STATE OF NEW YORK

DIVISION OF TAX APPEALS

In the Matter of the Petition	:	
of	:	
MARTIN AND LINDA BROPHY	:	DETERMINATION DTA NO. 812052
for Redetermination of a Deficiency or for Refund of Personal Income Tax under Article 22 of the Tax Law for the Years 1988 and 1989.	:	

Petitioners, Martin Brophy and Linda Brophy, 172 Hunt Drive, Princeton, New Jersey 08540-2426, 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 1988 and 1989.

A hearing was held before Carroll R. Jenkins, Administrative Law Judge, at the offices of the Division of Tax Appeals, Riverfront Professional Tower, 500 Federal Street, Troy, New York, on February 10, 1994 at 1:00 P.M. The parties were granted until May 23, 1994 to file their respective briefs. All briefs were filed by the prescribed date. Petitioners appeared by James E. Conway, Esq. The Division of Taxation appeared by William F. Collins, Esq. (Andrew J. Zalewski, Esq., of counsel).

ISSUES

I. Whether the Division of Taxation, upon audit of petitioners' 1988 nonresident income tax return, properly included in New York source income an allocated portion of an $840,000.00 lump-sum payment.

II. Whether the Division of Taxation, upon audit of petitioners' 1989 nonresident income tax return, properly included in New York source income an allocated portion of an $840,000.00 lump-sum payment.

III. Whether Mr. Brophy had a three-year contract of employment with E.F. Hutton, Inc. for the years 1987, 1988 and 1989.

IV. Whether petitioners have shown that the allocation ratios used by the Division of

Taxation upon audit of petitioners' 1988 and 1989 nonresident income tax returns were erroneous.

V. Whether petitioners have shown reasonable cause for abatement of penalties.

FINDINGS OF FACT

Martin J. Brophy and Linda Brophy, husband and wife ("petitioners"),[1] have resided in the State of New Jersey for the past 20 years. Petitioner's employment has been in the City and State of New York during all of those years.

Petitioners filed joint Federal and State income tax returns for for the years 1988 and 1989 ("the subject years"), but only Martin Brophy was employed and had an income.

Martin J. Brophy ("petitioner" or "Brophy") went to work on Wall Street for the first time when he joined G.A. Saxton and Co. in 1968. G.A. Saxton & Co. merged with E.F. Hutton, Inc. ("Hutton") on January 1, 1976, and Brophy continued his employment with Hutton.

Brophy was employed as vice president in charge of Hutton's institutional risk trading. Brophy reported to Thomas B. Stiles, II ("Stiles"), executive vice president and managing director of the Equity Trading Division of Hutton. James E. Sweeney ("Sweeney") was senior vice president and was administrative assistant to Stiles. Kendrick R. Wilson,

III ("Wilson") was a senior executive vice president in charge of corporate finance, a member of the board of directors of E.F. Hutton and Co., Inc. and a member of the management committee of the parent company, The E.F. Hutton Group, Inc. Wilson reported to Robert P. Rittereiser ("Rittereiser"), president and chief executive officer of Hutton.

In or about September 1986, representatives of Hutton and Shearson Lehman Brothers, Inc. ("Shearson") held merger discussions. The discussions continued through the fall of 1986 but were terminated after Hutton's board of directors, rejecting a $50.00 per share offer, advised Shearson that it would require a proposal of $55.00 per share for it to support an acquisition of Hutton's stock. Shearson rejected Hutton's demand and the talks ended.

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[1]The singular, "petitioner", refers to Martin Brophy alone.

In the aftermath of these discussions, speculation about Hutton's merger or acquisition by another firm continued. These rumors caused employees of Hutton, including petitioner, to look elsewhere for employment. Hutton management devised a plan to stem this staff defection. This plan included aggressive efforts by Hutton management to retain certain "key employees" by promising employment with job security and generous compensation packages.

At the time of the 1986 merger discussions, Brophy was still in charge of institutional risk trading. In April 1987, during the implementation of Hutton's plan to keep its "key employees," Brophy was solicited by Nikko Securities ("Nikko") to assume a senior managerial position. In light of the continuing rumors regarding the sale of Hutton, and Brophy's concern for his job security, he decided he would accept Nikko's offer. Before formally accepting the Nikko offer, however, he approached Stiles to advise him that he would be tendering his resignation. Stiles voiced his opposition and urged Brophy to remain with Hutton.

To fend off Nikko's offer to Brophy, Stiles thereafter arranged for a meeting between Brophy and Wilson. During that meeting, Wilson told Brophy that he considered Brophy a valuable person in the trading component at Hutton and that he did not want Brophy to leave Hutton. Wilson told Brophy that it would be damaging to Hutton if Brophy left and that he would do everything in his power to keep Brophy with the firm. Wilson told Brophy that Hutton's offer would be competitive with Nikko's. Wilson also told Brophy that something could be structured whereby Brophy would take on additional responsibilities and would be protected in the event of a takeover. In this way he assured Brophy that it would be worthwhile for him to stay with Hutton. Wilson arranged a meeting among Stiles, Rittereiser, Brophy and himself to discuss Brophy's future at Hutton.

