STATE OF NEW YORK

TAX APPEALS TRIBUNAL

In the Matter of the Petition	:	
of	:	
MARTIN AND LINDA BROPHY	:	DECISION DTA No. 812052
for Redetermination of a Deficiency or for Refund of Personal Income Tax under Article 22 of the Tax Law for the Years 1988 and 1989.	:	

Petitioners Martin and Linda Brophy, 172 Hunt Drive, Princeton, New Jersey 08540-2426, filed an exception to the determination of the Administrative Law Judge issued on November 23, 1994. Petitioners appeared by James E. Conway, Esq. The Division of Taxation appeared by Steven U. Teitelbaum, Esq. (Andrew J. Zalewski, Esq., of counsel).

Petitioners filed a brief in support of their exception. The Division of Taxation filed a brief in opposition. Petitioners filed a reply brief. Oral argument was heard on June 8, 1995, which date began the six-month period for the issuance of this decision.

Commissioner Dugan delivered the decision of the Tax Appeals Tribunal. Commissioners Koenig and DeWitt concur.

ISSUES

I. Whether the Division of Taxation, upon audit of petitioners' 1988 nonresident income tax return, properly included in New York source income an allocated portion of an $840,000.00 lump-sum payment.

II. Whether the Division of Taxation, upon audit of petitioners' 1989 nonresident income tax return, properly included in New York source income an allocated portion of a $600,000.00 lump-sum payment.

III. Whether Mr. Brophy had a three-year contract of employment with E.F. Hutton, Inc. for the years 1987, 1988 and 1989.

IV. Whether petitioners have shown that the allocation ratios used by the Division of Taxation upon audit of petitioners' 1988 and 1989 nonresident income tax returns were erroneous.

V. Whether petitioners have shown reasonable cause for abatement of penalties.

FINDINGS OF FACT

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

Martin J. Brophy and Linda Brophy, husband and wife ("petitioners"),[1] have resided in the State of New Jersey for the past 20 years. Petitioner's employment has been in the City and State of New York during all of those years.

Petitioners filed joint Federal and State income tax returns for the years 1988 and 1989 ("the subject years"), but only Martin Brophy was employed and had an income.

Martin J. Brophy ("petitioner" or "Brophy") went to work on Wall Street for the first time when he joined G.A. Saxton and Co. in 1968. G.A. Saxton & Co. merged with E.F. Hutton, Inc. ("Hutton") on January 1, 1976, and Brophy continued his employment with Hutton.

Brophy was employed as vice president in charge of Hutton's institutional risk trading. Brophy reported to Thomas B. Stiles, II ("Stiles"), executive vice president and managing director of the Equity Trading Division of Hutton. James E. Sweeney ("Sweeney") was senior vice president and was administrative assistant to Stiles. Kendrick R. Wilson, III ("Wilson") was a senior executive vice president in charge of corporate finance, a member of the board of directors of E.F. Hutton and Co., Inc. and a member of the management committee of the parent company, The E.F. Hutton Group, Inc. Wilson reported to Robert P. Rittereiser ("Rittereiser"), president and chief executive officer of Hutton.

In or about September 1986, representatives of Hutton and Shearson Lehman Brothers,

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[1]The singular, "petitioner," refers to Martin Brophy alone.

Inc. ("Shearson") held merger discussions. The discussions continued through the fall of 1986 but were terminated after Hutton's board of directors, rejecting a $50.00 per share offer, advised Shearson that it would require a proposal of $55.00 per share for it to support an acquisition of Hutton's stock. Shearson rejected Hutton's demand and the talks ended.

In the aftermath of these discussions, speculation about Hutton's merger or acquisition by another firm continued. These rumors caused employees of Hutton, including petitioner, to look elsewhere for employment. Hutton management devised a plan to stem this staff defection. This plan included aggressive efforts by Hutton management to retain certain "key employees" by promising employment with job security and generous compensation packages.

At the time of the 1986 merger discussions, Brophy was still in charge of institutional risk trading. In April 1987, during the implementation of Hutton's plan to keep its "key employees," Brophy was solicited by Nikko Securities ("Nikko") to assume a senior managerial position. In light of the continuing rumors regarding the sale of Hutton, and Brophy's concern for his job security, he decided he would accept Nikko's offer. Before formally accepting the Nikko offer, however, he approached Stiles to advise him that he would be tendering his resignation. Stiles voiced his opposition and urged Brophy to remain with Hutton.

To fend off Nikko's offer to Brophy, Stiles thereafter arranged for a meeting between Brophy and Wilson. During that meeting, Wilson told Brophy that he considered Brophy a valuable person in the trading component at Hutton and that he did not want Brophy to leave Hutton. Wilson told Brophy that it would be damaging to Hutton if Brophy left and that he would do everything in his power to keep Brophy with the firm. Wilson told Brophy that Hutton's offer would be competitive with Nikko's. Wilson also told Brophy that something could be structured whereby Brophy would take on additional responsibilities and would be protected in the event of a takeover. In this way he assured Brophy that it would be worthwhile for him to stay with Hutton. Wilson arranged a meeting among Stiles, Rittereiser, Brophy and himself to discuss Brophy's future at Hutton.

