STATE OF NEW YORK

DIVISION OF TAX APPEALS

In the Matter of the Petition of ANDREW J. O'CONNELL, JR. AND BLANCHE M. O'CONNELL for Redetermination of a Deficiency or for Refund of New York State and New York City Income Taxes under Article 22 of the Tax Law and the New York City Administrative Code for the Years 1984 through 1988.	DETERMINATION DTA NO. 811794

Petitioners, Andrew J. O'Connell, Jr. and Blanche M. O'Connell, 343 Laurel Road, New Canaan, Connecticut 06840, filed a petition for redetermination of a deficiency or for refund of New York State and New York City income taxes under Article 22 of the Tax Law and the New York City Administrative Code for the years 1984 through 1988.

A hearing was held before Marilyn Mann Faulkner, Administrative Law Judge, at the offices of the Division of Tax Appeals, 500 Federal Street, Troy, New York, on December 8, 1994 at 1:15 P.M., with all briefs due by May 19, 1995, which commenced the six-month period for issuance of this determination. Petitioners, represented by Chadbourne & Parke (Donald Schapiro, Esq., of counsel), filed a brief on March 22, 1995. The Division of Taxation, represented by William F. Collins, Esq. (Michael J. Glannon, Esq., of counsel), filed a brief on April 28, 1995. Petitioners filed a reply brief on May 17, 1995.

ISSUES

I. Whether Tax Law § 631(c) permits petitioner Andrew J. O'Connell, Jr., who is a municipal bond salesman, to allocate his commission income within and without New York State based on the location of his customers.

II. Whether there is reasonable cause to abate the penalties imposed.

FINDINGS OF FACT

Petitioner proposed 34 findings of fact. These proposed findings of fact have been incorporated in the following Findings of Fact unless otherwise indicated.

Petitioners, Andrew J. O'Connell, Jr. and Blanche M. O'Connell, filed joint New York State nonresident income tax returns on Form IT-203 for the calendar years 1984 through 1988.

Petitioners resided in New Canaan, Connecticut during all the years in issue, were not domiciliaries of New York State and did not maintain a place of abode in New York State. Accordingly, petitioners were subject to tax as nonresidents. [1]

Petitioner was employed by First Boston Corporation ("FBC") during the calendar years 1984 through 1988 as a municipal bond salesman. During each of these years he was compensated by FBC solely by commissions based upon the volume of sales and purchases of bonds made by him on behalf of his customers. His compensation was approximately 15% of the sales credit -- the difference between the purchase price and sale

[1]Because the issue in this case involves only the amount of compensation received by Andrew J. O'Connell, Jr., the term "petitioner" refers to Mr. O'Connell.

price of the bond. Although petitioner received an annual draw from FBC, this amount was applied against his commissions.

FBC did not provide petitioner with a private office in New York City, but did provide him with a desk and telephone. Petitioner was

required to travel as a condition of employment and was reimbursed for travel expenses.

Because of the competitive nature of his business, petitioner maintained close contacts with his customers by telephone and by frequent personal visits to his customers' places of business. Petitioner testified, concerning the nature of his relationship with his customers, as follows:

A. "The primary thing that I do is I have to distinguish myself from my competition, and the way that I do that is by getting the closest possible relationship and the closest knowledge of my clients and what their objectives are."

Q. "This is accomplished by being in close contact with your clients?"

A. "I talk to [my clients] all the time on the phone and I go see them on a frequent basis. One of the problems that somebody in my business faces is the fact that your clients are called constantly by ourselves and our competitors. So, it is very difficult to compete for their time on the phone. It is very difficult to get them on the phone, so it is of paramount importance in my job that when I call, my calls get received, and that I am regarded in the highest fashion by my clients. It has been my experience over the past thirty-somewhat years that I have been doing this, that there is no substitute for personal relationships with my clients. The greatest way to have that personal relationship with the client is having the greatest personal contact with them."

Q. "Do you go out and visit your clients at their place of business?"

A. "Yes, I do."

Q. "Do you spend time with them there?"

A. "Yes, I do."

Q. "Do you go there on a regular basis?"

A. "Yes."

Q. "What are you hoping to accomplish by visiting your clients at their place of business?"

A. "Ultimately, to sell them bonds and buy bonds from them to create sales credits. In that process the key thing is the relationship and the knowledge of what the client wants to do and what the client is thinking, what his objectives are. There is no question that to attain that kind of a situation and that kind of a reputation, it can't be done over the phone. First of all, there is no substitute for sitting across from somebody and having personal contact with them. But more important than that, when you call a client on the phone you are one of many, many people that are fighting for their time on the phone at a time when there is a lot of activity going on around them and a lot going on in the market" (tr., pp. 25-26).

