STATE OF NEW YORK

TAX APPEALS TRIBUNAL

In the Matter of the Petition	:	
of	:	
HUGO MATSON AND JOAN MATSON	:	DECISION DTA NO. 802297
for Redetermination of a Deficiency or for Refund of Personal Income Tax under Article 22 of the Tax Law for the Year 1982.	:	

Petitioners, Hugo and Joan Matson, Box 128, Waterford, New York 12188, filed an exception to the determination of the Administrative Law Judge issued on September 24, 1987 with respect to their petitions for a redetermination of a deficiency of personal income tax under Article 22 of the Tax Law (Files Nos. 802297 and 802298). Petitioners appeared by Urbach, Kahn & Werlin, P.C. (David Evans, CPA). The Division of Taxation appeared by William Collins, Esq. (Thomas C. Sacca, Esq., of Counsel).

Petitioners and the Division filed briefs on the exception and petitioners requested oral argument. Oral argument was heard on January 13, 1988. After reviewing the entire record of this case, the Tax Appeals Tribunal renders the following decision.

ISSUES

I. Was it necessary for the Division of Taxation to provide an evidentiary foundation in order for the Notice of Deficiency to be introduced into evidence at the hearing?

II. Was the Division of Taxation correct in allowing only 65% of the petitioners' distributive share of partnership income as personal service income within the

meaning of section 603-A(b)(1) of the Tax Law, for purposes of calculating the maximum tax on such income under section 603-A(a) of the Tax Law (former Tax Law § 603-A[a] and [b][1][A])?

FINDINGS OF FACT

The facts found by the Administrative Law Judge are adopted by the Tribunal and are summarized and supplemented as follows.

The petitioners, Hugo and Joan Matson, husband and wife, were partners in the ownership and operation of three McDonalds restaurants. On their 1982 New York State individual income tax return (they filed separately on one return), they each reported that 100% of their respective share of partnership income was personal service income ($42,784 for Hugo Matson and $43,336 for Joan Matson).

Initially, the Division determined that capital was a material income-producing factor in petitioners' business and that only 30% of their partnership income was personal service income under section 603-A(b)(1)(A) of the Tax Law. The remaining 70%, said the Division, was subject to tax at the higher rate. This determination was the basis for the Notice of Deficiency issued by the Division to the petitioners pursuant to section 681 of the Tax Law.

The Notice of Deficiency issued by the Department to Mrs. Matson indicates on its face that a deficiency has been determined in a shown amount and contains an explanation on the computation of the deficiency, i.e, it refers to the statement of audit changes made by the Division which provides the basis for the Notice. The statement of audit changes, under the heading "Explanation," indicates "Review of your return disclosed that the maximum tax benefit was incorrectly computed. The maximum personal service income is limited to 30% of

the partnership distributive income. As the amount would be below $17,000 no tax benefit is gained." There then follows a recomputation of the tax liability.

The Notice for Mr. Matson was similar except for the last sentence of the explanation which made reference to his IT-250 form, which was attached to the Notice.

Petitioners filed petitions for hearing in which they challenged only the Division's determination on the percentage of income that could be treated as personal service income for tax purposes. A copy of the relevant Notice of Deficiency was attached to each petition and the petitions were received by the Tax Appeals Bureau on July 1, 1985.

In its answer, the Division increased from 30% to 65% the amount of each petitioner's distributive share of partnership income that would be treated as personal service income.

Mr. Matson worked 70 to 90 hours each week in connection with the three restaurants, and the general responsibility for the operation of the businesses exercised by Mr. Matson as owner. Mrs. Matson spent many hours in connection with the business, including the preparation of the payroll for the three restaurants, community liaison work and filling in for Mr. Matson when needed. Petitioners had 10-20 employees at each restaurant location and each restaurant had a store manager. Petitioners had a total of approximately $600,000 invested in the business, $500,000 of which was borrowed. Their 1982 New York partnership return indicated the following:

1. rental payments of almost $196,967 for the three restaurants

2. depreciable assets with a basis of $730,545

3. the three McDonald franchises as assets with a basis of $140,757

4. cost of goods sold was $806,481

At hearing, a copy of the Notice of Deficiency was allowed into evidence by the Administrative Law Judge over the objection of the petitioners' attorney. The objections were that: no foundation had been laid as to who prepared the documents; the documents were hearsay; petitioners had no opportunity to cross examine as to how the documents were prepared; and there was no foundation laid as to how the documents were transmitted to the petitioners.

The petitioners did not raise these objections in their petitions nor did petitioners' attorney request the Administrative Law Judge to subpoena an auditor or other Division employee to explain the actions of the Division or the Notice issued by it. Nor did the attorney request the judge to subpoena documents or other materials of the Division in connection with the case and the attorney himself did not take any such action. These procedures were available to the petitioners pursuant to section 601.11(c) of the State Tax Commission Rules of Practice (20 NYCRR 601.11[c]).

