STATE OF NEW YORK

DIVISION OF TAX APPEALS

In the Matter of the Petition	:	
of	:	
MAXIMILIAN AND MIRIAM SCHEIN	:	DETERMINATION DTA NO. 818771
for Redetermination of a Deficiency or for Refund of New York State Personal Income Tax under Article 22 of the Tax Law for the Year 1997.	:	

Petitioners, Maximilian and Miriam Schein, 525 Highview Avenue, Pearl River, New York 10965-1230, filed a petition for redetermination of a deficiency or for refund of New York State personal income tax under Article 22 of the Tax Law for the year 1997.

A hearing was held before Jean Corigliano, Administrative Law Judge, at the offices of the Division of Tax Appeals, 641 Lexington Avenue, New York, New York, on May 17, 2002, at 10:30 A.M., with all briefs to be submitted by September 30, 2002, which date began the six-month period for the issuance of this determination. Petitioners appeared *pro se.* The Division of Taxation appeared by Barbara G. Billet, Esq. (Barbara J. Russo, Esq., of counsel).

This matter was assigned to Catherine M. Bennett, Administrative Law Judge, on September 26, 2002, who, after review of the record, renders the following determination.

ISSUE

Whether petitioner[1] Maximilian Schein has established by clear and convincing evidence that the notice of deficiency was incorrect or improper, where the Division of Taxation limited

[1] Although the notice in question was issued to both petitioners, the matter at hand concerns Mr. Schein alone, and thus, any reference to petitioner will refer only to Mr. Schein.

petitioner's pension and annuity exclusion to the amount of IRA distributions reported as pension income for 1997, and disallowed the exclusion for income received by petitioner, a retired partner, from his former partnership as reported on Schedule K-1.

FINDINGS OF FACT

1. Petitioner Maximilian Schein was employed by KMG Main Hurdman ("MH") from 1959 until 1984 when he reached mandatory retirement age of 63. Having commenced his career as a staff accountant, he retired as a partner of MH on March 31, 1984. During the years 1985 and 1986, petitioner received a Form 1099R from MH and he availed himself of the $20,000.00 pension and annuity exclusion, also referred to as a subtraction modification, on his State income tax return. In 1987, MH merged with Peat Marwick ("PM") who assumed the obligation to pay petitioner's pension without any changes (except cost of living adjustments which became effective for later years, commencing April 1, 1997). PM reported pension payments to petitioner on Schedule K-1 for the year 1987 and every year thereafter. During each of those years petitioner availed himself of the $20,000.00 pension exclusion. At no time prior to the 1997 tax year did the Division of Taxation ("Division") question the propriety of the pension exclusion.

2. In 1997, petitioner received Schedule K-1 of Form 1065 indicating him to be a "former general partner now retired." The K-1 reported $28,579.00 on Line 5 which is entitled "guaranteed payments to partner." A separate schedule provided to petitioner entitled "KPMG Peat Marwick LLP, 1997 Partnership Taxable Income Reconciliation" identified the $28,579.00 as exclusively pension payments. Petitioner was also provided a 1997 Guide to Partner Tax Schedules and Information for Retired Partners from PM (also referred to as KPMG) which explained the Federal Schedule K-1 received by petitioner. It stated in relevant part:

> The amount on line 5 includes retirement allowance plan (RAP) payments made by the firm from the Bank of New York, any applicable installment payments of your interest in unrealized receivables and ACRS amounts, and any interest on your partner account. The line 5 amount should be reported on Form 1040, Schedule E, Part II, Column k - Nonpassive income from Schedule K-1.
>
> You will note that there is no net earnings from self-employment reported on line 15a. The total amount paid to you by the firm, including RAP payments, any applicable portion of your unrealized receivables and any interest on your partner account is reported on line 5. It is the firm's view that all three items are integral parts of the partner retirement program and, therefore, are excluded from self-employment tax pursuant to Internal Revenue Code § 1402(a)(10). A contrary view would segregate the unrealized receivables and classify them as a separate obligation of the firm to a retired partner apart from retirement payments. Such a classification would subject all elements of your retirement payments to self-employment tax. At present, we recommend that the amount shown on line 5 not be reported on Schedule SE. Instead, attach a written explanation to Schedule SE stating:
>
> 'The amount reported on Schedule E as partnership income from KPMG Peat Marwick LLP is a payment on account of retirement specifically excluded from the Social Security self-employment tax under § 1402(a)(10) of the Internal Revenue Code.'