The bulk of petitioner's transactions with customers located outside New York for the audit period in question involved the following 10 customers:

Merrill Lynch Asset Management (New Jersey)
Travelers Indemnity Group (Connecticut)
Prudential Insurance Co. of America (New Jersey)
Farmers Insurance Exchange (California)
Nationwide Financial Services (Ohio)
Connecticut General Life Insurance Co. (Connecticut)
General Electric Co. (Connecticut)
Cigna Investments, Inc. (Connecticut)
Zenith National Insurance Co. (California)
Crum & Forster (New Jersey)

These 10 customers generated sales credits for petitioner in the following amounts and percentages:

	Sales Credits in $1,000	
	Sales 10	Total

	Largest Customers	Outside of New York	Percentage of Total
1984	$2,893.2	$3,042.2	95.1%
1985	4,641.9	4,932.4	94.1%
1986	5,766.6	6,055.7	95.2%
1987	4,109.9	4,153.3	99.0%
1988	4,138.6	4,240.1	97.6%

Over the five-year period of 1984 through 1988, four out-of-state customers generated approximately 65% of the aggregate sales credits from all out-of-state customers.[2] These four customers were Merrill Lynch, Travelers Insurance, Prudential Insurance and Connecticut General.

At hearing, petitioner testified that he would visit these out-of-state customers located in New Jersey and Connecticut at least once a week or more for no less than half an hour for some customers and no less than an hour for others.[3] Petitioner described the nature of these visits as follows:

> "When you go to visit a client there is a definite purpose you have in mind, and some of them are very direct and some of them are indirect. Obviously the principal goal that I have is to always maintain that client relationship so as to maximize my sales credits. In the process of doing that, when you see a client, the primary thing I would always do is endear my relationship with them, and get a much better and closer personal contact with them. Another thing that would also happen in a client visit was that you would get their undivided attention. You have discussions about things that you really can't have on the phone

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[2]If the year 1984 is omitted, the four customers generated 70% of the aggregate sales credits.

[3]Proposed finding of fact "26" is not included in this Finding of Fact to the extent that it concludes that petitioner's testimony and other evidence in support of this finding constitutes "credible evidence". Whether this evidence constitutes credible evidence to support a fact is a conclusion of law.

> because you are in their office sitting face to face. So, this is a time that we would find out a lot of information about customers and their portfolio, about our competition, about what they really like and don't like about the economy and other issues that effect their performance in their portfolios, and things like that" (tr., p. 29).

Petitioner testified that the trades would frequently take place at a customer's office or would occur when he was in his New York office, at his Connecticut home or at other customer offices. He stated that at times he would conduct business over the telephone for one client while at another client's office or while at his home in the evening. He testified that many

times he would conduct an actual trade at 8:00 P.M. or 9:00 P.M. because in California the traders were still at work at 4:00 P.M. or 5:00 P.M. California time. He also noted that sometimes he could call the trader's home in the evening with respect to bonds that the trader might or might not be willing to send to him overnight for a particular customer. In a "secondary trade" situation, one of petitioner's clients might want to sell certain bonds. Petitioner would then call the office to check on a price and then call another client to sell the bonds to him or her.

In order to complete the trade, petitioner noted that a ticket would be written indicating a sale or purchase of a particular bond. When petitioner was not in the office, this ticket was either written by someone in the office at petitioner's direction or written by petitioner when he returned to the office that day. Petitioner noted that the ticket did

not contain information as to petitioner's location at the time of the trade because the ticket was designed to comply with the regulations of the Securities and Exchange Commission, which did not require such information.

Petitioner stated that he handled approximately 100 telephone calls a day when at his New York desk. He described his manner of conducting business while traveling as follows:

> "I can't afford to travel and see clients and just let my business go, so I am in constant contact with the office. As things develop I can call a client. The customers like the fact that we are in their office and selling bonds to someone else. It's a little bit of Hollywood. It is kind of fun for them" (tr., pp. 91-92).

Petitioner testified that it was not important to his customers where petitioner was physically located when he made a trade on their behalf. He also opined that the essence of the sales credit "derived from the client, his mind and what he wants to do" (tr., p. 27).

In support of his testimony, petitioner submitted affidavits by Robert S. Waas, Justin D. Hennessey, Phillip A. Duncan and Richard Cahill. Each affiant was a representative of the respective customers -- Merrill Lynch, Cigna Investment,[4] Travelers Insurance and Prudential Asset Management -- during the audit period in question.[5] Each affiant was responsible for

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[4]During the hearing, petitioner referred to Mr. Hennessey as a representative of Connecticut General, whereas in his affidavit, Mr. Hennessey identifies himself as an employee of Cigna Investments. There is nothing in the record that resolves this discrepancy. Therefore, it is assumed that petitioner misspoke in his reference to Mr. Hennessey.

