allow a person who lacked any economic interest in a firm to claim that he was a partner in the firm if that resulted in reduced taxation, merely because the person was designated as a “partner” in the partnership documents. The department should apply the same standards when determining whether a nonresident nonequity partner with no attributes of ownership in the firm should be treated as a partner for income allocation purposes. ☆

⁸850 F Supp. at 660.

⁹850 F. Supp. at 863.