Brophy told Rittereiser that he had been with the firm for 11 years and was desirous of

job security, especially in the event of a takeover. Rittereiser advised Brophy that something could be done about that if Brophy would agree to remain with the firm. Rittereiser told Brophy that he would receive an enhanced wage package which would include 10,000 shares of Hutton stock and an option on 5,000 additional shares which would have immediate vesting privileges in the event of a buy-out or merger of the firm. Neither the stock nor the stock options are an issue in this proceeding.[2]

Stiles told Brophy that if he would agree to stay with Hutton for three years, thereby giving him job security for that period, he would be paid a minimum cash compensation of $1,000,000.00 for 1987, and $750,000.00 per year for 1988 and 1989, plus a merit bonus based on performance, in addition to the stock and stock option offered by Rittereiser.

Stiles continued to press Brophy to accept Hutton's offer, but Brophy demurred. Brophy told Stiles that he wanted to know that his position would be protected in the event Hutton was sold or taken over. Stiles assured him that he would. Thereafter, Brophy notified Nikko that he would be remaining at Hutton.

Stiles requested that Brophy see Rittereiser. Brophy did so and informed Rittereiser that on the basis of Stile's promises of job security and the salary and benefits offered, he had decided to remain with Hutton. Rittereiser was pleased. Brophy also met with Wilson and advised him that he was staying with Hutton. Brophy was promoted to executive vice president in charge of all listed trading operations.

Petitioner did not use the services of an attorney in negotiating his future employment with Hutton. The employment agreement between Brophy and Hutton was not a formal written contract. But several internal memoranda make reference to Brophy's new salary and benefits. These memoranda are in evidence as petitioners' Exhibit "7."

Exhibit "7" is comprised of the following: (a) a partial typewritten memorandum from Thomas Stiles to Jay Partin dated July 10, 1987 summarizing the newly assigned duties of

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[2]Petitioner's interest in the 10,000 shares of stock is presently being litigated in a class action suit.

Martin J. Brophy as head of all listed trading operations for Hutton; (b) a second undated, handwritten memorandum on the stationery of Robert Rittereiser, Hutton's president and chief executive officer, praising Brophy's performance in his new position; (c) a third memorandum, also handwritten, on the stationery of James Sweeney, senior vice president of Hutton, stating:

> "Brophy___
> 1987 Comp 1 million___
> Min Guarantee of $750M for 3 pay periods
> Plus stock
> 10M Shares 1/6 per year"

Exhibit "7" also includes the redacted version of a memorandum from Michael G. Reiff to Paul Cholak which is dated January 6, 1987.[3] This memo was written at the beginning of the month following Brophy's termination and states, in pertinent part:

> "Paul, we have identified . . . compensation arrangements which need to be addressed . . . .
>
> "The next two items are significant issues which have surfaced this week that effect . . . Martin Brophy . . . . In summary, verbal commitments were made to Brophy by Robert Rittereiser, Ken Wilson and Tom Stiles. The arrangements were as follows:
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> "Martin Brophy: Total compensation of $1,000,000. for 1987 and $750,000 bonus in 1988 and 1989. Again, the recommended bonus for 1987 reflects the verbal commitment. Additional stock grants of 10,000 shares, which were granted July 1987, to vest 100% on a change of control."

Finally, the last document in Exhibit "7" is from Thomas Stiles to Robert Rittereiser, also dated January 6, 1988. This memorandum states, in pertinent part:

> "As there appears to be some confusion as regards our agreements with Marty Brophy . . . I wanted to express to you my knowledge of the particulars in each case:
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> "MARTY BROPHY, Executive Vice President and Manager of all Listed Traded Activities, indicated to me in April his intention to resign to pursue another opportunity. Again, after extensive discussions between you, myself and Ken Wilson, we deemed Marty to be a critical professional and managerial resource of the firm and attempted to dissuade him from leaving. In order to induce Marty to

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[3]The date on this memo appears to be a misprint and should read January 6, 1988, since Paul Cholak was Director of Human Resources for Shearson Lehman (see, tr. pp. 38-39).

stay, we jointly developed the following package:

> "Minimum cash compensation of $1,000,000 in 1987 and $750,000 in both 1988 and 1989. We indicated the potential for performance-based increments above this level in both 1988 and 1989 . . . .
>
> "In my judgement, these discussions and agreements were conducted and entered into in good faith and represent commitments made by the senior management of the firm to retain key long-term employees."

Thus, Hutton had secured the services of Brophy and staved off his defection to Nikko. For his part, Brophy had turned down a lucrative job offer to go with Nikko in return for three years of job security, and an enhanced salary and benefits package.

From approximately April 1987 until December 31, 1987, Brophy performed his new duties. By the end of 1987 Brophy had effectively taken over responsibility of nearly all of the equity trading department, i.e., sales trading management, convertibles arbitrage, risk arbitrage and options trading.

On November 25 and 30, 1987, Hutton representatives met with American Express and Shearson representatives to discuss a possible combination. Shearson was invited to submit a written proposal to acquire Hutton. On December 1, 1987, Shearson submitted an offer for the acquisition of all of the outstanding shares of Hutton. On December 2, 1987, the Board of Directors of Hutton agreed to a merger of Hutton with Shearson.

On December 3, 1987 Shearson and Hutton announced that a definitive agreement had been signed for Shearson to acquire all outstanding shares of Hutton's common stock at $29.25 per share. The deal was consummated.

On December 9, 1987, Hutton published policies and procedures which provided for severance benefits for those employees who were to be terminated as a result of Hutton's acquisition by Shearson. Under that policy, Brophy would have been entitled to severance pay.