[5]Mr. Waas and Mr. Hennessey were employed by their respective companies for the period 1985 to 1988 and Mr. Duncan and Mr. Cahill were employed by their respective companies for

the purchase and sale of municipal bonds for the respective customers. The affidavits were similarly worded as follows:

> "All municipal bond fund activity including muni bond transactions were executed at [the respective office of the customer].
>
> "Andrew J. O'Connell, Jr. was the Municipal Bond Salesman at the First Boston Corporation with whom I dealt during the period [1984 or 1985] to 1988. During this time, Mr. O'Connell regularly visited my office on an average of at least once per week to discuss all aspects of the bond business and economy and to assist me in developing portfolio strategies and to present credit information on a variety of issuers.
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> * * *
>
> "Also on occasion, I would visit Mr. O'Connell in his office in NY. The visits to his NY office occurred once or maybe twice per year."

In all four affidavits, the affiants stated that the transactions concerning the purchases and sales of municipal bonds occurred: (1) while petitioner was visiting the affiant in the affiant's office; (2) while petitioner was in his New York office; (3) while petitioner was at his Connecticut home speaking over the telephone with the affiant; and (4) while petitioner was in other customer offices. Mr. Duncan also stated that the transactions would also take place when he was with petitioner at petitioner's vacation house in Vermont. In addition, both Mr. Duncan and Mr. Hennessey stated the following:

> "While I never kept track of Mr. O'Connell's location when we bought and sold municipal bonds, I am sure that more than half the transactions occurred

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the period 1984 to 1988.

while Mr. O'Connell was out of his office."[6]

Petitioner testified that he would also make trades for New York State clients when he was traveling out of state or from his Connecticut home. He estimated that 50% of his business time was spent out of New York State when he conducted business. In support of his method of conducting business, petitioner submitted an affidavit of James L. Gammon, a representative of Loews Corporation with an office in New York State. Mr. Gammon stated that he sold to petitioner and purchased from petitioner municipal bonds during the period March 1984 through 1988. He affirmed that many of the purchases and sales occurred while both he and petitioner were out of New York State, that they were in communication throughout the day regardless of their extensive travel schedules, and that they often

conducted business from their respective homes in Connecticut after hours and on weekends.

With respect to the out-of-state customers that were located further than New Jersey or Connecticut, petitioner testified that he would visit them at least once a year for a period of several days in order to plan strategies for buying

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[6] For the years 1985 through 1988, Merrill Lynch transacted trades in the amounts of $823,600.00, $1,343,000.00, $496,800.00, and $1,714,135.00, respectively. For the year 1988, Cigna transacted trades in the amount of $361,800.00. For the years 1984 through 1988, Travelers Insurance transacted trades in the amounts of $25,900.00, $984,000.00, $1,323,500.00, $1,049,000.00, and $839,500.00, respectively. For the years 1984 through 1988, Prudential Asset Management transacted trades in the amounts of $571,100.00, $709,200.00, $1,192,800.00, $747,800.00, and $803,600.00, respectively.

and selling municipal bonds for the following year. Two affidavits were submitted by representatives of Nationwide Insurance, located in Ohio, and Farmers Insurance Group, located in California, confirming that petitioner visited their out-of-state offices at least once a year.[7] They both noted that if circumstances changed during the year, petitioner would meet with them again at their offices in order to implement revised investment programs or strategies.

The Division of Taxation ("Division") submitted a printout of petitioner's absence from the New York office of FBC provided by the vice-president of human resources of FBC. The printout included the period 1985 through 1990. The printout indicated that petitioner was in California from August 12 through 14, 1985, in California from July 16 through 23, 1986, in Ohio on June 15, 1987, in California from July 16 through 20, 1987, and in Ohio on August 22, 1988. The Division offered no explanation as to the nature of the request which resulted in the production of this document. Also, no explanation was provided as to how this document was generated.

Although petitioner was reimbursed for his travel expenses, he testified that he did not request reimbursements for his routine weekly visits to customers in New Jersey or Connecticut. These visits would take up only part of the day.

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[7]The affidavit of Laszlo G. Heredy, a vice-president of investments with Farmers Insurance Group, indicated that he dealt with petitioner during the period 1978 to 1988. The affidavit of James W. Pruden, vice-president of securities with Nationwide Insurance, did not specify the time period of his business association with petitioner.

Petitioner spent the remainder of the day at his New York City desk.

Since the mid-1970's, petitioner allocated his income within and without New York State on his New York income tax returns based on the physical location of his customers. Petitioner testified at hearing that he believed that he disclosed his method of allocation on the schedules attached to these State income tax returns. The schedules contained the following statement:

> "Pursuant to regulation SEC. 131.15 New York State Income Tax Regulations & John Mc G. Dalenz [sic] v. State Tax Comm. 9 AD 2d 599; 189 N.Y. Supp 2d 348, taxpayer, a non-resident securities salesman compensated solely by a commission based upon his total production, hereby elects to allocate his commission income to New York State and City based upon the volume of business transacted within and without the State and City.
>
> "Taxpayer's commission is allocated to New York State and City by the formula represented by the following fractions:"

Next to the amount he allocated to New York State and City was an asterisk indicating an explanation at the bottom of the page. Next to the corresponding asterisk at the bottom of the page was the following statement: "All customers within N.Y. State are also located within N.Y. City."

