STATE OF NEW YORK

DIVISION OF TAX APPEALS

In the Matter of the Petition	:	
of	:	
ZALMAN C. AND ELAINE K. BERNSTEIN	:	DETERMINATION DTA NO. 807529
for Redetermination of a Deficiency or for Refund of Personal Income Tax under Article 22 of the Tax Law for the Years 1984 and 1985.	:	

Petitioners,[1] Zalman C. and Elaine K. Bernstein, c/o Shereff, Friedman, Hoffman & Goodman, Esqs., 919 Third Avenue, New York, New York 10022, filed a petition for redetermination of a deficiency or for refund of personal income tax under Article 22 of the Tax Law for the years 1984 and 1985.

A hearing was held before Frank W. Barrie, Administrative Law Judge, at the offices of the Division of Tax Appeals, Two World Trade Center, New York, New York, on January 9, 1991 at 9:15 A.M., with all briefs to be submitted by April 26, 1991. Petitioner's brief was filed on February 25, 1991. The Division of Taxation's answering brief was filed on April 4, 1991, and petitioner's reply brief on April 19, 1991. Petitioner appeared by Shereff, Friedman, Hoffman & Goodman, Esqs. (Lawrence G. Goodman, Esq., of counsel).[2] The Division of Taxation appeared by William F.

[1]Petitioners filed joint tax returns for the years at issue. However, the assessment against petitioners relates solely to the activities of petitioner Zalman C. Bernstein and all references to "petitioner" in this determination are to Mr. Bernstein.

[2]According to an attachment to petitioners' Request for Conciliation Conference, petitioners at the time were in the process of obtaining a divorce, and Mr. Bernstein was unable to obtain his wife's signature on the request. Further, only Mr. Bernstein executed the power of attorney appointing the named representative.

Collins, Esq. (Michael J. Glannon, Esq., of counsel).

ISSUES

I. Whether distributions of ordinary income received by petitioner from a subchapter S corporation in the amounts of $6,607,428.00 in 1984 and of $10,677,800.00 in 1985 constituted reasonable compensation for personal services, when such amounts were in addition to W-2 salary income of $4,638,517.00 in 1984 and $3,203,869.00 in 1985 from the same corporation.

II. Whether the issuance of the statutory notices against petitioner was arbitrary and capricious.

III. Whether, at petitioner's request, the transcript of this hearing and/or documents introduced into the record may be given confidential treatment.

FINDINGS OF FACT

Petitioner, Zalman C. Bernstein, a very successful entrepreneurial financier, prospered mightily on Wall Street during the heady years of the 1980s. For the year 1984, out of "total income" of $13,405,710.00,[3] petitioner reported $11,244,954.00 as personal service income subject to the benefit of the maximum tax limitation. A statement attached to petitioner's 1984 tax return itemized his personal service income as follows:

Salaries and wages [per wage and tax statement from Sanford C. Bernstein & Co., Inc.]	$ 4,638,517
Other earned income from Sanford C. Bernstein & Co., Inc.	6,607,428
Schedule C income	-991
Total personal service income	$11,244,954

On petitioner's Schedule K-1, "Shareholder's Share of Income, Credits, Deductions, etc." from Sanford[4] C. Bernstein & Co., Inc. (hereinafter "Bernstein & Co.") for 1984, the following

[3]This amount was shown on Line 20 of the 1984 New York State Resident Income Tax Return.

[4]In 1979, Mr. Bernstein, for religious reasons, changed his first name from Sanford to Zalman. However, the company's name remained the same.

distributive share items were reported:

Ordinary income	$8,347,041
Dividends qualifying for the exclusion	102,743
Net short-term capital gain	171,364
Net long-term capital gain	839,654
Total	$9,460,802

Qualified investment income of $1,739,613.00 was shown on the Schedule K-1 as being included in petitioner's distributive share of ordinary income of $8,347,041.00. In calculating his "other earned income" of $6,607,428.00 from Bernstein & Co., petitioner subtracted the qualified investment income from the ordinary income reported on Schedule K-1 ($8,347,041.00 - $1,739,613.00 = $6,607,428.00).

For the year 1985, out of total income of $16,780,451.00,[5] petitioner reported $13,859,373.00 as personal service income subject to the maximum tax limitation. A statement attached to petitioner's 1985 tax return itemized his personal service income as follows:

Salaries and wages [per wage and tax statement from Bernstein & Co.]	$ 3,203,869[6]
Other earned income from Bernstein & Co.	10,677,800
Schedule C income	-22,296
Total	$13,859,373

On petitioner's Schedule K-1 from Bernstein & Co. for 1985, the following distributive share items were reported:

Ordinary income	$12,627,744
Dividends qualifying for the exclusion	134,593

[5]This amount was shown on Line 20 of the 1985 New York State Resident Income Tax Return.

