STATE OF NEW YORK

TAX APPEALS TRIBUNAL

| | | |
|---|---|---|
| In the Matter of the Petition | : | |
| of | : | |
| **ANDREW J. O'CONNELL, JR. & BLANCHE M. O'CONNELL** | : | DECISION<br>DTA No. 811794 |
| for Redetermination of a Deficiency or for Refund of New York State and New York City Income Taxes under Article 22 of the Tax Law and the New York City Administrative Code for the Years 1984 through 1988. | : | |

Petitioners Andrew J. O'Connell, Jr. and Blanche M. O'Connell, 343 Laurel Road, New Canaan, Connecticut 06840 and the Division of Taxation each filed an exception to the determination of the Administrative Law Judge issued on November 16, 1995. Petitioners appeared by Chadbourne & Parke, LLP (Donald Schapiro, Esq., of counsel). The Division of Taxation appeared by Steven U. Teitelbaum, Esq. (Michael J. Glannon, Esq., of counsel).

The Division of Taxation filed a brief in support of its exception and in opposition to petitioners' exception. Petitioners filed a brief in support of their exception, a brief in opposition to the Division of Taxation's exception and in reply to the Division of Taxation's brief in opposition. The requests by both parties for oral argument were denied.

Commissioner DeWitt delivered the decision of the Tax Appeals Tribunal. Commissioners Jenkins and Pinto concur.

***ISSUES***

I. Whether the Division of Taxation's assessment of additional income tax lacks a rational basis.

II. Whether the Administrative Law Judge correctly determined that petitioner Andrew J. O'Connell, Jr., a municipal bond salesman, must allocate his commission income within and without New York State based on a 50/50 formula for certain New Jersey and Connecticut

customers but based on his actual physical location at the time of bond trades made for all other customers.

III. Whether there was reasonable cause to abate the penalties imposed.

***FINDINGS OF FACT***

We find the facts as determined by the Administrative Law Judge and make an additional finding of fact. The Administrative Law Judge's findings of fact and the additional finding of fact are set forth below.

1. Petitioners proposed 34 findings of fact. These proposed findings of fact have been incorporated in the following Findings of Fact unless otherwise indicated.

2. Petitioners, Andrew J. O'Connell, Jr. and Blanche M. O'Connell, filed joint New York State nonresident income tax returns on Form IT-203 for the calendar years 1984 through 1988.

3. Petitioners resided in New Canaan, Connecticut during all the years in issue, were not domiciliaries of New York State and did not maintain a place of abode in New York State. Accordingly, petitioners were subject to tax as nonresidents.[1]

4. Petitioner was employed by First Boston Corporation ("FBC") during the calendar years 1984 through 1988 as a municipal bond salesman. During each of these years he was compensated by FBC solely by commissions based upon the volume of sales and purchases of bonds made by him on behalf of his customers. His compensation was approximately 15% of the sales credit -- the difference between the purchase price and sale price of the bond. Although petitioner received an annual draw from FBC, this amount was applied against his commissions.

---

[1]Because the issue in this case involves only the amount of compensation received by Andrew J. O'Connell, Jr., the term "petitioner" refers to Mr. O'Connell.

5. FBC did not provide petitioner with a private office in New York City, but did provide him with a desk and telephone. Petitioner was required to travel as a condition of employment and was reimbursed for travel expenses.

6. Because of the competitive nature of his business, petitioner maintained close contacts with his customers by telephone and by frequent personal visits to his customers' places of business. Petitioner testified, concerning the nature of his relationship with his customers, as follows:

A. "The primary thing that I do is I have to distinguish myself from my competition, and the way that I do that is by getting the closest possible relationship and the closest knowledge of my clients and what their objectives are."

Q. "This is accomplished by being in close contact with your clients?"

A. "I talk to [my clients] all the time on the phone and I go see them on a frequent basis. One of the problems that somebody in my business faces is the fact that your clients are called constantly by ourselves and our competitors. So, it is very difficult to compete for their time on the phone. It is very difficult to get them on the phone, so it is of paramount importance in my job that when I call, my calls get received, and that I am regarded in the highest fashion by my clients. It has been my experience over the past thirty-somewhat years that I have been doing this, that there is no substitute for personal relationships with my clients. The greatest way to have that personal relationship with the client is having the greatest personal contact with them."

Q. "Do you go out and visit your clients at their place of business?"

A. "Yes, I do."

Q. "Do you spend time with them there?"

A. "Yes, I do."

Q. "Do you go there on a regular basis?"

A. "Yes."

Q. "What are you hoping to accomplish by visiting your clients at their place of business?"

A. "Ultimately, to sell them bonds and buy bonds from them to create sales credits. In that process the key thing is the relationship and the knowledge of what the client wants to do and what the client is thinking, what his

objectives are. There is no question that to attain that kind of a situation and that kind of a reputation, it can't be done over the phone. First of all, there is no substitute for sitting across from somebody and having personal contact with them. But more important than that, when you call a client on the phone you are one of many, many people that are fighting for their time on the phone at a time when there is a lot of activity going on around them and a lot going on in the market" (tr., pp. 25-26).