Petitioner explained the basis for his belief that the attached schedules indicated his method of allocation in the following direct testimony:

> Q. "And do you believe that [the statement in the attached schedules] disclosed that you were reporting on the basis of the location of the customer?"
>
> A. "Yes."

Q. "And tell me what made you say that you were reporting on the basis of the location of the customer?"

A. "Well, the entire statement, but specifically if you look it says 'All customers located within New York State are also located in New York City.' That is a further refinement of the point" (tr., p. 44).[8]

Petitioner followed the practice of overpaying his Federal and New York income tax by overwithholding and then seeking a refund. This practice included petitioner filing for an extension of time to file his Federal and State tax returns prior to their due dates and postponing the filing for three years, at which time he also showed a refund due. Petitioner recognized that this practice of extending the filing date and delaying the refund deprived him of interest on the refunded amount. He also recognized that while this practice did not give him any tax advantage, it also did not subject him to any penalties. Petitioner's rationale for the overpayment of taxes and the postponement of refunds was to create a forced savings plan for himself. He stated that he had a hard time saving money and that this practice allowed him to set money aside as a kind of "nest egg or emergency fund" (tr., p. 75-76).

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[8] I did not include within this Finding of Fact that portion of petitioner's proposed finding of fact "34" which states "[t]hese returns all contained a schedule showing that income was being allocated based on the physical location of the customer. Respondent acknowledges this fact (R-13)." Instead, Finding of Fact "17" recites in greater detail the actual statement contained in the schedules and the basis for petitioner's belief that these schedules showed petitioner's method of allocating income based on the physical location of the customer. Moreover, the opening statement of the Division's counsel, recited on page 13 of the transcript, does not constitute an acknowledgement that these schedules informed the Division of petitioner's method of allocating income based on the physical location of the customer.

Petitioner allocated his income to New York in his tax returns as follows:

	Income Per Form W-2	Percentage New York to New York	Dollars Allocated
1984	$ 784,510.00	34.837%	$273,300.00
1985	695,009.00	42.330%	294,197.00
1986	1,216,341.00	33.668%	409,518.00
1987	1,282,166.00	46.740%	599,284.00
1988	1,071,279.00	24.620%	263,749.00

Petitioner filed tax returns showing taxes withheld and refunds due in the following amounts:

	A Taxes Withheld	B Refunds Claimed and Paid	C Net Taxes Paid	D Refunds Claimed Not Paid
1984	$46,941.00	$23,946.00	$22,995.00	$ -0-
1985	42,535.00	19,842.00	22,693.00	-0-
1986	71,064.00	37,315.00	33,749.00	-0-
1987	73,730.00	-0-	73,730.00	25,141.00
1988	61,801.00	-0-	61,801.00	40,693.00

The Division accepted these filed returns and issued timely refunds based on the reported overpayments until it audited petitioner's returns for 1984 through 1988.

After an audit, the Division issued to petitioner statements of personal income tax audit changes, dated August 31, 1990. In those statements, the Division's auditor rejected petitioner's method of allocating income to New York. The auditor stated that 20 NYCRR former 131.17 did not apply because petitioner's compensation did not depend directly upon

the volume of business transacted by petitioner,[9] and

that, instead, 20 NYCRR former 131.18 applied which allocates income based on the days in and out of New York State. The auditor also opined that even if the provisions of 20 NYCRR former 131.17 were to apply, the method used by petitioner is inconsistent with those provisions. The auditor contended that the proper method of determining the source of income is based on where the taxpayer performs the services and not on the location of the customer. The auditor concluded that the services performed by petitioner for FBC were conducted mainly at the employer's place of business in New York City; that the infrequent visits by petitioner to his customers at their place of business were of an informational or customer relations nature; and that no documentation was submitted to substantiate that any business was consummated during those customer visits. In the statements of audit changes, the auditor recalculated petitioner's New York allocation of income for the years 1984 through 1988 as follows:

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[9]20 NYCRR former 131.17 provided, in pertinent part, that:

> "Earnings of salesman. If the commissions for sales made or other compensation for services performed by a nonresident traveling salesman, agent or other employee depend directly upon the volume of business transacted by him, his items of income, gain, loss and deduction . . . derived from or connected with New York State sources include that proportion of the net amount of such items attributable to such business which the volume of business transacted by him within New York State bears to the total volume of business transacted by him within and without New York State."

	Percentage Allocation	Increase in Compensation Allocated to New York
1984	98.6842%	$500,887.00
1985	98.6842%	391,667.00
1986	97.2602%	773,499.00
1987	97.7578%	654,133.00
1988	99.5689%	802,912.02

The auditor determined that petitioner worked only 3 days out of 225 work days outside New York in 1984; 3 days out of 225 work days in 1985; 6 days out of 213 work days in 1986; 5 days out of 218 work days in 1987; and 1 day out of 231 work days in 1988.