[6]Petitioner's wages were less in 1985 than 1984 because he received a bonus in January 1984, at the end of the company's 1983-84 fiscal year before it became a subchapter S corporation. Without the bonus, wages were essentially level from 1984 to 1985.

Net short-term capital gain	715,781
Net long-term capital gain	394,399
Total	$13,872,517

Qualified investment income of $2,009,750.00 was shown on the Schedule K-1 as being included in petitioner's distributive share of ordinary income of $12,627,744.00. In calculating his "other earned income" of $10,677,800.00 from Bernstein & Co., petitioner subtracted the qualified investment income from the ordinary income reported on Schedule K-1 and then added qualified investment expenses reported of $59,806.00 ($12,627,744.00 - $2,009,750.00 + $59,806.00 = $10,677,800.00).

The Division of Taxation issued a Statement of Audit Changes against petitioner dated November 12, 1987 asserting State[7] income tax due of $240,329.18, plus interest, for 1984 and of $188,746.27, plus interest, for 1985. The following explanation was provided:

> "The maximum tax benefit has been recalculated allowing the personal service income as shown on your wage and tax statement less the business losses. The amounts of $6,607,428.00 and $10,667,800.00 for 1984 and 1985 respectively from Sanford C. Bernstein and Company, Incorporated, a Sub-Chapter S corporation, is deemed a distribution of income and not personal service compensation subject to maximum tax benefits."

The Division of Taxation then issued two notices of deficiency dated February 29, 1988 against petitioner, one assessing income tax due of $240,383.57, plus interest, for 1984, the other assessing income tax due of $188,746.27, plus interest, for 1985. The notices referenced the Statement of Audit Changes described in Finding of Fact "2", supra.

Petitioner obtained an automatic four-month extension of time (to August 15, 1985) and an additional two-month extension (to October 15, 1985) to file his 1984 tax return. Prior to

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[7]A very small part of the additional State tax asserted as due, as well as a small amount of additional New York City tax, resulted from an adjustment made by the Division of Taxation because of petitioner's failure "to make the modification for depletion of $1,342 and $1,160 for 1984 and 1985 respectively as required under Section 612(b)(10)(i)." This adjustment is not at issue herein.

such filing, petitioner's accountant communicated with a tax technician employed by the Division of Taxation's Technical Services Bureau who, in a letter dated July 11, 1985 (which reworded an earlier letter), advised petitioner, in part, as follows:

> "The portion of income from an 'S' corporation or a partnership that represents a reasonable allowance as compensation for the services performed for the corporation or partnership is considered personal service income, whether or not denominated as compensation....
>
> There are many items to be considered for S corporation shareholders to determine what portion if any of the income derived from the 'S' corporation is eligible for maximum tax [limitation]. Some of these are: what services were performed for the 'S' corporation, how much time was expended, the type of business activity engaged in, amount of guaranteed payments, whether an individual is an employee of the S corporation and receives wages for the services performed, etc. All of these factors and others must be weighed to determine if any of the monies received constitute personal service income."

Petitioner's accountant believed that the rationale provided by the Statement of Audit Changes dated November 12, 1987, as described in Finding of Fact "2", supra, conflicted with the advice received from the tax technician. In a letter dated December 1, 1986, petitioner's accountant wrote to the Division as follows:

> "...[T]he rationale for your notice [of deficiency] is erroneous in that 'deemed distributions' of income from an S corporation (or partnership) clearly can qualify as N.Y.S. personal service income. In fact only the portion of the distributive income representing personal service income was included as subject to the maximum tax."

Approximately four months later, by a letter dated April 15, 1987, the Division responded, in part, as follows:

> "Your client did receive wages for services rendered as shown on the wage statements submitted for 1984 and 1985 for $4,638,517.21 and $3,203,869.03 respectively which are considered to be a reasonable allowance for compensation constituting personal service income.
>
> We, therefore, sustain our position that the amounts of $6,607,428.00 and $10,677,800.00 for 1984 and 1985 respectively from Sanford C. Bernstein and Company, Inc. are deemed to be a distribution of income and not personal service income."

The Division of Taxation's letter dated April 15, 1987 did not satisfy petitioner, whose accountant wrote back, three weeks later, in a five-page letter dated May 6, 1987, which detailed petitioner's position and requested that the Division review the matter. In particular,

petitioner's accountant contended as follows:

> "[I]t is now commonplace for high level executives to have a substantial portion of their compensation based on the profitability of the business. The fact that a portion of an individual's total compensation package is contingent upon profitability does not preclude treating the entire amount as compensation."

The Division was unpersuaded and in a letter dated June 2, 1987 reiterated its position that:

> "The wages received by your client of $4,638,517.21 and $3,203,869.03 for 1984 and 1985 respectively are considered to be a reasonable allowance for personal services rendered to the Subchapter S Corporation."