Brophy told Rittereiser that he had been with the firm for 11 years and was desirous of job security, especially in the event of a takeover. Rittereiser advised Brophy that something could be done about that if Brophy would agree to remain with the firm. Rittereiser told Brophy that he would receive an enhanced wage package which would include 10,000 shares of Hutton stock and an option on 5,000 additional shares which would have immediate vesting privileges

in the event of a buy-out or merger of the firm. Neither the stock nor the stock options are an issue in this proceeding.[2]

Stiles told Brophy that if he would agree to stay with Hutton for three years, thereby giving him job security for that period, he would be paid a minimum cash compensation of $1,000,000.00 for 1987, and $750,000.00 per year for 1988 and 1989, plus a merit bonus based on performance, in addition to the stock and stock option offered by Rittereiser.

Stiles continued to press Brophy to accept Hutton's offer, but Brophy demurred. Brophy told Stiles that he wanted to know that his position would be protected in the event Hutton was sold or taken over. Stiles assured him that he would. Thereafter, Brophy notified Nikko that he would be remaining at Hutton.

Stiles requested that Brophy see Rittereiser. Brophy did so and informed Rittereiser that on the basis of Stile's promises of job security and the salary and benefits offered, he had decided to remain with Hutton. Rittereiser was pleased. Brophy also met with Wilson and advised him that he was staying with Hutton. Brophy was promoted to executive vice president in charge of all listed trading operations.

Petitioner did not use the services of an attorney in negotiating his future employment with Hutton. The employment agreement between Brophy and Hutton was not a formal written contract. But several internal memoranda make reference to Brophy's new salary and benefits. These memoranda are in evidence as petitioners' Exhibit "7".

Exhibit "7" is comprised of the following: (a) a partial typewritten memorandum from Thomas Stiles to Jay Partin dated July 10, 1987 summarizing the newly assigned duties of Martin J. Brophy as head of all listed trading operations for Hutton; (b) a second undated, handwritten memorandum on the stationery of Robert Rittereiser, Hutton's president and chief executive officer, praising Brophy's performance in his new position; (c) a third memorandum,

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[2]Petitioner's interest in the 10,000 shares of stock is presently being litigated in a class action suit.

also handwritten, on the stationery of James Sweeney, senior vice president of Hutton, stating:

> "Brophy___
> 1987 Comp 1 million___
> Min Guarantee of $750M for 3 pay periods
> Plus stock
> 10M Shares 1/6 per year"

Exhibit "7" also includes the redacted version of a memorandum from Michael G. Reiff to Paul Cholak which is dated January 6, 1987.[3] This memo was written at the beginning of the month following Brophy's termination and states, in pertinent part:

> "Paul, we have identified . . . compensation arrangements which need to be addressed . . . .
>
> "The next two items are significant issues which have surfaced this week that effect . . . Martin Brophy . . . . In summary, verbal commitments were made to Brophy by Robert Rittereiser, Ken Wilson and Tom Stiles. The arrangements were as follows:
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> "Martin Brophy: Total compensation of $1,000,000. for 1987 and $750,000 bonus in 1988 and 1989. Again, the recommended bonus for 1987 reflects the verbal commitment. Additional stock grants of 10,000 shares, which were granted July 1987, to vest 100% on a change of control."

Finally, the last document in Exhibit "7" is from Thomas Stiles to Robert Rittereiser, also dated January 6, 1988. This memorandum states, in pertinent part:

> "As there appears to be some confusion as regards our agreements with Marty Brophy . . . I wanted to express to you my knowledge of the particulars in each case:
>
> "MARTY BROPHY, Executive Vice President and Manager of all Listed Traded Activities, indicated to me in April his intention to resign to pursue another opportunity. Again, after extensive
>
> discussions between you, myself and Ken Wilson, we deemed Marty to be a critical professional and managerial resource of the firm and attempted to dissuade him from leaving. In order to induce Marty to stay, we jointly developed the following package:
>
> "Minimum cash compensation of $1,000,000 in 1987 and $750,000 in both 1988 and 1989. We indicated the potential for performance-based increments above this level in both 1988 and 1989 . . . .
>
> "In my judgement, these discussions and agreements were conducted and entered into in good faith and represent commitments made by the senior management of the firm to retain key long-term employees."

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[3]The date on this memo appears to be a misprint and should read January 6, 1988, since Paul Cholak was Director of Human Resources for Shearson Lehman (see, tr. pp. 38-39).

Thus, Hutton had secured the services of Brophy and staved off his defection to Nikko. For his part, Brophy had turned down a lucrative job offer to go with Nikko in return for three years of job security, and an enhanced salary and benefits package.

From approximately April 1987 until December 31, 1987, Brophy performed his new duties. By the end of 1987 Brophy had effectively taken over responsibility of nearly all of the equity trading department, i.e., sales trading management, convertibles arbitrage, risk arbitrage and options trading.

On November 25 and 30, 1987, Hutton representatives met with American Express and Shearson representatives to discuss a possible combination. Shearson was invited to submit a written proposal to acquire Hutton. On December 1, 1987, Shearson submitted an offer for the acquisition of all of the outstanding shares of Hutton. On December 2, 1987, the Board of Directors of Hutton agreed to a merger of Hutton with Shearson.

On December 3, 1987 Shearson and Hutton announced that a definitive agreement had been signed for Shearson to acquire all outstanding shares of Hutton's common stock at $29.25 per share. The deal was consummated.

On December 9, 1987, Hutton published policies and procedures which provided for severance benefits for those employees who were to be terminated as a result of Hutton's acquisition by Shearson. Under that policy, Brophy would have been entitled to severance pay.