The Division issued to petitioner a Notice of Deficiency, dated October 12, 1990, for the total amount of $283,393.72. In the notice, the amount due for each period was broken down as follows:

Tax Period Ended	Tax (=) Current Amount Assessed Due	(+) Interest Amount Assessed	(+) Penalty Amount Assessed	(-) Assessment Payments/ Credits	Balance
12-31-84	$ 40,362.65	$22,475.83	$ 4,679.15	$176.51	$ 67,341.12
12-31-84	2,253.84	1,255.19	0.00	0.00	3,509.03
12-31-85	28,358.82	11,698.08	2,579.95	0.00	42,636.85
12-31-85	1,762.38	726.99	0.00	0.00	2,489.37
12-31-86	61,406.53	18,934.59	6,930.35	0.00	87,271.47

12-31-86	3,480.57	1,073.23	0.00	0.00	4,553.80
12-31-87	28,869.61	6,648.68	7,217.40	0.00	42,735.69
12-31-88	23,587.38	3,372.21	5,896.80	0.00	32,856.39
Totals	$190,081.78	$66,184.80	$27,303.65	$176.51	$283,393.72

The following column A sets forth the deficiencies of income tax claimed by the Division; column B sets forth the refund amounts claimed by petitioner; and column C sets forth the net amounts in dispute for each audit year:

	A Tax Deficiency	B Refund Claimed	C Amount in Dispute
1984	$42,616.49	$ -0-	$42,616.49
1985	30,131.20	-0-	30,121.20
1986	64,887.10	-0-	64,887.10
1987	28,869.61	25,141.00	54,010.61
1988	23,587.38	40,693.00	64,280.38

At hearing, petitioner submitted, with some corrections, exhibits which listed and summarized information concerning the total amount of trades petitioner made for companies both within and without New York State for the years 1984 through 1988. Those exhibits show the following allocations in $1,000.00 increments:[10]

	Total Sales Credits	Total Sales Credits Within New York	Percent Within New York
1984	$4,723.5	$1,681.3	35.6%
1985	8,481.4	3,549.0	41.8%
1986	9,093.9	3,038.0	33.4%

[10]Proposed findings of fact "10" through "16" are not included in these Findings of Fact inasmuch as they include detailed descriptions of the exhibits and corrections to those exhibits that are not necessary to recite in the Findings of Fact.

1987	7,799.2	3,645.9	46.7%
1988	5,722.9	1,482.8	25.9%

After a conciliation conference, the conferee issued a Conciliation Order, dated January 8, 1993, sustaining the statutory notice.

Petitioner filed a petition, dated April 6, 1993, arguing that the Division applied the wrong regulation to petitioner's situation when it calculated an apportionment of income based on 20 NYCRR former 131.18 rather than 20 NYCRR former 131.17; that the Division's interpretation of "transacting business" to include only the actual taking of orders excluding all other customer contact is arbitrary, results in an unfair apportionment

and violates the U.S. Constitution; that petitioner correctly allocated his commission income; and that the imposition of penalties was inappropriate because petitioner acted reasonably and in good faith.

The Division filed an answer, dated September 29, 1993, stating that petitioner had not established that the assessment was erroneous or improper.

SUMMARY OF THE PARTIES' POSITIONS

In brief, petitioner argues that his commission income is subject to allocation under 20 NYCRR former 131.17 and not under the days-in and days-out-of-New-York rule of 20 NYCRR former 131.18, as asserted by the Division's auditor in the statements of audit changes. Petitioner further argued that his method of allocating income based on the customer's location was

reasonable under 20 NYCRR former 131.17. Petitioner contends that the critical factor for his success as a salesman was the personal relationship he developed and cultivated with his customers while visiting their offices; that he made the actual trades while in customers' offices or at other locations outside of New York State; and that his physical location when he made trades over the telephone was immaterial to him or his customers. Petitioner finally argues that it would be inequitable for the Division to require him to keep records of his whereabouts when trades were made. Petitioner testified that he did not keep contemporaneous diaries of his out-of-state visits or of his location when making each individual trade because he reasonably believed that his method of allocation was reasonable and correct. Petitioner stated that he based this belief on the fact that his prior New York State tax returns clearly showed his allocation method based on the physical location of the customer and had been consistently accepted by the Division, with refunds granted.[11]

In brief, the Division argues that petitioner failed to establish during audit that his income was based on commissions, but concedes that at hearing petitioner established that his commission income qualified for the application of 20 NYCRR former 131.17. The Division maintains, however, that petitioner's allocation of income under 20 NYCRR former 131.17

[11]Although petitioner alleged in his petition that the Division's assessment violated the U.S. Constitution, there was no reference to this argument at hearing or in his brief. Therefore, this argument is deemed abandoned.

was improper. The Division asserts that the key factor in allocating commission income is petitioner's physical location for each trade which generated the income and that it was petitioner's duty to maintain adequate records establishing where he made the trades. The Division reasons that allowing petitioner's method of allocation would permit a nonresident bond salesman working in New York to allocate all his commission income outside New York on the basis that all his clients were located out of New York. The Division opines that petitioner's proposed test is "illogical with inequitable results and could not have been intended by the Regulation" (Division's brief, p. 4). The Division also questions the credibility of petitioner's testimony concerning the frequency of his visits to clients' offices. The Division argues that petitioner's testimony is inconsistent with FBC's records and that little or no weight should be given to the "generally worded form affidavits" submitted by petitioner in support of his testimony.

