

STATE OF NEW YORK  
DIVISION OF TAX APPEALS

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In the Matter of the Petition  
of  
HUGO MATSON AND JOAN MATSON  
for Redetermination of a Deficiency or for  
Refund of Personal Income Tax under Article 22  
of the Tax Law for the Year 1982.

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DETERMINATION

Petitioners, Hugo Matson and Joan Matson, Box 128, Waterford, New York 12188, filed a petition for redetermination of a deficiency or for refund of personal income tax under Article 22 of the Tax Law for the year 1982 (File Nos. 62285 and 62286).

A hearing was held before Arthur Bray, Hearing Officer, at the offices of the State Tax Commission, Building #9, W. A. Harriman State Office Building Campus, Albany, New York, on January 15, 1987 at 1:15 P.M., with all briefs to be submitted by April 30, 1987. Petitioner appeared by Urbach, Kahn & Werlin, P.C. (David Evans, CPA). The Audit Division appeared by John P. Dugan, Esq. (Thomas C. Sacca, Esq., of counsel).

ISSUES

- I. Whether it was necessary for the Audit Division to provide a foundation prior to the admission into evidence of the Notice of Deficiency.
- II. Whether petitioners properly reported that their distributive share of partnership income was subject to the maximum tax on personal service income for the year 1982.

FINDINGS OF FACT

1. Petitioners, Hugo W. Matson and Joan W. Matson, filed a New York State Resident Income Tax Return for the year 1982 wherein they elected a filing status of "Married filing separately on one return". With certain modifications, each petitioner reported that his or her distributive share of partnership income from operating three McDonald's restaurants was subject to the maximum tax on personal service income.

2. During the year in issue, petitioners, Hugo W. Matson and Joan W. Matson, operated as partners three McDonald's restaurants. The restaurants were located in Waterford, Ballston Spa and Mechanicville, New York.

3. On April 8, 1985, the Audit Division issued separate notices of deficiency to Hugo W. Matson and Joan W. Matson. The Notice of Deficiency issued to Hugo Matson asserted a deficiency of personal income tax for the year 1982 in the amount of \$1,171.00 plus interest of \$247.96 for a balance due of \$1,418.96. The Notice of Deficiency issued to Joan Matson asserted a deficiency of personal income tax for the year 1982 in the amount of \$683.00 plus interest of \$144.64 for a balance due of \$827.64. Each of the respective statements of personal income tax audit changes explained that the basis for the adjustment was that the Audit Division considered 30 percent of each petitioner's distributive share of the net profit from the operation of McDonald's restaurants was income eligible for the maximum tax on personal service income.

4. Prior to the hearing, the Audit Division concluded that 65 percent of petitioners' income from the partnership constituted income subject to the maximum tax on personal service income. Consequently, the Audit Division reduced the amount of tax asserted to be due from Mr. Matson and Mrs. Matson to, respectively, \$591.00 and \$510.00.

5. Petitioners filed a New York State Partnership Return for 1982 under the name of "Hugo W. & Joan W. Matson, DBA McDonald's of Waterford". On this return, petitioners reported depreciation on the following types of property:

<u>Description of Property</u>	<u>Cost or Other Basis</u>
Transportation equipment	\$ 2,198.00
Machinery and other equipment	419,413.00
Leasehold improvements	143,268.00
Signs	26,475.00

The partnership reported that it incurred interest expense of \$31,779.00.

6. Mr. Matson retired from the army with the rank of Lieutenant Colonel prior to the year in issue. From 1972 until 1976, Mr. Matson worked for the City of Philadelphia. During his spare time, he learned how to operate a McDonald's restaurant.

7. In May 1976, petitioners began operating their first restaurant in Waterford. By the end of 1977, petitioners were operating the current three restaurants. Petitioners were the first operators of these particular restaurants.

8. During the first two years the partnership operated at a loss and it was necessary for petitioners to borrow money in order to keep the restaurants functioning.

9. During the year in issue, it was Mr. Matson's practice to personally open up one of the restaurants between 4:30 A.M. and 5:00 A.M. In order to open up a store, Mr. Matson would check the store for cleanliness, examine the cash in the cash registers and count inventory to be

certain that there had not been a theft. Mr. Matson would then turn on the equipment in a particular sequence in order to avoid an excessive demand on electricity at one moment. This equipment included two six foot grills, fry vats, toasters, hot chocolate machine and a danish steamer.

