STATE OF NEW YORK

DIVISION OF TAX APPEALS

In the Matter of the Petition	:	
of	:	
PETER R. AND SUSAN BRINCKERHOFF	:	DETERMINATION DTA NO. 816329
for Redetermination of a Deficiency or for Refund of Personal Income Tax under Article 22 of the Tax Law for the Years 1992 and 1993.	: :	

Petitioners, Peter R. and Susan Brinckerhoff, 25 Lake Drive, Riverside, Connecticut 06878, 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 1992 and 1993.

A hearing was held before Arthur S. Bray, Administrative Law Judge, at the offices of the Division of Tax Appeals, 641 Lexington Avenue, New York, New York, on September 29, 1998, at 11:00 A.M. with all briefs to be submitted by March 8, 1999, which date began the six-month period for the issuance of this determination. Petitioner Peter R. Brinckerhoff appeared *pro se* and for Susan Brinckerhoff. The Division of Taxation appeared by Terrence M. Boyle, Esq. (Michael J. Glannon, Esq., of counsel).

ISSUES

I. Whether the Notice of Deficiency is moot because the amount asserted to be due by the Division of Taxation was modified by a conciliation order.

II. Whether the Conciliation Order is barred by the three-year statute of limitations, or whether it is unlawful because the method used by the conciliation conferee to allocate income to New York is arbitrary, capricious and erroneous.

III. Whether the Division of Taxation's general denial of certain paragraphs of the petition renders the claims by the Division of Taxation groundless.

IV. Whether income received by a nonresident under the terms of an incentive plan with his New York employer constituted New York source income.

FINDINGS OF FACT

1. Petitioners, Peter Brinckerhoff[1] and his wife, Susan Brinckerhoff, filed a joint New York State Nonresident and Part-Year Resident Income Tax Return for the year 1992. On this return, petitioner reported that his address was 25 Lake Drive, Riverside, Connecticut 06878. The return included a wage and tax statement from the firm of Donaldson, Lufkin & Jenrette ("DLJ") which stated that petitioner received wages in the amount of $599,045.00. This income was reported as gross receipts or sales on a Federal Schedule C. Petitioner described his business or profession as "[c]onsulting - general" and placed an "x" in a box to indicate that these were earnings which petitioner received as a statutory employee. According to the wage and tax statement, the address of DLJ was 140 Broadway, New York, New York. Petitioner did not allocate any income to New York on his return.

2. Petitioner and his wife filed a joint New York State Nonresident and Part-Year Resident Income Tax Return for the year 1993 which listed the same home address as was used the previous year. The return included a wage and tax statement from DLJ which stated that petitioner received wages in the amount of $454,445.12. As he had done in the previous year, petitioner reported this amount as gross receipts or sales on a Federal Schedule C and stated that

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[1]Petitioner Susan Brinckerhoff is included in these proceedings only by virtue of having filed a joint return with her husband, Peter R. Brinckerhoff. All references to petitioner should be understood to apply to Mr. Brinckerhoff unless specifically noted otherwise.

his principal business or profession was "[c]onsulting - general." Petitioner also checked a box to indicate that this amount represented earnings received as a statutory employee. The only items allocated to New York on this tax return were a capital loss and a loss from "rents, royalties, partnerships, estates, trusts, etc."

3. Petitioner reported the income from DLJ on a Schedule C rather than as wages because he was not working for the firm at the time and did not think that it would be correct to characterize the income as wages.

4. The Division of Taxation ("Division") issued a Notice of Deficiency, dated March 11, 1996, which asserted a deficiency of New York State and New York City personal income tax for the years 1992 and 1993 in the amount of $71,412.59, plus interest in the amount of $14,079.13 and penalty in the amount of $10,610.20 for a balance due of $96,101.92. Statements of audit changes for the years 1992 and 1993 explained the adjustments in relevant part as follows:

> Based on review of the information submitted, income reported to you by Donaldson Lufkin & Jenrette on form W-2 is determined to be wages rather than self-employment as reported on the tax return. Expenses claimed on federal Schedule C have, therefore, been disallowed.
>
> Because you claimed to have performed no services in the year under review on behalf of Donaldson Lufkin & Jenrette, a New York employer, compensation reported on form W-2 is considered paid based on past services performed on behalf of this employer. All wages have been included in New York income. (Division's exhibit "B.")

5. The Division's conclusion was based, in part, on a letter dated January 24, 1996 from Rudolph M. Nolfo, Senior Vice President of the Administrative Division of DLJ, to the Division which stated that for 1992 the wages in box number one represented a payout of prior years' deferred compensation and that the 1993 wages represented a commission payout. The Division also had a copy of an office memorandum, dated April 1, 1993, addressed to the participants of

the "DLJ/LBO [Leveraged Buy-Out] Incentive Plan - 1988" ("Plan"). The memorandum stated, in part:

> Enclosed is a check representing your proportionate interest in the proceeds of sales by DLJ of all shares of Caldor Corp. and debt of TVH Acquisition Corp. (Home Holdings) which had been allocated to the subject Plan.
>
> Also enclosed is a statement showing your proportionate interest in various securities that remain allocated to the Plan. As you probably know, a number of securities allocated to the Plan were distributed to active employees last year. For complicated reasons, we could not make such distribution to terminated employees. Because many have asked for it, I am also enclosing a list of the securities that were distributed to employees and the tax basis (market value) per share on December 15, 1992, the effective date of the distribution. (Division's exhibit "L.")

