STATE OF NEW YORK

DIVISION OF TAX APPEALS

In the Matter of the Petition of **MATTHEW J. AND RACHEL A. DOMBER** 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 1989 and 1990.	: : : : : :	DETERMINATION DTA NO. 813972

Petitioners, Matthew J. Domber and Rachel A. Domber, P.O. Box 58028, Tierra Verde, Florida 33714, 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 1989 and 1990.

A hearing was commenced before Dennis M. Galliher, Administrative Law Judge, at the offices of the Division of Tax Appeals, 500 Federal Street, Troy, New York, on February 9, 1996 at 1:00 P.M., and was scheduled for continuance at the same location before the same Administrative Law Judge on May 3, 1996 at 1:15 P.M. Prior to the continued hearing date the parties, by their representatives, agreed that the record could be finalized without further hearing dates, upon submission of documents and affidavits by June 12, 1996, followed by briefs to be submitted by September 23, 1996, which date commenced the six month period for issuance of this determination (Tax Law § 2010[3]). The Division of Taxation, appearing by Steven U. Teitelbaum, Esq. (Michael J. Glannon, Esq., of counsel), submitted documents on April 4, 1996. Petitioner, appearing by Maurice A. Reichman,Esq., submitted documents and affidavits on June 12, 1996. Neither party submitted a brief.

ISSUES

I. Whether the Division of Taxation properly disallowed petitioners' out-of-state allocation of certain income attributed to the law partnership of Domber and Ward for the years 1989 and 1990.

II. Whether, assuming petitioners' out-of-state income allocation was not proper, they have nonetheless established that such allocation was based on reasonable cause and was not the result of willful neglect such that a penalty imposed for negligence may be abated.

FINDINGS OF FACT

1. On November 15, 1993, the Division of Taxation ("Division") issued to petitioners, Matthew J. Domber and Rachel A. Domber, husband and wife, a Notice of Deficiency asserting additional personal income tax due for the years 1989 and 1990 in the aggregate amount of $26,175.88, plus penalty and interest. The computation section of the notice specifies the amount of tax at issue to consist of $23,827.65 (State) and $479.14 (City) for 1989, and $1,714.39 (State) and $154.70 (City) for 1990.[1]

2. A Statement of Personal Income Tax Audit Changes, previously issued to petitioners on September 28, 1993, details the basis for the above-asserted liabilities for each of the subject years. Specifically, this statement provides that "[p]artnership income has been found to be improperly allocated to New York. Audit adjustments are being proposed to pick up the proper allocation of partnership income to New York." The statement reveals that the audit adjustments increased petitioners' New York income by reallocating to New York (as New York source income) the aggregate amounts of $329,055.00 for 1989 and $24,828.00 for 1990, as follows:

<u>1989</u>

Ordinary income allocated to New York.................$73,690.00
Rental, interest and dividend income.........................24,322.00
Net long-term capital gain...........................172,666.00

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[1]Petitioners executed a validated consent extending the period of limitation on assessment such that the Division was entitled to determine petitioners' personal income tax liability for the years 1989 and 1990 at any time on or before April 15, 1994.

Section 1231 gain..58,377.00

1990

Ordinary income allocated to New York................$22,730.00
Interest income allocated to New York.......................1,983.00
Dividend income allocated to New York.......................115.00

3. For each of the years at issue, petitioners jointly filed New York State (and City) nonresident and part-year resident income tax returns (Forms IT-203). In August 1992, the Division commenced an audit of petitioners' returns for the years 1989 through 1991. The initial focus of the audit was petitioners' claimed status as nonresidents of New York. After reviewing information submitted, the Division accepted that petitioners were domiciliaries of Florida and were not taxable as residents of New York. However, the Division determined that, consistent with the results of a prior audit, petitioner Matthew J. Domber improperly allocated out of New York a portion of his distributive share of items of income and gain from the law partnership of Domber and Ward ("the Firm"). The auditor concluded that petitioner Matthew J. Domber was a general partner in the Firm; that the Firm maintained only one office, which was in New York; that the business of the Firm was centered around housing projects and real estate developments located outside of New York; and that, while all distributions from such real estate partnerships were accounted for as distributions to the Firm, petitioner Matthew J. Domber nonetheless allocated to New York as New York source income (on petitioners' nonresident returns) his distributive share of the Firm's income relating only to legal services performed by the Firm. Since the Firm did not maintain an office outside of New York and commingled all funds received in one account, the auditor denied petitioners' claimed allocation and instead reallocated to New York all of the distributive items from the Firm received by petitioner Matthew J. Domber.