In a 24 to 48-hour period around December 14, 1987, between 5,500 and 6,000 people (1/3 of Hutton's work force) were terminated by Hutton (hereinafter "Shearson-Hutton"). Brophy was one of them. Brophy was notified that his termination would take effect

December 31, 1987. Under the terms of the severance policy in effect at the time of his notice of termination, Brophy was entitled to one year's base pay, based on his 1987 compensation. Subsequently, however, this severance benefits policy was amended to provide that employees having employment contracts with Hutton would not be entitled to severance pay. As a result of this amended policy, Brophy was never offered severance pay.

The record does not disclose any period when Mr. Brophy did not work in New York. The services he provided as an employee of Hutton were provided in New York. After his termination from Hutton, Mr. Brophy continued (in his new employment) to work in New York. It is reasonable to infer that had his employment with Hutton continued, his services to that company would have continued in New York.

After December 31, 1987, petitioner performed no work for Shearson-Hutton or any of its affiliates. Upon leaving Shearson-Hutton, petitioner was not subject to any restrictions on his employment or any covenant not to compete.

Mr. Brophy retained William Marshall, Esq., as his attorney to challenge his termination. Petitioner states that after several demands by Mr. Marshall, Shearson-Hutton, on February 23, 1988, paid Brophy $840,000.00, which when combined with his $160,000.00 base salary, satisfied the $1,000,000.00 minimum compensation guarantee for 1987. Shearson-Hutton refused to otherwise comply with the terms of the employment agreement with Brophy.

Brophy initiated an arbitration proceeding (sometimes "litigation") against Shearson-Hutton by Statement of Claim dated July 15, 1988 seeking, inter alia, damages of $1,500,000.00, representing guaranteed compensation for 1988 and 1989 and $1,000,000.00 in severance pay arising from his wrongful termination.

Brophy was unemployed for the first 3½ months of 1988. On or about April 11, 1988, petitioner found employment with UBS Securities, Inc. ("UBS") on Park Avenue in New York City. At UBS he had a two-year contract at $500,000.00 a year which consisted of $150,000.00 base pay (on an annual basis) with an end-of-year minimum bonus of $350,000.00. The base pay actually received from UBS in 1988 for 8½ months work was $105,952.00. The bonus was

paid in 1989.

In December 1989, Brophy's arbitration proceeding with Shearson-Hutton was settled. The terms of settlement did not include any restrictions on petitioner's future employment. The promised 10,000 shares of stock is a matter of a pending class action suit. Petitioner will receive his vested pension rights as a former employee of Hutton and Co. when he reaches age 65. Petitioner did not, as a condition of the settlement, agree to perform any future services for Shearson-Hutton. In negotiating the settlement, petitioner believed that Shearson-Hutton still owed him $1,500,000.00 as guaranteed compensation for 1988 and 1989. He had made about $850,000.00 at UBS in 1988. Subtracting that amount from the $1,500,000.00 he thought Shearson still owed him left a balance of $650,000.00.

To settle petitioner's claim, Shearson-Hutton offered $600,000.00, and petitioner accepted. Shearson-Hutton paid Brophy $600,000.00 on December 8, 1989. This amount was reduced by $40,895.00 in litigation fees and expenses, which resulted in a net $559,105.00 paid to Brophy. The release signed by petitioner in return for this payment was prepared by his attorney and states that it releases Shearson-Hutton from all claims "from the beginning of the world to the day of the date of this RELEASE arising out of or relating to the employment agreement between BROPHY and Hutton" (Ex. 8-A). The release form does not specify whether the $600,000.00 was intended to compensate petitioner for lost wages, lost bonuses, lost benefits, or whether it constituted severance pay.

In 1988, petitioner received a lump-sum payout of $1,273,850.00, plus interest of $6,146.00, which represented amounts accumulated over the years in Brophy's deferred compensation account. He also received the $840,000.00, representing the balance of his 1987 minimum compensation guarantee. These amounts total $2,119,996.00 and are referred to hereinafter as the 1988 "lump sum" payments. In addition, Brophy received 1988 wage income of $105,952.00 from UBS for his 8½ months of employment there. Altogether, these amounts total $2,225,948.00 and constitute Brophy's total wage income for 1988 (Ex. "K"; tr. pp. 46-47).

Petitioners filed an original joint 1988 New York State ("State") and New York City

("City") Nonresident and Part-Year Resident Income Tax Return ("IT-203" or "State return") dated April 12, 1989 (Ex. "F").

Petitioners' 1988 State return reported that Brophy worked 100 days in New York out of 209 total days worked.[4] Petitioners arrived at this ratio as follows:

	1988
NON-WORKING DAYS:	
Saturdays and Sundays:	104
Holidays:	12
Sick Leave:	10
Vacation:	30
Other non-working days:	0
Total non-working days:	156
Total days worked outside NY:	109
Days Worked in NY State:	100
Total days worked in year:	209

1988 Ratio		Federal Wages Reported		Allocated to NYS Source Income
100/209	x	$2,225,948.00	=	$1,065,047.00

Total wage income of $2,225,948.00 was allocated to New York income, resulting in total New York wage income of $1,065,047.00. This original 1988 State return reported total taxable income of $ 2,252,320.00, base tax of $189,070.00, and a New York income percentage of 46.13%, which resulted in tax allocated to New York State of $87,220.00. Total income tax reported due the City was $4,793.00. Petitioners' combined State and City income tax reported and paid based on this original 1988 return was $92,013.00. At hearing, petitioners offered no evidence in support of the allocation ratio used on their 1988 return.