10. By 8 o'clock or 9 o'clock in the morning, there was a constant arrival of customers and restaurant crew. Mr. Matson made certain that the crew was properly positioned.

11. When Mr. Matson was opening one of the restaurants, other individuals would be responsible for opening the other restaurants in the morning.

12. Usually, Mr. Matson would leave his restaurant between 9 and 10 o'clock in the morning. Thereafter, he would visit the other restaurants, travel to the bank, go to his office, examine mail and attend meetings. These meetings would concern the local chamber of commerce or promotional or staff meetings to discuss reducing costs or what business direction the restaurant should pursue.

13. In the late afternoon, Mr. Matson returned to his office to make telephone calls.

14. Each evening, Mr. Matson checked for problems at each of the restaurants. On Friday nights, Mr. Matson would spend time at the restaurant in Mechanicville because of a vandalism problem the restaurant was experiencing. If there was a performance at the Saratoga Performing Arts Center, Mr. Matson would provide assistance at the restaurant in Ballston Spa.

15. Mr. Matson's duties also included hiring and firing managers, training managers and participating in the orientation of almost all new employees. Mr. Matson completed salary reviews of store managers and discussed performance reviews with the store managers. He also prepared business projections for the new year.

16. In the course of a day, from 10 to 20 people would work in a restaurant. When Mr. Matson was not in a particular restaurant, the store manager would be in charge.

17. Mrs. Matson has a bachelor of arts degree from William Smith College in Geneva, New York.

18. During the year in issue, Mrs. Matson's duties included preparing payroll records and acting as a liaison to the firm that prepared the payroll checks. She also maintained the vacation records.

19. Since the restaurants initially had a low volume of business, petitioners felt that it was important to be active in the communities in which the restaurants were located in order to generate business. Consequently, petitioners were active in various community events. Mrs. Matson acted as a liaison between the partnership and various community groups.

20. Mrs. Matson participated in an organization made up of owners of McDonald's restaurants which purchased supplies as a group. In addition, the organization worked on promotions and community services.

21. Mrs. Matson controlled the daily operations of the restaurants when her husband was not present. She also oversaw certain school lunch programs.

22. During the year in issue, Mrs. Matson worked as a hostess one or two days a week as needed. This entailed making sure that the tables were cleared and that the store was presentable. She also assisted in preparing food as well as wrapping and delivering products for the school lunch program.

23. The buildings in which the restaurants are located are leased from McDonald's.

#### CONCLUSIONS OF LAW

A. That there is no requirement that the Audit Division offer a foundation prior to the admission of a Notice of Deficiency (see \_\_\_ State Administrative Procedure Act § 306[1],[2]).

B. That Tax Law § 603-A provides for a maximum tax rate on New York personal service income. Section 603-A(b)(1), in effect for the year at issue, defined "New York personal service income" to mean, in part:

"(A) wages, salaries, or professional fees, and other amounts received as compensation for personal services actually rendered.... In the case of a taxpayer engaged in a trade or business in which both personal services and capital are

material income-producing factors, under regulations prescribed by the tax commission, a reasonable allowance as compensation for the personal services rendered by the taxpayer shall be considered as earned income".

C. That it is clear that both personal services and capital were material income-producing factors in petitioners' business. The significance of capital is evidenced by the fact that petitioners had a very substantial investment in machinery and equipment. It is also noted that the physical premises of the restaurant are also considered capital since leased property is considered capital for the purpose of determining whether capital is a material income-producing factor (Moore v. Commissioner, 71 TC 533 [1979]). Since personal services and capital were material income-producing factors in petitioners' business, they were entitled to a reasonable allowance as compensation for the personal services which they rendered to the business.

D. That petitioners have failed to sustain their burden of proving that the Audit Division's allowance of 65 percent of the net profit from the restaurant as personal service income was improper (Tax Law § 689[e]).

E. That the petition of Hugo Matson and Joan Matson is denied and the notices of deficiency, as modified in Finding of Fact "4", are sustained.

DATED: Albany, New York  
October 27, 1987

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ADMINISTRATIVE LAW JUDGE