6. The foregoing memorandum included a copy of a pay statement from DLJ showing a payment to petitioner on March 29, 1993. The Division also reviewed two other memorandums, dated August 25, 1993 and November 17, 1993, respectively, with a total of five additional pay statements evidencing a series of further distributions to petitioner from the Plan. The memorandums of August 25, 1993 and November 17, 1993 referred to a "Bonus Payment" next to the term "SUBJECT." The text of the memorandums showed that the income that was distributed in 1993 arose from the Plan's sale of securities.

7. Following a conciliation conference before the Bureau of Conciliation and Mediation Services, a Conciliation Order was issued which reduced the amount of tax asserted to be due to $23,934.90 for 1992 and $21,201.06 for 1993. To the extent in issue, the conciliation conferee allocated income to New York for the years 1992 and 1993 on the basis of petitioner's allocation of wages to New York in the years 1989 through 1991. For the year 1991, the amount of New York wages was determined by multiplying an average of the allocation percentages for the years 1989 and 1990 by the amount of wages shown on the wage and tax statements.

8. Petitioner filed a petition which alleged, among other things:

> 17. The Division claims the income received by the Petitioner in 1992 and 1993 that was derived from the DLJ/LBO Plan was New York source.
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> * * *
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> 24. What is in dispute is whether the income from the cash distributions received by the Petitioner in 1992 and 1993, which were cash distributions from the DLJ/LBO Plan derived from the sale of securities held on behalf of this Petitioner by the DLJ/LBO Plan, were New York source income in 1992 and 1993, and as the Division contends are subject to allocation.

9. The Division's answer denied the allegations contained in paragraphs 17 and 24.

10. In 1988, petitioner was a senior investment banker with Paine Webber Inc. During 1988, DLJ recruited petitioner and, on February 23, 1989, he started working at DLJ. Petitioner was hired as a managing director to work on financial restructurings, leveraged buyouts, exchange offers and similar financial projects. While working at DLJ, petitioner traveled extensively within the United States and Europe working on various projects that DLJ had been hired to complete.

11. As part of the recruitment process, petitioner and DLJ negotiated an employment contract. The terms of this agreement were memorialized in a letter addressed to petitioner, dated, February 23, 1989, which stated, in part:

> I wanted to summarize for you the conversations we have had regarding the terms of your employment at DLJ. You will be elected a Senior Vice President of DLJ Securities Corporation and will be in both our Mergers & Acquisition/LBO Group and our generalist new business group. You will also be designated a "Principal" in the DLJ Principal's Program. Your salary will be at the rate of $140,000 per annum. You will be allocated 65 points in the 1989 Senior Vice President's bonus pool. Such points would have had a value in last year's bonus pool (exclusive of any discretionary awards and after looking through certain allocations of the 1988 bonus pool made in 1986) of approximately $900,000.00. The value of the points in this year's pool will depend on the economic success of the Investment Banking Group. In addition, we will allocate you a participation

> of $300,000 in our 1988 DLJ LBO Investment Fund for investments made subsequent to January 1, 1989. Such allocation will be funded by a $75,000.00 contribution by you (to be retained from your 1989 bonus payable in January, 1990 with interest from January, 1989) and the equivalent of a $225,000 non-recourse loan from the firm for the benefit of your account pursuant to the terms of that program. As we have discussed the DLJ LBO Investment Fund was formed in early 1988 and you will not have a participation in the economic results of investments which were made in 1988. For the next DLJ LBO Investment Fun [sic] you will be allocated a participation of at least $700,000 to be funded by a $175,000 contribution by you (to be retained from your January 1990 bonus) with the equivalent of a $525,000 non-recourse loan from the firm for the benefit of your account pursuant to the terms of that program. Should direct investments by DLJ professionals in the LBO's be permitted you will be offered such opportunity in the amounts at least equal to other professionals in your position. As a principal of DLJ you will also be entitled to participation in the DLJ Automobile Program pursuant to the terms of that Program which will be provided you.

12. As described in the foregoing letter, the $75,000.00 initial contribution was funded by a bonus which petitioner was to receive in 1990. The bonus, in turn, was a benefit petitioner received as a result of his negotiating an employment contract prior to his employment by DLJ.

13. The phrase "the equivalent of a $225,000.00 non-recourse loan," set forth in the letter of February 23, 1989, referred to a loan from DLJ to the Plan. Under the terms of the Plan, if and when the securities held by DLJ were sold at a profit, the non-recourse loan, with interest, would first be repaid to DLJ. Thereafter, any further profit would be distributed to the Plan participant in proportion to the Plan participant's vested interest in the Plan. As a result, the participants of the Plan would receive a net distribution after repayment of the loan. Since petitioner was not a recipient of the loan, he did not have an obligation to repay it. The loans were totally repaid by December 1992. Thereafter, any proceeds distributed to Plan participants were the net proceeds from the sale of securities.

14. Near the conclusion of the second full paragraph of the letter of February 23, 1989 there is a reference to a subsequent investment fund where petitioner would have a participation

of at least $700,000.00. This second stage did not take place while petitioner was at DLJ and therefore, only one DLJ/LBO investment fund is involved in this matter.