Petitioner's wage and salary income for 1989 consisted of the annual base salary of $150,000.00, from UBS, plus $255,000.00 which represented a part-year bonus from 1988, plus miscellaneous income of $920.00. The above wage and salary income totals $405,920.00, which was reported on petitioners' 1989 Federal income tax returns (Ex. "1," line 7). In

[4]This same ratio is used on the 1988 amended return, infra.

addition, Brophy received the $600,000.00 less legal expenses of $40,895.00, leaving a net settlement amount of $559,105.00 from Shearson-Hutton. Petitioner's reported total adjusted gross income from all sources on his 1989 Federal income tax returns was $1,407,620.00 (Ex. "1," line 31). The corresponding amounts are also reported on petitioners' 1989 State return (Ex. "H," lines 1, 19 and Schedule 1).

Petitioners also filed a joint State return for 1989 dated April 8, 1990 (Ex. "H").

Petitioners' original State return for 1989 reported total wages and salaries of $405,920.00 which were allocated to New York income as follows:[5]

	1989
NON-WORKING DAYS:	
Saturdays and Sundays:	104
Holidays:	8
Sick Leave:	10
Vacation:	10
Other non-working days:	0
Total non-working days:	132
Total days worked outside NY:	25
Days Worked in NY State:	208
Total days worked in year:	233

1989 Ratio	Total Wage Income		Wage Income Allocated to NY
208/233 x	$405,920.00	=	$362,366.00

This original 1989 State return also reported "other income" of $559,105.00 as New York income (Ex. "H", Line 16). This represents the $600,000.00 settlement received from Shearson-Hutton, less legal expenses of $40,895.00. Total wage income plus "other income" allocated to New York on the original 1989 State return was $921,471.00 (Ex. "H", Lines 1, 16 and 19).

This original 1989 State return reported total New York taxable income of $1,315,236.00.00, base tax of $102,857.00 and a New York income percentage of 65.46%.

[5]This same ratio was used on the amended 1989 return, discussed infra.

Applying this income percentage to base tax of $102,857.00 resulted in tax allocated to New York State of $67,330.00. Total 1989 income tax reported due the City was $1,631.00. Petitioners' combined State and City income tax liability reported and paid based on this original 1989 return was $68,961.00. Total State income tax paid by petitioners for 1989 was $70,066.00, so on this original return they claimed a refund of $1,105.00. This amount was refunded to petitioners. At hearing, petitioners offered no evidence in support of the allocation ratio used on their 1989 return.

The Division of Taxation ("Division") conducted an audit of petitioners' original 1988 and 1989 returns which concluded on September 13, 1991.

The Division's audit revised the allocation of Brophy's income found on the original 1988 return. Specifically, the lump-sum income[6] received from Hutton in 1988 was allocated by using an average ratio of days worked in New York during the years 1985 through 1987 as reported on petitioners' returns. Petitioners' returns for those three years had used the following allocation ratios of days worked in New York to total days worked:

1985	1986	1987
172/219	176/219	178/219

The average ratio for these three years was determined on audit to be 175/219. The Division then applied this average ratio to petitioners' 1988 lump-sum income (see, above) received from Shearson-Hutton as follows:

Average Ratio		Hutton Lump-Sum Income		Income Allocated to NY
175/219	x	$2,119,996.44[7]	=	$1,694,061.08

With respect to the 1988 wage income from UBS, the Division modified petitioner's allocation ratio, by taking into account the 3½-month period at the beginning of 1988 when

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[6]This lump-sum income includes not only the $840,000.00 paid to Brophy but also amounts representing deferred income, plus interest, that had accumulated over the years and was paid to him in 1988.

[7] Reported on Schedule 1 of U.S. Individual Income Tax Return for 1988 (Form 1040).

petitioner was unemployed. This had the effect of reducing petitioner's "total days worked."

Based on a 365-day year, the following shows petitioners' and the Division's respective figures for 1988:

	Petitioner	Division
NON-WORKING DAYS:		
Saturdays and Sundays:	104	104
Holidays:	12	12
Sick Leave:	10	10
Vacation:	30	30
Other non-working days:	0	84
Total non-working days:	156	240
WORKING DAYS:		
Total days worked outside NY:	109	16
Days Worked in NY State:	100	109
Total days worked in year:	209	125

The Division arrived at an allocation ratio of 109/125 to allocate petitioner's 1988 UBS wage income as follows:

Division's Ratio		UBS Wages Reported		Allocated to NYS Income
109/125	x	$105,952.00[8]	=	$ 92,390.14

Based on total wage income for 1988 of $2,225,948.44, the Division allocation of lump-sum wage income and UBS wage income to New York totalled $1,786,451.22, which was an audited increase in petitioners' New York income of $721,404.22. This increase resulted in an audited New York State income percentage increase to 77.38%,[9] and recomputed State and City tax liabilities of $146,302.28 and $8,039.03, respectively. As a result of the audit of the 1988 return, petitioners owed additional State income tax of $59,082.29 and additional City income

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[8] Reported on Schedule 1 of U.S. Individual Income Tax Return for 1988 as UBS wages.

[9] Increased from 46.13% on the 1988 return.

tax of $3,246.03, for a combined State and City increase in 1988 tax of $62,328.32.