7. The bulk of petitioner's transactions with customers located outside New York for the audit period in question involved the following 10 customers:

Merrill Lynch Asset Management (New Jersey)
Travelers Indemnity Group (Connecticut)
Prudential Insurance Co. of America (New Jersey)
Farmers Insurance Exchange (California)
Nationwide Financial Services (Ohio)
Connecticut General Life Insurance Co. (Connecticut)
General Electric Co. (Connecticut)
Cigna Investments, Inc. (Connecticut)
Zenith National Insurance Co. (California)
Crum & Forster (New Jersey)

These 10 customers generated sales credits for petitioner in the following amounts and percentages:

Sales Credits in $1,000

| | Sales 10 Largest Customers | Total Outside of New York | Percentage of Total |
|---|---|---|---|
| 1984 | $2,893.2 | $3,042.2 | 95.1% |
| 1985 | 4,641.9 | 4,932.4 | 94.1% |
| 1986 | 5,766.6 | 6,055.7 | 95.2% |
| 1987 | 4,109.9 | 4,153.3 | 99.0% |
| 1988 | 4,138.6 | 4,240.1 | 97.6% |

8. Over the five-year period of 1984 through 1988, four out-of-state customers generated approximately 65% of the aggregate sales credits from all out-of-state customers.[2] These four customers were Merrill Lynch, Travelers Insurance, Prudential Insurance and Connecticut General.

---

[2] If the year 1984 is omitted, the four customers generated 70% of the aggregate sales credits.

9. At hearing, petitioner testified that he would visit these out-of-state customers located in New Jersey and Connecticut at least once a week or more for no less than half an hour for some customers and no less than an hour for others.[3] Petitioner described the nature of these visits as follows:

> "When you go to visit a client there is a definite purpose you have in mind, and some of them are very direct and some of them are indirect. Obviously the principal goal that I have is to always maintain that client relationship so as to maximize my sales credits. In the process of doing that, when you see a client, the primary thing I would always do is endear my relationship with them, and get a much better and closer personal contact with them. Another thing that would also happen in a
>
> client visit was that you would get their undivided attention. You have discussions about things that you really can't have on the phone because you are in their office sitting face to face. So, this is a time that we would find out a lot of information about customers and their portfolio, about our competition, about what they really like and don't like about the economy and other issues that effect their performance in their portfolios, and things like that" (tr., p. 29).

10. Petitioner testified that the trades would frequently take place at a customer's office or would occur when he was in his New York office, at his Connecticut home or at other customer offices. He stated that at times he would conduct business over the telephone for one client while at another client's office or while at his home in the evening. He testified that many times he would conduct an actual trade at 8:00 P.M. or 9:00 P.M. because in California the traders were still at work at 4:00 P.M. or 5:00 P.M. California time. He also noted that sometimes he could call the trader's home in the evening with respect to bonds that the trader might or might not be willing to send to him overnight for a particular customer. In a "secondary trade" situation, one of petitioner's clients might want to sell certain bonds. Petitioner would then call the office to check on a price and then call another client to sell the bonds to him or her.

---

[3]Proposed finding of fact "26" is not included in this Finding of Fact to the extent that it concludes that petitioner's testimony and other evidence in support of this finding constitutes "credible evidence." Whether this evidence constitutes credible evidence to support a fact is a conclusion of law.

11. In order to complete the trade, petitioner noted that a ticket would be written indicating a sale or purchase of a particular bond. When petitioner was not in the office, this ticket was either written by someone in the office at petitioner's direction or written by petitioner when he returned to the office that day. Petitioner noted that the ticket did not contain information as to petitioner's location at the time of the trade because the ticket was designed to comply with the regulations of the Securities and Exchange Commission, which did not require such information.

12. Petitioner stated that he handled approximately 100 telephone calls a day when at his New York desk. He described his manner of conducting business while traveling as follows:

> "I can't afford to travel and see clients and just let my business go, so I am in constant contact with the office. As things develop I can call a client. The customers like the fact that we are in their office and selling bonds to someone else. It's a little bit of Hollywood. It is kind of fun for them" (tr., pp. 91-92).

13. Petitioner testified that it was not important to his customers where petitioner was physically located when he made a trade on their behalf. He also opined that the essence of the sales credit "derived from the client, his mind and what he wants to do" (tr., p. 27).