In a 24 to 48-hour period around December 14, 1987, between 5,500 and 6,000 people (1/3 of Hutton's work force) were terminated by Hutton (hereinafter "Shearson-Hutton"). Brophy was one of them. Brophy was notified that his termination would take effect December 31, 1987. Under the terms of the severance policy in effect at the time of his notice of termination, Brophy was entitled to one year's base pay, based on his 1987 compensation. Subsequently, however, this severance benefits policy was amended to provide that employees having employment contracts with Hutton would not be entitled to severance pay. As a result of this amended policy, Brophy was never offered severance pay.

The record does not disclose any period when Mr. Brophy did not work in New York.

The services he provided as an employee of Hutton were provided in New York. After his termination from Hutton, Mr. Brophy continued (in his new employment) to work in New York. It is reasonable to infer that had his employment with Hutton continued, his services to that company would have continued in New York.

After December 31, 1987, petitioner performed no work for Shearson-Hutton or any of its affiliates. Upon leaving Shearson-Hutton, petitioner was not subject to any restrictions on his employment or any covenant not to compete.

Mr. Brophy retained William Marshall, Esq., as his attorney to challenge his termination. Petitioner states that after several demands by Mr. Marshall, Shearson-Hutton, on February 23, 1988, paid Brophy $840,000.00, which when combined with his $160,000.00 base salary, satisfied the $1,000,000.00 minimum compensation guarantee for 1987. Shearson-Hutton refused to otherwise comply with the terms of the employment agreement with Brophy.

Brophy initiated an arbitration proceeding (sometimes "litigation") against Shearson-Hutton by Statement of Claim dated July 15, 1988 seeking, inter alia, damages of $1,500,000.00, representing guaranteed compensation for 1988 and 1989 and $1,000,000.00 in severance pay arising from his wrongful termination.

Brophy was unemployed for the first 3½ months of 1988. On or about April 11, 1988, petitioner found employment with UBS Securities, Inc. ("UBS") on Park Avenue in New York City. At UBS he had a two-year contract at $500,000.00 a year which consisted of $150,000.00 base pay (on an annual basis) with an end-of-year minimum bonus of $350,000.00. The base pay actually received from UBS in 1988 for 8½ months work was $105,952.00. The bonus was paid in 1989.

In December 1989, Brophy's arbitration proceeding with Shearson-Hutton was settled. The terms of settlement did not include any restrictions on petitioner's future employment. The promised 10,000 shares of stock is a matter of a pending class action suit. Petitioner will receive his vested pension rights as a former employee of Hutton and Co. when he reaches age 65. Petitioner did not, as a condition of the settlement, agree to perform any future services for

Shearson-Hutton. In negotiating the settlement, petitioner believed that Shearson-Hutton still owed him $1,500,000.00 as guaranteed compensation for 1988 and 1989. He had made about $850,000.00 at UBS in 1988. Subtracting that amount from the $1,500,000.00 he thought Shearson still owed him left a balance of $650,000.00.

To settle petitioner's claim, Shearson-Hutton offered $600,000.00, and petitioner accepted. Shearson-Hutton paid Brophy $600,000.00 on December 8, 1989. This amount was reduced by $40,895.00 in litigation fees and expenses, which resulted in a net $559,105.00 paid to Brophy. The release signed by petitioner in return for this payment was prepared by his attorney and states that it releases Shearson-Hutton from all claims "from the beginning of the world to the day of the date of this RELEASE arising out of or relating to the employment agreement between BROPHY and Hutton" (Ex. 8-A). The release form does not specify whether the $600,000.00 was intended to compensate petitioner for lost wages, lost bonuses, lost benefits, or whether it constituted severance pay.

In 1988, petitioner received a lump-sum payout of $1,273,850.00, plus interest of $6,146.00, which represented amounts accumulated over the years in Brophy's deferred compensation account. He also received the $840,000.00, representing the balance of his 1987 minimum compensation guarantee. These amounts total $2,119,996.00 and are referred to hereinafter as the 1988 "lump sum" payments. In addition, Brophy received 1988 wage income of $105,952.00 from UBS for his 8½ months of employment there. Altogether, these amounts total $2,225,948.00 and constitute Brophy's total wage income for 1988 (Ex. "K"; tr. pp. 46-47).

Petitioners filed an original joint 1988 New York State ("State") and New York City ("City") Nonresident and Part-Year Resident Income Tax Return ("IT-203" or "State return") dated April 12, 1989 (Ex. "F").

Petitioners' 1988 State return reported that Brophy worked 100 days in New York out of 209 total days worked.[4] Petitioners arrived at this ratio as follows:

1988

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[4]This same ratio is used on the 1988 amended return, infra.

NON-WORKING DAYS:

Saturdays and Sundays:	104	
Holidays:		12
Sick Leave:		10
Vacation:		30
Other non-working days:	0	
Total non-working days:		156
Total days worked outside NY:	109	
Days Worked in NY State:	100	
Total days worked in year:	209	

1988 Ratio		Federal Wages Reported		Allocated to NYS Source Income
100/209	x	$2,225,948.00	=	$1,065,047.00

Total wage income of $2,225,948.00 was allocated to New York income, resulting in total New York wage income of $1,065,047.00. This original 1988 State return reported total taxable income of $ 2,252,320.00, base tax of $189,070.00, and a New York income percentage of 46.13%, which resulted in tax allocated to New York State of $87,220.00. Total income tax reported due the City was $4,793.00. Petitioners' combined State and City income tax reported and paid based on this original 1988 return was $92,013.00. At hearing, petitioners offered no evidence in support of the allocation ratio used on their 1988 return.