3. A December 1997 Bank of New York notification of direct deposit statement indicates that petitioner was receiving benefit payments from the account of "Peat, Marwick Main Suppl Ret Al," plan number E27027. The current gross payment amount for December 1997 was $2,391.91, and the year to date gross amount was $28,579.65.

4. Article II of the MH partnership agreement provides:

> 2. Duties of Partners.
>
> The partners agree as follows:
>
> A. To devote their full time, attention and influence to the business and interests of the Firm.
>
> B. To engage in no other business other than personal investment activities which do not conflict with professional ethics or overall Firm objectives, and do not materially affect time available for Firm business.

3. Covenants.

All partners covenant as follows:

A. To be bound by each and every term and condition of this Agreement and any amendments to such Agreement promptly after notification of approval thereof by the partners as provided in Article III.

B. To deal with clients and the affairs of clients solely as a member of the Partnership as distinguished from acting in respect of either on their own behalf.

C. To maintain independence as to all Firm clients as required by the applicable regulations and rules and the directives issued by the Firm, the Securities and Exchange Commission, and relevant professional bodies.

D. To pay and satisfy their debts promptly when they become due.

E. To file their individual income tax returns required to be filed and to timely pay the taxes which are required to be paid.

F. To notify their Partner in Charge without delay when becoming a party defendant in a legal proceeding.

* * *

5. Expenditures by Partners.

The Partnership shall reimburse each partner in respect of all proper business related expenses reasonably incurred. Partners shall be reimbursed for practice development expenditures made for the benefit of the Firm upon submitting vouchers containing the details required by the Firm. In addition, each partner is expected to perform promotional work for the Firm and bear the expense thereof when, for whatever reason, it does not qualify for reimbursement by the Firm.

* * *

5. Article IV set forth the Firm's management functions:

1. Policy Board.

In addition to the duties and responsibilities of the Policy Board specified elsewhere in this Agreement, the Policy Board, acting only as a body, shall have the following duties and responsibilities:

A. To establish Firm policies consistent with this agreement.

B. To receive, review and discuss the periodic reports of the Chairman and Chief Executive Officer as to the planning and the operations of the Firm and to report to the partners as to such matters and as to the activities of the Policy Board.

* * *

D. To review and, subject to the provisions of Article V, consummate mergers.

E. To recommend to the partners the adoption of resolutions for changes in the Partnership Agreement.

F. To recommend to the partners the participation in Firm Net Income and other income distributions and rights to receive income from the Firm.

G. To recommend reserve capital requirement of partners.

* * *

K. To suspend or terminate a partner as set forth in Article VIII.

L. To borrow money or obtain credit for and on behalf of the Firm on such terms and conditions as it deems appropriate.

* * *

2. Chairman and Chief Executive Officer.

The Chairman and Chief Executive Officer shall report directly to the Policy Board and by virtue of the office, be a member of the Policy Board and the Advisory Board. The Chairman and Chief Executive Officer shall preside as Chairman of the meetings of the partners, the Policy Board and the Advisory Board.

The Chairman and Chief Executive Officer shall be responsible for

A. Relations of the Firm with

(1) principal clients and shall coordinate the overall marketing efforts of the Firm with potential significant clients;

(2) representatives of the financial community such as investment bankers, institutional lenders, financial analysts and financial writers;

(3) professional societies (AICPA, State CPA Societies, etc.) and the Securities and Exchange Commission and other governmental regulatory bodies;

* * *

B. The development of the financial requirements of the Firm and in conjunction therewith, the capital requirements of the Firm.

* * *

3. Managing Partner.

The Managing Partner shall be appointed by the Chairman and Chief Executive Officer and shall have such duties and responsibilities as may be delegated or established by the Chairman and Chief Executive Officer.

* * *

The Managing Partner shall, in the absence or temporary disability of the Chairman and Chief Executive Officer perform the duties and exercise the powers of the Chairman and Chief Executive Officer.