14. In support of his testimony, petitioner submitted affidavits by Robert S. Waas, Justin D. Hennessey, Phillip A. Duncan and Richard Cahill. Each affiant was a representative of the respective customers -- Merrill Lynch, Cigna Investment,[4] Travelers Insurance and Prudential Asset Management -- during the audit period in question.[5] Each affiant was responsible for the purchase and sale of municipal bonds for the respective customers. The affidavits were similarly worded as follows:

---

[4]During the hearing, petitioner referred to Mr. Hennessey as a representative of Connecticut General, whereas in his affidavit, Mr. Hennessey identifies himself as an employee of Cigna Investments. There is nothing in the record that resolves this discrepancy. Therefore, it is assumed that petitioner misspoke in his reference to Mr. Hennessey.

[5]Mr. Waas and Mr. Hennessey were employed by their respective companies for the period 1985 to 1988 and Mr. Duncan and Mr. Cahill were employed by their respective companies for the period 1984 to 1988.

"All municipal bond fund activity including muni bond transactions were executed at [the respective office of the customer].

"Andrew J. O'Connell, Jr. was the Municipal Bond Salesman at the First Boston Corporation with whom I dealt during the period [1984 or 1985] to 1988. During this time, Mr. O'Connell regularly visited my office on an average of at least once per week to discuss all aspects of the bond business and economy and to assist me in developing portfolio strategies and to present credit information on a variety of issuers.

* * *

"Also on occasion, I would visit Mr. O'Connell in his office in NY. The visits to his NY office occurred once or maybe twice per year."

15. In all four affidavits, the affiants stated that the transactions concerning the purchases and sales of municipal bonds occurred: (1) while petitioner was visiting the affiant in the affiant's office; (2) while petitioner was in his New York office; (3) while petitioner was at his Connecticut home speaking over the telephone with the affiant; and (4) while petitioner was in other customer offices. Mr. Duncan also stated that the transactions would also take place when he was with petitioner at petitioner's vacation house in Vermont. In addition, both Mr. Duncan and Mr. Hennessey stated the following:

"While I never kept track of Mr. O'Connell's location when we bought and sold municipal bonds, I am sure that more than half the transactions occurred while Mr. O'Connell was out of his office."[6]

16. Petitioner testified that he would also make trades for New York State clients when he was traveling out of state or from his Connecticut home. He estimated that 50% of his business time was spent out of New York State when he conducted business. In support of his

---

[6] For the years 1985 through 1988, Merrill Lynch transacted trades in the amounts of $823,600.00, $1,343,000.00, $496,800.00 and $1,714,135.00, respectively. For the year 1988, Cigna transacted trades in the amount of $361,800.00. For the years 1984 through 1988, Travelers Insurance transacted trades in the amounts of $25,900.00, $984,000.00, $1,323,500.00, $1,049,000.00, and $839,500.00, respectively. For the years 1984 through 1988, Prudential Asset Management transacted trades in the amounts of $571,100.00, $709,200.00, $1,192,800.00, $747,800.00, and $803,600.00, respectively.

method of conducting business, petitioner submitted an affidavit of James L. Gammon, a representative of Loews Corporation with an office in New York State. Mr. Gammon stated that he sold to petitioner and purchased from petitioner municipal bonds during the period March 1984 through 1988. He affirmed that many of the purchases and sales occurred while both he and petitioner were out of New York State, that they were in communication throughout the day regardless of their extensive travel schedules, and that they often conducted business from their respective homes in Connecticut after hours and on weekends.

17. With respect to the out-of-state customers that were located further than New Jersey or Connecticut, petitioner testified that he would visit them at least once a year for a period of several days in order to plan strategies for buying and selling municipal bonds for the following year. Two affidavits were submitted by representatives of Nationwide Insurance, located in Ohio, and Farmers Insurance Group, located in California, confirming that petitioner visited their out-of-state offices at least once a year.[7] They both noted that if circumstances changed during the year, petitioner would meet with them again at their offices in order to implement revised investment programs or strategies.

18. The Division of Taxation ("Division") submitted a printout of petitioner's absence from the New York office of FBC provided by the vice-president of human resources of FBC. The printout included the period 1985 through 1990. The printout indicated that petitioner was in California from August 12 through 14, 1985, in California from July 16 through 23, 1986, in Ohio on June 15, 1987, in California from July 16 through 20, 1987, and in Ohio on August 22, 1988. The Division offered no explanation as to the nature of the request which resulted in the production of this document. Also, no explanation was provided as to how this document was generated.

---

[7]The affidavit of Laszlo G. Heredy, a vice-president of investments with Farmers Insurance Group, indicated that he dealt with petitioner during the period 1978 to 1988. The affidavit of James W. Pruden, vice-president of securities with Nationwide Insurance, did not specify the time period of his business association with petitioner.