4. The additional income set forth above as reallocated to New York (see Finding of Fact "2") represents the difference between petitioner Matthew J. Domber's distributive share of items from the Firm as set forth on Schedule K-1 ("Partner's Share of Income, Credits,

Deductions, Etc.") and the amounts claimed to be allocable to New York on petitioners' New York income tax returns for each of the years at issue as follows:

1989

a) The additional ordinary income amount ($73,690.00) represents Mr. Domber's distributive share of the Firm's ordinary income from trade or business activities per Schedule K-1 at line 1 ($109,406.00) less his New York allocated amount of partnership income per Form IT-203 at line 12 ($35,716.00).

b) The additional rental, interest and dividend income amount ($24,322.00) represents the total of Mr. Domber's distributive share of the Firm's net income from rental real estate activities ($19,164.00), portfolio interest ($12,522.00) and portfolio dividends ($42.00) per Schedule K-1 at lines 2, 4a and 4b, respectively, less his New York allocated amount of taxable interest income per Form IT-203 at line 2 ($7,436.00).

c) The additional income described as net long-term capital gain ($172,666.00) and section 1231 gain ($58,377.00) represents items reported as such from the Firm per Schedule K-1 at lines 4e and 6, respectively, with no part of such amounts reported as allocable to New York per Form IT-203.

1990

a) The additional ordinary income amount ($22,730.00) represents Mr. Domber's distributive share of the Firm's ordinary income from trade or business activities per Schedule K-1 at line 1 ($50,261.00) less his New York allocated amount of partnership income per Form IT-203 at line 12 ($27,531.00).

b) The additional interest income allocated to New York ($1,983.00) represents the Firm's portfolio interest per Schedule K-1 at line 4a ($4,066.00) less his New York allocated amount of taxable interest income per Form IT-203 at line 2 ($2,083.00).

c) The additional dividend income allocated to New York ($115.00) represents the Firm's portfolio dividends per Schedule K-1 at line 4b ($115.00) less his New York allocated dividend income per Form IT-203 at line 3 ($0.00).

5. During the years at issue, the Firm maintained an office at 20 Vesey Street, New York, New York. It is conceded that the Firm did not maintain a law office in any other jurisdiction, and there is no claim that either of the two capital partners in the firm, Matthew J. Domber (petitioner herein) or Jacob B. Ward, were licensed to practice law in any jurisdiction other than New York.

6. The Firm's partnership agreement, dated August 15, 1972, includes the following relevant provisions:

"Section 1.2 Purpose

> The purpose of the firm shall be to engage in the practice of law in the State of New York in accordance with the Code of Professional Responsibility as adopted by the American Bar Association and in accordance with all rules of practice and other regulations adopted by any courts and administrative bodies before which the partners or associates of the firm shall be admitted to practice. The firm may also engage in the acquisition, ownership, development, management and disposition of real estate projects, provided, however, that any partnership interest in such real estate projects shall, if held in the name of a capital partner, be deemed to be held as a nominee for this partnership.
>
> "Section 1.3 Location
>
> The offices of the firm shall be at 258 Broadway, New York, New York or at such other or additional locations as may be agreed upon by the capital partners.
>
> * * *
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> "Section 3.2 Drawings
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> The drawings of the capital partners shall be in such amounts as Domber and Ward shall determine from time to time.
>
> * * *
>
> "Section 4.1 Profits or Losses
>
> The capital partners shall share equally all partnership profits and losses."

7. Petitioner Matthew J. Domber and his law partner Jacob B. Ward have been involved since the 1970s in developing low and moderate income apartment housing projects. Such projects, as relevant to this proceeding, are all United States Department of Housing and Urban Development ("HUD") assisted developments, and all are located in the states of Pennsylvania and West Virginia.[2] As discussed more fully below, the record does not include documents showing petitioner Matthew J. Domber individually owning an interest in any of the partnerships. However, the record includes Schedules K-1 prepared by a certified public accountant in Pennsylvania and issued on behalf of each of the development project partnerships to Mr. Domber's law partner, Jacob B. Ward. On each of these Schedules K-1,

[2]Tenant apartment rental payments at each development are augmented with supplemental rent payments from HUD to enable the tenants to pay the market rental for the apartments they occupy.