CONCLUSIONS OF LAW

A. Tax Law § 631(a) provides that New York source income of a nonresident individual includes the net amount of items of income, gain, loss and deduction reported in the Federal adjusted gross income that are "derived from or connected with New York sources." The statute further provides that income derived from or connected with New York sources:

"shall be those items attributable to:

* * *

> "(B) a business, trade, profession or occupation carried on in this state . . ." (Tax Law § 631[b][1]).

With respect to a business or trade carried on both within and without New York State, the statute provides that:

> "If a business, trade, profession or occupation is carried on partly within and partly without this state, as determined under regulations of the tax commission, the items of income, gain, loss and deduction derived from or connected with New York sources shall be determined by apportionment and allocation under such regulations" (Tax Law § 631[c]).

The regulations in effect during this audit period provided that if an employee depends upon commissions based on the volume of business transacted by him, then his New York income includes:

> "that proportion of the net amount of such items attributable to such business which the volume of business transacted by him within New York State bears to the total volume of business transacted by him within and without New York State" (20 NYCRR former 131.17).

As noted above, in brief the Division has conceded that based on the evidence at hearing, 20 NYCRR former 131.17 applies; however, it disagrees with petitioner's method of allocation. The Division asserts that petitioner cannot allocate his income within and without New York State based on the physical location of his customers but instead must allocate the income based on petitioner's physical location at the time he actually transacted the trade. The Division contends that petitioner's proof was inadequate to establish that he was outside of New York State when he transacted a trade.

B. There are no regulations which specifically address how the allocation of income should be made with respect to business transacted by a bond salesman. There are, however, regulations

with respect to security and commodity brokers doing business both within and without the State (20 NYCRR former 131.21). Under those regulations, commissions derived from the execution of purchase or sale orders for the account of a customer must be allocated and apportioned 20% to New York State if the sale order is (1) received at the broker's New York place of business for execution on an exchange located within New York State and (2) originates at a bona fide established office of the broker located without the State (20 NYCRR former 131.21[b][2]). If the sale order originates in the New York State place of business but is transmitted to a bona fide established office of a broker located without New York State for execution on an exchange located without New York State, 80% of the commissions must be allocated to New York State as income derived from or connected with New York State sources (20 NYCRR former 131.21[b][3]).

The regulations also provide that if the regulations do not apportion and allocate income in a fair and equitable manner, the Tax Commission may prescribe a different method, as long as such method results in a fair and equitable apportionment and allocation (20 NYCRR former 131.23). A nonresident individual may also submit an alternative method of apportionment and allocation which must be "fully explained" in the taxpayer's New York State nonresident personal income tax return and must be "approved" by the Tax Commission (id.).

In this case, petitioner elected to use a method of apportionment and allocation based on the physical location of

his customers. However, contrary to petitioner's contentions, although his method might have been implied by the schedules attached to his income tax returns, it was never "fully explained" by petitioner on those returns or "approved" by the Tax Commission at that time[12] (cf., Matter of Wyman, Tax Appeals Tribunal, December 31, 1992). The issue remains, however, as to what constitutes a fair and equitable method for allocating petitioner's commission income based on the facts of his situation (see, Matter of Wyman, supra).[13]

C. Although not applicable to bond salesmen, the regulations with respect to security and commodity brokers is instructive. The regulations differentiate between the place of origin of a purchase or sale order and the place of execution of the order on the exchange. In petitioner's situation, his commissions originate from the sale or purchase order of the customer and are executed or confirmed at petitioner's place of business in New York. It appears that petitioner's allocation method using the physical

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[12]The Legislature abolished the Tax Commission in 1986, transferring all functions, powers and responsibilities of the Commission to the Department of Taxation and Finance, with the exception of the administration of the adjudicatory system of resolving controversies between taxpayers and the Department (L 1986, ch 282).

[13]Petitioner cites Matter of Wyman for the proposition that because the Division used the wrong regulation (20 NYCRR former 131.18 instead of 20 NYCRR former 131.17) for determining a tax deficiency, the Notice of Deficiency lacked a rational basis and should therefore be cancelled. This case does not stand for that proposition. In Wyman, the Tribunal reversed the Administrative Law Judge's determination to cancel the notice on that ground and remanded the case to address the issues under the proper regulation -- 20 NYCRR former 131.17.

location of the customer is similar to the approach taken in the regulation with respect to security and commodity brokers. However, if one were to analogize petitioner's situation to a broker's, then the 80/20 rule would apply using the customer's physical location as the place of origin of the sale or purchase. Under this scenario, 20% of petitioner's volume of sales with respect to out-of-state customers would be allocated as income derived from New York sources. However, the dealings of a broker are distinguishable from that of a salesman, the most notable of which, as indicated in the regulations, is that a broker deals with other brokers with "bona fide established offices".