At hearing, the petitioners did not introduce any evidence as to the preparation or the mailing of the documents by the Division.

OPINION

On exception to this Tribunal, the petitioners argue:

1. that the records were not properly admitted since a foundation was not laid and that the Administrative Law Judge's decision to admit the Notices was arbitrary and capricious, and
2. that the Administrative Law Judge's conclusion that the petitioners failed to satisfy their burden of proving that the Audit Division's allowance of 65% of the partnership income was personal service income was improper.

This Tribunal affirms the determination of the Administrative Law Judge on the law and the facts.

We will deal first with the issue of the admissibility of the Notice of Deficiency.

Tax Law section 681(a) authorizes the Division to examine a taxpayer's return to determine the amount of personal income tax properly to be collected from the taxpayer by the State. If, upon such examination, the determination results in a deficiency, the statute authorizes the Division to mail a Notice of Deficiency to the taxpayer by registered or certified mail. The taxpayer has 90 days to file a petition challenging the Notice and ask for a hearing on the issue (Tax Law §689[a]).

The crux of the petitioners' argument appears to be that the Division has a burden of going forward to explain the basis for its actions (i.e. , the adjustment made to the return) and to provide evidence of timely and proper mailing before such a Notice may be admitted into evidence at hearing. Petitioners contend that the Administrative Law Judge determination to admit the Notices in this case without imposing such a burden was arbitrary ard capricious. Under the circumstances in this case, we disagree.

It is clear in this State that "Unless otherwise provided by any statute, agencies need not observe the rules of evidence observed by the courts, but shall give effect to the rules of privilege recognized by law" (State Administrative Procedure Act, § 306[l]).

Further, "All evidence, including records and documents in the possession of the agency of which it desires to avail itself, shall be offered and made part of the records, and all such documentary evidence may be received in che form of copies or excerpts. . ." (State Administrative Act, § 306[2]).

What is required of administrative hearings is that no essential element of a fair trial can be dispensed with unless waived (see, Matter of Hecht v. Monaghan, 307 NY 461). Clearly this standard was met here.

First, with respect to the timely and proper mailing of the Notices, the Division introduced the petitioners' petitions. In themselves, these petitions evidence that the Notices were received. Actual receipt satisfies the technical mailing requirements of section 681(a) of the Tax Law. (See Agosto v. State Tax Commission, 68 NY2d 893.)

Further, a copy of the Notice was attached to the petition and the petition was received (July 1, 1985) by the Tax Appeals Bureau well within the three year assessment period which would have ended April 15, 1986. Thus, it is clear the Notice was timely mailed by the Division.

Had there not been actual receipt, the result would be different[1].

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[1] In McClean v. Procaccino (53 AD2d 965) where there was no actual receipt of the Notice by the petitioner, the Division relied only on a mail log for proof of mailing. The Appellate Division said this was insufficient stating "Although respondents (the Division) claim, ... that they mailed a notice of deficiency to petitioner by certified mail ... they are unable to produce either the return receipt or the letter. The only evidence in this record is a copy of the mailing

With respect to the asserted burden on the Division to go forward and to explain the basis for the Notice of Deficiency, we find no justification for this position in this case, because the petitioners were not impaired in any wav in their efforts to argue the facts and the law of their case (see, Hecht supra). As stated earlier, the Notice of Deficiency was explained in the accompanying statement of audit changes. We would also point out that although the Division did not produce a witness for the petitioners to cross examine, the record indicates that the petitioners did not request the Administrative Law Judge to subpoena a witness, an action authorized by the State Administrative Procedure Act, section 304.2 and the Tax Commission Rules of Practice (20 NYCRR 601.11[c]).The Court of Appeals in Eagle v. Paterson (57 NY2d 831) pointed out that petitioners must request a witness pursuant to this section of the State Administrative Procedure Act in order for failure to produce such witness to offend petitioner's due process rights.

In Megson v. State Tax Commission (105 AD2d 481), the court sustained the admission into evidence of a dummy return prepared by the Division of Taxation. The Megson decision held that since the taxpayer was not deprived of his right to inspect documents, offer evidence in rebuttal or to cross examine witnesses, the petitioners were not denied any essential element ol a fair trial by the admission of the evidence.

In summary then, the failure of the Division on its own to produce witnesses and documentary evidence did not deny the petitioners anv element of a fair hearing. The action of

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log. There are no affidavits or testimony as to the accuracy or authenticity of this log and no signature or initials appear thereon. Respondents have also failed to produce affidavits or other evidence as to their course of business or office practices which would tend to prove that the instant mailing was, in fact, effected... ."

the Administrative Law Judge in admitting these Notices of Deficiency was in all respects proper and was not arbitrary and capricious.

We turn next to the treatment accorded the petitioners with respect to the computation of their income subject to the maximum tax on personal service income.

For tax year 1982, section 603-A of the Tax Law provided for separation of income for tax rate purposes into two categories, personal service income which was subject to a maximum tax rate of 10% and income from other than personal service, i.e., unearned income, which was subject to a maximum rate of 14%.