Approximately three months later, on September 1, 1987, petitioner filed a petition for an advisory opinion continuing his attempt to resolve this matter without the need for a hearing. An advisory opinion dated December 15, 1987 concluded as follows:

> "[T]he Audit Division is justified in limiting Petitioner's personal service income to the amount designated by SCB [Bernstein & Co.] as salary if such amount represents a reasonable allowance for personal services actually rendered. Petitioner bears the burden of proving that any amount of income included on his K-1 forms is also personal service income. Inasmuch as any such proof will entail a question of fact, such proof must be presented in the context of the audit performed by the Audit Division since questions of fact cannot be resolved in an advisory opinion."

Petitioner argued that the issuance of the statutory notices against him was arbitrary and capricious because the Division of Taxation refused to consider any portion of the subchapter S distributions of ordinary income from Bernstein & Co. as personal service income and used W-2 wages as an "arbitrary cutoff point". Nonetheless, petitioner proceeded on the merits to show that the portion of the Subchapter S distributions of ordinary income reported as personal service income was, in fact, compensation from Bernstein & Co. for his personal services. Petitioner introduced much evidence in support of his case, including his own testimony and that of the following witnesses: Lewis H. Sanders, president of Bernstein & Co.; Neil Kuttner, currently vice-president of finance of Bernstein & Co. and, during the years at issue, a senior accountant in the company; and Arthur Rosenbloom, an expert witness.

Petitioner obtained an MBA from Harvard University in 1948. From 1948 to 1951 he worked for the Marshall Plan in France as an economist and then very briefly in sales for the

Bulova Watch Company. In 1952, his career on Wall Street began with his employment as a research analyst for Value Line Research Survey. After a four-year interruption, from 1955 to 1959, when he was employed as a financial assistant to the president of a large supermarket chain in Philadelphia, petitioner returned to Wall Street, employed at Oppenheimer and Co., from 1959 to 1965, and then at Ralph N. Samuel and Co., from 1965 to 1967, where he was a partner. In 1967, petitioner founded Bernstein & Co. and to date remains at the center of its operations.

History of Bernstein & Co.

Bernstein & Co. was capitalized in 1967 with $1,000,000.00, $700,000.00 of which was contributed by petitioner. The company had 21 employees and had approximately $25,000,000.00 in assets under management. An investment management and research business, Bernstein & Co. underwent a dramatic change in size during the next 20-odd years. In comparison to the $25,000,000.00 in assets under management in 1967, during 1984 and 1985, the years at issue, Bernstein & Co. had approximately $6½ billion and $11 billion in assets under management, respectively. In 1989, the company reached a peak of approximately $17 billion in assets under management. Similarly, from 21 employees in 1967, the company had approximately 250 employees during the years at issue and 500 employees in 1991. Between 1982 and 1988, Bernstein & Co. went from being the 297th largest money manager to the 75th largest.

During 1984 and 1985, the firm had total revenues of $71,700,000.00 and $99,400,000.00, respectively, and "profit before taxes" of $29,200,000.00 and $47,000,000.00, respectively. According to Mr. Kuttner, 70 to 80% of the firm's income came from the services it provided, investment management and brokerage services, and the remainder of 20 to 30% from capital gains, interest income and dividends, which were separately reflected on the schedules K-1.

By the late 1970s, Bernstein & Co. had established a distinguishing character on Wall Street. The firm had developed a clearly defined investment process rooted in a quantitative

system known as value investing. By the systematized use of computers, investment choices were made based upon a dividend discount model,[8] which also took into consideration critical variables that might affect a company's future earnings. For example, fuel prices would be carefully analyzed for industries dependent on fuel. This investment process enabled Bernstein & Co. to develop a firm-wide policy of money management. Investors engaged not a particular money manager in the company but the firm. In fact, the particular individual responsible for handling a client's account was not the person making selections of stocks and equity investments. Portfolio selection was based on the systematized computer analysis described above and was subject to a committee's analysis. In sum, the money management function was kept separate from the firm's sales function.

Petitioner's Role in the Firm

A cover story, "The Bernstein Formula, Sometimes Wrong But Never In Doubt" by Julie Rohrer, appeared in the November 1989 issue of Institutional Investor. Ms. Rohrer observed:

> "[W]orking within a controlled, highly systematized investment approach creates an entirely different internal hierarchy than is found in most traditional money management organizations. Egos must be sublimated to the end product."

Nonetheless, it is fair to say that two individuals have dominated Bernstein & Co.: petitioner and Lewis Sanders. Petitioner, throughout the company's existence, has been chief executive officer, chief financial officer and chairman of the board of directors. Lewis Sanders, whose loyalty to petitioner seems almost filial, joined the firm as a research assistant in 1968 out of college with a BA in applied mathematics. Petitioner oversaw Mr. Sanders' progress in the firm: 1972, director of research; 1979, executive vice-president in charge of the development and provision of all the products and services of the firm; and 1981, at the age of 33, president of Bernstein & Co.