Inasmuch as petitioner's income was based on commissions, the applicable regulation clearly provides that the allocation of income should not be based on the amount of time he spent out of state, but instead on the volume of business he transacted out of state to generate those commissions. Based on the facts of petitioner's situation, the question is what is a fair and equitable method to determine the volume of business he transacted out of state.

The Division asserts that the determinative factor is petitioner's physical location at the time the trade is initiated by the customer rather than the physical location of the customer. Given the nature of petitioner's business, where such transactions are conducted primarily by telephone, but also on a person-to-person basis, the Division is correct to question petitioner's method of allocation inasmuch as this method would

exempt from New York tax all business transactions conducted by petitioner from his New York desk with out-of-state customers, including those out-of-state customers whom petitioner never visited. Of course, the converse situation is also questionable -- where all petitioner's commissions from sales to a particular customer would be subject to tax because all trades were conducted by telephone from petitioner's New York desk even though petitioner spent considerable time at the customer's out-of-state office cultivating and maintaining a business relationship and developing financial strategies with the customer.

Petitioner has provided credible testimony supported by affidavits that he spent considerable time with four New Jersey and Connecticut customers on a regular basis.[14] Petitioner's person-to-person contact was essential to the development of his business relationship with his customers. Contrary to the Division's claim, the nature of these personal visits cannot be dismissed as token informational sessions in the form of customer relations. From petitioner's testimony, customer relations were the core of petitioner's success in maintaining an ongoing relationship that affected the prospective nature of

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[14]The Division contends that records provided by FBC disprove the amount of time petitioner claimed as out-of-state travel. As noted in Finding of Fact "16", the Division submitted an attendance record provided by FBC; however, the utility of this record is limited inasmuch as there was no testimony or other evidence indicating the nature of the request made to secure this record or how this record was generated (e.g., based on travel vouchers, etc.). Petitioner testified that he did not submit travel vouchers with respect to his visits to New Jersey and Connecticut customers and would often spend only part of the day on those visits with the remainder of the working day spent at his New York desk. Because of its limitations, this record cannot serve as proof that petitioner did not visit his New Jersey and Connecticut clients on a weekly basis.

his commissions. The sales credits generated by each trade resulted from this close relationship. Failure to recognize the importance of these personal contacts in determining where petitioner conducted his business transactions in generating his commissions may be inconsistent with a fair and equitable method for income allocation.

In essence, the question is how much importance should be attached to these personal visits -- should these personal visits be taken into account only when an actual trade takes place at the time of those visits, or, can they also be taken into account when trades are made over the telephone while petitioner is at his New York desk, at other customers' offices or while petitioner is at his Connecticut home. More precisely, the issue is what constitutes a business transaction -- is it simply the actual trade in these circumstances, or, does it also include the time spent in the customer's office assessing the customer's needs or likes, developing a financial strategy or plan with a customer, or securing the customer's confidence to rely on petitioner's advice for future trades.[15]

The regulations do not contain a definition of what constitutes a business transaction and also do not set forth a definitive method to account for business transactions performed both within and without New York State. Instead, the

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[15]The definition of a "transaction" in Webster's Third New International Dictionary encompasses the latter situation. "Transaction" is defined as "a communicative action or activity involving two parties or two things reciprocally affecting or influencing each other."

regulations recognize that alternative methods may be adopted as long as they are fair and equitable. A fair and equitable standard clearly contemplates the particular circumstances of an individual's business conduct.

While the Division's allocation method based on petitioner's location at the time of the trade is reasonable, this method is not necessarily the only method or the most fair and equitable one in the circumstances of this case. The Division's allocation method requires evidence in the form of

contemporaneous records of petitioner's whereabouts at the time of each trade. While the evidence required under the Division's allocation method might present a clear-cut picture of petitioner's out-of-state business transactions, this method does not preclude the use of an alternative method. At the time he filed his returns, the only regulation available that approximated petitioner's situation was the 80/20 rule with respect to brokers. Based on this regulation, petitioner could have reasonably believed that his method of allocation based on the customer's location would be acceptable with respect to customers he visited on a regular basis. This belief, however, was not warranted with respect to out-of-state customers he visited on an infrequent basis. Petitioner kept records to support his calculations and filed his returns using the same method since 1978 without a question raised by the Division until the audit in the 1980's. In the absence of case law or regulations that might have served as some notice to petitioner,

it would be unfair to require petitioner in retrospect to produce contemporaneous records to document his physical location for each trade transacted with the out-of-state customers that he visited on a regular weekly basis when the regulations did not specifically indicate this level of recordkeeping but did indicate some flexibility in accepting alternative methods that are fair and equitable.