Jacob B. Ward is listed as an individual partner. The names of the development partnerships relevant to this proceeding, and Jacob B. Ward's ownership percentage in each, are as follows:[3]

PARTNERSHIP NAME	OWNERSHIP PERCENTAGE
Evergreen Arbors Associates	2.000%
Fairmont Arbors Associates	1.000%
Butler Arbors Associates	5.000%
Franklin Arbors Associates	2.500%
Charleston Arbors Associates	2.000%
Bedford Crawford Associates	1.333%
Jacob Arbors Associates	2.000%
Carmichaels Arbors Associates	2.000%
Weston Arbors Associates	2.000%
Washington Arbors Associates	2.000%
Hulton Arbors Associates	1.333%
Penn Arbors Associates	0.275%
Sykesville Associates	29.70%

8. In or about 1982, Matthew J. Domber and Jacob B. Ward formed Arbors Management, Inc. ("Arbors Management"), a Pennsylvania corporation, to centrally manage the above-described properties. One-third of the stock of Arbors Management was owned by one Edward J. Quinlan, who described himself as an officer, director and "head of the office" of Arbors Management. The remaining two-thirds of the stock was owned, in equal one-sixth amounts, by George W. McAnallan, Robert McAnallan (both of whom were described as Pennsylvania residents), Matthew J. Domber and Jacob B. Ward. Documents in the record bear out that the McAnallans and Messrs. Domber and Ward have, over the years, participated in joint ventures in the development, construction, ownership and operation of various low and moderate income housing projects located in West Virginia and Pennsylvania.

9. During the years in issue, the various Arbors partnerships made partnership distributions to Jacob B. Ward which were, in turn, deposited into the operating account of the law firm of Domber and Ward in New York City. It is alleged by petitioners that the Arbors partnership distributions represent the amounts due to both Mr. Domber and Mr. Ward, and that Mr. Ward was receiving such distributions for himself and as trustee for Mr. Domber. Such

[3]The development partnerships may, hereinafter, be referred to collectively as the "Arbors" partnerships.

receipt, allegedly as trustee, was necessary because petitioner Rachel A. Domber was an employee of HUD which, coupled with her marriage to Mr. Domber, presented conflict of interest circumstances preventing Mr. Domber from holding direct ownership interests in any HUD affiliated projects.

10. Copies of Arbors partnership agreements, regulatory agreements and power of attorney forms were included in the record as part of the Division's post-hearing submission of documents. These documents bear out that petitioner was an authorized agent (per power of attorney) with full authority to act for and on behalf of the partners with respect to all matters of Arbors partnership business. However, the documents show that only Jacob B. Ward, not petitioner, held an ownership interest (i.e., partner status) in the Arbors partnerships. The record contains no documents substantiating the alleged trust agreement between Mr. Ward and Mr. Domber.

11. During the years in question, the Firm received fees for services rendered. Such payments included not only legal fees for services rendered for private clients, but also legal fees paid by Arbors Management for services rendered to the various Arbors partnerships. Bills for such services were issued by the Firm to Arbors Management, and checks in payment thereof were drawn on the account of Arbors Management. Such checks were made payable to the law firm of Domber and Ward, as distinguished from Arbors partnership distribution checks which were payable to Jacob B. Ward.

12. All of the receipts described above, including Arbors distributions, legal fees from Arbors Management, fees from other clients, etc., were deposited into the Firm's one operating account. According to an affidavit of Jacob B. Ward, all fees were deposited in one account for convenience, primarily because the Firm account was the only account held in common by Messrs. Domber and Ward.