Petitioner has always been involved in every facet of the firm's business. According to

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[8]Petitioner's expert witness described the dividend discount model as "a disciplined mathematical model which analyzes value of a company by looking at its future dividend stream and analyzing that stream, discounting it back...."

Mr. Sanders' testimony, petitioner was "the chief executive officer in the fullest sense of the word", involved in the design of the firm's services and products and the way they would be marketed.

Mr. Sanders described Bernstein & Co. as a people-driven business:

> "There are obviously no machines, there are no patents, there are only people whose work in assembling information and trying to impart insight to its meaning in a manner that would help individuals make appropriate investments is all that there is. And so perhaps the single most important element in any investment organization is the nature and character of its staff."

Capital was not central for the production of the company's income. Therefore, of primary importance was the recruitment and retention of the firm's personnel, which, according to Mr. Sanders, "was a central activity of Mr. Bernstein's from the outset to the present". Petitioner was extremely successful in avoiding turnover of personnel.

Mr. Bernstein has always been intensively involved in the firm's budget process. Neil Kuttner, currently the firm's vice-president of finance, and during the years at issue director of accounting in the company, testified that petitioner has an extraordinary grasp of financial matters. According to Mr. Kuttner, every month a 50-page financial document is developed which details the firm's activities. Petitioner closely reviews this monthly report and prods his managers based on his analysis of the financial data. Furthermore, Mr. Bernstein supervises the preparation of the firm's annual budget. Petitioner testified that the "hallmark of our firm has been our vigorous budgeting process, which I intimately created". The firm's earnings and business plans are closely monitored in this budgeting process.

Bernstein & Co. from the outset defined itself in substance, if not technically, as a partnership. However, it was one of the first firms to incorporate on Wall Street, when it did so in 1969. Mr. Bernstein testified:

> "I was getting very concerned with certain things I was seeing happening in the financial community...and I started looking at the balance sheets of other Wall Street firms, and I saw trouble coming. So I decided...to have a corporate shield...."

In 1984, the corporation elected to be taxed as an "S" corporation. Mr. Bernstein explained why this decision was made as follows:

> "[W]e would have liked to become a partnership, but I was concerned about losing the corporate shield. So we worked with Mr. Seidman [firm's outside accountant] in developing a plan where we could have the benefits of a partnership and the liability shield of the corporation.... [W]e were able to make a substantial portion of the income of many of the top people of the company very variable, based on the earnings of the company...variable compensation for the top people in the company."

Compensation for the key professionals was set by the company's board of directors, of which petitioner was chairman, and was based upon the profitability of the business. During 1984, in addition to Mr. Bernstein, there were four other members of the board of directors: Lewis Sanders; Roger Hertog, senior-most executive in charge of sales and marketing activities; Stuart Nelson, chief counsel; and Joe Greeley, senior-most executive in charge of operations, including stock clearing operations. During 1985, there was an additional member of the board of directors, Kevin Brine, who managed the firm's sales force dedicated to serving the individual investor (distinguished from institutional investors such as pension funds).

During 1984, only four individuals owned a significant percentage of shares in Bernstein & Co.: petitioner, 32,041 shares;[9] Lewis Sanders, 17,589 shares; Roger Hertog, 11,464 shares; and Joe Greeley, 5,211 shares. The remaining 33,775 shares (out of the total shares issued of 100,000) were distributed among approximately 15 to 20 people with no one, other than the four gentlemen noted, owning more than 1% of the shares (or 1,000 shares). During 1985, only five individuals owned a significant percentage of shares in the company: petitioner, 29,903

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[9]Petitioner's capital investment in the firm was approximately $6,000,000.00 during the years at issue. His return on investment was 47.56% for 1984 and 53.25% for 1985 calculated as follows:

		1984	1985
Investment income received (as noted in Finding of Fact "1", supra):			
Dividends		$ 102,743	$ 134,593
Short-term capital gain	171,364	715,781	
Long-term capital gain	839,654	394,399	
Net investment income	1,739,613	1,949,944	
Totals		$2,853,374	$3,194,717
Return on investment (Yearly totals divided by $6,000,000)		47.56%	53.25%

shares (approximately a 2% decrease, from 32% to 30%, in his ownership interest in the total number of outstanding shares of Bernstein & Co.); Lewis Sanders, 19,935 shares (approximately a 2½% increase, from 17½% to 20%, in his ownership interest in the total number of outstanding shares of Bernstein &

Co.); Roger Hertog, 11,462 shares; Joe Greeley, 5,211 shares; and Kevin Brine (who also became a board member in 1985), 2,084 shares. The remaining 31,405 shares were distributed among approximately 15 to 20 people with no one, other than the five gentlemen noted, owning more than 1% of the shares (or 1,000 shares).[10]

In addition to the approximately 20 individuals who received a share of subchapter S ordinary income, roughly 15 to 20 individuals received a distribution from a profit participation pool.[11] During the years at issue, a subchapter S corporation could have no more than 35 shareholders. Mr. Sanders testified:

> "[S]ince our partnership included considerably a number above that [35], and promised to get far above it in time, we designed the profit participation pool to, within the law, come as close as we could to creating the same kind of share of partnership income as would have been the case had we not been limited by the 35 in the S corporation law."