In auditing petitioners' 1989 return, the Division allocated petitioners' 1989 wage income as follows, assuming a 365-day year:

	1989
Wage Income:	$405,920.00
NON-WORKING DAYS:	
Saturdays and Sundays:	104
Holidays:	8
Sick Leave:	10
Vacation:	10
Other non-working days:	0
Total non-working days:	132
WORKING DAYS:	
Total days worked outside NY:	21
Days Worked in NY State:	212
Total days worked in year:	233

It will be recalled that petitioners' original 1989 return[10] used an allocation ratio of 208/233.

Based on its modified ratio, the Division arrived at allocated 1989 New York wage income as follows:

Division's 1989 Ratio		Federal Wages Reported		Allocated to NYS Income
212/233	x	$405,920.00	=	$369,334.94

Petitioners' original 1989 State return had a computed New York State income percentage of 65.46%. Petitioners' original 1989 return[11] allocated $362,366.00 to New York income. The Division's figure of $369,334.94[12] represents an audited increase in New York 1989 income of $6,968.94. This resulted in an audited increase in New York adjusted gross income from

[10]Petitioners' amended return for 1989, as will be seen, used the same ratio.

[11]And also their 1989 amended return.

[12]The Division's computation has a typographical error, i.e., $232,366.00 instead of $362,366.00. Nevertheless, the computation of the audited difference is correct, i.e., $6,968.94.

$921,471.00 to $ $928,439.93. There was no change upon audit in petitioners' reported New York taxable income of $1,315,236.50, which had a reported New York base tax of $102,857.37. Petitioners' New York income percentage upon audit was increased to 65.96%, which, when applied to base tax of $102,857.37, resulted in recomputed 1989 State and City income tax liabilities of $67,844.72 and $1,662.00, respectively. This audited tax liability represented an increase of $514.72 in State income tax and an increase of $31.00 in City income tax.

On September 13, 1991, the Division issued petitioners a Statement of Personal Income Tax Audit Changes. This statement asserted additional tax due for the year 1988 in the amount of $62,328.32, consisting of State tax in the amount of $59,082.29 and City tax in the amount of $3,246.03. This statement also asserted additional tax due for the year 1989 in the amount of $545.72, consisting of State tax in the amount of $514.72 and City tax in the amount of $31.00. The statement of audit changes advised petitioners of the Division's position that they had erred in allocating their lump sum payments as set forth above, and if they did not respond (agreeing or disagreeing) to the audit changes by September 23, 1991, a statutory Notice of Deficiency asserting the additional tax, penalty and interest would be issued. The evidence does not show that petitioners made any response to this notice.

On March 19, 1992, a Notice of Deficiency was issued to petitioners on the same basis as set forth in the Statement of Personal Income Tax Audit Changes, asserting additional State and City income tax due for 1988 and 1989 in the amount of $62,874.04, plus penalty and interest.

Amended Returns for 1988 and 1989

On April 15, 1992, after the Division's Statement of Personal Income Tax Audit Changes and Notice of Deficiency had been issued, petitioners filed amended State returns for 1988 and 1989 (Ex. "G" and "I"). These amended returns do not refer to or otherwise acknowledge that the original returns had been audited or that a Notice of Deficiency asserting additional State and City income tax had been issued.

The amended 1988 return did not include the $840,000.00 Brophy had received from Shearson-Hutton to satisfy his 1987 minimum salary guarantee, as New York source income. By deducting $840,000.00 from total Federal wage income of $2,225,948.00, that left a balance of $1,385,948.00. This amount in wage income was allocated on the amended return as follows:

Ratio		Total Wage Income		Wage Income Allocated to NY
100/209	x	$1,385,948.00	=	$663,133.00

This amended return included a statement that the amendment to the return was for the purpose of deleting "monies received as damages in settlement of employment contract which was tortiously and erroneously terminated by former employer" (Ex. "G").

Total wage income of $2,225,948.00 was allocated to New York income, resulting in total amended New York wage income of $663,133.00. This amended 1988 State return reported the same[13] total New York taxable income of $ 2,252,320.00 (Ex. "G", line 51), and the same base tax[14] of $189,070.00. However, the New York income percentage was changed to 28.72%,[15] which resulted in tax allocated to New York State of $54,301.00. Total amended income tax reported due the City was $2,984.00. Petitioners' combined State and City income tax liability for 1988 based on this amended return was $57,285.00. Since petitioners had paid tax of $92,013.00 with their original return, they claimed a refund of $34,728.00 on their 1988 amended State return.

The 1989 amended return did not include in "other [N.Y.] income" the $600,000.00 ($559,105.00 after legal expenses) received from Shearson-Hutton pursuant to the 1989 settlement. By not including this "other income" of $559,105.00 (Ex. "I", line 16), total reported Federal wage income of $405,920.00 (id., at line 1) was left to be apportioned. The

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[13]The same amount as appeared on the original 1988 return.

[14]The same base tax as appeared on the original 1988 return.

[15]The New York income percentage on the original 1988 return was 46.13%.

wages and salaries apportioned to New York income is the same as on the original return, i.e., $362,366.00 (id., at lines 1, 17, 19 and Schedule 1). However, amended New York adjusted gross income was reduced from $921,471.00 to $362,366.00 (id., at line 19).