15. The DLJ/LBO Investment Fund referred to in the previous letter is set forth in a document entitled DLJ/LBO Incentive Plan - 1988. Paragraph two of the first article of the Plan provided:

> The purpose of this Plan is to enhance the ability of Donaldson, Lufkin & Jenrette, Inc. and its subsidiary corporations to attract, retain, and positively motivate key executive personnel by providing an opportunity for these personnel to participate in equity and equity-related investments made by the Corporation's Banking Group in Leveraged Buy-Out ("LBO") or similar investment opportunities which offer the prospect of substantial capital appreciation.

16. The first paragraph of the fourth article of the Plan provided that the administration of the Plan would be vested solely in the Committee[2] which would have absolute discretion regarding the exercise of its powers. The Committee's determination as to what constituted sufficient cause for any action taken or not taken with respect to the Plan was final.

17. The fifth article of the Plan was entitled "Award and Vesting of Units" and provided, among other things, that the vesting of units was a function of longevity at DLJ. There was no performance criteria for vesting at DLJ. Upon termination of a participant's employment, vested units would remain in the participant's account as if the participant remained an employee. The Plan gave DLJ the option, within one year of the termination of the participant's employment, to cancel all or any portion of the nonvested units by making a cash payment for each canceled unit. If DLJ chose not to cancel a unit, then the unit which was not canceled would remain in the

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[2]The term Committee was defined by the third paragraph of the second article of the Plan as the Award Committee of at least three persons selected by the Chief Executive Officer. If the Committee was not in existence, the term referred to the Chief Executive Officer.

participant's account as if the participant had remained an employee.

18. The seventh article of the Plan provided that it would be operated as an investment fund. Twenty-five percent of the Plan's theoretical investments were considered to have come from the Plan's investment pool (considered the equity amount) and the balance to have come in the form of a loan from DLJ (considered the loan amount). Pursuant to the ninth article of the Plan, "the Committee [in its sole discretion] may cause distributions to be made to a [p]articipant from the Plan's allocated share of profits realized on the Company's investments which have been credited to such Participant's Account." (Petitioner's exhibit "4.")

19. Petitioner was interested in the plan because it offered investment opportunities for capital appreciation.

20. Petitioner resigned from DLJ in January 1991.

21. In a memorandum dated October 23, 1991, petitioner was advised that DLJ had decided to exercise its right to cancel his nonvested units under the Plan. As a result, one-quarter of petitioner's $75,000.00 participation was redeemed which, in turn, reduced his investment to $56,250.00. Petitioner was also informed that his vested units would remain in the Plan and that the ultimate value would be distributed to him when the Plan was terminated and distributions were made to all participants.

22. During the years in issue, petitioner was a nonresident of New York and did not conduct a business in New York. He did not have any assets connected with a business in New York. Petitioner did not provide any services to DLJ in 1992 and 1993.

23. A letter from Mr. Thomas E. Siegler, DLJ's senior vice president and secretary, dated July 25, 1997, shows that the $599,045.00 reported on petitioner's wage and tax statement by

DLJ for the year 1992 was the aggregate cash distribution made to petitioner by DLJ based upon his Plan interest in the proceeds realized by DLJ on the sales of Caldor Corporation, Chicago and Northwestern Holdings and GTECH Holdings. For the year 1993, petitioner's distribution of $454,445.12 was based upon the Plan's disposition of the following assets:

Investment	**Petitioner's Cash Distribution**
The Caldor Corporation and TVH Acquisition Company	$59,493.00
Penncorp	22,384.62
CNW Holdings	101, 472.50
GTECH Holdings	271,095.00
Total 1993 Distributions	$454,445.12

24. The securities described in the memorandums of August 25, 1993 and November 17, 1993 correspond with the securities mentioned in the letter of July 25, 1997 from DLJ (***see***, Findings of Fact "6" and "23").

25. The income from DLJ reported by petitioner in 1992 and 1993 was due only to the sale of securities by DLJ on behalf of the Plan for petitioner's account. During the years in issue, petitioner did not have any other income from DLJ. The tax asserted to be due by the Division results solely from the income generated from the Plan.

26. There were two reasons that the Plan distributed income to petitioner during the years in issue. First, the companies, whose securities were held by the Plan, were successful. As a result, the market valuation of the securities dramatically increased. Second, the Committee which oversaw the operation of the Plan caused distributions to be made.

27. Petitioner was not involved with the management of the Plan. Petitioner's service to

DLJ had no bearing on the success of the investments of the Plan.

28. Following his resignation from DLJ, petitioner sought but was unable to find employment with other securities firms. He also turned his attention to managing his financial assets. Petitioner's success with his investments combined with the income received from the Plan allowed petitioner to retire.

SUMMARY OF THE PARTIES' POSITIONS

29. In the course of the proceeding, petitioner raised the following arguments:

(a) Petitioner contends that the Notice of Deficiency "has no standing" (Petitioner's exhibit "8", p. 6). Petitioner submits that the Notice of Deficiency is moot because the Division is bound by the conciliation order. According to petitioner, since the Division stated in its hearing memorandum that the only issue to be decided is the Notice of Deficiency, the Division's claims should be disallowed.