13. Petitioners maintain that the business of the Arbors projects was conducted outside of New York State by Arbors Management. Petitioners assert that the Firm had no involvement in the management of the Arbors partnerships and that Messrs. Domber and Ward owned their

interests in such partnerships in their own right and not through the Firm. In addition, petitioners note that for previous years, the Division conducted an audit of the Firm and of petitioners' personal returns, and concluded that, because the Firm did not maintain an office out of state, the Arbors income distributions received by the Firm represented Firm income from New York activities which was not subject to allocation out of state. In contrast, petitioners argued then, and argue now, that the distributions represent income and gain items generated directly from the real estate activities of the Arbors partnerships. Petitioners assert that in the prior proceedings the auditor excluded direct real estate items (i.e., capital gains, rental income, etc.) from his adjustments, and only included fees (i.e., management fees, legal fees, etc.) received from the out-of-state partnerships as nonallocable New York source law firm income. However, petitioners argue that in the present matter the auditor did not conduct an audit of the law firm but rather simply disallowed the allocation of any items of distribution to Mr. Domber per the Schedule K-1 issued to him by the Firm.

14. In support of their argument, petitioners submitted Schedules K-1 issued to Jacob B. Ward for the year 1989 by each of the Arbors partnerships, together with a summary sheet listing the various items of distribution on an individual and a total basis (from such Schedules K-1) for each of the partnerships. Comparing this summary sheet to the Schedule K-1 issued to petitioner Matthew J. Domber by the Firm reveals that exactly one-half of the total Arbors distributions of net long-term capital gain and section 1231 gain is reflected on Mr. Domber's Schedule K-1 from the Firm. In turn, such one-half amount is carried through to the "Federal Amount" column but not to the "New York Amount" column on petitioners' Form IT-203 for 1989. Stated differently, petitioners show an inflow of capital gain and section 1231 gain from Arbors through the Firm and on to Mr. Domber, with such gains treated as not allocable to or taxable by New York (as non-New York source income). The record, however, is not so clear with regard to tracing the other amounts (specifically the items of adjustment for ordinary income and rental, interest and dividend income) from the Arbors Schedules K-1 and summary

sheet, to the Domber and Ward Schedule K-1, and on to petitioners' Form IT-203. Such items for 1989 may be presented, for purposes of comparison, as follows:

AS REFLECTED PER ARBORS' K-1's AND SUMMARY SCHEDULE

ITEM	AMOUNT
Ordinary income rental activity	$ 37,732.00
Portfolio interest	$ 6,517.00
Ordinary income to be reported	$ 44,249.00
Net long-term capital gain	$345,333.00
Section 1231 gain	$116,755.00
Development/management fees	$ 26,875.00

AS REFLECTED PER DOMBER AND WARD K-1 ISSUED TO MR. DOMBER

ITEM	AMOUNT
Ordinary trade or business income	$109,406.00
Net income from rental activities	$ 19,164.00
Portfolio income:	
Interest	$ 12,522.00
Dividends	$ 42.00
Net long term capital gain	$172,666.00
Section 1231 gain	$ 58,377.00

AS REFLECTED PER PETITIONER'S FORM IT-203

ITEM	AMOUNT
Partnership income alloc. to New York	$ 35,716.00[4]
Interest income alloc to New York	$ 7,436.00

15. Included with petitioners' post-hearing submission of documents was an affidavit of their accountant (who also testified at hearing), an index listing documents examined on audit, and a one-page printout entitled "Domber and Ward 1989 Income." According to the affidavit, this printout was included as a representative page of Domber and Ward's cash receipts. The printout shows, in columns, receipts for the period January 4, 1989

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[4]Income from the Domber and Ward law partnership per Schedule 6 to Form IT-203.

through June 2, 1989, including, inter alia, management fees/legal fees in the "income" column and Arbors distributions in the "project income" column.[5]

16. In sum, the main thrust of petitioners' argument is that the returns, as filed, correctly reflect that a portion of the income "run through" the Firm's operating account and reflected as items of distribution to Mr. Domber, was income derived from non-New York sources, specifically from real estate located outside of New York. Petitioners argue that such income was not income from the Firm's business activities and that the Firm itself had no ownership interest in the Arbors partnerships. Petitioners maintain that Messrs. Domber and Ward were, individually, the owners of the out-of-state real estate interests, and that the Firm was simply a convenient conduit by which to receive, distribute and account for distributions from the Arbors partnerships. Thus petitioners argue that the income was correctly allocated out of state because the same represented non-New York source income earned by a nonresident partner from real estate located out of state.

CONCLUSIONS OF LAW

A. Tax Law § 601 (former [f]), as in effect during the years in issue, stated as follows:

> "Partners and Partnerships. -- A partnership as such shall not be subject to tax under this article. Persons carrying on business as partners shall be liable for tax under this article only in their separate or individual capacities."