This amended 1989 State return reported the same total New York taxable income of $ 1,315,236.00 (Ex. "I", line 51), and the same base tax of $102,857.00. However, the New York income percentage was changed on this 1989 amended return from 65.46% to 25.74%, which resulted in an amended 1989 tax allocated to New York State of $26,475.00. Total amended income tax liability reported due the City was $1,631.00. Petitioners' combined State and City income tax liability for 1989 based on this amended return was $28,106.00.

Petitioners' original 1989 return showed State and City tax due of $68,961.00. Petitioners had paid 1989 State and City tax of $70,066.00 and were refunded $1,105.00 based on the original return. Upon filing the amended 1989 return, petitioners argue that the $68,961.00 tax paid (after deducting the refund) represents an overpayment in tax for 1989 of $40,855.00. Petitioners' 1989 amended return claimed a refund of $40,855.00.

The amended 1989 return also includes the statement that the amendment to the return was for the purpose of deleting "monies received as damages in settlement of employment contract which was tortiously and erroneously terminated by former employer."

There is nothing in the record to indicate whether the amended returns for 1988 and 1989 were processed by the Division or that the refunds claimed for those years were denied.

One month after petitioners filed their amended returns, they filed a request for conciliation conference with the Division's Bureau of Conciliation and Mediation Services challenging the Notice of Deficiency, supra, and claiming a refund. On June 25, 1993, a Conciliation Order (CMS# 122822) was issued to petitioners denying the request and sustaining the Notice of Deficiency (which implicitly denied the refund).

Petitioners filed a timely petition with the Division of Tax Appeals again challenging the Notice of Deficiency, and the instant proceeding ensued.

The petition in this matter challenges the Notice of Deficiency, supra, but refers to the

refunds claimed on the amended returns. Neither the request for conciliation conference nor this petition claim the refund was ever denied. There is nothing in this record to apprise the trier of fact as to what happened, if anything, once these amended returns were filed. Accordingly, the substance of petitioners' amended returns for 1988 and 1989 have been included in the Findings of Fact solely for the purpose of setting forth a complete record. This case will be considered in terms presented by petitioners, i.e., as a challenge to the Notice of Deficiency.

OPINION

We deal first with the issue of whether petitioner had a three-year employment contract with Hutton.

The Administrative Law Judge determined that petitioner did not have an employment contract with Hutton and that the payments received from Hutton, i.e., the $840,000.00 in February 1988 and the $600,000.00 in 1989, were income from New York sources as defined in Tax Law § 631(a) and (b) and the Division's regulations.[16]

The Administrative Law Judge found that "[t]he substance of Brophy's agreement with Hutton is contained in Exhibit '7.' The evidence establishes that there was part performance of the agreement by both Hutton and Brophy" (Determination, conclusion of law "C").

The Administrative Law Judge then determined that the writings in Exhibit "7" do not satisfy the statute of frauds (General Obligations Law § 5-701[a][1]) because:

> "none of the writings offered by petitioner specify that his employment contract with Hutton would be for a three-year period or any other definite time period. Since [petitioner] has not proved an enforceable employment contract of definite duration, his was an employment at will . . . . 'which [could] be freely terminated by either party at any time for any reason or even for no reason' [cites omitted]" (Determination, conclusion of law "E").

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[16]Tax Law § 601(e) imposes a tax on the New York source income of a nonresident individual. New York source income of a nonresident individual is defined as "the sum of the net amount of items of income, gain, loss and deduction entering into his federal adjusted gross income, as defined in the laws of the United States for the taxable year, derived from or connected with New York sources" (Tax Law § 631[a]). Income from New York sources are those items attributable to a business trade profession or occupation carried on in New York State (Tax Law § 631[b]).

On exception, petitioner, relying on the rationale of the Court of Appeals in Crabtree v. Elizabeth Arden Sales Corp. (305 NY 48), asserts that the five memoranda comprising petitioner's Exhibit "7," satisfy the Statute of Frauds. Petitioner asserts that the writings are unambiguous, consistent, state all the material terms including specific duration, and in light of petitioner's uncontradicted testimony, clearly confirm that the parties altered their position based on the agreement (Petitioner's brief, p. 46).

On exception, the Division asserts that the Administrative Law Judge was correct and that petitioner has failed to prove that he had a valid and enforceable employment contract right with Hutton which provided him with the right to employment in 1988 and 1989. The Division's contention is that the evidence submitted by petitioner failed to satisfy the Statute of Frauds because the evidence does not prove an agreement for a specific duration.

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

We agree with petitioner that the documents in Exhibit "7" satisfy the Statute of Frauds (General Obligations Law, § 5-701[a][1]) and prove clearly that petitioner and Hutton entered into a valid and enforceable employment contract for a specific period of time. The core question is the meaning of the reference to the years 1987, 1988 and 1989. What purpose would the specific reference to these three years have except to denote the specific duration of the contract. Clearly, both parties were seeking more than an employment at will. Hutton's "plan" was to "keep its 'key employees,'" one of whom was petitioner. For his part, petitioner, in light of the continuing rumors regarding the sale of Hutton, and his "concern for job security," had decided he would accept the offer from Nikko (Determination, finding of fact "7"). In the course of the ensuing negotiations, petitioner expressed his continued concern for job security. Hutton told petitioner "that if he would agree to stay with Hutton for three years, thereby giving him job security for that period, he would be paid a minimum cash compensation of $1,000,000.00 for 1987, and $750,000.00 per year for 1988 and 1989, plus a merit bonus based on performance" (Determination, finding of fact "10"). We agree with the Administrative

Law Judge that as a result of the negotiations, there was an agreement whereby "Hutton had secured the services of Brophy and staved off his defection to Nikko. For his part, Brophy turned down a lucrative job offer to go with Nikko in return for three years of job security, and an enhanced salary and benefits package" (Determination, finding of fact "14," emphasis added). The "security" for each party is provided by the three-year reference to the years 1987, 1988 and 1989 in the memoranda.