19. Although petitioner was reimbursed for his travel expenses, he testified that he did not request reimbursements for his routine weekly visits to customers in New Jersey or Connecticut. These visits would take up only part of the day. Petitioner spent the remainder of the day at his New York City desk.

20. Since the mid-1970's, petitioner allocated his income within and without New York State on his New York income tax returns based on the physical location of his customers. Petitioner testified at hearing that he believed that he disclosed his method of allocation on the schedules attached to these State income tax returns. The schedules contained the following statement:

> "Pursuant to regulation SEC. 131.15 New York State Income Tax Regulations & John Mc G. Dalenz [sic] v. State Tax Comm. 9 AD 2d 599; 189 N.Y. Supp 2d 348, taxpayer, a non-resident securities salesman compensated solely by a commission based upon his total production, hereby elects to allocate his commission income to New York State and City based upon the volume of business transacted within and without the State and City.
>
> "Taxpayer's commission is allocated to New York State and City by the formula represented by the following fractions:"

Next to the amount he allocated to New York State and City was an asterisk indicating an explanation at the bottom of the page. Next to the corresponding asterisk at the bottom of the page was the following statement: "All customers within N.Y. State are also located within N.Y. City."

Petitioner explained the basis for his belief that the attached schedules indicated his method of allocation in the following direct testimony:

Q. "And do you believe that [the statement in the attached schedules] disclosed that you were reporting on the basis of the location of the customer?"

A. "Yes."

Q. "And tell me what made you say that you were reporting on the basis of the location of the customer?"

A. "Well, the entire statement, but specifically if you look it says 'All customers located within New York State are also located in New York City.' That is a further refinement of the point" (tr., p. 44).[8]

21. Petitioner followed the practice of overpaying his Federal and New York income tax by overwithholding and then seeking a refund. This practice included petitioner filing for an extension of time to file his Federal and State tax returns prior to their due dates and postponing the filing for three years, at which time he also showed a refund due. Petitioner recognized that this practice of extending the filing date and delaying the refund deprived him of interest on the refunded amount. He also recognized that while this practice did not give him any tax advantage, it also did not subject him to any penalties. Petitioner's rationale for the overpayment of taxes and the postponement of refunds was to create a forced savings plan for himself. He stated that he had a hard time saving money and that this practice allowed him to set money aside as a kind of "nest egg or emergency fund" (tr., pp. 75-76).

22. Petitioner allocated his income to New York in his tax returns as follows:

| | Income Per Form W-2 | Percentage New York | Dollars Allocated to New York |
|---|---|---|---|
| 1984 | $ 784,510.00 | 34.837% | $273,300.00 |
| 1985 | 695,009.00 | 42.330% | 294,197.00 |
| 1986 | 1,216,341.00 | 33.668% | 409,518.00 |
| 1987 | 1,282,166.00 | 46.740% | 599,284.00 |
| 1988 | 1,071,279.00 | 24.620% | 263,749.00 |

23. Petitioner filed tax returns showing taxes withheld and refunds due in the following amounts:

B C D

---

[8] I did not include within this Finding of Fact that portion of petitioners' proposed finding of fact "34" which states "[t]hese returns all contained a schedule showing that income was being allocated based on the physical location of the customer. Respondent acknowledges this fact (R-13)." Instead, Finding of Fact "17" recites in greater detail the actual statement contained in the schedules and the basis for petitioner's belief that these schedules showed petitioner's method of allocating income based on the physical location of the customer. Moreover, the opening statement of the Division's counsel, recited on page 13 of the transcript, does not constitute an acknowledgement that these schedules informed the Division of petitioner's method of allocating income based on the physical location of the customer.

| | A<br>Taxes Withheld | Refunds Claimed<br>and Paid | Net Taxes<br>Paid | Refunds Claimed<br>Not Paid |
|---|---|---|---|---|
| 1984 | $46,941.00 | $23,946.00 | $22,995.00 | $ -0- |
| 1985 | 42,535.00 | 19,842.00 | 22,693.00 | -0- |
| 1986 | 71,064.00 | 37,315.00 | 33,749.00 | -0- |
| 1987 | 73,730.00 | -0- | 73,730.00 | 25,141.00 |
| 1988 | 61,801.00 | -0- | 61,801.00 | 40,693.00 |

24. The Division accepted these filed returns and issued timely refunds based on the reported overpayments until it audited petitioner's returns for 1984 through 1988.