(b) Petitioner posits that the conciliation order is unlawful because it is based on a supplemental assessment made after the expiration of the statute of limitations. It is petitioner's position that the conciliation order is null and void because it was not issued within the statutory three-year period. Petitioner also argues that the conciliation order is unlawful because the allocation method used by the conferee is arbitrary, capricious and erroneous. Petitioner submits that the income he received in 1992 and 1993 had no connection with 1989 and 1991. He also objects to the use of a calculated allocation percentage for 1991 rather than using the information on petitioner's 1991 income tax return. Lastly, petitioner states that the premise underlying the allocation methodology utilized by the conciliation conferee incorrectly characterizes the income received by petitioner in 1992 and 1993. He submits that the Conciliation Order is infirm because it "applies an allocation methodology appropriate for pension and other retirement benefits to income from a benefit plan that is not intended by its sponsor, DLJ, as a retirement benefit." (Petitioner's brief, p. 11.) Petitioner posits that the DLJ investment fund was an element of the firm's competitive strategy for attracting, retaining and motivating key employees. Petitioner further notes that he did not consider the Plan as a retirement benefit and that he did not receive any distributions on units that were not vested. According to petitioner, the Plan's distributions in 1992 and 1993, resulting in the income in dispute, were obtained from a contribution made in January 1990. He contends that the distributions in 1992 and 1993 had nothing to do with 1991 and 1992 making the allocation method followed by the conferee irrational. Petitioner also posits that the Conciliation Order did not follow the mandated calculations of 20 NYCRR 132.20.

(c) Petitioner contends that the Division's counsel must be held to his denial that the income in dispute was New York source income. According to petitioner, the effect of the denial is to render any claims by the Division groundless since, if the income does not have a New York source, there is no basis to tax petitioner's income in 1992 and 1993.

(d) Petitioner maintains that the income in dispute is not taxable by New York State. In his brief, petitioner relies upon ***Matter of Michaelsen v. New York State Tax Commission*** (67 NY2d 579, 505 NYS2d 585) and ***Matter of Pardee v. State Tax Commission*** (89 AD2d 294, 456 NYS2d 459), for the proposition that the income he received in 1992 and 1993 was not of a character that was taxable by New York State. According to petitioner, the income reported by DLJ for the years 1992 and 1993 was the income and gains on the securities held by the Plan that were sold by DLJ on petitioner's behalf. Petitioner stresses that the success of the investments in the Plan had no relation to the services performed by petitioner for DLJ. The success of the investments was based upon the success of the companies which received the investment and the equity markets evaluation of the companies and their securities. It is petitioner's position that since the profits of the Plan could not be influenced by any element of his service to DLJ, the income and gain from the Plan should not be construed as income from personal services or compensation. Continued employment had no bearing upon the income from the Plan because the profits arose only from vested units. DLJ was not the source of the investment gains and income from the Plan and petitioner had no control over his contribution once it was made. According to petitioner, it was the commitment of capital from the 1990 bonus which produced the income and gains from the Plan.

Petitioner maintains that the source of the income in dispute was the $75,000 contribution to the Plan. It is argued that this contribution created an intangible asset, i.e., the right to receive a distribution from the Plan. Petitioner submits that he performed no services in New York in 1992 and 1993 in return for the income in dispute.

According to petitioner:

> the disputed income was the result of the Petitioner's commitment of $75,000 of his funds, later reduced to $56,250, to the Plan in January 1990. Those funds, derived from the bonus due the Petitioner by DLJ in January 1990, with the $168,750 non recourse loan, were invested on the Petitioner's behalf pursuant to the Plan . . . . After the repayment of the non recourse loan in late 1992, . . . distributions were made to the Petitioner in 1992 and several times in 1993 pursuant to the terms of the Plan . . . from the proceeds of sales of securities on the Petitioner's behalf, thus creating the income in dispute . . . . The distributions were from units in the Plan which were vested in the Petitioner. Therefore, it is apparent that the substance of what transpired between January 1990, the date of the commitment of the funds derived from the bonus paid to the Petitioner, and the dates when distributions were made to the Petitioner in late 1992, and several times in 1993, is that substantial income and gain were produced by the Plan which from the skillful investment of the Petitioner's funds, pursuant to the terms

> of the Plan, were distributed to the Petitioner as well as other Plan participants. Accordingly, what happened is that the Petitioners received in 1992 and 1993 income and gain *from* compensation that was deferred and invested successfully not the deferred compensation itself . . . . (Petitioner's brief, p. 8, emphasis in original.)

Petitioner stresses that the income is not as described in the letter from Mr. Nolfo of January 24, 1996 (***see,*** Finding of Fact "5") which, according to petitioner, lacks credibility. Petitioner submits that the letter from Mr. Nolfo is contradicted by the letter from the DLJ corporate secretary (Finding of Fact "23 ") which states that the income was from the sale of securities on behalf of the Plan participants. Petitioner contends that the Division made no effort to evaluate the evidence in its possession which corroborates the fact that the Plan is the source of the income in dispute. Petitioner further submits that the Division has not offered substantial evidence in support of its determination.

Petitioner maintains that the correct way to report the income and gains from investing deferred compensation when it is distributed to Plan participants is on a Form W-2. It is further submitted that the income and gain earned from the investment of contributions to a benefit plan is not compensation for personal service.