We deal next with the issue of whether the $840,000.00 paid to petitioner in 1988 constituted damages arising from petitioner's arbitration proceeding initiated against Hutton.

The Administrative Law Judge rejected petitioner's assertion that the payment was the result of litigation since the payment was received in February 1988, within the normal time for payment of 1987 bonuses by Hutton; petitioner did not initiate the arbitration proceeding until July 1988, several months after payment of the $840,000.00; and the demand made by petitioner's attorney does not amount to litigation. The Administrative Law Judge concluded that the $840,000.00 was the balance of petitioner's guaranteed minimum $1,000,000.00 salary from Hutton, which he earned through his personal service to Hutton in 1987. The fact that Hutton or petitioner characterized this lump sum payment as a special payout does not change the fact that the payment was compensation for petitioner's past personal services to Hutton in New York. Accordingly, the Division properly included this amount as part of petitioners New York source income (Determination, conclusion of law "F").

On exception, petitioner asserts that the $840,000.00 received by him from Shearson in 1988 was payment of damages by Shearson for erroneously terminating his employment contract, representing lump-sum payments made in exchange for the relinquishment of his right to future employment, which future right had no connection to New York sources.

Petitioner asserts that had he remained in the employ of Shearson-Hutton, there is no doubt but that the $840,000.00 paid to him in 1988, although delayed, would have been part of his regular compensation, subject to allocation as New York income. Petitioner asserts, however, that the unilateral breach of the contract by Hutton in 1987, his firing, the subsequent

legal dispute, the demand for payment made by petitioner's attorney, the institution of the arbitration proceeding, all result in the characterization of this payment as a settlement of a breach of contract action for which no present consideration, i.e., 1988, was given to Shearson-Hutton, and since petitioner was unemployed at the time of receipt of the $840,000.00, it should not be treated as taxable income from New York sources (Petitioner's brief, p. 55).

The Division asserts that the determination of the Administrative Law Judge was correct. Specifically, that the $840,000.00 received by Brophy in 1988 was for personal services that he performed in New York State in 1987 for Hutton.

We agree with the Administrative Law Judge for the reasons stated in his determination that the $840,000.00 payment to petitioner was for services rendered to Hutton in New York State for the year 1987 and did not constitute damages for breach of contract as asserted by petitioner.

We next address the issue of the $600,000.00 payment to petitioner in 1989.

The Administrative Law Judge opined that:

> "[t]his case does not involve a lump-sum payment to a taxpayer in return for his relinquishing his contract rights to perform future services in another state. Rather, the question that must be answered is whether the $600,000.00 paid to Brophy in 1989 was 'derived from or connected with' his New York employment (Tax Law § 631[a], [b][1][B]; Matter of Gleason v. State Tax Commn., 76 AD2d 1035, 429 NYS2d 314). The Tax Appeals Tribunal stated in Laurino (Tax Appeals Tribunal, May 20, 1993) that '"in determining whether income is derived from or connected with New York sources," it is necessary to identify the activity upon which the income was secured or earned'" (Determination, conclusion of law "H").

The Administrative Law Judge concluded that:

> "Mr. Brophy's employment with Hutton, his salary, and his stock benefits were negotiated in New York. Mr. Brophy's negotiations with Hutton ripened into an agreement in New York. Mr. Brophy provided his services to Hutton at its New York offices. Brophy's employment was terminated at Hutton's New York offices, and the arbitration proceeding was initiated against Shearson-Hutton in New York. The basis of petitioner's litigation was Mr. Brophy's New York employment by Hutton. When petitioner signed the release settling the New York litigation against Shearson-Hutton, he gave up all claims (unspecified in the release) against Shearson-Hutton "from the beginning of the world to the day of the date of this RELEASE arising out of or relating to the employment" agreement with Hutton

> (Ex. "8-A").[17] Whatever this payment represented, it clearly arose out of Mr. Brophy's New York employment with Hutton. Accordingly, petitioners having offered nothing in the way of clear and convincing evidence to the contrary, the $600,000.00 paid to petitioner to settle this litigation represented amounts received in connection with his New York employment (20 NYCRR former 131.4(d); Matter of Norris v. State Tax Commn., 140 AD2d 876, 528 NYS2d 694 [3d Dept 1988]), and constitutes New York source income subject to personal income tax (Tax Law § 631[a], [b][1][B]). Petitioners' arguments to the contrary, while commendably presented, are without merit" (Determination, conclusion of law "I").

Petitioner asserts that the $600,000.00 was paid as damages in settlement of the arbitration proceeding and was not income derived from an occupation carried on in New York since Mr. Brophy performed no services for Hutton or Shearson after December 31, 1987.

