STATE OF NEW YORK

TAX APPEALS TRIBUNAL

In the Matter of the Petition	:	
of	:	
MAXIMILIAN AND MIRIAM SCHEIN	:	DECISION DTA NO. 818771
for Redetermination of a Deficiency or for Refund of New York State Personal Income Tax under Article 22 of the Tax Law for the Year 1997.	:	

The Division of Taxation filed an exception to the determination of the Administrative Law Judge issued on March 27, 2003 with respect to the petition of Maximilian and Miriam Schein, 525 Highview Avenue, Pearl River, New York 10965-1230. Petitioners appeared *pro se*. The Division of Taxation appeared by Mark F. Volk, Esq. (Barbara J. Russo, Esq., of counsel).

The Division of Taxation filed a brief in support of its exception, petitioners filed a brief in opposition and the Division of Taxation filed a reply brief. The Division of Taxation's request for oral argument was denied.

After reviewing the entire record in this matter, the Tax Appeals Tribunal renders the following decision.

ISSUE

Whether otherwise taxable retirement allowance payments made to petitioner,[1] Maximilian Schein, in1997 and reported on Schedule K-1, are entitled to the $20,000.00 reduction modification from Federal adjusted gross income provided for by Tax Law § 612(c)(3-a).

FINDINGS OF FACT

We find the facts as determined by the Administrative Law Judge except for findings of fact "1," "2," "4," "5" and "9" which have been modified. We have also made an additional finding of fact. The Administrative Law Judge's findings of fact, the modified findings of fact and the additional finding of fact are set forth below.

We modify finding of fact "1" of the Administrative Law Judge's determination to read as follows:

> Petitioner Maximilian Schein worked as an accountant for KMG Main Hurdman ("MH") from 1959 until 1984, starting as an employee and later becoming a partner in the firm (Tr., pp. 12-23, 31). He retired in 1984 when he reached mandatory retirement age of 63. During the years 1985 and 1986, the amounts paid to petitioner were reported by MH on Form 1099-R, and petitioner availed himself of the $20,000.00 pension and annuity exclusion, also referred to as a subtraction modification, on his State income tax return. In 1987, MH merged with Peat Marwick who assumed the obligation to pay petitioner's retirement benefit payments without any changes (except cost of living adjustments which became effective for later years, commencing April 1, 1997). Petitioner received his retirement benefit payments during his retirement from MH, and later Peat Marwick (hereinafter the merged company is referred to as "KPMG"), pursuant to the Partnership Agreement of Main Hurdman and the Revised Retirement, Disability and Death Benefit Plan for Partners of Main Hurdman ("the Plan") (Tr., pp. 17-20, Exhibit "J" and Exhibit "K"). Unlike MH, KPMG reported petitioner's retirement benefit payments on Schedule K-1 for the year 1987 and every year thereafter. During each of those years, petitioner

[1]Although the notice in question was issued to both petitioners, the matter at hand concerns Mr. Schein alone and, thus, any reference to petitioner will refer only to Mr. Schein.

continued to avail himself of the $20,000.00 pension exclusion. At no time prior to 1997, the tax year in question, did the Division of Taxation ("Division") question the propriety of petitioner's taking the pension exclusion.[2]

We modify finding of fact "2" of the Administrative Law Judge's determination to read as follows:

