STATE OF NEW YORK

DIVISION OF TAX APPEALS

In the Matter of the Petition	:	
of	:	
KENNETH R. AND CHERYL ETHEREDGE	:	DETERMINATION
for Redetermination of a Deficiency or for Refund of New York State Personal Income Tax under Article 22 of the Tax Law and New York City Nonresident Earnings Tax under Chapter 46, Title U of the Administrative Code of the City of New York for the Years 1981 and 1982.	:	

Petitioners, Kenneth R. and Cheryl Etheredge, 750 North St. Paul Street, Dallas, Texas 75201, filed a petition for redetermination of a deficiency or for refund of New York State personal income tax under Article 22 of the Tax Law and New York City nonresident earnings tax under Chapter 46, Title U of the Administrative Code of the City of New York for the years 1981 and 1982 (File No. 803820).

A hearing was held before Dennis M. Galliher, Administrative Law Judge, at the offices of the Division of Tax Appeals, Two World Trade Center, New York, New York, on May 10, 1989 at 9:15 A.M., with all briefs to be filed by September 30, 1989. Petitioners appeared by Larry Kars, Esq. The Division of Taxation appeared by William F. Collins, Esq. (Andrew Zalewski, Esq., of counsel).

ISSUES

I. Whether "commissions" paid to a nonresident partner of a New York partnership must be included in that nonresident partner's New York adjusted gross income.

II. Whether petitioner Kenneth Etheredge was, in fact, a nonresident partner in a New York partnership in 1981 and/or 1982.

III. Whether the imposition of New York taxes upon amounts earned by a nonresident partner of a New York partnership (in accordance with such partnership's allocation percentage) violates the commerce and/or due process clauses of the U.S. Constitution.

IV. Whether penalties imposed against petitioners should be abated.

FINDINGS OF FACT

Petitioners, Kenneth R. and Cheryl Etheredge, were during the years in question

residents of the State of Texas and were not residents of New York State or New York City.[1] During such years, Mr. Etheredge was listed in Standard and Poor's Publication "Security Dealers of North America" as a partner in the New York stock brokerage partnership known as Schaenen Fellerman and Company ("S & F"). S & F is a member of the New York Stock Exchange ("the Exchange"), and engages in stock trading thereon. S & F maintained offices in New York City and in Dallas, Texas during the years in question.

Petitioner Kenneth Etheredge worked out of S & F's Dallas, Texas office as a stockbroker engaged in the analysis and sale of stock in small to medium sized growth companies. All of the clients with whom petitioner dealt were located in Texas, and consisted of approximately 90% institutional clients (banks, insurance companies, mutual funds, etc.) and 10% individual clients. In 1981, S & F's Texas office consisted of two persons, namely petitioner and a secretary, while in 1982 said office employed four persons, such two additional persons having been hired by petitioner as salesmen. Petitioner functioned as the partner in charge of and managed S & F's Texas office. He hired and fired office personnel in Texas, leased office space in Texas and entered into such other agreements and arrangements on behalf of S & F as were necessary to operate the Dallas office. Petitioner made no such similar decisions and had no such similar duties with respect to S & F's New York office.

S & F is known as a "non-clearing" firm, meaning that S & F hires another firm, namely Wall Street Clearing, Inc., to process its stock trades. Petitioner's function within S & F was as follows: petitioner would obtain an order to either buy or sell stock for a Texas client; such order would be placed by S & F with a trader on the floor of the New York Stock Exchange; once the trade was made, Wall Street Clearing, Inc. would handle confirmation of the trade and all collections and disbursements of funds. In fact, Wall Street Clearing, Inc. would send a confirmation of the trade to the client with a duplicate confirmation sent to S & F. Such confirmations were labeled "S & F courtesy of Wall Street Clearing".

A daily production run of all trades was sent to both the Texas and New York offices of S & F, showing all trades and all commissions thereon earned by S & F. These production runs were reconciled at the end of each month by petitioner in Dallas and were also confirmed as to accuracy with Wall Street Clearing, Inc. and with S & F's New York office. Wall Street Clearing, Inc. would then send a check in the amount of the

commissions earned by S & F to S & F's New York office, and thereafter, S & F's New York office would send petitioner a check equal to 50% of the commission amounts earned on the various trades.[2]

During 1981 there appear to have been a total of seven general partners in S & F, including petitioner, and three limited partners. The various partnership interests among the partners ranged from a high of a 27.58% interest in partnership profits and losses to a low of

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[1]Cheryl Etheredge, listed as a petitioner herein, appears solely by virtue of the fact that she filed a joint Federal income tax return for each of the years 1981 and 1982 with petitioner Kenneth R. Etheredge. Accordingly, all references to petitioner in this determination shall, unless otherwise noted, pertain solely to petitioner Kenneth R. Etheredge.