B. It is well established that nonresidents of New York may be taxed only on their New York source income and, likewise, may deduct only their New York source losses. In the case of partnerships and nonresident partners, Tax Law former § 632(a)(1) provided that:

> "[i]n determining New York source income of a nonresident partner of any partnership, there shall be included only the portion derived from or connected with

[5]The Division's representative objected to paragraphs "2" through "5" of the affidavit as "incorrect, contradicted by documents in the record, or lacking supporting source documents", and to the affidavit itself since the affiant had testified at hearing. Such objections are overruled and the affidavit is included as part of the record. The posthearing submission of affidavits and documents was anticipated in this matter. Further, with respect to the objections to the specific paragraphs, it is noted that paragraph "2" may contain accurate statements, yet the same are of little value in verifying petitioners' claims since only a partial cash receipts sheet is included (see Conclusion of Law "M"). Paragraph "3" merely repeats an allegation made at hearing. Paragraph "4" essentially points toward a conclusion supported independently by other evidence (see Conclusion of Law "K"). Paragraph "5" speaks of Federal tax law, a matter of which notice may be taken independently.

New York sources of such partner's distributive share of items of partnership income,
gain, loss and deduction entering into his federal adjusted gross income, as such portion shall be determined under regulations of the tax commission consistent with applicable rules of section six hundred thirty-one."

C. Tax Law former § 631(b), describing income and deductions from New York sources, provided:

(1) "[i]tems of income, gain, loss and deduction derived from or connected with New York sources shall be those items attributable to:

(A) the ownership of any interest in real or tangible personal property in this state; or

(B) a business, trade, profession or occupation carried on in this state . . . ."

D. In turn, 20 NYCRR former 132.4(a)(2) provided that:

"[a] business, trade, profession, or occupation . . . is carried on within New York State by a nonresident when such nonresident occupies, has, maintains or operates desk space, an office, a shop, a store, a warehouse, a factory, an agency or other place where such nonresident's affairs are systematically and regularly carried on, notwithstanding the occasional consummation of isolated transactions without New York State. This definition is not exclusive. Business is carried on within New York State if activities within New York State in connection with the business are conducted in New York State with a fair measure of permanency and continuity."

E. Where the items of income, gain, loss and deduction at issue are attributable to rental income or gains from sales of real property, 20 NYCRR former 131.16 calls for sourcing such items according to the situs of the real property, as follows:

"[i]ncome from, and deductions connected with, the rental of real property, and gain and loss from the sale, exchange or other disposition of real property, are not subject to allocation under sections 131.13 or 131.15 of this Part, but are considered as entirely derived from or connected with the situs of such real property."

F. The issue of proper allocation of Arbors distributions received by petitioners through the Firm has been addressed, for prior years, in this forum. In the prior case involving petitioners (Matter of Domber, Tax Appeals Tribunal, February 27, 1993, confirmed 210 AD2d 529, 619 NYS2d 829, lv denied 85 NY2d 287, 496 NYS2d 972), it was argued (as here) that a portion of the Firm's distributions to Mr. Domber consisted of income derived from out-of-state real estate ventures, which income was attributable to Mr. Domber's (and not the Firm's) interests in such ventures. During the period then under dispute, the distributions were handled in the same manner as described above, to wit, they were made to Mr. Ward allegedly as trustee for Mr. Domber, and were "run through" the Firm's operating account. Petitioners maintained that 20 NYCRR former 131.16 dictated that a nonresident partner's items of distribution relating to real property located out of state were not taxable by New York. The Tax Appeals Tribunal rejected this argument, however, observing that "[t]he inquiry does not end simply because the source of the income or loss is related to out-of-state real property; rather the factors listed in [Matter of Ausbrooks v. Chu, 66 NY2d 281, 496 NYS2d 969] must be considered." The Tribunal stated:

> "Based on the language of the statute and regulation, the focus of the present inquiry is on where the income was generated notwithstanding the location of the real property. Specifically, our inquiry is whether the revenue from out-of-state real property was generated by active management which took place in New York State, or whether the revenue represents passive investment income flowing from the out-of-state real property to a recipient in New York. Although this passive/active distinction is not explicitly set forth in 20 NYCRR former 131.16, the type of activities which are mentioned in the regulation, as well as the decision in [Voght v. Tully, 53 NY2d 586, 444 NYS2d 441 and Matter of Ausbrooks v. Chu, supra.], indicate that this is the required inquiry."

