STATE OF NEW YORK

TAX APPEALS TRIBUNAL

In the Matter of the Petitions	:	
of	:	
PAUL O. AND NATALIE I. KOETHER	:	DECISION DTA Nos. 801737
for Redetermination of Deficiencies or for Refunds of New York State Personal Income Tax under Article 22 of the Tax Law and New York City Nonresident Earnings Tax: under Chapter 46, Title U of the Administrative Code of the City of New York for the Years 1979 through 1984.	:	and 804085

Petitioners Paul O. and Natalie I. Koether, Box 56, Pennbrook Road, Far Hills, New Jersey 07931, filed an exception to the determination of the Administrative Law Judge issued on April 23, 1992. Petitioners appeared by Davidson, Dawson & Clark (T. Randolph Harris, Esq., of counsel). The Division of Taxation appeared by William F. Collins, Esq. (Laura J. Witkowski, Esq., of counsel).

Petitioners filed a brief in support of their exception. The Division of Taxation filed a brief in opposition. Petitioners also filed a reply brief. Oral argument, at petitioners' request, was heard on June 16, 1994, which date began the six-month period to issue this decision.

Commissioner Dugan delivered the decision of the Tax Appeals Tribunal. Commissioner Koenig concurs.

ISSUES

I. Whether petitioner Paul O. Koether was a nonresident partner of a New York partnership within the meaning of Tax Law §§ 632(a)(1)(A) and 637(a)(1).

II. Whether it is unconstitutional for New York State and New York City to impose income tax liability on the income which Mr. Koether received from a partnership located in New York City.

III. Whether the penalties imposed against petitioners should be abated.

FINDINGS OF FACT

We find the facts as determined by the Administrative Law Judge. These facts are set forth below.

Prior to the closing of the record, the parties entered into a stipulation of facts. To the extent relevant herein, those facts, supplemented with pertinent facts which may be obtained from the exhibits, are set forth as follows:

Petitioners, Paul O. Koether and Natalie I. Koether, resided in Far Hills, New Jersey during the years in issue.

Petitioners filed joint Federal income tax returns with the Internal Revenue Service for the years 1979 through 1984, inclusive, prepared by Klatzkin and Company, CPA's. They were, at all times, cash method, calendar year taxpayers.

Petitioners filed a joint State of New Jersey Gross Income Tax - Resident Return with the State of New Jersey for each of the years in issue, inclusive, prepared by Klatzkin and Company, CPA's.

Prior to the date on which New York State and New York City personal income tax returns would have been due for any of the years in question, Mr. Koether consulted with his regular tax accountant, Lloyd Klatzkin, a CPA licensed in both New York and New Jersey, of Klatzkin & Co., CPA's, as to whether petitioners were required to file New York returns. Mr. Koether provided Mr. Klatzkin with complete background information regarding, among other things, his status as a registered representative and limited partner in Ingalls & Snyder, a stock brokerage firm with which Mr. Koether was affiliated. He also provided Mr. Klatzkin with the Federal schedules K-1 (Partner's Share of Income, Credits, Deductions, Etc.) provided to him each year by the partnership's accountants, together with such accountants' cover letter. Neither Mr. Koether nor Mr. Klatzkin were ever provided with a contemporaneous copy of the partnership's Federal or New York tax returns or with the partnership's New York allocation computation schedule.

Mr. Klatzkin advised Mr. Koether that petitioners had no New York source income and were therefore not required to file New York State or City income tax returns or to pay any such tax for any of the years in issue. Petitioners reported on both their Federal and New Jersey returns all of the income shown on the partnership K-1's, with no reduction, offset or credit on the New Jersey returns resulting from the New York status of the partnership. For the years 1979, 1980 and 1981, this income was characterized on the Federal returns as both partnership income and as non-farm self-employment income. For the year 1982, this income was characterized as guaranteed payments, partnership income and non-farm self-employment income. For the years 1983 and 1984, the income was shown as partnership income and non-farm self-employment income.

Petitioners did not file New York State or City personal income tax returns for the years 1979 through 1984, inclusive.