30. In its brief, the Division states that there is no dispute that the income in question was from DLJ. The Division further asserts that the conciliation conferee properly used 1989 and 1990 allocation figures to compute an allocation ratio for 1991 since petitioner's work situation changed in 1991. According to the Division, the conciliation conferee's reduction of additional unreported income for 1992 and 1993 was correct and in accordance with 20 NYCRR 132.20.

The Division also argues that it denied paragraphs 17 and 24 of the petition since it did not want to be precluded from arguing that the income may have come from other than the Plan if the evidence showed this to be the case. The Division also notes that it moved at the hearing to amend the answer to conform to the proof.

The Division submits that the income in question should be deemed taxable under either Tax Law § 631(b)(1)(B) or (b)(2). Further, the income in question was New York income as either deferred compensation, commission income or bonuses.

The Division notes that one of its exhibits states that terminated employees did not receive a distribution from the Plan (Finding of Fact "5") and then asks whether, if petitioner was employed by DLJ in 1992, the income received in 1992 was compensation for present services. The Division asserts that if the income came from the DLJ/LBO Incentive Plan, it was compensation for prior or present services.

The Division submits that:

> The fact that petitioner treated the DLJ income in 1992 and 1993 as business income, the fact that he took expenses against the DLJ income, the fact that the January 24, 1996 letter from Mr. Nolfo stated that the 1992 DLJ income was deferred compensation and the 1993 DLJ income was commissions, the fact that the April 1, 1993 memorandum from Mr. Siegler indicated that only active employees received income from the DLJ/LBO Incentive Plan in 1992 and that the 1993 distributions from the Plan were characterized as bonus payments all point to the conclusion that the income Mr. Brinckerhoff received from DLJ in 1992 and 1993 was New York income for services rendered. (Division's brief, p. 4.)

The Division maintains that even if the DLJ income in question was not for personal services rendered in 1992 and 1993, then the distributions made during the years in question were New York source income in the form of deferred compensation for services rendered in New York. Relying principally upon ***Matter of Laurino*** (Tax Appeals Tribunal, May 20, 1993), the Division argues that the income received by petitioner in 1992 and 1993 was income for prior service provided to DLJ. The Division also argues that petitioner's reliance upon ***Matter of***

Michaelsen v. New York State Tax Commission (67 NY2d 579, 505 NYS2d 585) and ***Matter of Pardee v. State Tax Commission*** (89 AD2d 294, 456 NYS2d 459) is misplaced.

31. In his reply brief, petitioner again stresses that the income in question was from the Plan and not a distribution from DLJ. Petitioner then reiterates his contentions that the income in dispute was generated from the cash bonus petitioner was to receive in January 1990; that the allocation method followed by the conferee was not in compliance with 20 NYCRR 132.20; that the Division's denials in its Answer render its' claim baseless; that petitioner has established that the income in dispute is not of a character that is subject to taxation by New York State; that Tax Law § 631(b)(2) is irrelevant; that petitioner's reporting income on a Federal Schedule C does not make the income taxable by New York State; that what was received by petitioner in 1992 and 1993 was the income and gain from the investment of the contribution made to the Plan by petitioner; and that petitioner's reliance upon ***Pardee*** and ***Michaelsen*** is appropriate.

CONCLUSIONS OF LAW

A. Before addressing the substantive arguments raised by petitioner, the procedural concerns will be discussed. First, petitioner is correct that the Division is bound by the conciliation order (Tax Law § 170[3-a][e]). However, this does not render the Notice of Deficiency moot. Having filed a petition for a hearing in the Division of Tax Appeals, the conciliation order cannot "be considered as precedent or be given any force or effect in any subsequent administrative proceeding" with respect to petitioners (Tax Law § 170[3-a][f]). Moreover, the authority of the Division of Tax Appeals to review a notice of deficiency, as modified by the conciliation order, arises from the filing of a petition challenging a notice of deficiency (Tax Law § 689[b]; § 2008). Therefore, the Notice of Deficiency retains its status as a basic jurisdictional document despite its modification by the conciliation order.

B. Petitioner maintains that the conciliation order is a nullity because it was not issued within the statutory three-year period. Section 683(a) of the Tax Law provides, in part, "any tax under this article shall be assessed within three-years after the return was filed (whether nor not such return was filed on or after the date prescribed)." The three-year statute of limitations set forth in this section commences when the tax return is filed[3] and is suspended when the notice of deficiency is mailed (Tax Law § 683[e]). The date when the conciliation order is issued has no bearing on the three-year statute of limitations. It is noted that the Division did not present a supplemental assessment at the hearing and therefore the supplemental assessment mentioned earlier has not been considered.

[3] Generally, if a tax return is filed before the last day prescribed for filing a return, the tax return is deemed filed on such last day (Tax Law § 683[b]).

C. Petitioner has strenuously argued that the income allocated to New York by the conciliation conferee was based upon an erroneous allocation methodology. As noted above, a conciliation order is not considered precedent nor is it given any force and effect in a subsequent administrative hearing with respect to petitioners (Tax Law § 170(3-a)(f); ***Matter of Incantalupo***, Tax Appeals Tribunal, April 3, 1997; ***Matter of Sandrich***, Tax Appeals Tribunal, April 15, 1993.) Therefore, this argument may not be addressed because an Administrative Law Judge has no authority to consider the validity of the methodology used in proceedings before the Bureau of Conciliation and Mediation Services and to consider a different methodology than that used by the conferee (***Matter of Sandrich***, Tax Appeals Tribunal, April 15, 1993).