To some extent, bonuses were also used to compensate professional staff. In sum, according to Mr. Sanders, the approximately 75 or 80 professional people who were the key to the company in 1984 and 1985 were compensated "in a combination of ways, depending upon their development: a draw, a bonus in

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[10]None of the shareholders were passive investors. All contributed, in Mr. Sanders' words, "directly to the income of the firm because they all work at the firm".

[11]Ms. Rohrer, in her 1989 article on Bernstein & Co. in Institutional Investor, noted that 58 of the company's 400 employees share the firm's earnings, "but only if they perform, not simply because they've been around a certain number of years." It would appear that the 35 to 40 employees who shared the firm's earnings had grown to 58 at the time of the article, approximately four years later.

some cases, and as well in some cases, a share in 'partnership's' income."[12]

The board of directors sets compensation for these key 75 or 80 professional people annually (in advance of actual performance for the particular year) through extensive deliberations. For example, in 1983, the company's income and earnings would be estimated for 1984 based upon the utilization of the vigorous budgeting process described, supra, which according to Mr. Bernstein permits the firm to be comfortable with the concept of picking percentages of ownership in advance. The firm's earnings would be estimated per share and shares would be allocated according to what the members of the board of directors believed was a fair distribution, with each board member, according to Mr. Bernstein, having one vote:

> "[T]here are other guys in this board of directors that think I am worth some money. And by the way, I would say one thing: we surely are not equals, but when it comes to voting we are equal...if there is not a majority vote, it [his compensation package] doesn't pass."

The board would have some 50-odd meetings on the subject of compensation before making its final decisions.

Mr. Kuttner testified that W-2 compensation was "pretty much guaranteed" and that the board of directors "tries to keep W-2...at low levels and have most of the income basically based on the S earnings." Mr. Kuttner suggested that this compensation formula "gives people motivation to do better, because the better they did the more the firm will make and the more they will make."

In support of his position that $11,244,954.00 in 1984 and $13,859,373.00 in 1985 was reasonable personal service income, petitioner introduced into evidence a 70-page study by MMG Patricof & Co., Inc. entitled "A Study of the Operations of Sanford C. Bernstein & Co., Inc. and of the Compensation of Zalman C. Bernstein." This study was prepared under the supervision of Arthur Rosenbloom, chairman of the board of MMG Patricof & Co., Inc.

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[12]Prior to 1984 and the election of subchapter S status by Bernstein & Co., petitioner received compensation in the form of salary and bonuses.

Mr. Rosenbloom's education and experience, including the authorship of 50-odd articles two of which were on the subject of reasonableness of executive compensation, made him an extremely well-qualified expert witness on the subject of reasonable compensation.

The study was based upon interviews of eight members of the management of Bernstein & Co., Messrs. Bernstein, Sanders, Greeley, Hertog, Nelson and Kuttner, previously identified, supra, Samuel J. Silberman, described as a principal, and Peter Carman, described as chief investment officer. Further, among the records and documents reviewed were the following:

(1) the company's audited financial statements for the fiscal years 1977 through 1988;

(2) the company's Federal and State tax returns for the fiscal years 1977 through 1988;

(3) the company's annual "Report to Clients" for the fiscal years 1977 through 1988;

(4) records and documents with respect to the compensation of Mr. Bernstein as well as other top members of management for the fiscal years 1977 through 1988;

(5) various data on the company, including its assets under management in various types of securities, data on institutional trading and commissions, and data on numbers of research analysts and portfolio managers, both for the company and for various of its competitors;

(6) various brochures prepared by the company, including "Management Services and Policies" (May 1989), "Investment Management Policy and Procedures" (November 1984, March 1987, and May 1989), "Asset Management Strategy" (April 1989), and "Sixth Annual Bernstein Institutional Asset-Management Conference" (September 1988); and

(7) various articles written about Bernstein & Co., its investment philosophy, and Mr. Bernstein, including "The 1984 Pension Olympics" (Institutional Investor, February 1984), "The 1985 Pension Olympics" (Institutional Investor, February 1985), and "The Bernstein Formula" (Institutional Investor, November 1989).