The Division of Taxation issued a Statement of Personal Income Tax Audit Changes, dated June 26, 1984, which asserted a deficiency of personal income tax for the years 1979 and 1980. The statement explained that petitioners had additional New York taxable income in the amount of $79,606.00 and $202,845.00, for the years 1979 and 1980, respectively. The statement asserted that the income was subject to New York State and New York City personal income tax because these amounts represented Mr. Koether's payments from the partnership.

The Division issued a Notice of Deficiency to petitioners, dated October 17, 1984, which asserted a deficiency of New York State and New York City personal income tax for the years 1979 and 1980 in the amount of $32,122.00, plus penalties of $17,630.90 and interest of $10,716.74, for a total amount due of $60,469.64. The penalties were asserted pursuant to Tax Law § 685(a)(1), (2); (b), (c).

Petitioners, by their attorneys, filed a petition on January 14, 1985 contesting the assertions in the Statement of Personal Income Tax Audit Changes for 1979 and 1980 and requesting that the Notice of Deficiency for the years 1979 and 1980 be cancelled.

The Division issued a Statement of Personal Income Tax Audit Changes, dated April 11,

1986, which asserted a deficiency of New York State and New York City personal income tax for the years 1981 through 1984. According to the statement, petitioners' New York taxable income was $294,078.00 in 1981, $626,523.00 in 1982, $1,157,102.00 in 1983 and $728,490.00 in 1984. As before, the statement was based on the Division's position that this income was subject to New York State and New York City personal income tax because the amounts represented Mr. Koether's payments from the partnership.

The Division issued two notices of deficiency, dated August 1, 1986, which asserted a deficiency of New York State and New York City personal income tax. One notice pertained to the years 1981 and 1982 and asserted that tax was due in the amount of $102,138.00, plus penalties of $48,313.00 and interest of $42,776.95, for a total amount due of $193,227.95. The remaining notice asserted that tax was due for the years 1983 and 1984 in the amount of $199,584.00, plus penalties of $74,218.00 and interest of $40,310.52, for a total amount due of $314,112.52. The penalties were asserted pursuant to Tax Law § 685(a)(1), (2); (b).

Petitioners, by their attorneys, filed petitions on October 29, 1986 contesting the assertions in the Statement of Personal Income Tax Audit Changes for 1981, 1982, 1983 and 1984 and requesting that the notices of deficiency for the years 1981, 1982, 1983 and 1984 be cancelled.

On December 30, 1986, petitioners paid $453,773.05 to the New York State Tax Commission. The amount represents tax and interest due to both New York State and New York City for the years 1979 through 1984, inclusive.

On January 13, 1989, the Division prepared a schedule which calculated a revised business allocation percentage for the partnership for the years 1979 and 1980.

In January 1989, the Division prepared a revised Statement of Personal Income Tax Audit Changes. On the basis of petitioners' Federal itemized deductions and a schedule of over-the-counter sales, the Division corrected the percentage of partnership income which was attributable to New York sources. The revisions asserted that petitioners' New York taxable income, tax, interest and penalties were as follows:

Year	New York Taxable Income	Tax	Interest	N.Y. Tax Law §685(c) Penalty	N.Y. Tax Law §685(a)(1),(2);(b) Penalties
1979	$ 74,238	$ 8,471	$ 7,376	$ 384	$ 4,448
1980	192,829	21,864	16,501	990	11,478
1981	231,340	24,399	14,368	1,366	12,809
1982	59,035	62,739	25,859	4,228	31,369
1983	1,005,076	109,511	31,609	6,761	48,176
1984	516,636	55,088	9,146	3,658	20,934
TOTALS	$2,079,154	$282,072	$104,859	$17,387	$129,214

Paul Koether's Affiliation with Ingalls & Snyder

The partnership is a New York limited partnership engaged in the stock brokerage business. It is a member of the New York Stock Exchange among other exchanges and associations. On February 15, 1978, the partnership received approval from the New York Stock Exchange to open and maintain a residence office located at Box 56, Pennbrook Road, Far Hills, New Jersey 07931, the home of petitioner Paul O. Koether. Beginning on June 8, 1978, Mr. Koether was the registered representative in charge of the partnership's New Jersey office. At all times during his affiliation with Ingalls & Snyder, Mr. Koether worked solely in Far Hills, New Jersey, and at no time did he have an office in New York.

Mr. Koether was at no time listed as an allied member with the New York Stock Exchange or any other exchange or association in which the partnership was a member.