* * *

5. Advisory Board.

* * *

The purpose of the Advisory Board is to represent the partners of the Firm by reviewing all substantive proposals of the Policy Board for action at meetings of partners.

* * *

6. Professional Standards Committees.

* * *

The Professional Standards Committee shall be responsible for maintaining the Firm's professional standards at the highest level. The Committee shall report directly to the Policy Board.

* * *

7. Audit Committee.

* * *

> The Committee shall carry out the responsibilities assigned to it under this Agreement, making reports thereon periodically to the Policy board and annually to the partners.

6. The MH partnership agreement prohibited a transfer of the partner's partnership interest.

7. Article VII of the MH partnership agreement provides for the payment of retirement benefits, in addition to other benefits, as stipulated in the Partner's Benefit Manual. The Benefit Manual stipulates the age for mandatory retirement and provides the procedures for determining the amount of the basic retirement benefit and the periodic monthly payment.

The Partner's Benefit Manual indicates that:

> Retired, disabled and deceased partners or their estates shall not be liable for any net operating loss incurred by the firm.
>
> For the purpose of computing allocable net profits for any period, the benefit paid to any such persons will be considered a part of the operating costs.

8. Article VI of the MH partnership agreement defines "firm net income" as "net income determined by the cash receipts and disbursements method of accounting after deducting all pension or retirement payments to former partners or their estates."

9. Petitioner filed a 1997 Form IT-201, New York State Resident Income Tax Return, and in doing so, reported a taxable IRA distribution on Line 9 of the return in the amount of $9,670.00, a taxable amount on Line 11 of the return under Rental Real Estate, royalties, partnerships, S corporations, trusts, etc., in the amount of $28,579.00, and $20,000.00 on Line 27, as the pension and annuity income exclusion. No entry appeared on Line 10 for taxable pensions and annuities. Petitioner had been reporting taxable IRA distributions from 1992 through 1997.

10. The Division issued a Statement of Proposed Audit Changes to petitioners dated July 24, 2000, limiting the 1997 pension and income annuity exclusion to the $9,670.00 amount reported in the income section of petitioners' tax return, thereby disallowing the pension and annuity exclusion in the amount of $10,330.00.

11. The Division issued a Notice of Deficiency dated September 18, 2000, to petitioners, Maximilian and Miriam Schein, under Notice Number L-018296600-6. The deficiency assessed tax due in the amount of $709.00, plus interest of $133.16, for a total of $842.16.

SUMMARY OF THE PARTIES' POSITIONS

12. Petitioner maintains that the income reported on his partnership K-1 was pension income, as indicated by his partnership documents, and eligible for the New York State pension exclusion. Petitioner argues that when he retired and began receiving retirement payments in 1985, he was permitted to avail himself of the $20,000.00 pension exclusion, and based on the fact that his payment status and the type of payments received never changed, a Tax Appeals Tribunal decision in 1995 should not adversely affect his ability to use the pension exclusion.

13. The Division argues that petitioner has not carried his burden of proof by clear and convincing evidence that the notice of deficiency was incorrect. The Division maintains that the payments received by a retired partner from his former partnership do not meet the requirements of Tax Law § 612(c)(3-a) for petitioner to utilize the subtraction modification (the $20,000.00 pension exclusion), citing ***Matter of Blue*** (Tax Appeals Tribunal, April 6, 1995), since the payments are not derived from an employer-employee relationship and did not arise from contributions to a retirement plan deductible for Federal income tax purposes.

CONCLUSIONS OF LAW

A. Tax Law § 612(a) provides that the adjusted gross income of a resident individual is his federal adjusted gross income ("federal AGI") with certain modifications provided for in subsections (b) and (c) of Tax Law § 612. Subsection (c) provides for certain subtraction modifications which reduce federal AGI, and specifically, the modification in issue herein. Tax Law § 612(c)(3-a) provides for a subtraction from federal AGI as follows:

> Pensions and annuities received by an individual who has attained the age of fifty-nine and one-half, not otherwise excluded pursuant to paragraph three of this subsection [not applicable herein], to the extent includible in gross income for federal income tax purposes, but not in excess of twenty thousand dollars, which are periodic payments attributable to personal services performed by such individual prior to his retirement from employment, which arise (i) from an employer-employee relationship or (ii) from contributions to a retirement plan which are deductible for federal income tax purposes. However, the term 'pensions and annuities' shall also include distributions received by an individual who has attained the age of fifty-nine and one-half from an individual retirement account or an individual retirement annuity as defined in section four hundred eight of the internal revenue code, and distributions received by an individual who has attained the age of fifty-nine and one-half from self-employed individual and owner-employee retirement plans which qualify under section four hundred one of the internal revenue code, whether or not the payments are periodic in nature.

B. The parties do not dispute whether petitioner received retirement benefits in the form of an annuity. The issue in this matter centers around whether such payments entitled petitioner to utilize the $20,000.00 annual pension exclusion. The Division maintains that the clear language of Tax Law § 612(c)(3-a) requires that the payments arise either from an employer-employee relationship or from contributions to a retirement plan deductible for federal income tax purposes. The latter requirement is not met, and is not disputed. The Division relies on ***Matter of Blue*** (Tax Appeals Tribunal, April 6, 1995) in support of its position that the

requirement of an employer-employee relationship is not satisfied when, as here, the pension income is received by a retired partner from his former partnership.

C. In ***Blue***, petitioner was a retired partner of his former law firm partnership. When Mr. Blue retired he became a life partner pursuant to the partnership agreement. It was determined by the Tax Appeals Tribunal that the life partner payments made to Mr. Blue were not a distributive share since petitioner therein had no right to the profits or losses of the partnership and his interest in the partnership had been completely liquidated at the time he became a life partner. However, the retirement payments made to Mr. Blue were taxable despite his nonresident New York status at the time of receipt since the retirement payments were attributable to services he rendered in New York prior to his retirement, and constituted income attributable to a business, trade, profession or occupation carried on in New York. The Tribunal reasoned, citing ***Matter of Walsh*** (Tax Appeals Tribunal, November 19, 1992, ***confirmed on other grounds Walsh v. Tax Appeals Tribunal***, 196 AD2d 367, 609 NYS2d 405), that when analyzing whether the payments were derived or connected with New York sources, it was necessary to examine the nonresident's activities from which the income was secured or earned, not when the benefit was received or realized. Since the payments were in consideration of services rendered to the partnership prior to Mr. Blue's retirement, the Tribunal connected them to New York. In support of its conclusion in ***Blue*** and ***Walsh***, the Tribunal cited the Court of Appeals decision in ***Matter of Michaelsen v. New York State Tax Commn***. (67 NY2d 579, 505 NYS2d 585). The Tribunal explained:

> In ***Michaelsen***, the Court held that a portion of the income generated from stock options received as a result of New York employment retained its character as income derived from or connected with New York sources even though the nonresident taxpayer did not recognize the income from the options until much

> later when the stock was sold. *We can think of no reason why a former partner should be treated differently from an employee under former section* 632(b)(1)(B) (***see, Matter of Norris v. State Tax Commn***., 140 Ad2d 876, 528 NYS2d 694; emphasis supplied).

Among the remaining issues to be addressed in ***Blue*** was whether petitioner was entitled to the section 612(c)(3-a) subtraction modification. Petitioner alleged that the Legislature intended the term "employee" to include a partner, and that intent was evidenced by the fact that in other subsections of section 612 (specifically, subsections [o][1][B][iii] and [p][5]), the term "employee" does include partners. The Tribunal, though finding that a partner should not be treated differently from an employee for purposes of whether payments are connected with New York, rejected that argument for pension purposes in favor of a viewpoint that the sections petitioner referred to

> evidence only an excess of caution in legislative drafting intended to ensure that 'employees' in those particular provisions not be interpreted to mean partners and does not evidence that the Legislature generally meant employee to mean partner.