25. After an audit, the Division issued to petitioners statements of personal income tax audit changes, dated August 31, 1990. In those statements, the Division's auditor rejected petitioner's method of allocating income to New York. The auditor stated that 20 NYCRR former 131.17 did not apply because petitioner's compensation did not depend directly upon the volume of business transacted by petitioner,[9] and that, instead, 20 NYCRR former 131.18 applied which allocates income based on the days in and out of New York State. The auditor also opined that even if the provisions of 20 NYCRR former 131.17 were to apply, the method used by petitioner is inconsistent with those provisions. The auditor contended that the proper method of determining the source of income is based on where the taxpayer performs the services and not on the location of the customer. The auditor concluded that the services performed by petitioner for FBC were conducted mainly at the employer's place of business in

---

[9] 20 NYCRR former 131.17 provided, in pertinent part, that:

> "Earnings of salesman. If the commissions for sales made or other compensation for services performed by a nonresident traveling salesman, agent or other employee depend directly upon the volume of business transacted by him, his items of income, gain, loss and deduction . . . derived from or connected with New York State sources include that proportion of the net amount of such items attributable to such business which the volume of business transacted by him within New York State bears to the total volume of business transacted by him within and without New York State."

New York City; that the infrequent visits by petitioner to his customers at their place of business were of an informational or customer relations nature; and that no documentation was submitted to substantiate that any business was consummated during those customer visits. In the statements of audit changes, the auditor recalculated petitioner's New York allocation of income for the years 1984 through 1988 as follows:

| | Percentage Allocation | Increase in Compensation Allocated to New York |
|---|---|---|
| 1984 | 98.6842% | $500,887.00 |
| 1985 | 98.6842% | 391,667.00 |
| 1986 | 97.2602% | 773,499.00 |
| 1987 | 97.7578% | 654,133.00 |
| 1988 | 99.5689% | 802,912.02 |

The auditor determined that petitioner worked only 3 days out of 225 work days outside New York in 1984; 3 days out of 225 work days in 1985; 6 days out of 213 work days in 1986; 5 days out of 218 work days in 1987; and 1 day out of 231 work days in 1988.

26. The Division issued to petitioners a Notice of Deficiency, dated October 12, 1990, for the total amount of $283,393.72. In the notice, the amount due for each period was broken down as follows:

| Tax Period Ended | Tax Amount Assessed | (+) Interest Amount Assessed | (+) Penalty Amount Assessed | (-) Assessment Payments/ Credits | (=) Current Balance Due |
|---|---|---|---|---|---|
| 12-31-84 | $ 40,362.65 | $22,475.83 | $ 4,679.15 | $176.51 | $ 67,341.12 |
| 12-31-84 | 2,253.84 | 1,255.19 | 0.00 | 0.00 | 3,509.03 |
| 12-31-85 | 28,358.82 | 11,698.08 | 2,579.95 | 0.00 | 42,636.85 |
| 12-31-85 | 1,762.38 | 726.99 | 0.00 | 0.00 | 2,489.37 |
| 12-31-86 | 61,406.53 | 18,934.59 | 6,930.35 | 0.00 | 87,271.47 |
| 12-31-86 | 3,480.57 | 1,073.23 | 0.00 | 0.00 | 4,553.80 |
| 12-31-87 | 28,869.61 | 6,648.68 | 7,217.40 | 0.00 | 42,735.69 |
| 12-31-88 | 23,587.38 | 3,372.21 | 5,896.80 | 0.00 | 32,856.39 |
| Totals | $190,081.78 | $66,184.80 | $27,303.65 | $176.51 | $283,393.72 |

27. The following column A sets forth the deficiencies of income tax claimed by the Division; column B sets forth the refund amounts claimed by petitioner; and column C sets forth the net amounts in dispute for each audit year:

| | A<br>Tax Deficiency | B<br>Refund Claimed | C<br>Amount in Dispute |
|---|---|---|---|
| 1984 | $42,616.49 | $ -0- | $42,616.49 |
| 1985 | 30,131.20 | -0- | 30,121.20 |
| 1986 | 64,887.10 | -0- | 64,887.10 |
| 1987 | 28,869.61 | 25,141.00 | 54,010.61 |
| 1988 | 23,587.38 | 40,693.00 | 64,280.38 |

28. At hearing, petitioners submitted, with some corrections, exhibits which listed and summarized information concerning the total amount of trades petitioner made for companies both within and without New York State for the years 1984 through 1988. Those exhibits show the following allocations in $1,000.00 increments:[10]

| | Total Sales Credits | Total Sales Credits Within New York | Percent Within New York |
|---|---|---|---|
| 1984 | $4,723.5 | $1,681.3 | 35.6% |
| 1985 | 8,481.4 | 3,549.0 | 41.8% |
| 1986 | 9,093.9 | 3,038.0 | 33.4% |
| 1987 | 7,799.2 | 3,645.9 | 46.7% |
| 1988 | 5,722.9 | 1,482.8 | 25.9% |

29. After a conciliation conference, the conferee issued a Conciliation Order, dated January 8, 1993, sustaining the statutory notice.