Prior to July 1, 1979, the only form of compensation the partnership paid to Mr. Koether was a percentage of the gross commissions earned by the partnership on transactions in which Mr. Koether was the broker, all of which originated from his work in New Jersey. At no time prior to or subsequent to July 1, 1979 did Mr. Koether personally conduct any business in New York.

On July 1, 1979, Mr. Koether invested $40,000.00 in cash as a limited partner in the partnership. This cash investment was increased to $50,000.00 on January 1, 1980. On January 1, 1982, he also invested $25,000.00 in securities.

As a limited partner, Mr. Koether had no right to participate in the management of the

partnership and was not consulted on firm policy or as to general management decisions as a whole. Mr. Koether never attended a partners' meeting and visited the partnership's New York office a total of nine times in ten years.

Subsequent to his investment as a limited partner, Mr. Koether continued to be paid the same percentage of the gross commissions derived from his New Jersey trading activity. In addition, Mr. Koether received interest payments on the limited partnership capital he invested in the partnership.

The partnership filed New York State partnership returns for the years 1979 through 1983, which returns contained a New York State nonresident partnership allocation schedule listing Mr. Koether as a partner. That schedule showed the following amounts which should have been reported on Mr. Koether's New York State personal income tax returns: $25,609.27 for 1979; $39,324.99 for 1980; $67,255.34 for 1981; $171,165.28 for 1982; and $296,726.71 for 1983. The partnership's 1984 return showed a New York allocation on Schedule K, parts I and II, of $188,913.97 to Mr. Koether.

The partnership's Agreement of Limited Partnership, dated as of July 1, 1979, as amended ("Agreement"), provided that Mr. Koether would receive interest payable by the partnership on the last business day in each month, at the rate of 8% per annum on his cash invested and 1% per annum on the value of his invested securities. In addition, if in any fiscal year, net earnings of the partnership for the year reached at least a minimum "floor" amount, additional interest would be payable to Mr. Koether on his average cash and securities invested.

(a) The annual rate of additional interest paid increased from 1% to 6% as net earnings rose from the floor amount to a maximum "ceiling" amount. The floor amount was $200,000.00 prior to 1981, $500,000.00 as of January 1, 1981 and $450,000.00 as of January 1, 1982. The ceiling amount rose from $650,000.00 prior to 1981 to $950,000.00 as of January 1, 1981.

(b) If net earnings in any fiscal year (after 1979) exceeded the ceiling amount, limited partners would receive additional interest on their invested cash at the rate of 1% for each additional $75,000.00 of net earnings over the ceiling amount.

During the years in issue, the following table shows the total income received by Mr. Koether from the partnership, broken down into commission compensation and interest on his limited partner's capital:

	Commission Compensation	Interest on Capital	Total Income
1979	$ 125,246	$ 2,800	$ 128,046
1980	284,621	12,000	296,621
1981	322,777	13,500	336,277
1982	832,826	23,000	855,826
1983	1,457,633	26,000	1,483,634
1984	924,132	20,438	944,570
Total	$3,947,235	$97,738	$4,044,973

Pursuant to the Agreement, only the general partners of the partnership were entitled to share in the profits or losses of the partnership. Mr. Koether was not entitled or required to share in either profits or losses of the partnership.

Pursuant to the Agreement, only the general partners could vote on whether the partnership would be dissolved. Mr. Koether was never entitled to vote, nor did he ever vote, on partnership dissolution or other management matters.

Pursuant to the Agreement, Mr. Koether was entitled to withdraw from the partnership at any time and would thereupon receive from the partnership his capital contributed plus interest thereon until paid.

On September 6, 1984, Mr. Koether advised the partnership that he wished to resign as a limited partner. Pursuant to his request, the Agreement was amended as of October 1, 1984 to exclude Mr. Koether from the partnership. He continued his status as a registered representative in charge of the New Jersey office, the same status that he had maintained at all times after June 8, 1978.

OPINION

During the years in issue, Tax Law former § 632(a)(1) provided that the New York adjusted gross income of a nonresident individual includes the sum of the net amount of the items of income, gain, loss and deduction entering into that individual's Federal adjusted gross

income which were derived from or connected with New York sources. Tax Law former § 632(a)(1)(A) further provided that these items include the nonresident's "distributive share of partnership income, gain, loss and deduction determined under section six hundred thirty-seven." The income subject to the New York City nonresident earnings tax is governed by the same principles (Administrative Code of the City of New York former §§ U46-1.0[f]; U46-4.0[a]).