The Tribunal went on to discuss the legal responsibilities of partners and their relationship to one another. Although the Tribunal's goal was to contrast the relationship between partners and their partnership with that of an employer-employee relationship, it did so citing ***Matter of Villa Maria Inst. of Music v. Ross*** (54 NY2d 691, 442 NYS2d 972), a case which, in fact, contrasts the relationship of an independent contractor with that of an employee for the purpose of holding the employer liable for unemployment insurance contributions based upon certain compensation paid. The backbone of the discussion of whether an employment relationship existed was the degree of control and direction reserved to the employer. Highlighting the aspect of control, the Tribunal concluded the Legislature did not intend "employee" to include a partner

for purposes of the section 612(c)(3-a) subtraction modification. I believe the Tribunal's analysis and its conclusion should be revisited.

D. First, and most importantly, the Tribunal's analysis did not consider the purpose of the enactment of the subtraction modification, i.e., to place recipients of private and Federal pensions on a more equal footing with New York public pension recipients, as revealed by a review of the Bill Jacket and the Governor's Memorandum filed with Assembly Bill number 4043-A. There is no reference in the Bill Jacket which would indicate an intention that the subtraction modification be applied other than uniformly to pension recipients of qualifying age, having received the type of annuity so described.

Second, no reference to a definition of the terms "employer" or "employee" was offered in the Tribunal's discussion. Such terms are either discussed or defined by the Unemployment Insurance Law (Labor Law art 18), as well as by Tax Law article 22, in connection with the requirements of withholding tax from wages. The term "employer" is defined by Unemployment Insurance Law (Labor Law art 18) § 512 (1) as including:

> the state of New York and other government entities and any person, partnership, firm association, public or private, domestic or foreign corporation, the legal representatives of a deceased person, or the receiver, trustee, or successor of person, partnership, firm association, public or private, domestic or foreign corporation.

In order to create liability and coverage in the context of unemployment insurance, it is critical that an employment relationship exist. Whether an employment relationship exists requires an examination of the aspects of the relationship to determine whether the degree of control and direction reserved to the employer establishes such relationship (***Matter of Villa Maria Institute of Music, supra***). If the employer exercises control over the results produced by

the individual or the means used to achieve the results, an employer-employee relationship is likely to be found (CCH-EXP, NY-Tax-Analysis § 111.41[1], citing ***12 Cornelia St. v. Ross,*** 56 NY2d 895, 453 NYS2d 402). An employer-employee relationship may be found where there is control over important aspects of the services performed other than means or ends. Under this formulation, professionals, whose services do not lend themselves to control over means and results, may be employees when other aspects of the performance of their services are regulated (CCH-EXP, NY-Tax-Analysis § 111.41[1], citing ***Stat Services, P.C. v. Hartnett***, 148 AD2d 903, 539 NYS2d 531). The Court in ***Stat Services*** (***supra,*** 539 NYS2d at 532) noted that where professional services are involved, as here, and there is an absence of direct control by the employer, a slightly different rule has evolved (***see, Matter of Concourse Ophthalmology Associates v. Roberts***, 60 NY2d 734, 469 NYS2d 78). "Courts have held that an organization which solicits . . . the services of individuals skilled in professional endeavors, agrees to pay them . . . and then offers their services to clients exercises sufficient control to create an employment relationship" (***Stat Services, P.C. v. Hartnett, supra,*** 539 NYS2d at 532). Although the Tribunal relied on ***Matter of Villa Maria (supra)***, it did not discuss the specific aspects of the relationship of petitioner to his partnership in ***Blue***, but rather merely mentioned the concept of control and its possible relationship to hypothetical partners.

A prerequisite to the requirement of withholding taxes on New York State personal income, is the existence of an employer-employee relationship. The Tax Law requires that every employer who maintains an office or transacts business within New York and pays wages to residents or nonresidents must deduct from such wages for each payroll period an amount of tax such that the total withheld for the year is approximately equal to the taxes due from the

employee for the year (Tax Law § 671[a][1]). Although all circumstances are taken into account in determining whether or not an individual is an employee, other factors taken into account are right to control, instructions, training, method of payments, reimbursement of business or travel expenses, and the furnishing of tools and a place to work (Merten TaxLink Treatise, §§ 47A:07, 47A:12). New York withholding is based on the federal withholding provisions of the Internal Revenue Code (20 NYCRR 171.1[b]), including its conformity to the meaning of various federal terms, such as "employer" and "employee" (***id***). Since 1961, the Tax Law has expressly provided that terms used in the article relating to personal income tax have the same meaning as they have in federal income tax law, unless a different meaning is clearly required (Tax Law § 607[a]). In the context of withholding tax rules, Treasury Regulation § 31.3401(d)-1(c) states that

> an employer may be an individual, a corporation, a partnership, a trust, an estate, a joint-stock company, an association, or a syndicated, group, pool, joint venture, or other unincorporated organization, group, or entity.