30. Petitioners filed a petition, dated April 6, 1993, arguing that the Division applied the wrong regulation to petitioner's situation when it calculated an apportionment of income based on 20 NYCRR former 131.18 rather than 20 NYCRR former 131.17; that the Division's interpretation of "transacting business" to include only the actual taking of orders excluding all other customer contact is arbitrary, results in an unfair apportionment and violates the U.S Constitution; that petitioner correctly allocated his commission income; and that the imposition of penalties was inappropriate because petitioner acted reasonably and in good faith.

---

[10] Proposed findings of fact "10" through "16" are not included in these Findings of Fact inasmuch as they include detailed descriptions of the exhibits and corrections to those exhibits that are not necessary to recite in the Findings of Fact.

31. The Division filed an answer, dated September 29, 1993, stating that petitioners had not established that the assessment was erroneous or improper.

We make the following additional finding of fact:

> At the hearing, petitioners' representative made a motion to conform the petition to the evidence submitted on the refund claims not paid by the Division. The Division offered no objection to this motion.

## *OPINION*

In her determination, the Administrative Law Judge concluded that although petitioner elected to use a method of apportionment and allocation based on the physical location of his customers, he never fully explained it on his tax returns nor was his methodology approved by the Tax Commission, at that time. It was necessary, she concluded, to determine "what constitutes a fair and equitable method for allocating petitioner's commission income based on the facts of his situation" (Determination, conclusion of law "B"). She found that the Division's regulations with respect to allocation of income by security and commodity brokers (i.e., 20 NYCRR former 131.21) were instructive even though they were not applicable to bond salesmen. She found that petitioner's allocation method using the physical location of the customer was similar to the approach taken in the regulation with respect to security and commodity brokers. Therefore, petitioner could have reasonably believed that his method of allocation based on the customer's location would be acceptable with respect to customers he visited on a regular basis but not with respect to out-of-state customers he visited on an infrequent basis. For petitioner's four largest New Jersey and Connecticut customers, the Administrative Law Judge allocated petitioner's income on a 50/50 formula similar to the 80/20 formula adopted for brokers. As to petitioner's remaining customers, the Administrative Law Judge determined that the Division's method of allocating income based on petitioner's location at the time of actual bond trades was appropriate. She stated that "[i]nasmuch as there is no evidence to support an adjustment with respect to these customers, no adjustment can be made and petitioner's commissions relating to out-of-state customers, other than the four customers

discussed above, are all attributable to business transacted by petitioner in New York State" (Determination, conclusion of law "D"). In addition, the Administrative Law Judge sustained the imposition of penalty.

On exception, petitioners argue that the assessment by the Division lacks a rational basis while petitioner's method of income allocation is reasonable and rational and, therefore, the Notice of Deficiency should be cancelled and the refund claims granted. Alternatively, petitioners argue that if the basis of an appropriate allocation is by way of an analogy to the regulations dealing with commodity and securities brokers, as was determined by the Administrative Law Judge, then the customer-location methodology employed by petitioner is more appropriate to this method of allocation than that which was proposed by the Division or by the Administrative Law Judge.

The Division argues in its exception that the Administrative Law Judge erred in applying a 50% allocation formula to the commissions earned from certain of petitioner's customers and that without proof of petitioner's physical location at the time of his bond trades, all of his income should be allocated to New York State.

The income tax liability of a nonresident individual is initially calculated by applying a progressive tax rate to a taxpayer's income from all sources and then apportioning the tax based on the taxpayer's New York source income over his Federal adjusted gross income for the taxable year. Tax Law § 631(a) provides that the New York source income of a nonresident individual includes the net amount of items of income, gain, loss and deduction reported in the Federal adjusted gross income that are "derived from or connected with New York sources." This includes those items attributable to a business, trade, profession or occupation carried on in this State (Tax Law § 631[b][1]).

Tax Law § 631(c) provides, in part, that:

> "[i]f a business, trade, profession or occupation is carried on partly within and partly without this state, as determined under regulations of the

> [commissioner of taxation], the items of income, gain, loss and deduction derived from or connected with New York sources shall be determined by apportionment and allocation under such regulations."

The regulations in effect during this audit period (20 NYCRR former 131.17) provided that:

> "[i]f the commissions for sales made or other compensation for services performed by a nonresident traveling salesman, agent or other employee depend directly upon the volume of business transacted by him, his items of income, gain, loss and deduction . . . derived from or connected with New York State sources include that proportion of the net amount of such items attributable to such business which the volume of business transacted by him within New York State bears to the total volume of business transacted by him within and without New York State."