D. Petitioner argues that the Division's answer, which denied the assertion that the Division claims that the income had a New York source, makes the Division's claims baseless since, without a New York source, New York may not tax income from a nonresident. Section 3000.4(b)(1) of the Rules of Practice of the Tax Appeals Tribunal requires the Office of Counsel to serve an answer to the petition on the petitioner or his representative. Section 3000.4(b)(2) of the Rules of Practice provides, in part, as follows:

> The answer as drawn shall contain numbered paragraphs corresponding to the petition, and shall fully and completely advise the petitioner and the Division of Tax Appeals of the defense. It shall contain:
>
> (i) a specific admission or denial of each statement contained in the petition;

The Division's general denial does not set forth its position as clearly as it could have. However, it does satisfy the technical requirements of 20 NYCRR 3000.4(b)(2)(i). It is clear from petitioner's testimony at the hearing that he understood that he needed to show that the income in question did not have a New York source. Moreover, it is noteworthy that there has been no allegation of surprise or prejudice. Under these circumstances, petitioner's claim that his petition should be granted because of the Division's denial is rejected.

E. Before analyzing the legal issues presented, there is a critical factual question which must be resolved concerning the nature of the income received in 1992 and 1993. Petitioner stresses that the income in issue was the income and gain from the compensation that was deferred and successfully invested and not the deferred compensation itself. In contrast, the Division maintains that "the DLJ income was New York source income as either deferred compensation, commission income or bonuses." (Division's brief, p. 3.)

Unquestionably, there is evidence in the record to support the Division's position. The letter from Mr. Nolfo clearly states that the wages for 1992 represent a payout of deferred compensation and that the 1993 wages represent a commission payout (***see***, Finding of Fact "5"). This letter provides a rational basis for the Division's position. On the other hand, the weight of the evidence lends credence to petitioner's assertion that the income in issue was income and gain from compensation that was deferred and successfully invested and not the deferred compensation itself. The letter from Mr. Siegler, dated July 25, 1997, shows that the $599,045.00, which was reported on the wage and tax statement by DLJ, was petitioner's share of the income realized by DLJ on the sales of Caldor Corporation, Chicago and Northwest Holdings and GTECH Holdings held by DLJ for the Plan (***see***, Finding of Fact "23"). The amount set forth in the foregoing letter for 1992 corresponds with the amount reported by DLJ on the wage and tax statement issued to petitioner for 1992. Similarly, the letter of July 25, 1997 shows that there was a distribution in the amount of $454,445.12 arising from the disposition of certain investments in 1993 (***see***, Finding of Fact "23"). This explanation is supported by the fact that the amount of the distribution matches the amount reported by DLJ on the wage and tax statement issued to petitioner for 1993. It also corresponds with the amounts on the pay statements and the descriptions in the memorandums of August 25, 1993 and November 17, 1993 (***see***, Findings of Fact "6", "23" and "24").

The Division has relied on a paragraph set forth in an office memorandum dated April 1, 1993 which was addressed to the participants of the Plan (***see***, Finding of Fact "5").

The Division argues that the foregoing language implies that petitioner was employed by DLJ in 1992 because he received a distribution in 1992. It asks whether, if petitioner was employed by DLJ in 1992, the income received was compensation for present services. It further argues that if the income came from the DLJ/LBO Incentive Plan, it would have been compensation for prior or present services rendered. The Division submits that:

> the fact that the April 1, 1993 memorandum from Mr. Siegler indicated that only active employees received income from the DLJ/LBO Incentive Plan in 1992 and that the 1993 distributions from the Plan were characterized as bonus payments all point to the conclusion that the income Mr. Brinckerhoff received from DLJ in 1992 and 1993 was New York income for services rendered. (Division's brief, p. 4.)

The Division's reliance upon the foregoing paragraph is misplaced. The memorandum states that "a number of the securities allocated to the Plan were distributed to active employees last year." (Division's exhibit "L.") Although petitioner received a distribution in 1992, the memorandum does not state that any of the securities which were distributed to active employees were distributed to petitioner. The memorandum also does not state that only active employees received a distribution in 1992. The Division is correct that the memorandums of August 25, 1993 and November 17, 1993 refer to "Bonus Payment" next to the term "SUBJECT." However, the memorandums establish that the distributions in 1993 arose from the Plan's sale of securities and were not related to petitioner's employment. It is noted that the securities described in the memorandums of August 25, 1993 and November 17, 1993 from DLJ match those described in the letter from DLJ of July 25, 1997. Under the circumstances, the use of the term "Bonus Payment" does not support the Division's contention that the income in issue was for services rendered.

F. Petitioner primarily relies upon ***Matter of Pardee v. State Tax Commission*** (89 AD2d 294, 456 NYS2d 459) and ***Matter of Michaelsen v. New York State Tax Commission*** (67 NY2d 579, 505 NYS2d 585) to support his position that the income in issue is not subject to New York State personal income tax. In ***Pardee***, the taxpayer was an employee of Chase Manhattan Bank who worked in one of the bank's New York offices from 1937 to 1973. The bank had an employee profit-sharing plan which was funded through a Federally tax-exempt trust to which the bank and the employees contributed. The fund established two separate accounts for each participant, an "allocation account" for bank contributions and a "current deposit account" for the employee's contribution.