After studying the history of Bernstein & Co. and petitioner's role in it, the success of its management and a comparison of the performance of the firm against other similar companies,

Mr. Rosenbloom concluded that Bernstein & Co. was "an exceptionally successful service organization vitally dependent on the constant and intense devotion of its management" and petitioner's compensation for each of the years at issue, including the S corporation distributions, was reasonable and for services rendered. The study emphasized the following characteristics of Bernstein & Co.:

(1) historically generated exceptional growth in income on minimum levels of invested capital;

(2) pioneered use of mathematical formula and computer science in money management;

(3) phenomenal ability to retain its critical managers; and

(4) superior client services with very little loss of clients over the years.

The study noted petitioner's supervisory involvement and guiding hand over all major activities and stressed petitioner's extraordinary managerial skills, meticulous attention to detail, outstanding marketing abilities and vision. It concluded that petitioner's leadership was critical to the firm's "dramatic expansion into a major player in its industry".

In the study, petitioner's compensation was compared to other Wall Street executives. Seventeen had higher compensation than petitioner in 1985. They were as follows:

Ivan Boesky	$100,000,000[13]
George Soros	85,000,000
Michael Milken	50,000,000
Jerome Kohlberg	50,000,000
Henry Kravis	50,000,000
George Roberts	50,000,000
Jeffrey Tarr	35,000,000
Robert Wilson	30,000,000
Asher Edelman	26,000,000
John Mulheren	25,000,000
Morton Davis	23,000,000
Michael Sternhardt	23,000,000
Leon Levy	22,000,000
Jack Nash	22,000,000

[13]These amounts were taken from a chart in the expert's report entitled "Twenty Highest-Paid Wall Street Executives", which noted the source as "Financial World". The copy of the bar graph is not easily read, and these amounts are approximations.

John Weinberg	22,000,000
Michael David-Weill	20,000,000
Richard McKenzie	20,000,000
Zalman C. Bernstein	17,000,000

SUMMARY OF THE PARTIES' POSITIONS

The Division of Taxation has maintained the same position from the initial audit to date: petitioner's W-2 wages of $4,638,517 and $3,203,869 in 1984 and 1985, respectively, are a reasonable allowance for personal services rendered by Mr. Bernstein to Bernstein & Co. Personal service

income does not include compensation representing a distribution of the company's profits.

Petitioner argues that the Division of Taxation "cynically and without any justification imposed an arbitrary limit [on personal services income] based on petitioner's W-2 income." New York personal services income is not restricted to amounts on W-2's, and petitioner has proven that the portion of the Subchapter S distributions of ordinary income reported as personal service income was, in fact, compensation from Bernstein & Co. for his personal services rendered to the company. The fact that petitioner's compensation was based upon the profitability of the company did not alter the fact that it was compensation for personal services.

CONCLUSIONS OF LAW

A. Tax Law former § 603-A,[14] which prescribed a maximum tax rate on New York

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[14]When section 603-A was added to the Tax Law by chapter 70 and amended by chapter 729 of the Laws of 1978, "New York personal service income" was defined as items of income includible as personal service income for purposes of section 1348 of the IRC, an analogous federal maximum tax provision. Section 1348(b)(1)(A) of the IRC, prior to its repeal effective for taxable years beginning after December 31, 1981, defined "personal service income" as any income which is earned income within the meaning of section 401(c)(2)(C) of the IRC or section 911(b) of the IRC or which is an amount received as a pension or annuity which arises from an employer-employee relationship or from tax deductible contributions to a retirement plan.

After section 1348 of the IRC was repealed in 1981, section 603-A of the Tax Law was amended to incorporate substantially the same definition of earned income that was contained in section 401(c)(2)(C) of the IRC (section 603-A[b][1][B] of the Tax Law), section 911(b) of the IRC (section 603-A[b][1][A] of the Tax Law) and the pension and annuity provision of section 1348(b)(1) of the IRC (section 603-A[b][i][C] of the Tax Law). The maximum tax rate on New York personal service income was repealed by Laws of 1987 (ch 28, § 5, eff April 20, 1987).

personal service income, provided, in part, as follows:

> "(b)(1) For purposes of this section the term 'New York personal service income' means
> (A) wages, salaries, or professional fees, and other amounts received as compensation for personal services actually rendered, but does not include that part of the compensation derived by the taxpayer for personal services rendered by him to a corporation which represents a distribution of earnings or profits rather than a reasonable allowance as compensation for the 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..."