Petitioner's wage and salary income for 1989 consisted of the annual base salary of $150,000.00, from UBS, plus $255,000.00 which

represented a part-year bonus from 1988, plus miscellaneous income of $920.00. The above wage and salary income totals $405,920.00, which was reported on petitioners' 1989 Federal income tax returns (Ex. "1", line 7). In addition, Brophy received the $600,000.00 less legal expenses of $40,895.00, leaving a net settlement amount of $559,105.00 from Shearson-Hutton. Petitioner's reported total adjusted gross income from all sources on his 1989 Federal income tax returns was $1,407,620.00 (Ex. "1", line 31). The corresponding amounts are also reported on petitioners' 1989 State return (Ex. "H", lines 1, 19 and Schedule 1).

Petitioners also filed a joint State return for 1989 dated April 8, 1990 (Ex. "H").

Petitioners' original State return for 1989 reported total wages and salaries of $405,920.00 which were allocated to New York income as follows:[5]

	1989	
NON-WORKING DAYS:		
Saturdays and Sundays:	104	
Holidays:		8
Sick Leave:		10
Vacation:		10
Other non-working days:	0	
Total non-working days:		132
Total days worked outside NY:	25	
Days Worked in NY State:		208
Total days worked in year:		233

1989 Ratio	Total Wage Income		Wage Income Allocated to NY
208/233 x	$405,920.00	=	$362,366.00

This original 1989 State return also reported "other income" of $559,105.00 as New York income (Ex. "H", Line 16). This represents the $600,000.00 settlement received from Shearson-Hutton, less legal expenses of $40,895.00. Total wage income plus "other income" allocated to New York on the original 1989 State return was $921,471.00 (Ex. "H", Lines 1, 16 and 19).

This original 1989 State return reported total New York taxable income of $1,315,236.00.00, base tax of $102,857.00 and a New York income percentage of 65.46%. Applying this income percentage to base tax of $102,857.00 resulted in tax allocated to New York State of $67,330.00. Total 1989 income tax reported due the City was $1,631.00. Petitioners' combined State and City income tax liability reported and paid based on this original 1989 return was $68,961.00. Total State income tax paid by petitioners for 1989 was $70,066.00, so on this original return they claimed a refund of $1,105.00. This amount was refunded to petitioners. At hearing, petitioners offered no evidence in support of the allocation ratio used on their 1989 return.

The Division of Taxation ("Division") conducted an audit of petitioners' original 1988

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[5]This same ratio was used on the amended 1989 return, discussed infra.

and 1989 returns which concluded on September 13, 1991.

The Division's audit revised the allocation of Brophy's income found on the original 1988 return. Specifically, the lump-sum income[6] received from Hutton in 1988 was allocated by using an

average ratio of days worked in New York during the years 1985 through 1987 as reported on petitioners' returns. Petitioners' returns for those three years had used the following allocation ratios of days worked in New York to total days worked:

1985	1986	1987
172/219	176/219	178/219

The average ratio for these three years was determined on audit to be 175/219. The Division then applied this average ratio to petitioners' 1988 lump-sum income (see, Finding of Fact "27") received from Shearson-Hutton as follows:

Average Ratio		Hutton Lump-Sum Income		Income Allocated to NY
175/219	x	$2,119,996.44[7]	=	$1,694,061.08

With respect to the 1988 wage income from UBS, the Division modified petitioner's allocation ratio, by taking into account the 3½-month period at the beginning of 1988 when petitioner was unemployed. This had the effect of reducing petitioner's "total days worked."

Based on a 365-day year, the following shows petitioners' and the Division's respective figures for 1988:

	Petitioner	Division
NON-WORKING DAYS:		
Saturdays and Sundays:	104	104
Holidays:		12
Sick Leave:		10
Vacation:		30
Other non-working days:	0	84

[6]This lump-sum income includes not only the $840,000.00 paid to Brophy but also amounts representing deferred income, plus interest, that had accumulated over the years and was paid to him in 1988.

[7]Reported on Schedule 1 of U.S. Individual Income Tax Return for 1988 (Form 1040).

Total non-working days:		156	240
WORKING DAYS:			
Total days worked outside NY:	109	16	
Days Worked in NY State:		100	109
Total days worked in year:		209	125

The Division arrived at an allocation ratio of 109/125 to allocate petitioner's 1988 UBS wage income as follows:

Division's Ratio		UBS Wages Reported		Allocated to NYS Income
109/125	x	$105,952.00[8]	=	$ 92,390.14

Based on total wage income for 1988 of $2,225,948.44, the Division allocation of lump-sum wage income and UBS wage income to New York totalled $1,786,451.22, which was an audited increase in petitioners' New York income of $721,404.22. This increase resulted in an audited New York State income percentage increase to 77.38%,[9] and recomputed State and City tax liabilities of $146,302.28 and $8,039.03, respectively. As a result of the audit of the 1988 return, petitioners owed additional State income tax of $59,082.29 and additional City income tax of $3,246.03, for a combined State and City increase in 1988 tax of $62,328.32.

In auditing petitioners' 1989 return, the Division allocated petitioners' 1989 wage income as follows, assuming a 365-day year:

	1989	
Wage Income:		$405,920.00
NON-WORKING DAYS:		
Saturdays and Sundays:		104
Holidays:		8
Sick Leave:		10
Vacation:		10
Other non-working days:		0
Total non-working days:		132
WORKING DAYS:		
Total days worked outside NY:	21	

[8]Reported on Schedule #1 of Federal Individual Income Tax Return for 1988 as UBS wages.