[2]The amount of commission (percentage) on a given transaction was negotiated between petitioner and each client. Clients executing large volume trades received comparatively more favorable commission rates.

4.21%. Petitioner had initially invested $15,000.00 in the partnership, and he held a 4.21% partnership interest in the profits and losses of S & F. S & F's partnership agreement was not submitted in evidence. However, a "Fifth Amendment to Limited Partnership Agreement" was submitted, signed by and listing petitioner as a 4.21% S & F general partner. Petitioner never attended any partnership meetings and asserted that no such meetings were held.

Petitioner explained that the payment to each partner of 50% of the commissions generated by each such partner was a policy in effect to compensate each partner based on his own sales efforts, as opposed to enabling a partner who had done less sales work to obtain a disproportionately large compensation based solely on his percentage partnership interest. In fact, in one year petitioner received a larger share of partnership distribution than some other partners who had a greater partnership ownership interest.

S & F's New York State partnership returns (Form IT-204) for the years in question were filed reflecting total income (primarily commissions) less expenses resulting in ordinary income. For 1981, ordinary income (total income less expenses) totaled $994,424.00, while for 1982 ordinary income totaled $49,533.00. As noted hereinafter, petitioner claims the partnership actually incurred a "loss"[3] and that gain (i.e. "ordinary income") was shown only to avoid being put on a financial "watch" list by the Exchange. The partnership, as confirmed by a Division of Taxation review and audit thereof, calculated a partnership allocation percentage (allocation of items of income, loss, gain and deduction within and without New York) of 85.16% for 1981 and 90.216% for 1982.

Petitioner claimed that after total income less expenses was computed (as above), the additional reduction of partnership ordinary income based on the 50% commission amounts paid to each partner resulted in fact in an actual loss for each of the years in question for the partnership. In

the years in question, petitioner received from the partnership $150,443.00 and $53,549.00, respectively. These amounts were reported as distributions of partnership ordinary income on both the partnership's returns and petitioner's individual returns. Such amounts were not calculated based upon petitioner's 4.21% partnership owner's interest.

Petitioner filed no New York State or New York City tax returns for the years in question upon the basis that all of his earnings from the partnership represented commissions derived from services he performed for his institutional and individual clients, all of whom were located in Texas. Petitioner spent no more than one or two days in New York State during each of the years in question and all of his working time was spent in Texas. Petitioner has no background of education in tax law, and he engaged an accountant in Texas to prepare his tax returns for the years in question.

On April 11, 1986, the Division of Taxation issued to petitioners, Kenneth R. and Cheryl Etheredge, a Notice of Deficiency asserting additional personal income tax due for the years 1981 and 1982 in the aggregate amount of $11,196.00, plus penalties under Tax Law § 685(a)(1), (2) and (b), plus interest. A Statement of Audit Changes previously issued to petitioners on January 16, 1986 provided computations for each of the years in question (relative to the respective amounts of New York State and New York City tax imposed). The deficiency in question is premised upon treatment of petitioner's commission earnings from S & F as representing a distributive share of partnership income from a New York partnership

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[3]The "loss" petitioner speaks of would result if the commission amounts distributed to the partners were treated as expenses of the partnership rather than as distributions of partnership net ordinary income (see Finding of Fact "8", infra).

derived from or connected to New York sources to the extent of the partnership allocation percentages previously mentioned (see Finding of Fact "7", supra).

SUMMARY OF THE PARTIES' POSITIONS

The Division of Taxation asserts that the commission amounts received by petitioner were properly taxable to New York State. The Division notes that commission income was shown on the distribution to each partner (schedules K-1) as a distribution of the partnership's ordinary income and that petitioner was clearly a partner and not an employee of S & F.

Petitioner maintains that the income in question is not a distribution of partnership income, but rather is more in the nature of a salary equal to 50% of the commissions generated directly by petitioner's efforts. Petitioner thus asserts that said income is not derived from or connected with New York sources (i.e., the New York partnership of S & F) and should not be taxed by New York in accordance with partnership allocation percentages. Petitioner asserts that as compensation in the nature of a salary, the income would not be taxable to New York because petitioner, as a nonresident, did not spend any days working in New York and generated all of such commission income from activities he undertook in Texas. Finally, petitioner argues that the Division is taxing direct commission income earned by petitioner in Texas and that there is an insufficient nexus between such income and New York thus rendering taxation thereof constitutionally invalid on due process and commerce clause grounds.

Petitioner submitted proposed findings of fact numbered "1" through "24" each of which has been in substance incorporated herein.