During the period in issue, Tax Law former § 637(a)(1) defined the portion of income derived from New York sources as follows:

> "In determining New York adjusted gross 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-two."

The Administrative Law Judge dealt with three issues in his determination: 1) whether petitioner was a partner within the meaning of former sections 632(a)(1)(A) and 637; 2) whether petitioner had sufficient nexus with New York State so that the State could, constitutionally, tax his income; and 3) whether penalties were properly imposed.

We deal first with the issue of whether petitioner was a partner within the meaning of the Tax Law.

The Administrative Law Judge determined that the terms "partnership" and "partner" in former Tax Law §§ 632(a)(1)(A) and 637 included limited partnerships and limited partners; that petitioner was a limited partner in Ingalls and Snyder; that it is a characteristic of a limited partnership that a limited partner, such as petitioner, would not share as a general partner in the loss of the partnership and would not participate in the management of the partnership's affairs, thus, petitioner's assertion that he was not a partner because he was not personally liable for losses or lacked authority over the partnership's affairs, was without merit; that while the stipulated facts are "that [petitioner] did not share in the profits of the partnership," that portion of his compensation designated as interest indicates that he did have a financial interest in the profitability of the partnership; that the fact that petitioner's interest income was "relatively small

compared to his commission income" is of no consequence (see, Matter of Weil v. Chu, 120 AD2d 781, 501 NYS2d 515, affd 70 NY2d 783, 521 NYS2d 223, appeal dismissed 485 US 901); and that the fact that upon dissolution of the partnership petitioner would only have been entitled to the dollar amount of his capital contribution did not prove, as petitioner asserts, that his contribution was only a loan.

The Administrative Law Judge found petitioner's reliance on Farmer v. State Tax Commn. (144 AD2d 720, 535 NYS2d 453) and Matter of Pozen (State Tax Commn., October 19, 1979) "misplaced," stating that:

> "[i]n each case, the question presented was whether certain individuals were nonresident general partners of a New York partnership. In each instance, the nonresidents were found not to be members of the New York partnership because the nonresidents did not participate in the management of the partnership and because the nonresidents did not share in the partnership's profits and losses. Neither case raised the question of whether these factors were necessary to be considered a limited partner or whether distributions from a New York partnership to a nonresident limited partner were subject to tax" (Determination, conclusion of law "G").

On exception, petitioner asserts that "it is clear that the most critical element of a partnership [i.e., the ability to share in profits] was lacking in the relationship between [petitioner] and the Partnership" (Petitioners' brief, p. 5). Petitioner asserts that the Administrative Law Judge erred in finding:

> "that, because the interest rate on [petitioner's] contributed capital increased as the profitability of the Partnership increased, [petitioner] thus had an interest in the profits of the Partnership. This is a stretch at best, and the ALJ Determination specifically acknowledges that it is inconsistent with Findings of Fact ¶25. [Petitioner] did not have an interest in profits any more than a clerical worker whose bonus fluctuates depending on whether or not the company had a good year; and furthermore, the amount of the 'bonus' interest received by [petitioner] was so small in relation to his commission income as to be insignificant. If he was not a partner based on other criteria, this fluctuating interest cannot make him one" (Petitioners' brief, p. 5, fn. 1).

Relying on Farmer and Pozen, petitioner asserts that the fact that petitioner is denoted a limited partner is not a dispositive fact that he is a partner for purposes of the Tax Law. Petitioner faults the Administrative Law Judge's:

> "attempts to distinguish Pozen and Farmer because the taxpayers therein were denominated as general partners, whereas Koether was denominated as

> a limited partner. This is backward reasoning. The fact that those taxpayers were denominated as general partners but still found not to be partners for New York income tax purposes supports a fortiori the argument that denomination as a limited partner does not per se result in Koether being treated as a partner for tax purposes.
>
> "Viewed differently, petitioners certainly do not argue that the mere status of being a limited partner exempts a nonresident taxpayer from New York income taxation. The relevance of Koether's limited partner status is only that certain of the traditional indicia of partnership -- management rights and personal liability -- are by the very nature of the interest not present. It is only when the limitations inherent in Koether's limited partnership status are aggregated with the absence of the other critical partnership indicia -- sharing in profits and losses and having an ownership interest in partnership assets -- that the conclusion follows that the [sic] Koether was never truly a partner" (Petitioners' brief, pp. 8-9).