The Division, in calculating petitioner's tax liability, operated under the premise that petitioner's income was not based entirely on commissions and, therefore, did not depend directly upon the volume of business transacted by him. Rather, the Division concluded that petitioner did not consummate any business at the place of business of the customers that he visited; that petitioner performed the services for his employer in New York City; and that petitioner worked as few as one day and no more than six days out of the State in the years at issue. Therefore, the Division concluded that petitioner was required to allocate his income to New York State based on the number of days worked in and out of New York State, as provided in former regulation section 131.18 and not pursuant to former regulation section 131.17.

20 NYCRR former 131.18 provided, in applicable part, that:

> "(a) If a nonresident employee (including corporate officers, <u>but excluding employees provided for in [former] section 131.17 of this Part</u>) performs services for his employer both within and without New York State, his income derived from New York sources includes that proportion of his total compensation for services rendered as an employee which the total number of working days employed within New York State bears to the total number of working days employed both within and without New York State" (emphasis added).

Subsequent to the hearing, the Division conceded that 20 NYCRR former 131.17 (and not former 131.18) applied to petitioner. It is clear from the regulation, therefore, that if former regulation section 131.17 is applicable to determining a taxpayer's New York source income,

the methodology of former regulation section 131.18 is not appropriate. However, the Division still asserts that the calculation of additional tax assessed is accurate, arguing that the key factor in allocating commissions is petitioner's physical location at the time of each bond trade which generated his income and that petitioner had the duty to maintain adequate records establishing his location at the time he made the trades. Since petitioner does not have adequate records as to his physical location at the time that these trades were made, he is deemed to have been in New York City at the location of his employer. The Division expressed concern that using petitioner's method of allocation would allow a nonresident bond salesman working in New York to allocate all his commission income outside of New York on the basis that all his clients were located out of New York.

In her determination, the Administrative Law Judge described the issue in this proceeding as:

> "what constitutes a business transaction -- is it simply the actual trade in these circumstances, or, does it also include the time spent in the customer's office assessing the customer's needs or likes, developing a financial strategy or plan with a customer, or securing the customer's confidence to rely on petitioner's advice for future trades" (Determination, conclusion of law "C").

She found that there were no regulations which specifically addressed how to calculate the volume of business transacted within New York State by a traveling bond salesman. There is no definition of "transaction" in the regulations or in the statute. She concluded that:

> "[i]n the absence of case law or regulations that might have served as some notice to petitioner, it would be unfair to require petitioner in retrospect to produce contemporaneous records to document his physical location for each trade transacted with the out-of-state customers that he visited on a regular weekly basis when the regulations did not specifically indicate this level of recordkeeping but did indicate some flexibility in accepting alternative methods that are fair and equitable" (Determination, conclusion of law "C").

The Administrative Law Judge further concluded that petitioner has established that his personal visits with his customers were necessary components of petitioner's business. We agree.

In view of the fact that the Division has never prescribed a methodology for allocation in the case of a taxpayer subject to former section 131.17 of the regulations, it was not unreasonable for petitioner to allocate his commission income based on the location of the sources of that income (i.e., his customers) both within and without the State. We find that petitioner's method was not irrational for the very reason which has caused the Division such concern; i.e., the inability of a taxpayer to manipulate this allocation methodology to avoid tax. A taxpayer such as petitioner is quite capable of manipulating his location at the time of a bond trade in order to avoid subjecting to tax trades with customers both within and without New York State. Petitioner's methodology, on the other hand, is incapable of manipulation. The one factor that is immutable is the location of the customer's place of business. While the Division fears that such a rule would allow petitioner to remain in his New York City office and trade bonds with out-of-state customers and thereby escape personal income tax on his commission income, this was not the case for petitioner. In the years at issue, petitioner allocated from 24.6% to 46.7% of his gross commission income to New York State. In fact, when petitioner consummated a bond transaction with a New York-based customer while petitioner was out of New York State, that transaction was included as part of petitioner's New York source income.

In order to be sustained, a notice of deficiency must have a rational basis. That rational basis is provided by the presumption of correctness which attaches to assessments generally unless the petitioner introduces evidence to rebut that presumption. As we stated in Matter of Atlantic & Hudson Ltd. Partnership (Tax Appeals Tribunal, January 30, 1992):

> "[a]lthough a determination of tax must have a rational basis in order to be sustained upon review (see, Matter of Grecian Sq. v. New York State Commn., 119 AD2d 948, 501 NYS2d 219), the presumption of correctness raised by the issuance of the assessment, in itself, provides the rational basis, so long as no evidence is introduced challenging the assessment (see, Matter of Tavolacci v. State Tax Commn., 77 AD2d 759, 431 NYS2d 174; Matter of Leogrande, Tax Appeals Tribunal, July 18, 1991 [affd 187 AD2d 768, 589 NYS2d 383, lv denied 81 NY2d 704, 595 NYS2d 398]). Evidence that both rebuts the presumption of correctness and indicates the irrationality of the audit may appear: on the face of the audit as described by

> the Division through testimony or documentation [citations omitted]; from factors underlying the audit which are developed by the petitioner at hearing [citations omitted]; or in the inability of the Division to identify the bases of the audit methodology in response to questions posed at the hearing [citations omitted]" (Matter of Atlantic & Hudson Ltd. Partnership, supra).