[9]Increased from 46.13% on the 1988 return.

Days Worked in NY State:	212
Total days worked in year:	233

It will be recalled that petitioners' original 1989 return[10] used an allocation ratio of 208/233.

Based on its modified ratio, the Division arrived at allocated 1989 New York wage income as follows:

Division's 1989 Ratio		Federal Wages Reported		Allocated to NYS Income
212/233	x	$405,920.00	=	$369,334.94

Petitioners' original 1989 State return had a computed New York State income percentage of 65.46%. Petitioners' original 1989 return[11] allocated $362,366.00 to New York income. The Division's figure of $369,334.94[12] represents an audited increase in New York 1989 income of $6,968.94. This resulted in an audited increase in New York adjusted gross income from $921,471.00 to $ $928,439.93. There was no change upon audit in petitioners' reported New York taxable income of $1,315,236.50, which had a reported New York base tax of $102,857.37. Petitioners' New York income percentage upon audit was increased to 65.96%, which, when applied to base tax of $102,857.37, resulted in recomputed 1989 State and City income tax liabilities of $67,844.72 and $1,662.00,

respectively. This audited tax liability represented an increase of $514.72 in State income tax and an increase of $31.00 in City income tax.

On September 13, 1991, the Division issued petitioners a Statement of Personal Income Tax Audit Changes. This statement asserted additional tax due for the year 1988 in the amount of $62,328.32, consisting of State tax in the amount of $59,082.29 and City tax in the amount of $3,246.03. This statement also asserted additional tax due for the year 1989 in the amount of $545.72, consisting of State tax in the amount of $514.72 and City tax in the amount of $31.00.

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[10]Petitioners' amended return for 1989, as will be seen, used the same ratio.

[11]And also their 1989 amended return.

[12]The Division's computation has a typographical error, i.e., $232,366.00 instead of $362,366.00. Nevertheless, the computation of the audited difference is correct, i.e., $6,968.94.

The statement of audit changes advised petitioners of the Division's position that they had erred in allocating their lump sum payments as set forth above, and if they did not respond (agreeing or disagreeing) to the audit changes by September 23, 1991, a statutory Notice of Deficiency asserting the additional tax, penalty and interest would be issued. The evidence does not show that petitioners made any response to this notice.

On March 19, 1992, a Notice of Deficiency was issued to petitioners on the same basis as set forth in the Statement of Personal Income Tax Audit Changes, asserting additional State and City income tax due for 1988 and 1989 in the amount of $62,874.04, plus penalty and interest.

Amended Returns for 1988 and 1989

On April 15, 1992, after the Division's Statement of Personal Income Tax Audit Changes and Notice of Deficiency had been issued, petitioners filed amended State returns for 1988 and 1989 (Ex. "G" and "I"). These amended returns do not refer to or otherwise acknowledge that the original returns had been audited or that a Notice of Deficiency asserting additional State and City income tax had been issued.

The amended 1988 return did not include the $840,000.00 Brophy had received from Shearson-Hutton to satisfy his 1987 minimum salary guarantee, as New York source income. By deducting $840,000.00 from total Federal wage income of $2,225,948.00, that left a balance of $1,385,948.00. This amount in wage income was allocated on the amended return as follows:

Ratio		Total Wage Income		Wage Income Allocated to NY
100/209	x	$1,385,948.00	=	$663,133.00

This amended return included a statement that the amendment to the return was for the purpose of deleting "monies received as damages in settlement of employment contract which was tortiously and erroneously terminated by former employer" (Ex. "G").

Total wage income of $2,225,948.00 was allocated to New York income, resulting in total amended New York wage income of $663,133.00. This amended 1988 State return

reported the same[13] total New York taxable income of $ 2,252,320.00 (Ex. "G", line 51), and the same base tax[14] of $189,070.00. However, the New York income percentage was changed to 28.72%,[15] which resulted in tax allocated to New York State of $54,301.00. Total amended income tax reported due the City was $2,984.00. Petitioners' combined State and City income tax liability for 1988 based on this amended return was $57,285.00. Since petitioners had paid tax of $92,013.00 with their original return, they claimed a refund of $34,728.00 on their 1988 amended State return.

The 1989 amended return did not include in "other [N.Y.] income" the $600,000.00 ($559,105.00 after legal expenses) received from Shearson-Hutton pursuant to the 1989 settlement. By not including this "other income" of $559,105.00 (Ex. "I", line 16), total reported Federal wage income of $405,920.00 (id., at line 1) was left to be apportioned. The wages and salaries apportioned to New York income is the same as on the original return, i.e., $362,366.00 (id., at lines 1, 17, 19 and Schedule 1). However, amended New York adjusted gross income was reduced from $921,471.00 to $362,366.00 (id., at line 19).

This amended 1989 State return reported the same total New York taxable income of $ 1,315,236.00 (Ex. "I", line 51), and the same base tax of $102,857.00. However, the New York income percentage was changed on this 1989 amended return from 65.46% to 25.74%, which resulted in an amended 1989 tax allocated to New York State of $26,475.00. Total amended income tax liability reported due the City was $1,631.00. Petitioners' combined State and City income tax liability for 1989 based on this amended return was $28,106.00.

Petitioners' original 1989 return showed State and City tax due of $68,961.00. Petitioners had paid 1989 State and City tax of $70,066.00 and were refunded $1,105.00 based on the original return. Upon filing the amended 1989 return, petitioners argue that the $68,961.00 tax

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[13]The same amount as appeared on the original 1988 return.

