

# New York City UBT Addback Upheld for Payment by Partnership to Related S-DISC under “Third-Party Payment Rule”

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Commission payments made by a New York City-based partnership to an S-DISC, whose shareholders were all partners in the partnership, were subject to the unincorporated business tax (“UBT”) addback as nondeductible payments to partners, according to a recent decision of the New York City Tax Appeals Tribunal. *Matter of Skidmore, Owings & Merrill, LLP*, TAT (E) 17-21 (UB) (N.Y.C. Tax App. Trib. Jan. 26, 2023).

The UBT law disallows deductions for “amounts paid or incurred to a proprietor or partner for services or for use of capital.” This provision is often invoked by New York City auditors as the basis for UBT audit adjustments, such as to disallow payments to bona fide employees who also hold non-executive officer titles with corporate partners of the unincorporated business. In *Skidmore*, the addback involved commissions paid to a non-partner flow-through entity owned by the same partners as the petitioner.

**The Facts:** Skidmore, Owings & Merrill LLP (“Skidmore”) is an architectural, urban planning, and engineering firm subject to the UBT. During the years in issue (2011 and 2012), it had 14 active equity partners. Those partners were also the shareholders of a Domestic International Sales Corporation formed in 2004 that elected S-corporation tax treatment (“S-DISC”). S-DISC functioned as a commissioned sales agent, but also served two additional purposes. It enabled the shareholders—who, as noted, were also partners in Skidmore—to receive qualified dividends taxable at lower federal capital gains tax rates, and it increased the profit-sharing ratios of certain shareholders from their ratios in Skidmore.

Skidmore’s commission payments to S-DISC, based on a percentage of designated services revenues, were fully deductible for federal purposes, and Skidmore also deducted them on its UBT returns. The Department of Finance disallowed the deductions for the payments to S-DISC as payments to Skidmore’s partners for services. The dispute proceeded to litigation, and in a determination an Administrative Law Judge had sustained the addback, viewing the commissions as in substance payments to, or “for [the] benefit of,” Skidmore’s partners (discussed in the October 2021 issue of [Spotlight](#)). Skidmore appealed to the NYC Tax Appeals Tribunal (“NYC Tribunal”).

**The Decision:** The NYC Tribunal upheld the ALJ determination, concluding that Skidmore’s

commission payments to S-DISC were properly disallowed as payments to partners. It viewed the S-DISC as a conduit to compensate Skidmore's partners for their services for Skidmore rather than for S-DISC, which was effectuated through the commissions which S-DISC then distributed to those partners.

The NYC Tribunal principally relied on the "Third-Party Payment Rule"—a term it previously coined for UBT regulation 19 RCNY 28-06(d)(1)(i)(B)—which provides that a payment "to any person" who is not a partner must nonetheless be added back so long as "the payment was consideration for services provided by a partner" of the taxpayer partnership. It found that the requirements for application of the rule were met and therefore the payments were nondeductible. Even though the regulation was promulgated in 2007 for the express purpose of adopting "the tax principles of [the federal] 'assignment of income'" doctrine, the NYC Tribunal rejected Skidmore's argument that it should only be applied to those situations, but without fully explaining why the stated purpose that led to adoption of the rule was irrelevant. The examples in the regulation for treating payments to non-partners as subject to the addback suggest a more limited application of the rule.

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National Law Review, Volume XIII, Number 75

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