

STATE OF NEW YORK

STATE TAX COMMISSION

In the Matter of the Petitions

of

THOMAS E. HATCH AND MARGARET M. HATCH

DECISION

for Redetermination of Deficiencies or for
Refunds of New York State Personal Income Tax :
under Article 22 of the Tax Law and New York
City Nonresident Earnings Tax under Chapter 46, :
Title U of the Administrative Code of the City
of New York for the Years 1978 and 1979.

Petitioners, Thomas E. Hatch and Margaret M. Hatch, 172 Lawrence Park
Terrace, Bronxville, New York 10708, filed petitions for redetermination of
deficiencies or for refunds of New York State personal income tax under Article
22 of the Tax Law and New York City nonresident earnings tax under Chapter 46,
Title U of the Administrative Code of the City of New York for the years 1978
and 1979 (File Nos. 37546 and 44366).

On October 23, 1985, petitioners waived their right to a hearing and
requested that the State Tax Commission render a decision based on the entire
record contained in their file, with all briefs to be submitted by October 8,
1986. After due consideration, the State Tax Commission renders the following
decision.

ISSUES

I. Whether the notices of deficiency were issued without any basis and
for the sole purpose of extending the period of limitation on assessment.

II. Whether petitioners have substantiated that they were engaged in a
trade or business during the years in issue.

III. Whether petitioners have substantiated the character and amount of business expenses claimed as deductions from gross income for the years in issue.

FINDINGS OF FACT

1. Petitioners, Thomas E. Hatch and Margaret M. Hatch, filed New York State income tax resident returns, unincorporated business tax returns and New York City nonresident earnings tax returns for the years 1978 and 1979.

(a) The 1978 income tax return listed petitioners' occupations as "consultants" and reported \$27,582.00 in total income, consisting of \$19,201.00 in business income, \$462.00 in wages, salaries, tips and other employee compensation, \$119.00 in interest income and \$7,800.00 in other income.

(i) The copy of Federal Schedule C attached to petitioners' return showed "revenues" of \$33,969.00 with the following listed expenses:

Payments to Thomas Hatch	\$ 7,800.00
Delivery expense	1,703.00
Telephone	808.00
Printing & supplies	67.00
Accounting	125.00
Newspapers, magazines, etc.	294.00
Promotion & selling expense	1,821.00
Local travel	344.00
Hospitality in office	793.00
First aid expenses	109.00
Auto expenses	
a) 3,550 mi. @ 17c	604.00
b) Tolls	32.00
c) Parking	<u>268.00</u>
Total Expenses	\$14,768.00

The \$14,768.00 in expenses subtracted from the \$33,969.00 in "revenues" resulted in net income of \$19,201.00. In the list of expenses, payments to Thomas Hatch of \$7,800.00 are further explained in a footnote as being reported as "other income" on Form 1040, page 1, line 20.

(ii) The wage and tax statements attached to the return showed wages, tips and other compensation paid to MargaretX. McNamara of \$32,807.56 by Sudler and Hennessey and wages, tips and other compensation paid to Thomas E. Hatch by Banksville Racquet Club, Inc. of \$462.00. The statements issued to Mrs. Hatch are stamped with arrows pointing to the wages, tips and other compensationcategory on the wage and tax statements with the legend "Included in Schedule C".

(iii) The New York State unincorporated business tax return shows the following: net profit and total income from business before New York modifications of \$19,201.00 (this amount was also noted as "wages subject to FICA tax included in Schedule C"); from this amount was subtracted \$32,807.00, resulting in a total and net loss from business of \$13,606.00.

(b) The 1979 return listed petitioners' occupations as "consultants" and reported \$29,962.00 in total income, consisting of \$29,622.00 in business income and \$122.00 in interest income.

(i) The Federal Schedule C attached to the return showed "revenues" of \$37,541.00 for MargaretM. Hatch consisting of \$36,515.00 in consulting fees and \$1,026.00 in messenger services fees, with the following listed expenses:

Payments to Thomas Hatch	\$ 7,800.00*
Delivery expense	1,623.00
Telephone - inside	720.00
Printing & supplies	84.00
Accounting	125.00
Newspapers, etc.	316.00
Promotion, meeting expenses	1,987.00
Local travel expenses	408.00
Hospitality in office	843.00
First aid expenses	113.00

Travel expense	
a) 8,650 mi. @ 18 1/2c	1,601.00
b) Tolls	103.00
c) Parking	92.00
Telephone - outside	<u>312.00</u>
Total Expenses	\$16,127.00

* Reported as income in husband's Schedule C

The \$16,127.00 in total expenses deducted from revenues of \$37,541.00 resulted in the net business income reported of \$21,504.00 for Margaret M. Hatch.

(ii) The Federal Schedule C attached for Thomas Hatch showed revenues of \$11,249.00 consisting of \$7,800.00 in management consulting fees and \$3,449.00 as "racquet club", with the following listed expenses:

Field travel - 4,150 mi. @ 18 1/2c	\$ 768.00
Hosting attire maintenance	143.00
Hospitality	1,372.00
Magazines, newspapers, etc.	306.00
Meeting & solicitation expense	<u>492.00</u>
Total Expenses	\$3,131.00

The \$3,131.00 in total expenses deducted from revenues of \$11,249.00 resulted in the \$8,118.00 net business income reported.