The taxpayer, who was a resident of New Jersey throughout all of the pertinent periods, retired in 1973. At the time of his retirement, he was paid $65,000.00 as a lump-sum distribution. For the year 1973, the taxpayer and his wife filed a joint nonresident New York State income tax return in which they reported as income that portion of the distribution which constituted the bank's contribution but omitted the portion representing the dividends, interest, net gains and appreciation on the investments of his and the bank's contributions. Thereafter, the Division issued a Notice of Deficiency on the basis that petitioners should have included all of the income and gains derived from both accounts because they constituted deferred income.

Upon review, the State Tax Commission found, to the extent relevant herein, that the income and gains arising from the bank's contributions were taxable to petitioners because they were derived from New York sources within the meaning of Tax Law former § 632(a) (now Tax Law § 631[a]).

In the Article 78 proceeding which followed, the State Tax Commission's determination was annulled. In reaching this conclusion the Court first found that the income and gains derived from the bank's contribution did not constitute income or gain from "a business, trade, profession or occupation carried on in this state" within the meaning of Tax Law former § 632(b)(1)(B) (now Tax Law § 631[b][1][B]). This result followed from the Court's analysis of 20 NYCRR former 131.4(b) (now 20 NYCRR 132.4[b]) which stated that the income and gains from the bank's contribution may be included in the adjusted gross income under this category only if they are "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." The Court reasoned that the income and gains in issue could not be considered "compensation for services" rendered to the bank. This conclusion was based on several factors. The Court found it significant that once the bank made the contribution, it did not retain control over the funds. Second, the risk of loss was borne by the employee. Third, the value of the bank's contribution was not related to the employee's performance. Lastly, the Court concluded that the Internal Revenue Service would not treat income and gains from similar employers' contributions as additional compensation for personal services.

The Court further held that the income and gains in issue were not taxable under Tax Law former § 632(b)(2) (now Tax Law § 631[b][2]) as income from intangible personal property since this category is limited to situations where the property is "employed in a business, trade, profession, or occupation carried on in this state" (Tax Law former § 632[b][2]). In addition, the property must be the taxpayer's and not the employer's.

Pardee supports petitioner’s position. Tax Law § 631(a)(1) states that the New York source income of a nonresident individual is the sum of “[t]he net amount of items of income, gain, loss and deduction entering into his federal adjusted gross income . . . derived from or connected with New York sources . . . .” This phrase is limited to certain forms of income or gain set forth under Tax Law § 631(b) (***see, Matter of Pardee v. State Tax Commission***, ***supra***, 456 NYS2d at 461). Here, as in ***Pardee***, there are only two categories of income and gain that could possibly apply: (1) income or gain from a business, trade, profession or occupation carried on in this State (Tax Law § 631[b][1][B]) or (2) income from intangible personal property employed in a business, trade, profession or occupation carried on in this State (Tax Law § 631[b][2]).

Petitioner’s income and gains on the investment of DLJ’s loan and the investment of the bonus payment were not income or gain from a business, trade, profession or occupation carried on in this State within the meaning of the first category. Petitioner did not engage in a business, trade or profession in New York State during the years in issue. Under the regulations of the Commissioner, the income and gains in issue would only be included in New York adjusted gross income if they are “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” (20 NYCRR 132.4[b]). As was the case in ***Pardee***, the income and gains at issue in this matter cannot be considered “compensation for services” rendered to DLJ. In this instance, the administration of the Plan was vested in a committee (or the chief executive officer if a committee was not in existence) which had absolute powers regarding the exercise of its authority. The full risk of loss was borne by Mr. Brinckerhoff. Significantly, whether the investment made or lost money was not affected by Mr. Brinckerhoff's performance as an employee. DLJ was not the source of any gain or loss at issue here. It is also noteworthy that the pertinent regulation evidences an intent to conform to Federal tax treatment of employee compensation by providing that New York adjusted gross income includes compensation for personal services "entering into his [the employee's] Federal adjusted gross income." (20 NYCRR 132.4[b].) In analogous transactions, the Internal Revenue Service has not treated the gains and income from employer contributions to similar plans as compensation for personal services (***see***, ***Matter of Pardee v. State Tax Commn.***, ***supra***, 456 NYS2d at 461).

There is also no basis to consider this income taxable pursuant to Tax Law § 631(b)(2) as income from intangible personal property. This category is limited to instances where the property is "employed in a business, trade, profession, or occupation carried on in this state." (Tax Law § 631[b][2].) Mr. Brinckerhoff employed no property in a separate trade, business, profession or occupation in New York. Further, the investments attributable to the contributions were not employed in the operation of DLJ's business or related to the rendering of Mr. Brinckerhoff's services.

G. The Division's attempt to distinguish ***Pardee*** is unpersuasive. First, contrary to the Division's argument, petitioner's testimony and the documents in the record (***see, e.g.,*** the letter of July 25, 1997) establish that petitioner did not provide any services to DLJ in New York in 1992 and 1993.

The Division also argues that ***Pardee*** is distinguishable because DLJ continued to manage the DLJ/LBO Investment Fund while in ***Pardee*** the employer had no control over the investment program from which the distribution was made. The foregoing point is not sufficient to lead to a different result. The factor relied upon by the Division was one of several items mentioned in ***Pardee*** to show that the income and gains at issue therein were not compensation for services within the meaning of 20 NYCRR former 131.4(b). Here, as noted above, it is clear that the income and gains were not compensation for services to DLJ since petitioner bore the risk of loss, petitioner's performance as an employee did not have any bearing on whether the investments made or lost money, and DLJ was not the source of any gain or loss.