The Tribunal then reviewed the Voght and Ausbrooks decisions and concluded that:

> "Based on these two cases, it may be said that income is attributable to New York State if (i) the business was systematically conducted in New York State; (ii) activities related to the business were conducted in a permanent and continuous manner in New York State; and (iii) the out-of-state assets of the business were actively managed from New York State [citation omitted] . . . ."

The Tribunal held that the income was properly allocated to New York.

G. The Appellate Division, in turn, confirmed the Tribunal's decision denying out-of-state allocation, observing that "[a]s fees generated by real estate activities are not the equivalent of income from the rental of real property (and there being no proof of real estate sales gains) the passive/active analysis relating to petitioners' New York business activities used by the Tribunal was reasonable" (emphasis added). In a footnote to this statement, the Court specified that "[t]his is not a situation where the income transmitted to the New York law firm was either net rental income or gross rents from out-of-state rental properties which would result in the application of 20 NYCRR former 131.16." [6]

H. The prior Domber matter involved "fees generated by real estate activities", against which the "active/passive" analysis was applied to determine where such fees were generated for purposes of proper sourcing. Under this analysis, although fees may be related to and derived from rental real estate ventures located out of state, they are nonetheless properly considered New York source income if the business activity by which such fees are generated is conducted actively in New York. Based on the record the Tribunal and, ultimately, the Court concluded petitioners had not proven that the fees in question, sought to be allocated out of New York, did not result from the Firm's active involvement in the affairs of the out-of-state real estate ventures. The Tribunal concluded, and the Court confirmed, that the Arbors interests were held (owned) by the Firm, based on the "held as nominee" provision together with the balance of the terms of the Firm's partnership agreement and the lack of countervailing evidence in support of petitioners' claim of individual ownership. It was further held that petitioners failed to prove the distributions from Arbors to Jacob B. Ward were anything other than fees (such as rental income and/or sales gains). Accordingly, such fees, although derived from out-of-state real estate ventures, constituted business income generated by the Firm's activities in New York. Since the Firm had no non-New York locations, the income was held properly sourced to New York. However, the Court also recognized that if the distributive items were shown to be rental income and/or sales gains from the out-of-state ventures, as opposed to fees therefrom, such items would be sourced according to the situs of the real property pursuant to 20 NYCRR former 131.16. In turn, the Firm's distribution thereof to its partners would result in any nonresident partner (such as petitioner Matthew J. Domber) being entitled to treat his

[6] The Court pointed out that petitioners' witness (Jacob B. Ward) referred to the distributive items, in testimony, as "fees" including "management fees, syndication fees, development fees and operational profits", as opposed to net rental income, gross rents or real estate sales gains.

distributive share of such non-New York source income as not subject to New York tax.[7] In sum, the Court recognized that the character of the Arbors distributions determines the sourcing thereof, and that such items do not change their character simply by virtue of being "run through" the New York partnership.

I. Petitioners claim that all of the income allocated out of New York, as detailed in Findings of Fact "2", "4" and "14" (i.e., ordinary income from trade or business, net rental income, interest income, dividend income, capital gain, and section 1231 gain) was directly derived from the out-of-state real estate ventures. Petitioners assert the evidence bears out that such income was not Firm income, that the Firm was not managing the real estate ventures and did not possess HUD certification to do so, that Messrs. Domber and Ward each held their own interests individually in the real estate ventures (albeit that Mr. Domber's interests were allegedly held by Mr. Ward as trustee), and that the accounting documents bear out and support that all of the income was properly allocated out of New York by Mr. Domber. As set forth above, the Court observed that, for the earlier years, there was "no proof of real estate sales gains", and included the accompanying footnote clearly stating that the income in question for such years was not "net rental income or gross rents from out-of-state rental properties which would result in the application of 20 NYCRR former 131.16." (Matter of Domber v. Tax Appeals Tribunal, supra, 619 NYS2d at 831.) The question in this case thus devolves to whether petitioners have established their claim that some or all of the income was real estate sales gains and/or net rental income or gross rents, as opposed to business income/fees received as the result of the law firm's (and its partners') active involvement in conducting the affairs of the out-of-state real estate ventures.