> Petitioner was erroneously issued a Form 1099-R for 1997 reflecting the retirement benefit payments made to him that year (Exhibit "L"). Subsequently, he received a letter from the Bank of New York stating, in relevant part:
>
> > You recently received from The Bank of New York, tax form 1099-R, for a corresponding payment issued by the Bank to you during 1997. **You should not have received this tax form.** Your correct information, on tax form, schedule K-1, will be sent to you in early March, 1998 directly from KPMG Peat Marwick LLP. Tax form 1099-R from The Bank of New York should be disregarded.
>
> Subsequently, petitioner received the Schedule K-1 of Form 1065 for 1997 indicating him to be a "former general partner now retired." The K-1 reported, as petitioner's taxable distributive share of partnership income,[3] payments of $28,579.00 reported on Line 5 as "guaranteed payments to partner." Retirement allowance payments to petitioner (and other retired partners) are paid as an operating expense of KPMG, paid out of the partnership's annual gross income and deducted by the partnership in arriving at net partnership income (Exhibit "J" and Exhibit "K"; Tr., pp. 47-49).
>
> Petitioner was provided a "1997 Guide to Partner Tax Schedules and Information for Retired Partners"[4] from KPMG which explained the Federal Schedule K-1 received by petitioner. It stated in relevant part:
>
> > The amount on line 5 includes retirement allowance plan (RAP) payments made by the firm from the Bank of New York, any applicable installment payments of your interest in unrealized receivables and ACRS amounts, and any interest on your partner

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[2]We modified finding of fact "1" to more accurately reflect the record.

[3]See as part of Exhibit "4," "1997 Partnership Taxable Income Reconciliation" attached to petitioner's 1997 Resident Income Tax Return.

[4]Exhibit "I", section 6.

> account. The line 5 amount should be reported on Form 1040, Schedule E, Part II, Column k - Nonpassive income from Schedule K-1.
>
> You will note that there is no net earnings from self-employment reported on line 15a. The total amount paid to you by the firm, including RAP payments, any applicable portion of your unrealized receivables and any interest on your partner account is reported on line 5 [of Schedule K-1] . . . (Exhibit "I," section 6).

Under the heading "Partnership Taxable Income Reconciliation" this Partners' Guide states, in relevant part that:

> The Partnership Taxable Income Reconciliation provides a detailed breakdown of the individual components of your 1997 retirement payments from the firm that are included on your 1997 Schedule K-1. These items may include your Retirement Allowance Plan (RAP) payment, distribution of deferred IUR/ACRS account balances, and "interest" on such account balances.
>
> *This schedule does not show any payments to you from the qualified retirement plans* . . . (Exhibit "I," section 6, emphasis added).

Payments from a qualified retirement plan are reported on a Form 1099-R. While petitioner believes that the partnership paid into a qualified pension plan for its employees, it did not do so for partners (Tr., p. 48). A schedule provided to petitioner entitled "KPMG Peat Marwick LLP, 1997 Partnership Taxable Income Reconciliation," states that "The partnership return for the year ended December 31, 1997, will reflect the following amounts as your distributive share of [partnership] income, deductions and other items." The payments of $28,579.00 set forth on this form are characterized by KPMG variously as "retirement payments" and "pension payments" (***see***, Exhibit "4," 1997 Schedule K-1).[5]

A December 1997 Bank of New York notification of direct deposit statement indicates that petitioner was receiving benefit payments from the account of "Peat, Marwick Main Suppl Ret

[5]We have modified finding of fact "2" to more completely reflect the record.

Al," plan number E27027. The current gross payment amount for December 1997 was $2,391.91, and the year to date gross amount was $28,579.65.

We modify finding of fact "4" of the Administrative Law Judge's determination to read as follows:

> Article II of the MH partnership agreement addresses the general requirements and duties of partners and issues related thereto.[6]

We modify finding of fact "5" of the Administrative Law Judge's determination to read as follows:

> Article IV set forth the Firm's management functions.[7]

The MH partnership agreement prohibited a transfer of the partner's partnership interest.

Article VII of the MH partnership agreement provides for the payment of retirement benefits, in addition to other benefits, as stipulated in the Partner's Benefit Manual. The Benefit Manual stipulates the age for mandatory retirement and provides the procedures for determining the amount of the basic retirement benefit and the periodic monthly payment.

The Partner's Benefit Manual indicates that:

> Retired, disabled and deceased partners or their estates shall not be liable for any net operating loss incurred by the firm.
>
> For the purpose of computing allocable net profits for any period, the benefit paid to any such persons will be considered a part of the operating costs.

Article VI of the MH partnership agreement defines "firm net income" as "net income determined by the cash receipts and disbursements method of accounting after deducting all pension or retirement payments to former partners or their estates."