[14]The same base tax as appeared on the original 1988 return.

[15]The New York income percentage on the original 1988 return was 46.13%.

paid (after deducting the refund) represents an overpayment in tax for 1989 of $40,855.00. Petitioners' 1989 amended return claimed a refund of $40,855.00.

The amended 1989 return also includes the statement that the amendment to the return was for the purpose of deleting "monies received as damages in settlement of employment contract which was tortiously and erroneously terminated by former employer."

There is nothing in the record to indicate whether the amended returns for 1988 and 1989 were processed by the Division or that the refunds claimed for those years were denied.

One month after petitioners filed their amended returns, they filed a request for conciliation conference with the Division's Bureau of Conciliation and Mediation Services challenging the Notice of Deficiency, supra, and claiming a refund. On June 25, 1993, a Conciliation Order (CMS# 122822) was issued to petitioners denying the request and sustaining the Notice of Deficiency (which implicitely denied the refund).

Petitioners filed a timely petition with the Division of Tax Appeals again challenging the Notice of Deficiency, and the instant proceeding ensued.

The petition in this matter challenges the Notice of Deficiency, supra, but refers to the refunds claimed on the amended returns. Neither the request for conciliation conference nor this petition claim the refund was ever denied. There is nothing in this record to apprise the trier of fact as to what happened, if anything, once these amended returns were filed. Accordingly, the substance of petitioners' amended returns for 1988 and 1989 have been included in the Findings of Fact solely for the purpose of setting forth a complete record. This case will be considered in terms presented by petitioners, i.e., as a challenge to the Notice of Deficiency. To the extent that petitioners are entitled to a refund it will be based on their success, or lack thereof, in challenging the Notice of Deficiency.

SUMMARY OF THE PARTIES' POSITIONS

Petitioners argue that a contract existed between Brophy and Hutton which guaranteed him employment for 1987, 1988 and 1989 and that such contract was enforceable under New York Law. Petitioner believes that the writings contained in Exhibit 7 are sufficient to satisfy

the requirements of a written contract.

Petitioners claim that the $1,440,000.00 received from Shearson-Hutton was for Hutton's breach of contract and was not intended as severance pay (petitioners' reply brief, p. 4).

Petitioners argue that the Division has failed to prove the allocation ratios used on petitioners' income tax returns were erroneous. Petitioners also argue that the Division has failed to present "any evidence or documents to sustain a penalty" (petitioners' brief, p. 41).

The Division argues that petitioners have failed to establish that the $1,440,000.00 received from Shearson-Hutton in 1988 and 1989 should not have been included in New York source income.

The Division argues that Brophy has failed to prove that he had a valid and enforceable employment contract with Hutton that included a three-year employment guarantee for 1987, 1988 and 1989. The Division urges that petitioner's claim that he had a right to employment with Hutton for such years is barred by the Statute of Frauds (General Obligations Law ["GOL"] § 5-701[a][1]).

The Division also argues that petitioners have failed to establish by clear and convincing evidence that the $1,440,000.00 paid to Brophy was in exchange for relinquishing his contract rights to future employment. In addition, the Division argues that petitioners have failed to establish that any right of Brophy to future employment was secured by consideration having no connection with the State of New York.

CONCLUSIONS OF LAW

A. Tax Law § 631, describing New York source income of a nonresident individual, provides as follows:

> "(a) General. The New York source income of a nonresident individual shall be the sum of the net amount of items of income, gain, loss and deduction entering into his federal adjusted gross income, as defined in the laws of the United States for the taxable year, derived from or connected with New York sources . . . .
>
> * * *
>
> "(b) Income and deductions from New York sources.
>
> "(1) Items of income, gain, loss and deduction 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 . . . .

"(c) Income and deductions partly from New York sources. 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" (emphasis added).

The Personal Income Tax Regulations, at 20 NYCRR former 131.4, concerning New York source income, provide as follows:

"(b) The New York adjusted gross income of a nonresident individual rendering personal services as an employee includes the compensation for personal services entering into his Federal adjusted gross income, but only if, and to the extent that, his services were rendered within New York State . . . . Where the personal services are performed within and without New York State, the portion of the compensation attributable to the services performed within New York State must be determined in accordance with sections 131.16 through 131.18 of this Part."

The allocation rules set forth in 20 NYCRR former 131.18 provide as follows:

"(b) Where a nonresident employee . . . performs services both within and without New York State for only part of a taxable year, his income derived from New York State sources during that period includes only that portion of compensation received during the period he performs services both within and without New York State, multiplied by a fraction the numerator of which is the number of days he worked within New York State and the denominator of which is the number of days he worked both within and without New York State during the period he was required to perform services both within and without New York State."

B. In this case, petitioners' entire legal argument is based on the premise that Mr. Brophy had a three-year employment contract with Hutton. Accordingly, the first issue to be addressed is whether an enforceable three-year contract existed between Hutton and Brophy.

C. Petitioner argues that the documents in Exhibit "7" (Finding of Fact "13"), along with his testimony, establish the existence of a three-year employment contract. There can be no question that petitioner expected, as a condition of remaining with Hutton, that that company would grant him job security. As a result of Mr. Brophy's negotiations with the Hutton leadership, Brophy remained at Hutton. The substance of Brophy's agreement with Hutton is contained in Exhibit "7". The evidence establishes that there was part performance of the

agreement by both Hutton and Brophy.