B. The tax regulations at 20 NYCRR former 100.4(c) defined personal service income, in pertinent part, as follows:

> "(1) New York personal service income. For purposes of this section, the term New York personal service income means items of income includible as personal service income for purposes of section 1348 of the Internal Revenue Code....
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> * * *
>
> (2) Personal service income. (i) For purposes of section 1348 of the Internal Revenue Code, personal service income generally includes wages, salaries, professional fees, bonuses, commissions on sales or on insurance premiums, trips and other amounts received as compensation for personal services actually rendered. It also includes prizes and awards that are not gambling winnings....
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> * * *
>
> (iii) If an individual performs personal services for a corporation (including an electing small business corporation), personal service income generally is only the portion of income received from the corporation that represents a reasonable allowance for salaries and other compensation for personal services actually rendered.
> (iv) The entire amount received by an individual as professional fees is treated as personal service income if such individual is engaged in a professional occupation, such as a doctor, dentist, lawyer, architect, accountant, etc., and is individually and personally responsible for the services performed, even though he employs assistants to perform all or part of the service.
> (v) If an individual is engaged in an unincorporated trade or business in which both personal services and capital are material income-producing factors, a reasonable allowance as compensation for the personal services actually rendered is personal service income from the trade or business."

C. Before addressing the merits of whether the portion of the subchapter S distributions

of ordinary income reported by Mr. Bernstein as personal service income was, in fact, compensation from Bernstein & Co. for his personal services, it first must be concluded that petitioner bears the burden of proving such ultimate fact.

D. A notice of deficiency, that fails to provide taxpayers with information sufficient for the preparation of their case, does not raise a presumption of correctness that then places the burden of proof on the taxpayers (see, Tavolacci v. State Tax Commission, 77 AD2d 759, 431 NYS2d 174; Matter of Schneier, Tax Appeals Tribunal, November 9, 1989; Matter of Matson, Tax Appeals Tribunal, March 10, 1988). The argument by the Division of Taxation that the notices of deficiency herein raised a presumption of correctness is accepted. As noted in Finding of Fact "3", the notices referenced the earlier Statement of Audit Changes. The explanation provided in the Statement of Audit Changes, as detailed in Finding of Fact "2", supra, was sufficient to permit petitioners to prepare their case.

E. It is concluded that petitioner has shouldered his burden of proving the ultimate fact that the portion of the subchapter S distributions of ordinary income reported by him as personal service income was compensation from Bernstein & Co. for his personal services rendered to the firm. In addition, it is concluded that petitioner's proof was sufficient to establish that the deficiency, which failed to consider any portion of such distributions as personal service income was arbitrary and capricious (see, Matter of Fortunato, Tax Appeals Tribunal, February 22, 1990).

It is observed that the advisory opinion issued to petitioner, as noted in Finding of Fact "7", supra, properly noted that "in the context of the audit" proof must be presented by the taxpayer to establish that the distributions at issue represented compensation for his personal services. It was arbitrary for the Division of Taxation to reject the taxpayer's proof without any explanation for its rejection. There is no absolute bar to viewing distributions from a subchapter S corporation as compensation for personal services (cf., Foos v. Commissioner, 41 TCM 863; Matter of Coppola, State Tax Commission, February 18, 1986). Furthermore, the Division of Taxation's regulations did not restrict personal service income from a subchapter S

corporation to W-2 income, but impliedly recognized that distributions may be compensation for personal services (20 NYCRR former 100.4(c)(2)(iii), supra). Consequently, it was incumbent upon the Division of Taxation to elaborate upon the factors it considered in determining that the distributions were not of personal service income.

F. As noted in Footnote "14", supra, the maximum tax rate on New York personal service income was closely modelled on Federal law and precedent. As a result, in determining whether the personal service income reported by Mr. Bernstein for 1984 and 1985 was, in fact, personal service income, it is proper to look to precedent set under the Federal law. Foos v. Commissioner (supra) shows how the issue at hand is, at its heart, an extremely factual one, rooted in a close analysis of the facts concerning a business's operation and the individual taxpayer's role in it. In Foos, Tax Court Judge Dawson observed that to resolve the issue of what constitutes reasonable compensation for personal services raises a question of an ultimate fact "which must be resolved on the basis of all the facts and circumstances of each particular case [citations omitted]" (Foos v. Commissioner, supra, at 878).

In determining whether compensation was reasonable, Judge Dawson noted that courts have examined the following factors:

> "1. Employee's qualifications and training.
> 2. Nature, extent, and scope of his duties.
> 3. Responsibilities and hours involved.
> 4. Size and complexity of the business.
> 5. Results of the employee's efforts.
> 6. Prevailing rates for comparable employees in comparable business. (See section 1.162-7(b)(3), Income Tax Regs.)
> 7. Scarcity of other qualified employees.
> 8. Ratio of compensation to gross and net income (before salaries and Federal income tax) of the business.
> 9. Salary policy of the employer to its other employees.
> 10. Amount of compensation paid to the employee in prior years.
> 11. Employee's responsibility for employer's inception and/or success.
> 12. Time of year the compensation was determined.
> 13. Whether compensation was set by corporate directors.
> 14. Correlation between the stockholder-employees' compensation and his stockholdings.
> 15. Corporate dividend history.
> 16. Contingent compensation formulas agreed on prior to the rendition of services and based upon a free bargain between the employer and employee. (See section 1.162-7(b)(2), Income Tax Regs.)
> 17. Under-compensation in prior years.