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[6]We modified finding of fact "4" to more concisely reflect the record.

[7]We modified finding of fact "5" to more concisely reflect the record.

We find the following additional finding of fact.

> The Partnership Agreement and Revised Retirement, Disability and Death Benefit Plan for Partners provide that any partner who is terminated is not entitled to any retirement allowance plan payments (***see***, Exhibit "J" and Exhibit "K"). Retirement allowance payments to partners pursuant to the Plan are subject to being reduced if the benefits of all retired partners in the aggregate exceed 15% of the consolidated net income of the partnership (***see***, Exhibit "K").

We modify finding of fact "9" of the Administrative Law Judge's determination to read as follows:

> Petitioner filed a 1997 Form IT-201, New York State Resident Income Tax Return, and in doing so, reported a taxable IRA distribution on Line 9 of the return in the amount of $9,670.00, a taxable amount on Line 11 of the return under Rental Real Estate, royalties, partnerships, S corporations, trusts, etc., in the amount of $28,579.00, and $20,000.00 on Line 27, as the pension and annuity income exclusion. No entry appeared on Line 10 for taxable pensions and annuities. Petitioner claimed a New York Resident Tax Credit for portions of the income received from the partnership, for amounts taxable in other taxing jurisdictions. Included with petitioner's 1997 return is a statement from KPMG certifying:
>
> > (1) That each of the amounts of partnership income set forth in the attached schedule represents the above-named partner's share of partnership income derived from the state indicated; (2) that each of such amounts of income was (to the extent shown on the schedule) subject to income taxes imposed on the above-named partner by such state; and (3) that said amounts of partnership income were also includable in the New York taxable income of the above-named Partner and subject to the tax imposed by Chapter 60, Article 22 of the New York State Tax Law–Personal Income Tax.
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> Petitioner also filed, with his 1997 return, a Schedule of Income Allocation and Non-Resident Taxes from KPMG, reporting the partnership income allocated to other states.
>
> Petitioner had been reporting taxable IRA distributions from 1992 through 1997.[8]

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[8]We modified finding of fact "9" to more completely reflect the record.

The Division issued a Statement of Proposed Audit Changes to petitioners dated July 24, 2000, limiting the 1997 pension and income annuity exclusion to the $9,670.00 amount reported in the income section of petitioners' tax return, thereby disallowing the pension and annuity exclusion in the amount of $10,330.00.

The Division issued a Notice of Deficiency dated September 18, 2000, to petitioners, Maximilian and Miriam Schein, under Notice Number L-018296600-6. The deficiency assessed tax due in the amount of $709.00, plus interest of $133.16, for a total of $842.16.

THE DETERMINATION OF THE ADMINISTRATIVE LAW JUDGE

First addressing the applicable law, the Administrative Law Judge noted that Tax Law § 612(a) provides that the adjusted gross income of a resident individual is his federal adjusted gross income ("federal AGI") with certain modifications provided for in subsections (b) and (c) of Tax Law § 612. Subsection (c) provides for certain subtraction modifications which reduce federal AGI, and specifically, the modification in issue herein. Tax Law § 612(c)(3-a) provides, in relevant part, for a subtraction from federal AGI as follows:

> Pensions and annuities received by an individual who has attained the age of fifty-nine and one-half, not otherwise excluded pursuant to paragraph three of this subsection [not applicable herein], to the extent includible in gross income for federal income tax purposes, but not in excess of twenty thousand dollars, which are periodic payments attributable to personal services performed by such individual prior to his retirement from employment, *which arise* (i) from an *employer-employee* relationship *or (ii)* from *contributions to a retirement plan* which are deductible for federal income tax purposes. However, the term 'pensions and annuities' shall also include distributions received by an individual who has attained the age of fifty-nine and one-half from an individual retirement account or an individual retirement annuity, as defined in section four hundred eight of the internal revenue code . . . (emphasis added).