J. As a starting point, the evidence does not establish that the Firm had no interest in the Arbors partnerships. First, although the Arbors distributions were issued to Jacob B. Ward and not to the Firm, they were directly deposited in the Firm's bank account, were accounted for therein and were passed on as distributions from the Firm to its capital partners. In turn,

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[7]This sourcing distinction would be of no significance to New York resident partners since, generally, New York residents remain subject to tax on income from all sources.

consistent with the Firm's partnership agreement, such distributions to the partners were in equal amounts, at least (as discussed below) with respect to capital gains and section 1231 gains. The assertion that Mr. Domber was an individual equity partner in the Arbors partnerships is simply not borne out by the documentary evidence. On this score, petitioners did submit a certificate of doing business under an assumed name as filed with the State of Pennsylvania. This certificate, dated and filed in November 1975, lists Matthew J. Domber and Jacob B. Ward as doing business under the name Butler Arbors Equities. According to Mr. Ward's affidavit, this certificate establishes that Messrs. Domber and Ward, as individuals, rather than the Firm, intended to do business as individual partners in the Arbors partnerships. In contrast, however, none of the Arbors partnership agreements or other documents in the record reflect Mr. Domber as a partner. Further conspicuously absent is any documentary evidence of Mr. Domber's alleged transfer of his interests in trust to Mr. Ward, notwithstanding that such transfer was discussed and presented as part of petitioners' case in the earlier matter as well as in this case. In fact, the Arbors partnership agreements speak of required notifications to HUD and to the other Arbors partners upon the withdrawal of a partner or transfer of a partner's interest, yet the record is devoid of any such notifications with respect to Mr. Domber's alleged transfer of his ownership interests in trust to Mr. Ward. Similarly, according to Mr. Ward's affidavit, Mr. Domber notified HUD of regaining his Arbors partnership interests in his own right when Mrs. Domber retired from HUD in 1993, yet the record contains no documentary evidence of such notification.

In contrast to the foregoing, Jacob B. Ward is listed as an equity partner in the Arbors partnerships, and he received distributions therefrom in his own individual name. In turn, the Firm's partnership agreement specifically authorizes the Firm to engage in real estate ventures <u>and</u> specifically provides that any partnership interest in real property ventures held in the name of a capital partner (i.e., either Mr. Domber or Mr. Ward) would be deemed held as a nominee for the Firm. The Firm's partnership provisions vis-a-vis profits and losses is structured to (and at least for capital gains and section 1231 gains does) achieve the same result with respect to

Arbors distributions as if each capital partner in the Firm held the Arbors interests in his own right. The lack of evidence that Mr. Domber held any Arbors interests in his own name overrides the certificate of doing business referred to above and leads to the conclusion that he held his interests through and as a partner in the Firm. In fact, this same conclusion was reached in the prior case and there is no evidence clearly supporting a different result.

K. The foregoing conclusion that the interests in the Arbors partnerships in Jacob B. Ward's name were held as nominee for the Firm is not, however, fatal to petitioners' argument that the distributions from the Arbors partnerships may be sourced out of New York. That is, the fact that the Arbors interests were held by the Firm does not mean, as set forth above, that the Arbors distributions lose their initial character and become entirely business income of the Firm. Instead, the question becomes one of proof of the character of the items being allocated.

Petitioners have alleged that in the prior case the auditor reviewed not only their returns but also the Firm's records, and thereafter reallocated only fee income to New York while leaving intact the allocated items representing Arbors distributions of rental income and/or sales gains. That is, the latter items were not "picked up" on audit and included as taxable to New York based on the auditor's review and acceptance of the same as non-New York source items. In this case there was no audit review of the Firm. Instead, the auditor simply "picked up" and reallocated as taxable New York source income any differences between Mr. Domber's Schedule K-1 from the Firm and petitioners' Form IT-203. Support for petitioners' allegation can be found through review of the Statement of Personal Income Tax Audit Adjustments for 1985 (one of the prior audit years) in comparison to Mr. Domber's Schedule K-1 from the Firm for such year. Specifically, this comparison reveals that the Division's 1985 audit adjustments did not reallocate to New York, net long-term capital gain of $147,750.00 which was reported on the face of the Schedule K-1, but was not included among the items reported as allocable to New York on Part IV of a New York Equivalent Schedule K-1 appended to petitioners' 1985 nonresident return. In this case, there is no evidence of any audit inquiry as to the underlying nature of the items reallocated. The fact that the initial audit focus was on petitioners' domicile (i.e., residency status), as opposed to the nature and allocation of partnership distribution items, lends strength to petitioners' claim that the auditor may have erroneously reallocated items of sales gains, gross rents and net rental income as opposed to only fees (i.e., business income) of the Firm. Thus, the remaining question becomes whether the evidence shows that any of the specific amounts reallocated to New York on audit were properly allocated out of New York as non-New York source income, by petitioners in the first instance.