For purposes of this maximum tax provision personal service income was defined as: "(A) wages, salaries, or professional fees, and other amounts reviewed as compensation for personal services actually rendered ... In the case of a taxpayer engaged in a trade or business in which both personal services and capital are material income-producing factors, under regulations prescribed bv the Tax Commission, a reasonable allowance as compensation for the personal services rendered by the taxpayer shall be considered as earned income." (Emphasis added, former Tax Law § 603-Afb][1][A], see also, 20 NYCRR 100.4[c].)

The language in section 603-A(b) (1) (A) was almost identical to the Federal provisions on a similar subject except that the Federal law contained a 30% limit on the amount of personal service income where capital and service were material income-producing factors[2] (see, former Internal Revenue Code § 1348).

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[2] For tax years beginning after December 31, 1978 the Federal law was amended to remove the 30% limitation, so for the years 1979-1981 the Federal and State definitions of personal service income were the same.

The test under both Federal and State law was two-fold in nature. First, it was determined if both capital and personal services were material income-producing factors. If capital was a material income-producing factor, then a reasonable allowance was made as compensation for the personal services rendered by the taxpayer.

At the Federal level, the regulations promulgated by the Treasury guide the determination of whether, in fact, capital is material to the production of the taxpayer's income (26 CFR 1.1348-3[a][3)[ii])[3] . We need not go into great detail as to the Federal case law on the question, but need only note that the courts, guided by the regulation, have engaged in a case-by-case approach with varying results[4].

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[3] 26 CFR 1.1348-3(a)(3)(ii) states:

"Whether capital is a material income-producing factor must be determined by reference to all the facts of each case. Capital is a material income-producing factor if a substantial portion of the gross income of the business is attributable to the employment of capital in the business, as reflected, for example, by a substantial investment in inventories, plant, machinery, or other equipment. In general, capital is not a material income-producing factor where gross income of the business consists principally of fees, commissions, or other compensation for personal services performed by an individual. Thus, the practice of his profession by a doctor, dentist, lawyer, architect, or accountant, will not, as such, be treated as a trade or business in which capital is a material income-producing factor even though the practitioner may have a substantial capital investment in professional equipment or in the physical plant constituting the office from which he conducts his practice since his capital investment is regarded as only incidental to his professional practice."

[4] In Hicks v. United States (71 TC igi r 1978]), the Circuit Court of Appeals found that capital was a material factor in producing the income of a taxpayer's general contracting business. Thus, while the taxpayer devoted much time to the operation of the business, the court would not allow him to claim that 100% of the income was personal service income.

In VanKalker v. Commissioner (804 F2d 967 [7th Cir 1984]), where the taxpayer was engaged in the business of fabricating and installing wrought iron railings, the Tax Court reasoned that the business produced and sold tangible goods and not personal services. It rejected the argument that whether capital is a material income-producing factor should depend on a comparison of the relative value of the capital and services. The Circuit Court of Appeals reversed the Tax Court and determined that more important than the amount of capital is how the

New York has also followed a case-by-case approach (see, e.g., Matter of Seidel, State Tax Commission, January 17, 1986; Matter of Gallo, State Tax Commission, November 12, 1986). In this case, the petitioners do not challenge the determination that capital was a material income-producing factor, but only that the allowance, i.e., 65%, for personal services was not reasonable. Petitioners argue that 100% of the net income should be viewed as compensation for personal services. We cannot agree. While petitioners have introduced much evidence as to the number of hours worked in conjunction with their business as support for their allegation that 100% of the income from the business should be treated as personal service income, we find this single factor to be unpersuasive. The nature of the business was selling fast food. Petitioners utilized 10 to 20 employees and a manager in each restaurant location. They had a sizeable capital investment (over $600,000) in the business and they sold goods which cost in excess of $800,000. Under the circumstances, we believe petitioners have not sustained their burden to prove that it was improper for the Division to characterize 65% of the income as personal service income and the remainder as unearned income, in effect, generated by the capital invested by the petitioners in their business.

Accordingly, it is ORDERED, ADJUDGED AND DECREED that:

1. The exceptions of the petitioners, Fugo and Joan Matson are denied;

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capital is employed in the business. "The test is whether the capital is income-producing in its own right, or whether its worth depends on the application of the taxpayer's personal skills. Here the appellant's tools and machinery were not income-producing without his skills; rather, they were merely the conduit for his personal skills."

In Moore v. Commissioner (71 TC 533 [1979]), the Tax Court held that in a grocery business with substantial investment in inventory, depreciable assets and in leased property, capital was a material income-producing factor, notwithstanding the substantial and important services provided by the proprietors.

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

3. Except as modified by Finding of Fact "4" of the Administrative Law Judge's determination, the petitions of Hugo and Joan Matson are denied and the notices of deficiency sustained.

DATED: Albany, New York
March 10, 1988

/s/ John P. Dugan
President

/s/ Francis R. Koenig
Commissioner