The Administrative Law Judge noted that there is no claim or issue here that petitioner received retirement benefits in the form of an annuity. The Administrative Law Judge also pointed out that petitioner is not claiming that his retirement allowance payments arose from contributions to a qualified retirement plan deductible for federal income tax purposes. Therefore, to prevail, the sole remaining basis on which petitioner could satisfy the requirements of Tax Law § 612(c)(3-a), was for him to prove that the retirement allowance plan payments made to him arose from an employer-employee relationship thereby entitling him to utilize the $20,000.00 annual pension exclusion.

The Division argued that petitioner was a partner, not an employee of MH, and therefore, the requirement of an employer-employee relationship was not met (***see***, ***Matter of Blue,*** Tax Appeals Tribunal, April 6, 1995).

The Administrative Law Judge noted that in ***Blue***, petitioner was a retired partner of his former law firm partnership. When Mr. Blue retired, he became a life partner pursuant to the partnership agreement. It was determined by the Tax Appeals Tribunal that the life partner payments made to Mr. Blue were not a distributive share since petitioner therein, as a retired partner, had no right to the profits or losses of the partnership[9] and his interest in the partnership had been completely liquidated at the time he became a life partner. However, the retirement payments made to Mr. Blue were taxable despite his nonresident New York status at the time of receipt, since the retirement payments were attributable to services he rendered in New York

[9]Pursuant to the provisions of Mr. Blue's partnership agreement.

prior to his retirement, and constituted income attributable to a business, trade, profession or occupation carried on in New York.[10]

The Administrative Law Judge then addressed the issue of whether the petitioner in ***Blue*** was entitled to utilize the subtraction modification (i.e., the pension exclusion) authorized by Tax Law § 612(c)(3-a). The Administrative Law Judge stated that Mr. Blue urged that the Legislature intended the term "employee" to include a partner, referring to Tax Law § 612(o)(1)(B)(iii) and (p)(5), where the term "employee" does include partners. The Administrative Law Judge noted that the Tribunal in ***Blue***, though finding that a partner should not be treated differently from an employee for purposes of sourcing income to New York, rejected petitioner's argument that the term "employees" should be deemed to include "partners" for purposes of the pension exclusion under Tax Law § 612(c)(3-a).

The Administrative Law Judge then critiqued the Tribunal's analysis in ***Blue.*** The Tribunal's goal in ***Blue***, the Administrative Law Judge said, was to contrast the relationship between partners and their partnership with that of an employer-employee relationship. In ***Blue***, the Tribunal's discussion of whether an employment relationship existed, the Administrative Law Judge opined, rested on the degree of control and direction reserved to the employer. The Tribunal in ***Blue*** concluded the Legislature did not intend the term "employee" to include a "partner" for purposes of the section 612(c)(3-a) subtraction modification. The Administrative Law Judge disagreed.

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[10]The Administrative Law Judge spent a significant amount of time discussing our analysis in ***Matter of Blue*** (***supra***) regarding the sourcing of certain New York income to Mr. Blue, a nonresident filer. Since the instant matter involves a New York resident filer and the issue of sourcing his income is not in dispute, we decline to address much of the Administrative Law Judge's discussion in this area.

According to the Administrative Law Judge, the legislative history as contained in the bill jacket for the enabling legislation shows that the purpose of enacting the subtraction modification was to place recipients of private and Federal pensions on a more equal footing with New York public pension recipients. The bill jacket, the Administrative Law Judge noted, reflects no intention that the subtraction modification be applied other than uniformly to otherwise qualified pension recipients.

The Administrative Law Judge next addressed the definition of "employer" or "employee" as those terms are either discussed or defined by the Unemployment Insurance Law (Labor Law Art. 18), as well as by Tax Law Article 22, in connection with the requirements of withholding tax from wages. The Administrative Law Judge found that the common thread for liability between the unemployment insurance law, case law, and the withholding tax law is the element of "control" within the employment relationship. Whether an employment relationship exists requires an examination of the relationship to determine whether the degree of control and direction reserved to the employer establishes such a relationship, she said.