Moreover, the Division's method may not be the most accurate reflection of petitioner's business dealings with those particular customers. Given the nature of petitioner's business transactions with the four New Jersey and Connecticut customers, it appears that a more practical, fair and equitable method to account for his commissions relating to this particular volume of business was to allocate income based on a 50/50 formula similar to the 80/20 formula adopted for brokers. Petitioner has demonstrated that the use of this method is fair and equitable for these four customers only.[16] Petitioner's testimony was specific as to these four customers, and such testimony was supported by customer affidavits. Thus, this determination is based on the evidence that he visited these four customers on a weekly basis, assessing their needs and lending advice that led to trades at the customer's office that could be updated by telephone while petitioner was at home, at his New York desk or at another customer's office both within

[16]Merrill Lynch Asset Management (located in New Jersey), Travelers Insurance Company (located in Connecticut), Cigna Investment Management Co., Inc. (located in Connecticut), and Prudential Asset Management (located in New Jersey).

and without the State. The volume of the business transactions between petitioner and these four customers was dependent on the cultivation of a relationship built on these weekly person-to-person visits.

Because the amount of business generated by these visits cannot be calculated with any precision, a 50/50 formula is an equitable resolution. The 50/50 formula recognizes that 50% of the commissions relating to the business transactions with these four customers are considered as originating at the customer's office and should be attributable to business transacted by petitioner outside New York, and 50% of those same commissions should be allocated to business transacted by petitioner within New York (see, Finding of Fact 14, ftn. 6). In this scenario, the 50% attributed to New York recognizes that (1) while the business transaction originated outside New York, petitioner executed the trade or confirmed the trade at his New York desk, and (2) petitioner may have negotiated some trades over the telephone from his New York desk as a follow-up to his weekly visits or during those once- or twice-a-year visits by these customers to his New York City office.

D. Petitioner has not sufficiently established that he maintained the same relationship with his other customers located outside New York State. While petitioner's testimony and an affidavit confirmed petitioner's visits to Farmers Insurance Group in California once a year, there is no evidence indicating that trades were made during those visits nor is

there evidence of the number of trades these annual visits may have generated via the telephone throughout the year. Petitioner could have negotiated all the trades for those customers at the time of the annual visits or none of those trades. Petitioner has not provided sufficient evidence upon which to make a determination that petitioner's method of allocation would be fair and equitable with respect to the other out-of-state customers (see, Matter of Churchill v. Gallman, 38 AD2d 631, 326 NYS2d 917). In such circumstances, the Division's method of allocating income based on petitioner's location at the time of actual trades would be appropriate. Inasmuch as there is no evidence to support an adjustment with respect to these customers, no adjustment can be made and petitioner's commissions relating to out-of-state customers, other than the four customers discussed above, are all attributable to business transacted by petitioner in New York State.

E. In his petition and at hearing, Mr. O'Connell asserted that the imposition of penalties was inappropriate because he acted reasonably and in good faith in this situation. Tax Law § 685(a)(3) provides that a penalty shall be imposed for failure to pay tax required to be shown on an income tax return unless such failure is due to reasonable cause and not due to willful neglect. The regulations provide that a taxpayer may show reasonable cause if his or her cause for delinquency in paying the tax "would appear to a person of ordinary prudence and intelligence as a reasonable cause for delay and which clearly indicates an absence of willful neglect" (20 NYCRR former

102.7[d][4]). The regulations also provide, however, that ignorance of the law does not constitute a basis for reasonable cause.

Here, the regulations indicate that if a taxpayer proposed a method of allocation and apportionment of income with respect to business transactions carried on both within and without New York State, this method must be "fully explained" on the taxpayer's nonresident income tax returns for "approval" by the Tax Commission (20 NYCRR former 131.23). As noted in Conclusion of Law "B", petitioner neither fully explained the method of allocation on his returns nor obtained the approval of the Tax Commission to use that method. The Division's failure to disapprove the method until a subsequent audit does not constitute an "approval" within the meaning of the regulation such that petitioner demonstrated reasonable cause to abate the penalties. Notwithstanding the fact that an alternative method might subsequently be accepted for part of petitioner's liability, petitioner's failure to seek the Division's approval of an alternative method when filing his tax returns was not prudent or reasonable. Petitioner took a risk by his conduct. In sum, petitioner has offered no justification to waive penalties.

F. The petition of Andrew J. O'Connell, Jr. and Blanche M. O'Connell is granted to the extent indicated in Conclusion of Law "C" and is otherwise denied. The Notice of Deficiency,

dated October 12, 1990, is modified in accordance with Conclusions of Law "C" and "D" and is otherwise sustained.

DATED: Troy, New York
November 16, 1995

/s/ Marilyn Mann

Faulkner

ADMINISTRATIVE LAW JUDGE