Further, the Treasury Regulations state:

> If the relationship of employer and employee exists, the designation or description of the relationship by the parties as anything other than that of employer and employee is immaterial. Thus, if such relationship exists, it is of no consequence that the employee is designated as a partner, coadventurer, independent contractor, or the like (Treas Reg, § 31.3401[c]-1[d]).

The Treasury Regulations also discuss the characteristics of such relationship in section 31.3401(c)-1(b):

> Generally the relationship of employer and employee exists when the person for whom services are performed has the right to control and direct the individual who performs the services, not only as to the result to be accomplished by the work but also as to the details and means by which that result is accomplished. That is, an employee is subject to the will and control of the employer not only as to what shall be done but how it shall be done. In this connection, it is not necessary that the employer actually direct or control the

> manner in which the services are performed; it is sufficient if he has the right to do so. The right to discharge is also an important factor indicating that the person possessing that right is an employer. Other factors characteristic of an employer, but not necessarily present in every case, are the furnishing of tools and the furnishing of a place to work to the individual who performs the services. In general, if an individual is subject to the control or direction of another merely as to the result to be accomplished by the work and not as to the means and methods for accomplishing the result, he is not an employee.

E. The common thread between the unemployment insurance definition and case law, and that of the withholding taxes is the element of control within the employment relationship, the same criteria relied upon by the Tribunal in ***Blue (supra)***, but not factually determined. A review of petitioner's partnership agreement, over 60 pages in length, is replete with areas over which the partnership and its management exercised control over its members. The partnership agreement represents an agreement among the partners. However, much of the language makes it clear that the firm required that certain standards be met by the CPAs as professionals, and their manner of operating as partners and representation of clients was clearly controlled by the imposition of such standards. For example, Article II of the partnership agreement required the partners to devote their full time, attention and influence to the business and interests of the firm. It required that they agree to engage in no other business other than personal investment activities which do not conflict with professional ethics or overall firm objectives. The partners were required to deal with clients and the affairs of clients solely as a member of the partnership as distinguished from acting in respect of either on their own behalf. The partners were required to satisfy their debts as they came due, timely file and pay their individual tax returns and notify the partner in charge if they became a party in a legal proceeding. The parties could not transfer or pledge their partnership interest. The partnership agreed to reimburse each partner for all proper business related expenses reasonably incurred, in addition to expenses for practice

development, upon the submission of vouchers providing detail. The partnership agreement provided for the creation of a Policy Board, the management arm of the firm. The Policy Board established firm policies, reviewed the reports concerning planning and operations of the firm, reviewed and consummated mergers, recommended financial decisions, suspended or terminated partners, and borrowed money and obtained credit on behalf of the firm. The chairman and chief executive officer was responsible for the relations of the firm with principal clients, marketing efforts, representatives of the financial community and professional societies, as well as the development of the financial requirements of the firm. The partners agreed to be led by the CEO, a managing partner, an advisory board and a whole host of committees.

F. The Legislature did not intend to place employers and employees, and partnerships and partners on opposite sides with respect to the pension exclusion. Instead, the contrast is between those relationships where the substance is that of an employer-employee, regardless of the title, and those of independent contractors where the characteristics are truly distinguishable and control, or the lack thereof, is commonplace. The Legislature was in search of parity among the recipients of pension annuities where they arose out of an employment relationship, such as the one in this case. Accordingly, the pension exclusion was erroneously disallowed.

G. The petition of Maximilian and Miriam Schein is hereby granted and the notice of deficiency dated September 18, 2000, is canceled.

DATED: Troy, New York
March 27, 2003

/s/ Catherine M. Bennett
ADMINISTRATIVE LAW JUDGE