CONCLUSIONS OF LAW

A. Tax Law former § 632(a)(1), as in effect for the years at issue, provided that the New York adjusted gross income of a nonresident individual shall include the sum of the net amount of the items of income, gain, loss and deduction entering into that individual's Federal adjusted gross income which are derived from or connected with New York sources. Former section 632(a)(1)(A) of the Tax Law further provided that these items include the nonresident individual's "distributive share of partnership income, gain, loss and deduction, determined under section six hundred thirty-seven...." The income subject to the New York City nonresident earnings tax is computed in the same manner (Administrative Code of the City of New York former §§ U46-1.0[f]; U46-4.0[a]).

B. Tax Law former § 637(a)(1), in defining the portion of income derived from New York sources, provided:

> "In determining New York adjusted gross income of a nonresident partner of any partnership, there shall be included only the portion derived from or connected with New York sources of such partner's distributive share of items of partnership income, gain, loss and deduction entering into his federal adjusted gross income, as such portion shall be determined under regulations of the tax commission consistent with the applicable rules of section six hundred thirty-two."

C. Petitioner argues that he was not "in substance" a partner of S & F, noting that he ran "his own" office in Dallas, had no management authority over S & F's New York office, did not share in partnership profits or losses, attended no partnership meetings and generated his own business solely through clients located in Texas (receiving from S & F's New York office 50

percent of the commission amounts generated on transactions carried out for such clients). However, petitioner's argument does not suffice in light of all the facts. More specifically, petitioner testified that he entered the partnership via an executed partnership agreement and contributed $15,000.00 in capital to the partnership at such time. While the original partnership agreement was not submitted in evidence, a "Fifth Amendment" thereto was introduced on which document petitioner's signature appears as a general partner. Petitioner held a 4.21 percent interest in the partnership, managed S & F's Dallas office[4], and was listed as an

S & F partner in Standard and Poor's "Security Dealers of North America." S & F's partnership returns (including attached schedules K-1) and petitioner's personal returns were filed listing petitioner as a partner in S & F who received a distributive share of the partnership's ordinary income against which there were no reductions for social security or withholding taxes. Such facts, together with the fact that petitioner held himself out to the public as a partner, leave clear the conclusion that the Division's treatment of petitioner as a partner was entirely appropriate (Weinflash v. Tully, 93 AD2d 369; Heffron v. Chu, 144 AD2d 729; Faulkner, Dawkins and Sullivan v. Tax Commn., 63 AD2d 764).

D. Tax Law former § 637(b)(1) provided, in part, as follows:

> "In determining the sources of a nonresident partner's income, no effect shall be given to a provision in the partnership agreement which --
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> (1) characterizes payments to the partner as being for services or for the use of capital...."

E. In view of section 637(b)(1) of the Tax Law, as well as the manner in which the subject returns were filed, the Division properly determined that the payments to petitioner were distributions of partnership income which were connected with New York State and City and subject to New York State and New York City taxation (see, Matter of Baum v. State Tax Commn., 89 AD2d 646, 647, lv denied 57 NY2d 607; Matter of Faulkner, Dawkins and Sullivan v. State Tax Commn., supra; Matter of Jablin v. State Tax Commn., 65 AD2d 891).

F. The same specific constitutional arguments as are raised herein by petitioner were raised and rejected in Matter of Weil v. Chu (120 AD2d 781, affd 70 NY2d 783, appeal dismissed 108 S Ct 1069). Similarly, said arguments are rejected herein.

G. Finally, penalties were imposed against petitioner pursuant to Tax Law § 685(a)(1) and (2) (for petitioner's failure to file returns and pay taxes due) and pursuant to Tax Law § 685(b) (asserting the deficiencies in question were attributable to petitioner's negligence or intentional disregard of the Tax Law and regulations). Petitioner argues that his lack of education in tax matters and his engagement of an accountant serve to excuse such failures. Given the nature of the facts and the arguments advanced, considered in light of petitioner's testimony, the subject failures were not the result of willful neglect, negligence or intentional disregard. Hence, such penalties are cancelled.

H. The petition of Kenneth R. and Cheryl Etheredge is hereby granted to the extent indicated in Conclusion of Law "G", but is otherwise denied and the Notice of Deficiency dated

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[4]S & F's partnership returns listed office locations in New York City and Dallas. As noted, petitioner leased the Dallas office space on behalf of S & F and hired and fired employees. Though specific figures were not supplied, it appears clear that S & F and not petitioner paid the Dallas office expenses.

April 11, 1986, as modified in accordance herewith, is sustained.

DATED: Troy, New York
November 22, 1989

/s/ Dennis M. Galliher
ADMINISTRATIVE LAW JUDGE