The Administrative Law Judge then addressed petitioner's partnership agreement and found that it was replete with areas over which the partnership exercised control over its partners. The Administrative Law Judge, while noting that the partnership agreement represents an agreement among the partners, pointed out that in much of the language the firm requires certain professional standards to be met. The CPA's manner of operating as partners and in their representation of clients was also controlled by the imposition of standards, the Administrative Law Judge pointed out.

Therefore, the Administrative Law Judge found that the Legislature intended to treat employees and partners the same with respect to the Tax Law § 612(c)(3-a) pension exclusion. The Legislature, she said, was in search of parity among the recipients of pension annuities where they arose out of an *employment relationship, such as the one in this case* (Determination, conclusion of law "L"). Accordingly, the Administrative Law Judge found that the pension exclusion was erroneously disallowed and granted the petition.

ARGUMENTS ON EXCEPTION

In its exception, the Division argues that petitioner has not carried his burden of showing that the notice of deficiency was incorrect. The Division maintains that the payments received by a retired partner from his former partnership do not meet the requirements of Tax Law § 612(c)(3-a) for petitioner to utilize the subtraction modification (the $20,000.00 pension exclusion), citing ***Matter of Blue*** (***supra***), since the payments are not derived from an employer-employee relationship and did not arise from contributions to a qualified retirement plan deductible for Federal income tax purposes.

Petitioner maintains, as he did below, that the income reported on his partnership K-1 was in reality pension income eligible for the New York State pension exclusion. Petitioner argues that when he retired and began receiving retirement payments in 1985, that income was reported by MH on a Form 1099-R and he availed himself of the $20,000.00 subtraction modification (pension exclusion). Based on the fact that he views the retirement allowance payments as pension payments and the fact that the nature of these payments never changed, petitioner argues that our decision in ***Matter of Blue*** (***supra***) should not deprive him of the use of the $20,000.00 pension exclusion.

Moreover, petitioner adopts the argument of the Administrative Law Judge that the partners at KPMG are the same as employees, since "In the daily conduct and performance of activities and duties partners were subject to direction, control, supervision and review by management, and held accountable for their time and expenditure" (Petitioner's brief in opposition).

While petitioner urges that the benefits paid to him were a pension, the Division points out that KPMG treated the income as partnership income, and not an employee pension or annuity. The Division also rejects petitioner's claim that the Partnership Agreement (the "Agreement") provides for the payment of a pension as not supported by the record. Petitioner argues that Article VII of the Agreement provides for payment of a "pension" (Petitioner's brief in opposition, p. 1) but, the Division argues, the Agreement actually refers to "retirement benefits, disability benefits and death benefits" (Exhibit "J"). The Division also points out that the partnership specifically distinguishes payments received by partners as reported on a Schedule K-1 from pension payments received under a qualified pension plan reported on a Form 1099-R.[11] Further, the Division argues, petitioner was not an employee of MH at the time of his retirement.

OPINION

We reverse the determination of the Administrative Law Judge.

Tax Law § 612(c)(3-a) provides, in relevant part, as follows:

> (c) Modifications reducing federal adjusted gross income. There shall be subtracted from federal adjusted gross income:

[11]Exhibit "I," section 6, "1997 Guide to Partner Tax Schedules and Information"

* * *

> (3-a) *Pensions* and annuities received by an individual who has attained the age of fifty-nine and one-half . . . to the extent includible in gross income for federal income tax purposes, but not in excess of twenty thousand dollars, which are *periodic payments attributable to personal services performed by such individual prior to his retirement* from employment, *which arise* (i) *from* an *employer-employee relationship* or (ii) from contributions to a retirement plan which are deductible for federal income tax purposes . . . (emphasis added).

We first take issue with the Administrative Law Judge's conclusion that since petitioner was subject to controls imposed by his partnership agreement, he was, or should be treated as, an employee for purposes of Tax Law § 612(c)(3-a).