18. Compensation paid in accordance with a plan which has been consistently followed.
19. Prevailing economic conditions.
20. Whether payments were meant as an inducement to remain with the employer.
21. Examination of the financial condition of the company after payment of compensation." (Foos v. Commissioner, supra, at 878-879.)

After considering these factors, Judge Dawson raised substantially the amounts allowed by the IRS as reasonable compensation for personal services but not quite as high as claimed by the taxpayers therein. In particular, Judge Dawson explained that Foos's business was not a personal service business but needed capital to operate. Capital was not merely incidental. Further, no businesses comparable to Foos's (a coal brokerage business that made its profit on its own account by buying coal low and selling high and was not merely an agent or middleman) were available for comparison, and the taxpayers in Foos "had no expert witnesses regarding compensation levels" (Foos v. Commissioner, supra, at 882). On the other hand, an important factor in favor of the taxpayers in Foos was the fact that bonuses were not determined at the year's end:

> "Bonuses determined at year end can be indicative of a corporation's attempt to use up in the form of purported extra compensation those profits already determined and otherwise available for distribution as dividends [citations omitted]" (Foos v. Commissioner, supra, at 882).

Judge Dawson also noted that the use of a percentage of net profits to determine the taxpayer's Subchapter S distribution was a factor benefitting the taxpayers since the earnings of their business was "primarily due to the efforts of a few individuals, and the retention of these individuals in the employ of the corporation is necessary to its continued operation..." (Foos v. Commissioner, supra, at 883).

G. Unlike the taxpayers' business in Foos (supra), Bernstein & Co. was a personal services business where capital was only incidental to the firm's principal activity (see, Crowell v. Commissioner, 55 TCM 1276; Barnes v. Commissioner, 54 TCM 972). In addition, as noted in Footnote "9", supra, petitioner received a generous return on his capital of $6,000,000.00 invested in the firm. Further, petitioner's expert witness concerning compensation levels was extremely well-qualified, and his opinion must be given much weight. In addition, the

compensation of other Wall Street executives supports the conclusion that petitioner has proven his position. The fact that petitioner was and remains the vital center of Bernstein & Co. provides an adequate explanation for why the firm might have been the 75th largest money manager (in 1988 since the comparative size is not known for the years at issue) and yet petitioner was the 18th highest paid Wall Street executive (in 1985), especially in light of the dramatic increase in the firm's size and revenues, as noted in Finding of Fact "10", supra, for which petitioner's role was crucial.

It is also observed that the factors that weighed in favor of the taxpayers in Foos also hold sway in this matter. There can be no doubt that the retention of Mr. Bernstein in the employ of the company was necessary to its continued successful operation. Therefore, the use of a percentage of shares, which equated to a percentage of the firm's earnings, as a method of compensating petitioner was a positive factor in determining whether the earnings so distributed were for personal services rendered by petitioner to Bernstein & Co. Similarly, like the situation in Foos, the allocation of the firm's earnings was not determined at year end.

H. Some discussion is necessary concerning petitioner's request that the transcript of this hearing and/or documents introduced into the record be given confidential treatment. First, it should be noted that until the issuance of this determination, there is no public disclosure of the fact that petitioner has pursued a hearing in the Division of Tax Appeals. Therefore, unless petitioner has advised outside parties that he has proceeded to a hearing, any request for a copy of the hearing transcript and/or documents introduced into the record by an unrelated third party is extremely unlikely. Moreover, Tax Law § 697(e), "secrecy requirement and penalties for violation", would seem to prohibit such disclosure at the hearing stage.[15]

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[15]This statutory provision prohibits the disclosure of "the amount or any particulars set forth or disclosed in any report or return" which has been interpreted to mean information whose source is a filed tax return or report (cf., Kooi v. Chu, 129 AD2d 393, 517 NYS2d 601). The publication of this determination, however, is an explicit exception to the secrecy provision (Tax Law § 697[e][2]).

Furthermore, the Division of Tax Appeals is an adjudicatory body of limited and statutorily created jurisdiction (Tax Law § 2008), and the powers of an administrative law judge are specified by statute (Tax Law § 2010). Consequently, an administrative law judge would not have the authority to direct the records access officer of the Department of Taxation and Finance to deem the hearing transcript and hearing documents confidential. It is observed that the tax regulations include a specific section concerning the protection of trade secrets (20 NYCRR 2370.7), which outlines the procedure a person should follow to obtain exemption from disclosure of "records or portions thereof that are trade secrets...which if disclosed would cause substantial injury to the competitive position of the subject enterprise."

I. The petition of Zalman C. and Elaine K. Bernstein is granted, and the notices of deficiency dated February 29, 1988 are cancelled.

DATED: Troy, New York

10/31/91

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ADMINISTRATIVE LAW JUDGE