We reverse the determination of the Administrative Law Judge on this issue. In determining whether income is derived from or connected with New York sources, it is necessary to identify the activity upon which the income was secured or earned (Matter of Laurino, supra, citing Matter of Halloran, Tax Appeals Tribunal, August 2, 1990). It is incumbent upon petitioner to establish that the payment was not secured or earned pursuant to activities connected with or derived from New York sources (Matter of Laurino, supra). In making this determination, the controlling factor is the consideration given by petitioner in exchange for the right to the income at issue (Matter of Laurino, supra). Where the consideration has no connection with New York, the income will not be subject to tax by the State (Matter of Donahue v. Chu, 104 AD2d 523, 479 NYS2d 889). Where a taxpayer relinquishes his right to future employment and such right has no connection to New York, the income paid for the relinquishment will not be taxable in New York (see, Matter of Donahue v. Chu, supra; Matter of McSpadden, Tax Appeals Tribunal, September 15, 1994). The facts in this case are that petitioner's agreement with Hutton provided petitioner with employment for the three-year period 1987, 1988 and 1989. Petitioner and his employer agreed upon the $600,000.00 as a settlement to the arbitration agreement instituted by petitioner for damages for

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[17] And, as further consideration, Brophy gave up his right to pursue further New York litigation to pursue those employment rights.

breach of the employment agreement by Hutton. The release signed by petitioner in return for this payment was prepared by his attorney and states that it releases Shearson-Hutton from all claims from the beginning of the world to the day of the date of this RELEASE arising out of or relating to the employment agreement between Brophy and Hutton (Ex. "8-A," emphasis added).

Petitioner's rights under the agreement were originally secured by consideration having no connection to New York, i.e., petitioner's promise to work for Hutton in the future (Matter of Donohue v. Chu, supra; Matter of Laurino, supra; Matter of McSpadden, supra). The fact that the employment agreement was negotiated in New York, that petitioner worked in New York during the period of his employment or that the arbitration was initiated in New York do not alter the fact that the promise to work for Hutton in the future was not connected with New York.

We deal next with the issue of whether the allocation ratios used by the Division upon audit of petitioners' 1988 and 1989 nonresident income tax returns were erroneous.

The Division modified petitioner's allocation for 1988 wage income from UBS by taking into account the 3½-month period at the beginning of 1988 when petitioner was unemployed. This had the effect of increasing petitioner's total nonworking days from 156 to 240 and reducing the working days from 209 to 125. In short, the Division modified petitioner's ratio of 100/209 to 109/125.

With respect to petitioner's 1989 wage income, the Division modified the ratio from the 208/233 used by petitioner to 212/233.

The Administrative Law Judge determined that petitioners "offered no evidence at hearing to show that the allocation ratios used by the Division upon audit were erroneous" (Determination, conclusion of law "J").

On exception, petitioner asserts that he offered sufficient evidence at the hearing on the allocation issue. Petitioner also asserts that the Division, other than making the mathematical

changes in the allocation ratios, has "offered no testimony or evidence controverting the allocation used by the Petitioner. The Statement of Audit Changes does make numerical changes, but there is no explanation, no identification, and no authority for [the Division's] position, whatever it might be" (Petitioners' brief, p. 70).

We affirm the determination of the Administrative Law Judge with respect to the Division's change in the allocation ratio for the year 1988. The change merely reflects the uncontroverted fact that petitioner was not employed for the first 3½ months of 1988, i.e., from January 1, 1988 until April 11, 1988, when he joined UBS.

We also affirm the determination of the Administrative Law Judge concerning the changes for 1989. Petitioner has offered no evidence to rebut the presumption of correctness which attaches to the assessment issued by the Division (see, Matter of Atlantic & Hudson Ltd. Partnership, Tax Appeals Tribunal, January 30, 1992).

We deal finally with the issue of penalty. In our view, the facts of this case show that petitioner acted in good faith in seeking to ascertain his New York tax liability and has demonstrated reasonable cause within the meaning of the Division's regulations (20 NYCRR 107.7[g][2]). Specifically, penalty was imposed in connection with petitioner's "original" 1988 and 1989 returns on the basis of petitioner's error in arriving at his New York wage income percentage. Penalty was not imposed with regard to petitioner's treatment of the $840,000.00 and $600,000.00 payments which have been the focus of this decision. In fact, petitioner's "original" returns included the $840,000.00 and $600,000.00 as New York source income. Petitioner's basis for the 1988 allocation percentage was based on the fact that his W-2 represented 70% of the total wage income he was to receive from UBS for that year. His error was in computing this percentage against a full, 365-day year rather than allowing for the three and one-half months in 1988 for which he was unemployed. Petitioner's faux pas was computational in nature. Under the totality of the circumstances, we conclude that petitioner acted in good faith in seeking to ascertain his proper tax liability for the years at issue.

Accordingly, it is ORDERED, ADJUDGED and DECREED that:

1. The exception of Martin and Linda Brophy is granted with respect to the abatement of penalties and to the extent that the $600,000.00 payment received by petitioners in 1989 is not New York source income, but is in all other respects denied;

2. The determination of the Administrative Law Judge is modified in accordance with paragraph "1" above, but is in all other respects affirmed;

3. The petition of Martin and Linda Brophy is granted in accordance with paragraph "1" above, but is in all other respects denied; and

4. The Division of Taxation is directed to adjust the Notice of Deficiency, dated March 19, 1992, in accordance with paragraph "1" above, but such Notice is otherwise sustained.

DATED: Troy, New York
December 7, 1995

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

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

/s/Donald C. DeWitt
Donald C. DeWitt
Commissioner