Petitioner concludes that:

> "the cases are overwhelming that the formal designation of a person as a partner is only one factor to be considered in the determination of whether that person is a partner for purposes of former sections 632 and 637 of the Tax Law. The most important factor is generally considered to be whether or not the person has a genuine interest in the general profits and losses of the business. Although Paul Koether was given the title of limited partner, it is a stipulated fact, adopted in the ALJ Determination, that he had no interest in the profits or losses of the Partnership, and no management or ownership rights in the Partnership. Accordingly it should be determined that, as a matter of law, Koether was not a partner in the Partnership for purposes of former sections 632 and 637 of the Tax Law" (Petitioners' brief, p. 9).

We affirm the determination of the Administrative Law Judge on this issue.

The core of petitioner's argument is that a balancing of the facts in this case leads to the conclusion that petitioner was not a partner in Ingalls and Snyder and that to conclude that he was a partner, as did the Administrative Law Judge, is to exalt form over substance. We do not agree. The critical facts are that petitioner was a limited partner in Ingalls and Snyder; he contributed $50,000.00 in cash to the firm and invested $25,000.00 in securities pursuant to the partnership's Agreement of Limited Partnership; petitioner was entitled to interest on his cash capital at the rate of 8% per annum and on his security capital account at the rate of 1% per annum; if, in any year the partnership's net earnings exceeded specified amounts, he was entitled to additional interest on his capital; petitioner received from the partnership a percentage of the commissions it derived from his New Jersey trading activity; and the partnership filed New York

State partnership returns for the years 1979 through 1984, which contained a New York State nonresident partnership allocation schedule listing petitioner as a partner and listing specific dollar amounts "which should have been reported on [petitioner's] New York State personal income tax returns." These facts, on balance, are sufficient to establish that petitioner was a partner within the meaning of former sections 632(a)(1) and 637(a)(1) and the relevant provisions of the Administrative Code of the City of New York (see, Matter of Weinflash v. Tully, 93 AD2d 369, 463 NYS2d 94, 96 [where the Court found "unpersuasive" the general partner's assertion that he was not a partner "since he had only a 1% interest in the profits of the firm, received salary and commission, was not required to share in partnership losses, and did not participate in the management of that firm and that his partnership designation served only to enhance his prestige and aid his sales"]; see also, Matter of Heller v. New York State Tax Commn., 116 AD2d 901, 498 NYS2d 211 and Matter of Heffron v. Chu, 144 AD2d 729, 535 NYS2d 141).

We deal next with the issue of whether there was sufficient nexus for New York State to tax petitioner.

The Administrative Law Judge, relying on Matter of Weil v. Chu (supra), rejected petitioner's assertion that taxation of petitioner's income violated the Due Process Clause because there was not sufficient nexus with New York State. The Administrative Law Judge noted that:

> "[i]n Weil, the Court found that there was a sufficient nexus between nonresident taxpayers' income and New York to validate the tax where the nonresidents were partners of a law firm which maintained a considerable permanent presence in New York. The record does not reveal any reason why a similar holding would not be made here" (Determination, conclusion of law "I").

The Administrative Law Judge also found the fact that petitioner was a limited partner sufficient basis to distinguish this case from that of an employee who worked out of state citing Matter of Knapp v. State Tax Commn. (67 AD2d 1024, 413 NYS2d 237) and found that petitioner's reliance on Farmer was misplaced since in Farmer the Court found that the taxpayers were not partners while here petitioner is a limited partner.

On exception, petitioner argues that even if petitioner:

> "was a partner of Ingalls & Snyder for purposes of the New York Tax Law, the imposition of New York income tax on petitioners on the facts of this case would violate the Due Process Clause of the Fourteenth Amendment to the United States Constitution, because of a lack of sufficient nexus between Mr. Koether and the State of New York. This conclusion is based upon numerous United States Supreme Court and other federal and New York court decisions, including Farmer v. State Tax Commission, Slip Opinion (Sup. Ct. Alb. Co., Sept. 10, 1986), aff'd 144 A.D.2d 720, 535 N.Y.S.2d 453 (3d Dept. 1988)" (Petitioners' exception, p. 2).