The Statute of Frauds (GOL § 5-701[a][1]) provides, in pertinent part, that:

> "Every agreement, promise or undertaking is void, unless it or some note or memorandum thereof be in writing, and subscribed by the party to be charged . . . if such agreement, promise or undertaking . . . [b]y its terms is not to be performed within one year from the making thereof . . ." (emphasis added).

In New York, part performance of an oral contract for employment, not to be performed within one year, does not remove it from the statute of frauds (Tyler v. Windels, 186 App Div 698, 700, 174 NYS 762, affd 227 NY 589).

D. Do the writings contained in Exhibit "7" satisfy General Obligations Law § 5-701(a)(1)? The facts here, and petitioner's arguments, are very similar to those posed in Cunnison v. Richardson Greenshields Securities (107 AD2d 50, 485 NYS2d 272). Cunnison was employed for several years in the Toronto office of defendant, a New York corporation engaged in the securities business. Cunnison claimed that after extensive negotiations, defendant had orally agreed to employ her as a sales representative in its New York City office for a period of five years. The defendant memorialized this agreement in a letter and in a subsequent interoffice memorandum, offering Cunnison the job at a salary of "$2,000 per month [for the remainder of 1982] and, depending upon satisfactory performance, $30,000 annually thereafter, in addition to 30% of commissions earned in any one year in excess of $100,000.00" (id., at 51, 485 NYS2d at 274). Neither defendant's letter nor its memorandum specified a specific term of employment.

Cunnison moved to New York City and began her job in the defendant's New York office. She was terminated 14 months later.

Cunnison brought an action for wrongful discharge, alleging a five-year employment contract. She argued that in reliance on the defendant's promises, she had turned down other employment opportunities and gave up her Toronto residence. The Court held, in reversing the court below and dismissing the complaint, that "oral assurances of a five-year term of employment, even if established, are void and unenforceable under the statute of frauds" (Cunnison v. Richardson Greenshields Securities, supra, at 51-52, 485 NYS2d at 274-275).

The Court, to illustrate the point, referred to its decision in Chase v. United Hospital (60 AD2d 558, 400 NYS 2d 343), a very similar case on its facts. The Court noted that, in Chase, the plaintiff in support of her claim of breach of a two-year contract:

> "[R]eferred to a letter from the defendant which, as we noted, did no more than to establish an annual rate of salary for plaintiff. It provided for no specific terms of employment, so that even if the letter were considered to be a contract of employment it would still be insufficient in law . . . . Even assuming plaintiff's allegations concerning 'assurances' by defendant that her employment would be for two years were true, the Statute of Frauds rendered the oral promises void and unenforceable, as the two year term, obviously, could not be performed within one year" (id., citing GOL § 5-701[1]; Chase v. United Hospital, supra, at 559, 400 NYS2d at 343) (emphasis added).

E. In the instant matter, as in Cunnison and Chase, none of the writings set forth a specific contract term. The writings in Exhibit "7" are sufficient to determine what Mr. Brophy's compensation would be in 1987, 1988 and 1989. These writings are also sufficient to apprise the reader that Brophy was granted 10,000 shares of stock and an option on 5,000 more.

However, none of the writings offered by petitioner specify that his employment contract with Hutton would be for a three-year period or any other definite time period. Since Mr. Brophy has not proved an enforceable employment contract of definite duration, his was an employment at will. "It has long been the law of this state that unless an employment is for a definite period of time, the hiring is presumed to be at will" (Cunnison v. Richardson Greenshields Securities, supra, at 55, 174 NYS2d at 277). "Where an employment is for an indefinite term it is presumed to be a hiring at will which may be freely terminated by either party at any time for any reason or even for no reason" (Murphy v. American Home Products Corp., 58 NY2d 293, 461 NYS2d 232, 237; see also, Matter of Laurino, Tax Appeals Tribunal, May 20, 1993).

It is also noted, as it was by the Court in Cunnison, that Mr. Brophy's reliance on Weiner v. McGraw-Hill (57 NY2d 458, 457 NYS2d 193) is misplaced, since in that case, the Statute of Frauds was not the issue.

F. I next address whether the $840,000.00 paid to petitioner in 1988 constituted damages arising from petitioner's arbitration proceeding initiated against Shearson-Hutton. Petitioner

testified that bonus amounts were usually paid by Hutton in January of the year following the year they were earned. Shearson paid such bonuses in February of the year following the year they were earned. Petitioner's base salary in 1987 was $160,000.00. Petitioner's bonus necessary to bring him up to the promised minimum of $1,000,000.00, was $840,000.00. Mr. Brophy was paid the $840,000.00 in February 1988, which was approximately the time he would have received it if his employment with Hutton had continued.

Mr. Brophy says this money represented damages paid to him as a result of the litigation he initiated against Shearson-Hutton, but clearly that is not the case. Petitioner hired Mr. Marshall, his attorney, in December 1987. Mr. Brophy states that the $840,000.00 was only paid after it was "demanded" by his attorney (petitioner's brief, p. 36). That may be true, but an attorney's oral or written "demand" for payment is not the same thing as "litigation." Petitioner did not initiate the arbitration claim against Hutton until July of 1988, several months after he had been paid this $840,000.00. It is also noted that even if this amount constituted damages, damages arising from a contract action, where no personal injuries are involved, are treated as ordinary income (Internal Revenue Code § 104[a][2]; Matter of Sanchez, State Tax Commission, October 29, 1982, confirmed Matter of Sanchez v. State Tax Commn., Sup Ct, Albany County, June 21, 1983, Cholakis, J.; Rev Rul 85-143). Accordingly, it is concluded that the $840,000.00 paid to Mr. Brophy was the balance of his guaranteed minimum $1,000,000.00 salary from Hutton, which he earned through his personal services to Hutton in 1987. The fact that Hutton or petitioner characterized this lump-sum payment as a "special payout" does not change the fact that the payment was compensation for petitioner's past personal services to Hutton in New York. Accordingly, the Division properly included this amount as part of petitioner's New York source income.