Here, petitioners have met their burden to rebut the presumption of correctness and to show that the basis for the Division's assessment is irrational. In its Explanation of Audit Adjustments, the Division states that former section 131.17 of the regulations does not apply to petitioner and, if it did apply, petitioner's methodology of apportionment was inconsistent with the requirements of that section. However, the Division explicitly states that the assessment was calculated based on former regulation section 131.18. The assessment is calculated solely on an allocation of days worked inside and outside of New York, based on information reported by petitioner's employer. The auditor merely concluded that all of petitioner's business was transacted in New York State because of his presence in New York State. As the Administrative Law Judge concluded: "[i]nasmuch as petitioner's income was based on commissions, the applicable regulation clearly provides that the allocation of income should not be based on the amount of time he spent out of state, but instead on the volume of business he transacted out of state to generate those commissions" (Determination, conclusion of law "C").

This proceeding is distinguishable from Matter of Wyman (Tax Appeals Tribunal, December 31, 1992) where the applicability of these same two sections of the Division's regulations was at issue. There, both the taxpayer and the Division incorrectly believed that former regulation section 131.18 was applicable while the Administrative Law Judge felt that former regulation section 131.17 was the correct section. The Tribunal agreed with the Administrative Law Judge on the applicability of former regulation section 131.17 but remanded the case "for resolution of the factual issues based upon the application of 20 NYCRR former 131.17." In the present situation, the parties and the Administrative Law Judge have all agreed that former regulation section 131.17 is the section applicable for determining the allocation of petitioner's income and there is ample evidence in the record as to how

petitioner allocated his income for the years at issue pursuant to former regulation section 131.17. Therefore, there is no need for remand in this case. Based on the foregoing, we reverse the determination of the Administrative Law Judge and cancel the Notice of Deficiency issued to petitioner.

As stated in the findings of fact, petitioners made a motion to conform the petition to the evidence submitted on the refunds claimed but not paid by the Division. The Administrative Law Judge did not explicitly grant or deny this motion. However, it appears from a review of the Administrative Law Judge's findings of fact that the Administrative Law Judge deemed the denial of the refunds claimed for 1987 and 1988 to be properly before her and implicitly granted petitioners' motion (see, finding of fact "27"). However, in an effort to dispel any confusion that may exist, we feel that a brief discussion of the standards applicable to the granting of such a motion is in order.

Our rules of practice and procedure provided, in part, as follows:

> "The Administrative Law Judge or presiding officer may permit pleadings to be amended before the hearing is concluded to conform them to the evidence, upon such terms as may be just including the granting of continuances. . . . No such amended pleading can revive a point of controversy which is barred by the limitations of the Tax Law, unless the original pleading gave notice of the point of controversy to be proved under the amended pleading" (20 NYCRR former 3000.4[c]).

In this case, the granting of petitioners' motion is warranted. The methodology that petitioners employed in computing their tax liability and their refund claims for 1987 and 1988 is at the heart of the controversy and prompted the issuance of the Notice of Deficiency. The Division was in no way prejudiced by this motion and did not object when petitioners' representative requested that the petition be conformed to the evidence in relation to the refund claims. Further, there being no formal notice of disallowance on petitioners' refund claims for 1987 and 1988, and there being no issue raised on the timeliness of the refund claims filed with the Division, these claims were properly before the Administrative Law Judge (see, Tax Law

§ 689[c]). Accordingly, based on the foregoing and our disposition concerning the Notice of Deficiency, petitioners are entitled to the refunds claimed on their 1987 and 1988 income tax returns.

Accordingly, it is ORDERED, ADJUDGED and DECREED that:

1. The exception of Andrew J. O'Connell, Jr. and Blanche M. O'Connell is granted as indicated above;

2. The exception of the Division of Taxation is denied;

3. The determination of the Administrative Law Judge is reversed;

4. The petition of Andrew J. O'Connell, Jr. and Blanche M. O'Connell is granted; and

5. The Notice of Deficiency, dated October 12, 1990, is cancelled and the refunds claimed for 1987 and 1988 are granted.

DATED: Troy, New York
March 6, 1997

/s/Donald C. DeWitt
Donald C. DeWitt
President

/s/Carroll R. Jenkins
Carroll R. Jenkins
Commissioner

/s/Joseph W. Pinto, Jr.
Joseph W. Pinto, Jr.
Commissioner