Petitioner asserts that if he was not subject to taxation on his commission income when he was merely a registered representative of the partnership, "how did his becoming a limited partner in the Partnership create the required nexus which did not previously exist?" (Petitioners' brief, p. 10). Petitioner again asserts that to merely rely on his becoming a limited partner as the basis for finding nexus is to exalt form over substance. "The practical effect would be to impose a tax on a nonresident individual who in substance had no more connection to the State of New York than does any registered representative in any out-of-state branch office of a New York brokerage firm" (Petitioners' brief, p. 11). Petitioner asserts that:

> "Matter of Weil v. Chu, 120 A.D.2d 781, 501 N.Y.S.2d 515 (3rd Dept. 1986), affd 70 NY2d 783, 521 N.Y.S.2d 223 (1987), does not apply here. In Weil, the partners of a District of Columbia law firm tried to challenge the imposition of New York taxes on their income, and because the firm had offices in New York there was a sufficient nexus to justify the New York tax on the D.C. partners. In Weil, however, there was no issue of the partnership status of the taxpayers involved, unlike this case where the tenuous relationship of Koether to the New York firm does not result in a constitutional nexus" (Petitioners' brief, p. 12).

We affirm the determination of the Administrative Law Judge on this issue.

We agree with the Administrative Law Judge that Matter of Weil v. Chu (supra) is persuasive.[1] In short, we have already concluded that

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[1]In Weil, the Washington based partners of the law firm contended that application of the tax violated the Due Process Clause of both the Federal and State Constitutions because there was no appreciable connection between themselves and New York. The Court found the argument without merit stating the "connection is significant. Petitioners are partners in a law firm that maintains a considerable permanent practice in New York. Thus, there is a sufficient nexus between their income and New York to validate the tax in question (see, Matter of Knapp v. State Tax Comm., 67 AD2d 1024, 413 NYS2d 237)" (Matter of Weil v. Chu, supra, 501 NYS2d 515, 518).

petitioner was a limited partner in Ingalls and Snyder. We do not find petitioner's status as a limited partner requires a different nexus conclusion than that reached with regard to the partners in Weil. The simple fact of the matter is that the Tax Law treats partners differently than employees. Having chosen to become a limited partner in a New York partnership, petitioner must bear the consequences (Matter of Faulkner, Dawkins & Sullivan v. State Tax Commn., 63 AD2d 764, 404 NYS2d 735).

We deal next with the issue of whether penalty should be imposed.

Tax Law § 685(a)(1) and (2) provides for the imposition of penalties for failure to file a return and failure to pay tax shown on a return required to be filed. The penalty may be abated upon a showing by the taxpayer that the failure was due to reasonable cause and not due to willful neglect. Tax Law § 685(b) provides for imposition of penalty where the deficiency is due to negligence or intentional disregard of the tax law or rules and regulations of the Division. Tax Law § 685(c) imposes penalty for failure to pay estimated income tax. The conditions for waiver of the section 685(c) penalty are contained in section 685(d).

Initially, we need to clarify the facts concerning the assertion of penalty by the Division and the application of the reasonable cause standard for waiver of penalty.

First, finding of fact "8" is that the Notice of Deficiency for the years 1979 and 1980 asserted penalty under section 685(c) of the Tax Law. The Notice properly reflects the underlying statement of audit changes (Exhibit "B") referenced in finding of fact "7." Since the Tax Law for the years at issue did not prescribe a reasonable cause standard for the waiver of section 685(c) penalty and since petitioners did not meet the conditions set forth in Tax Law § 685(d), we affirm the determination of the Administrative Law Judge with regard to the imposition of the section 685(c) penalty for those years.