L. The evidence bears out that two items for 1989, to wit, net long-term capital gain ($172,666.00) and section 1231 gain ($58,377.00), were clearly not fees generated by the Firm's activities. The dollar amounts of these items flow from the individual Schedules K-1 for each of the Arbors partnerships to the summary schedule listing and accumulating such items. In turn, exactly one-half of the total dollar amount of each of such gain items appears on the Schedule K-1 issued to petitioner Matthew J. Domber from the Firm and, thereafter, appears on the schedules appended to petitioners' 1989 nonresident return. This accounting trail clearly spells out such items as non-fee direct distributions from the Arbors partnerships properly sourced according to the situs of the real property (i.e., out of state). Accordingly, petitioners, as nonresidents, were entitled to treat such items as non-New York source items not subject to New York tax.

Unfortunately, the evidence does not allow such a conclusion with respect to the balance of items reallocated by the auditor. Specifically, despite repeated attempts, the dollar amounts shown on the Arbors Schedules K-1 and accompanying summary sheet for 1989 as net income, interest, and dividends cannot be followed through and tied to the dollar amounts of such items as shown on Mr. Domber's Schedule K-1 from the Firm, or to the amounts on petitioners' 1989 Form IT-203. Petitioners, specifically through the testimony of their accountant, claim such a tracing can be performed. However, petitioners have not provided a complete explanation in this regard, and the record of evidence in this case is not sufficient to make such a trail independently (see Finding of Fact "14"). In this regard, petitioners' accountant testified that the accounting trail from the Arbors Schedules K-1 through to the Firm and on to petitioners' returns could be made via reference to the Firm's cash receipts records, yet only a partial year's cash receipts record (for January through June 1989) was submitted (see Finding of Fact "15"). Thus, it is concluded that petitioners have failed to prove that the items for 1989, other than capital gains and section 1231 gains, represented properly allocated items of rental income or gross rents from the out-of-state partnerships as opposed to fees from such partnerships properly treated as New York source business income of the Firm. In the same manner, petitioners have offered no specific evidence at all with regard to the amounts in question for 1990. This lack of specific evidence leaves it impossible to determine that the amounts allocated out of New York by petitioners were entirely, as claimed, items of net rental income, etc., as opposed to fees derived from the out-of-state partnerships. Simply put, the problem with the ordinary income items is that the dollar amounts cannot be tied together and traced from Arbors through the Firm to petitioners' returns via the evidence in the record.

M. In sum, petitioners have established that they appropriately treated the net long-term capital gains and the section 1231 gains distributed by the Arbors partnerships for 1989 (in the amounts of $172,666.00 and $58,377.00, respectively) as non-New York source items, and thus properly excluded the same from their New York taxable income on their nonresident return for 1989. Accordingly, the notice of deficiency shall be recomputed for 1989 by eliminating such amounts as additional New York income. However, petitioners have not established the propriety of sourcing the balance of items at issue out of New York, and thus the balance of the audit adjustments for 1989 and those for 1990 are sustained.

N. Petitioners requested abatement of penalty, yet have offered no bases challenging the imposition thereof nor any reasons serving to explain why penalty abatement would be warranted. It is true that a portion of the deficiency, and with it the dollar amount of penalty calculated thereon, is being cancelled. However, without more, there is no basis established by petitioners for cancelling penalty and it is sustained.

O. The petition of Matthew J. Domber and Rachel A. Domber is granted to the extent indicated in Conclusion of Law "M" but is otherwise denied, and the Notice of Deficiency dated November 15, 1993, as recomputed and reduced in accordance herewith, is sustained.

DATED: Troy, New York
March 13, 1997

/s/ Dennis M. Galliher
ADMINISTRATIVE LAW JUDGE