In ***Blue***, we noted a partnership is defined as "an association of two or more persons to carry on as co-owners a business for profit" (Partnership Law, § 10). The partners have a fiduciary relationship to each other (***see***, Partnership Law, § 43[1]). The relationship between the partners is based on the concept of *co-ownership* and an equal responsibility (***cf., Hill v. Curtis***, 154 App Div 662, 139 NYS 428). Petitioner and his fellow partners agreed to be led by the CEO, the managing partner, an advisory board and a whole host of committees. Since "control" in the partnership context is mutually imposed by agreement of the *owners* (partners) each of the partners have a financial interest in the partnership and the partners (as opposed to employees) also share in the profits and liabilities of the firm, the contrast between a partner-partnership relationship and employer-employee relationship is clear. The most important distinction is that a partner is an owner, while an employee is not. Petitioner testified that he was a partner at the time he retired. The record shows that his retirement payments were computed

based on his status as a partner, and his retirement payments were to be paid out of the partnership's gross income.[12] Those are the facts on which we rely.

The Administrative Law Judge, as noted earlier, found that the Tribunal in ***Blue*** was remiss in not delving into the legislative history of Tax Law § 612(c)(3-a) to determine its intent. Specifically, the Administrative Law Judge opined that we should have examined the bill jacket and the Governor's Memorandum filed with Assembly bill number 4043-A. According to the Administrative Law Judge, the bill jacket reflects no intention that the subtraction modification be applied other than uniformly to pension recipients of qualifying age.

When the meaning of a statute is unclear, there can be no doubt that resort to extraneous sources such as the legislative history found in the bill jacket can be helpful. However, the bill jacket is not a substitute for the statute. While the Administrative Law Judge could find no intent in the legislative history that retirement allowance payments to a partner and pension payments to an employee be treated differently for purposes of the subtraction modification, we do find that intent in the plain language of the statute itself. Statutory rules of construction provide that "[t]he legislative intent is to be ascertained from the words and language used, and the statutory language is generally construed according to its natural and most obvious sense, without resorting to an artificial or forced construction" (McKinney's Cons Laws of NY, Book 1, Statutes § 94). Where, as here, the statute is clear, we must follow the plain meaning of its words, and "there is no occasion for examination into extrinsic evidence to discover legislative intent . . ." (McKinney's Cons Laws of NY, Book 1, Statutes § 120). The bill jacket, although helpful in an appropriate case, is extrinsic to the statute. It is the bill itself that is voted

[12]If petitioner were still an active partner, we think it unlikely that he would be arguing in favor of being treated as an employee rather than a partner.

on by members of the Legislature, not the bill jacket. We are not to rely on extrinsic matters when the wording of the statute is unambiguous.

Tax Law § 612(c)(3-a) provides, as relevant here, that to be entitled to the pension exclusion, the payments to the retired taxpayer must be attributable to personal services performed by the taxpayer before his retirement and such payments must "arise (i) from an employer-employee relationship or (ii) from contributions to a retirement plan which are deductible for federal income tax purposes." This language is clear and unambiguous. The Legislature intended the quoted language as words of limitation, limiting the pension exclusion to retirement payments from qualified pension plans or *arising from an employer-employee relationship*. The Administrative Law Judge's interpretation of these words would render the Legislature's qualifying language a nullity.

Petitioner testified that the partnership did not contribute to a retirement plan deductible for federal income tax purposes, so that leaves only one basis under which petitioner could qualify for the pension exclusion. He was required to prove by clear and convincing evidence that his retirement payments arose from an employer-employee relationship. Since there is no evidence of an employment relationship in this case, petitioner has failed to carry his burden of proof. Thus, we conclude that the statute did not intend "employee" to include the term "partner" for purposes of the Tax Law § 612(c)(3-a) subtraction modification and, therefore, under the facts presented petitioner is not entitled to the pension exclusion.

Accordingly, it is ORDERED, ADJUDGED and DECREED that:

1. The exception of the Division of Taxation is granted;

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

3. The petition of Maximilian and Miriam Schein is denied; and

4. The Notice of Deficiency dated September 18, 2000, is sustained.

DATED: Troy, New York
November 6, 2003

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

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