Second, finding of fact "11" is that the notices of deficiency issued on August 1, 1986, for the years 1981, 1982, 1983 and 1984 (Exhibit "L") assert penalty under section 685(a)(1), (2) and (b), not under section 685(c). This is consistent with the underlying original statement of audit changes for those years (Exhibit "M"). However, finding of fact "15," the 1989 Statement

of Audit Changes, indicates that a portion of the penalties are asserted under section 685(c). Since this is inconsistent with the notices of deficiency and the original statement of audit changes, and an apparent oversight by the Division (see, Petitioners' Exhibit "15," the Division's workpapers for the statement), we conclude that section 685(c) penalties are not asserted for these years.

The Administrative Law Judge abated section 685(a)(1), (2) and (b) penalty for the year 1984. He sustained the imposition of penalty for the years 1979, 1980, 1981, 1982 and 1983, finding that petitioner's assertion that he relied on the professional advice of a Certified Public Accountant did not meet the burden of proving that failure to file returns and to pay the proper amount of tax was due to reasonable cause and not due to willful neglect.

On exception, petitioners assert that while:

> "mere consultation with a tax professional will not per se insulate a taxpayer from penalties, because of the potential evisceration of the deterrent effect of the penalties. L T & B Realty Corp. v. State Tax Commission, 141 AD2d 185, 535 NYS2d 121 (3d Dept. 1988); Matter of Erikson, Tax Appeals Tribunal, March 22, 1990. . . . it is a necessary and well-settled corollary to this rule that following the advice of a qualified tax professional will in many situations be a prudent and intelligent course of action, depending on the specific facts" (Petitioners' brief, p. 14).

Petitioners rely on the prudent ordinary man test of the regulations, i.e., "any other cause for delinquency which would appear to a person of ordinary prudence and intelligence as a reasonable cause for delay and which clearly indicates an absence of willful neglect may be determined to be reasonable cause" (Petitioner's brief, p. 13). Petitioners assert that:

> "[b]ased upon the facts found herein above and the relevant cases, it is apparent that petitioners reasonably relied on the advice of their tax accountant in failing to file returns and report New York source income for the periods in issue. The reasonableness of petitioners' reliance is proved by the facts that the accountant was a Certified Public Accountant licensed in both New York and New Jersey, the accountant was petitioners' regular tax accountant, the accountant was provided with all relevant information and documents, and there was (and is) substantial authority supporting petitioners' position. Because of such reasonable reliance on petitioners' part, it is concluded that petitioners have established that their failure to file New York returns and pay the resulting tax was based upon reasonable cause and not upon wilful [sic] neglect or negligence" (Petitioners' exception, p. 2).

In response, the Division asserts that the determination of the Administrative Law Judge is

correct and that petitioners have failed to establish that "noncompliance with the tax law was due to reasonable cause and not willful neglect or negligence" (Division's brief, p. 17). Specifically, the Division asserts that there "is no testimony or documentation concerning the accountant's qualifications (other than that he is licensed in both New York and New Jersey), his training and experience (specifically with respect to New York taxes), or evidence which would indicate why the accountant made the conclusions he did" (Division's brief, p. 18). The Division also argues that reliance upon a tax advisor "cannot function as a substitute for compliance with an unambiguous statute" (Division's brief, p. 19). In this context, the Division references Matter Mc Kittrick (State Tax Commn., December 13, 1978), "involving the same partnership," i.e., Ingalls and Snyder, implying that it involved the same issue as this case (Division's brief, p. 19).

We agree with petitioner and we reverse the determination of the Administrative Law Judge on this issue. In Matter of Erikson (supra), we stated:

> "[i]n making a determination as to whether reasonable cause exists when a taxpayer has relied on the erroneous advice of a professional, it must be shown that the taxpayer relied in good faith on the advice which he received and it must have been 'reasonable' for the taxpayer to rely upon the particular advice he was given (see, Auerbach v. State Tax Commn., 142 AD2d 390, 536 NYS2d 557, 561; L T & B Realty v. State Tax Commn., 141 AD2d 185, 535 NYS2d 121, 123). When determining whether the taxpayer has shown that his reliance was reasonable, the burden is on the taxpayer to demonstrate that he acted with ordinary business care and prudence in attempting to ascertain his liability for taxes (see, United States v. Boyle, 469 US 241, 85-1 USTC ¶ 13,602 at 88,255). Further, the nature and complexity of the matter giving rise to the dispute should be considered when making a determination as to whether a taxpayer's reliance was reasonable (see, Betson v. Commr., 802 F2d 365, 86-2 USTC ¶ 9826)" (Matter of Erikson, supra).