In ***Matter of Michaelsen v. New York State Tax Commn.*** (107 AD2d 389, 486 NYS2d 479, ***modified*** 67 NY2d 579, 505 NYS2d 585) the petitioner was granted certain stock options by his New York employer under a stock option plan. Pursuant to this plan, petitioner purchased 3,000 shares of Avon capital stock in 1972 and an additional 3,000 shares of capital stock in 1973. Subsequently, in 1973 petitioner sold the 6,000 shares and derived a gain of $179,761.00. Petitioner reported the gain from the sale of the stock as ordinary income on his Federal income tax return but did not report any portion of this gain on his 1973 New York nonresident income tax return. The Division issued a Notice of Deficiency and, after a hearing, the State Tax Commission found that the stock was acquired through the exercise of a stock option plan connected with petitioner's employment and, further, that the gain on the sale of the stock was subject to New York State income tax.

Petitioner commenced an Article 78 proceeding and Special Term found that the stock option plan by which the stocks were acquired was granted either as compensation for past services or as an incentive for future services. Therefore, there was a rational basis to conclude that the income was subject to tax.

On appeal before the Appellate Division, petitioner conceded, and the Appellate Division agreed, that the stock options were granted as compensation connected with employment in New York and were therefore taxable in New York. However, citing ***Pardee***, the Court further held that there was no evidence connecting the granting of the options with the subsequent appreciation in the market value of the stock and, as a result, no connection with the rendering of services in New York. Thus, the Court concluded that the only income attributable to New York was the value of the stock option on the date it became exercisable.

Subsequently, the Court of Appeals modified the order of the Appellate Division. Initially, the Court held that the options granted to petitioner were compensation attributable to a "business, trade, profession or occupation carried on in this state" and therefore taxable under Tax Law former § 632(b)(1)(B). The Court of Appeals was troubled with the Appellate Division's method of calculating the value of the options because that method differed from Federal law and left much of the compensation untaxed. The Court then noted that "[t]he employee's compensation comes from the employer's willingness to let the employee benefit from market appreciation in the stock without risk to his own capital." (***Michaelsen v. State Tax Commn., supra***, 505 NYS2d at 588.) Further, the Court stated that when the option becomes exercisable it is worth more than the difference between the fair market value of the stock and the option price. Therefore, in conformity with Federal law, the Court held "that the proper method of valuing the compensation derived from an option that has no readily ascertainable market value on the date it is granted is to subtract the option price from the fair market value of the stock on the date the option is exercised" (***id.***, 505 NYS2d at 589). Lastly, the Court held that any gain realized by petitioner between the time the option was exercised and the time the stock was sold was investment income and not compensation. Consequently, petitioner could not be taxed on this amount.

The Division's attempt to distinguish ***Matter of Michaelsen v. New York State Tax Commn.*** (***supra***) is also rejected. In its brief, the Division states that:

> [i]n ***Michaelsen*** the Court concluded that the increase in value of the stock option from the date of granting of the stock option to the date of exercise of the stock option constituted New York compensation. We could similarly conclude that the increase in the DLJ/LBO Investment Fund from when Mr. Brinckerhoff began working with DLJ to the 1992 and 1993 distributions constituted New York compensation for Mr. Brinckerhoff. (Division's brief, pp. 6-7.)

As noted above, two questions were presented in ***Michaelsen***. The first question was the proper treatment of a stock option granted to a nonresident as a form of compensation by a New York employer who subsequently disposes of the stock which was acquired pursuant to that option. The second question presented was the proper treatment by the nonresident of the gain derived from the subsequent sale of the stock. With respect to the second question, the Court held that the increase in the market value of the stock between the time the option was exercised and the time the stock was sold was clearly investment income and not compensation. Accordingly, a nonresident was not subject to tax on this amount.

Here, the record is clear that the income in issue is the gain on the value of the securities and not the initial compensation. Therefore, the Division's argument comparing the increase in the value of the stock options which were given as compensation in ***Michaelsen*** to the increase in the value of the stock, which is at issue in this matter, is without merit. Rather, as in ***Michaelsen***, Mr. Brinckerhoff, as a nonresident, is not taxable on the investment income in issue.

H. The Division's reliance upon ***Matter of Laurino*** (***supra***) is misplaced. Clearly, 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 (***Matter of Laurino***, ***supra***, citing ***Matter of Halloran***, Tax Appeals Tribunal, August 2, 1990). It is incumbent upon petitioner to establish that the payment was not secured or earned pursuant to activities connected with or derived from New York sources (***Matter of Laurino***, ***supra***). Here, by showing that the income in issue was the gain on the value of the securities after the initial purchase, petitioner has shown that the income was not derived from or connected with a New York source (***Matter of Pardee v. State Tax Commission***, ***supra***).

I. The petition of Peter R. and Susan Brinckerhoff is granted and the Notice of Deficiency, dated March 11, 1996, is canceled.

DATED: Troy, New York
August 19, 1999

/s/ Arthur S. Bray
ADMINISTRATIVE LAW JUDGE