G. Next the issue of the $600,000.00 payment to petitioner in 1989 must be addressed. Relying upon Matter of Donahue v. Chu (104 AD2d 523, 479 NYS2d 889), petitioners argue that the $600,000.00 paid to Mr. Brophy in 1989 was compensation for relinquishing his right to future employment and future services never performed in New York. Petitioners argue that

the facts in this case are similar to those in Donahue and that the subsequent decision of the Tax Appeals Tribunal in Matter of Laurino (supra) can be distinguished from the facts here. As will be seen, Donahue has no application to the facts in this case.

In Donahue, the taxpayer, a Connecticut resident, had a five-year written employment agreement with his New York employer. The agreement provided that, at the conclusion of the five-year period, the taxpayer would be paid for an additional 10 years as a consultant.

With one of the five years remaining, Donahue and the corporation entered into an agreement in Connecticut, which provided for the termination of both his employment and his right to be paid for the future consulting services. In exchange, Donahue received his existing salary for four months or until he accepted a regular position with another employer, whichever occurred first, and a sum of money in settlement of his rights to perform future consulting services.

The court found that the benefits granted to Donahue under the termination agreement were the result of the corporation's deliberate purpose to terminate its relationship with the taxpayer; that the termination agreement was of mutual benefit to the contracting parties which settled all future rights and obligations of those parties; and finally, that had his employment continued under the contract, Donahue's rights (and obligations) thereunder would not have been exercised in New York. Therefore, the court concluded, the amounts received by Donahue pursuant to the termination agreement were not subject to New York State personal income tax.

The Court found, with regard to the amounts paid to Donahue, that there was neither substantial evidence nor a rational basis for the Division's conclusion that the salary which the taxpayer received for work performed in Connecticut, after he became a resident of Connecticut, and the lump-sum settlement of his contract for future services (which would have been performed in Connecticut) was taxable by New York under Tax Law § 632. The Court reasoned that the taxpayer and his former employer reached an agreement which, insofar as it concerned the taxpayer's employment contract, was a settlement of future rights in Connecticut. Donahue stands for "the proposition that where a nonresident possesses a right to future

employment secured by consideration having no connection with New York, and relinquishes that right in exchange for a lump sum settlement, the lump sum settlement is not taxable by New York" (Matter of Laurino, supra [construing Donahue]). That is not the case here.

H. This case does not involve a lump-sum payment to a taxpayer in return for his relinquishing his contract rights to perform future services in another state. Rather, the question that must be answered is whether the $600,000.00 paid to Brophy in 1989 was "derived from or connected with" his New York employment (Tax Law § 631[a], [b][1][B]; Matter of Gleason v. State Tax Commn., 76 AD2d 1035, 429 NYS2d 314). The Tax Appeals Tribunal stated in Laurino (supra) that "'in determining whether income is derived from or connected with New York sources', it is necessary to identify the activity upon which the income was secured or earned."

I. Mr. Brophy's employment with Hutton, his salary, and his stock benefits were negotiated in New York. Mr. Brophy's negotiations with Hutton ripened into an agreement in New York. Mr. Brophy provided his services to Hutton at its New York offices. Brophy's employment was terminated at Hutton's New York offices, and the arbitration proceeding was initiated against Shearson-Hutton in New York. The basis of petitioner's litigation was Mr. Brophy's New York employment by Hutton. When petitioner signed the release settling the New York litigation against Shearson-Hutton, he gave up all claims (unspecified in the release) against Shearson-Hutton "from the beginning of the world to the day of the date of this RELEASE arising out of or relating to the employment" agreement with Hutton (Ex. "8-A").[16] Whatever this payment represented, it clearly arose out of Mr. Brophy's New York employment with Hutton. Accordingly, petitioners having offered nothing in the way of clear and convincing evidence to the contrary, the $600,000.00 paid to petitioner to settle this litigation represented amounts received in connection with his New York employment (20 NYCRR former 131.4(d); Matter of Norris v. State Tax Commn., 140 AD2d 876, 528 NYS2d 694 [3d

[16]And, as further consideration, Brophy gave up his right to pursue further New York litigation to pursue those employment rights.

Dept 1988]), and constitutes New York source income subject to personal income tax (Tax Law § 631[a], [b][1][B]). Petitioners' arguments to the contrary, while commendably presented, are without merit.

J. Petitioners offered no evidence at hearing to show that the allocation ratios used by the Division upon audit were erroneous, nor has any evidence or argument been presented as reasonable cause for abatement of

penalty. This was petitioners' burden with respect to both of these issues, and they have not met it (Tax Law § 689[e]).

K. The petition of Martin Brophy and Linda Brophy is denied, the Notice of Deficiency dated March 19, 1992 is sustained, and implicitly, petitioners' claim for refund is denied.

DATED: Troy, New York
November 23, 1994

/s/ Carroll R. Jenkins
ADMINISTRATIVE LAW JUDGE