In Matter of Felix Indus. v. Tax Appeals Tribunal (183 AD2d 203, 589 NYS2d 641), the Court, construing identical language in the sales tax regulations, stated:

> "[t]o that end, 'the most important factor to be considered is the extent of the taxpayer's efforts to ascertain the proper tax liability' (20 NYCRR 536.5[d][2]). Reliance upon professional advice may, where clearly established, indicate reasonable cause, 'provided such reliance was reasonable and the taxpayer had no knowledge of circumstances which should have put the taxpayer upon inquiry as to whether such facts were erroneous' (20 NYCRR 536.5[d][2][iii])" (Matter of Felix Indus. v. Tax Appeals Tribunal, supra, 589 NYS2d 641, 643).

The critical inquiry, then, is not whether petitioner's accountant was right or wrong in his

conclusion concerning petitioner's tax liability, but rather, did petitioner act with ordinary business care and prudence in attempting to ascertain his liability for tax.

The facts in this case are that as a registered representative of the partnership for the years prior to those at issue, petitioner had no New York tax liability. Prior to the date on which the income tax returns for the years at issue were due, petitioner consulted with his regular tax accountant, a Certified Public Accountant licensed in both New York and New Jersey (cf., Matter of Bachman v. State Tax Commn., 89 AD2d 679, 453 NYS2d 774; Matter of Etheredge, Tax Appeals Tribunal, July 26, 1990). Petitioner provided his accountant with complete background information regarding, among other things, his status as a registered representative and limited partner in Ingalls and Snyder, and the Federal schedules K-1 provided to him each year by the partnership's accountants, together with such accountants' cover letter (cf., Matter of A & V Crown, Tax Appeals Tribunal, May 24, 1990). Based on this information and his understanding of New York law, petitioner's accountant advised petitioner that he had no New York source income for the years in issue, and that, therefore, petitioner was not required to file New York State or City income tax returns or to pay any such tax for any of the years in issue (Petitioners' Exhibit "13," Affidavit from Lloyd Klatzkin, CPA). There is no evidence that petitioner was expert in tax matters (cf., Matter of L T & B Realty Corp. v. State Tax Commn., supra).[2] Finally, we would point out that in the Mc Kittrick[3] case, unlike the instant case, the taxpayer conceded his partnership status and challenged only the allocation of his income and whether it included interest earned on capital.

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[2]In fact, petitioner withdrew from the partnership approximately two months after he was apprised of the tax implications of his limited partner status. He continued his status as a registered representative in charge of the New Jersey office, the same status that he had maintained prior to becoming a limited partner.

[3]For 1971, Mc Kittrick, as a limited partner, filed a New York State nonresident return on which the income he received was allocated "on the ratio of days worked within and without New York." He did not include interest earned on his capital contributions as income. For 1972, Mc Kittrick, as a general partner, filed a return on which he again allocated his income and did not report interest earned on his capital contributions. The Tax Commission held that the partnerships allocation percentage governed with respect to his salary and commission income and that the interest income was New York sourced.

Under the circumstances in this case, we are at a loss to explain what petitioner could have been expected to do beyond what he did. We conclude that petitioner acted with ordinary business care and prudence in attempting to ascertain his tax liability and that penalties should be abated.

Accordingly, it is ORDERED, ADJUDGED and DECREED that:

1. The exception of Paul O. and Natalie I. Koether is denied except to the extent that penalties imposed under Tax Law § 685(a)(1), (2) and (b) for the years 1979 through 1983 are abated and that no Tax Law § 685(c) penalties were assessed or imposed for the years 1981 through 1984;

2. The determination of the Administrative Law Judge is affirmed, except as indicated in paragraph "1" above;

3. The petition of Paul O. and Natalie I. Koether is denied, except as indicated in paragraph "1" above and in the Administrative Law Judge's conclusions of law "R," "S" and "T"; and

4. The notices of deficiency dated October 17, 1984 and August 1, 1986, as previously modified, are sustained, except as indicated in paragraph "3" above.

DATED: Troy, New York
December 15, 1994

/s/John P. Dugan
John P. Dugan
President

/s/Francis R. Koenig
Francis R. Koenig
Commissioner