(iii) The wage and tax statements attached to the return showed \$3,449.40 in wages, tips and other compensation paid to Thomas Hatch by Banksville Racquet Club, Inc., \$217.60 in wages, tips and other compensation paid by Young and Rubicam to Margaret X. McNamara, \$15,515.29 paid to Margaret McNamara by Sudler and Hennessey, Inc. and finally a wage and tax statement from Sudler and Hennessey, Inc. stating wages, tips and other compensation in the sun of \$21,000.08 paid to Margaret McNamara. Like the 1978 statements, a stamped arrow with the legend "Included in Schedule C" pointed to said compensation on each statement except for the statement from Young and Rubicam. It should be

noted that the wage and tax statement from Young and Rubicam in the sum of \$217.60 was not included in Margaret Hatch's revenues.

(iv) The unincorporated business tax return for Margaret X. Hatch showed \$21,504.00 in net profit, less \$36,515.00 in subtractions, resulting in a loss from business of \$15,011.00. The unincorporated business tax return of Thomas E. Hatch showed \$8,118.00 in net profit, less subtractions of \$3,449.00 resulting in total income from business of \$4,669.00, from which an allowance for taxpayer's services of \$934.00 was subtracted to arrive at the net income from business of \$3,735.00. After subtracting the exemption of \$5,000.00, business income was zero with no tax due thereon.

(c) For the year 1978, both petitioners chose the standard deduction and for tax year 1979 both chose to itemize deductions. For tax year 1979, petitioners' itemized deductions consisted of the following:

Medical & dental expenses	\$1,848.00
Taxes	2,433.00
Interest expense	673.00
Contributions	<u>393.00</u>
New York State Itemized Deductions	\$3,427.00

It should be noted that for the tax year 1978, petitioners claimed itemized deductions on their Federal return and claimed the standard deduction on their State return.

(d) For both years in issue, petitioner Margaret Hatch filed an unincorporated business tax return with the City of New York reporting no additional taxes due.

2. Petitioners' tax returns were selected for examination along with those of approximately 100 other individuals on the basis that said returns had been prepared by a particular accountant. An investigation had disclosed that said accountant had consistently prepared returns on which an individual with

wage or salary income shown on wage and tax statements had reported said income as business receipts on Federal Schedule C. Department of Taxation and Finance auditors were directed to review the returns and to disallow claimed business expense deductions if the taxpayer appeared to be an employee receiving wage or salary income reported on wage and tax statements. Petitioners' claimed Schedule C deductions were disallowed on that basis.

3. (a) On April 2, 1982, the Audit Division issued a Statement of Audit Changes to petitioners for tax year 1978, asserting additional taxes due of \$1,542.98, with the following explanation:

"Income shown on wage and tax statements is considered to be wages and reportable as such on page 2, Schedule A at line 1.

Expenses claimed on Schedule C (business income) are not considered to be ordinary and necessary in the production of income as an employee.

Recomputation of the return on a joint basis is allowed since it results in the lowest tax liability."

The additional tax liability included additional New York State personal income tax and New York City nonresident tax. On April 14, 1982, the Audit Division issued a Notice of Deficiency to petitioners stating additional tax due of \$1,542.98, plus interest in the sum of \$452.56, for a total amount due of \$1,995.54.

(b) On January 28, 1983, the Audit Division issued a Statement of Audit Changes to petitioner Margaret M. Hatch for the year 1979, asserting additional tax liability of \$1,743.67, consisting of additional New York State personal income tax and New York City nonresident earnings tax. The following explanation was set forth thereon:

"As a salaried employee, you are not a business entity and therefore are not entitled to claim Schedule C deductions as these expenses are not ordinary and necessary for the production of income as an employee."

(c) For the year 1978, petitioners were allowed the standard deduction and in 1979 itemized deductions. No penalties were imposed in either year.

4. Petitioners submitted substantial documentary evidence:

(a) Sample billing sheets from Patient Care Publications, Inc. of Darien, Connecticut listing Thomas Hatch as vendor, a handwritten schedule of delivery expenses, a handwritten schedule of telephone payments, a handwritten schedule of promotion and selling expenses, a handwritten schedule of home hospitality expenses, handwritten notes and a copy of the Federal Form 1040, U.S. Individual Income Tax Return, for 1978. Petitioner Margaret Hatch also submitted a sworn affidavit listing the expenses set forth above attached to her Schedules C for tax years 1978 and 1979 and urged that she be entitled to deduct them.

(b) Petitioners submitted a copy of Form 1040, U.S. Individual Income Tax Return, for 1979 as documentation in support of their petition with regard to tax year 1979.

5. Petitioners contend:

(a) That the proposed deficiency was apparently made to protect against the expiration of the statute of limitations for assessments.

(b) That the proposed deficiency was arbitrary and capricious because petitioners were not audited.

(c) That the deficiency was based upon a disallowance of expenses because they were not ordinary and necessary business expenses under section 162 of the Internal Revenue Code and/or deductible for the production

or maintenance of income under section 212 of the Internal Revenue Code and, therefore, the deficiency was erroneous.

(d) That regardless of the classifications of the expenses under the different Internal Revenue Service code sections, the taxable income should be unchanged.

CONCLUSIONS OF LAW

A. That the notices of deficiency were properly issued and were not arbitrary or capricious. The returns were patently erroneous and the Audit Division was justified in disallowing Schedule C business income. Each Notice of Deficiency was preceded by a Statement of Audit Changes and petitioners had an opportunity to file amended returns claiming employee business expenses as adjustments on Federal Form **2106**, or as itemized miscellaneous deductions, but they chose not to do **so**.

B. That the fact that petitioners' returns were selected for examination because **of** certain practices of their accountant is irrelevant. Petitioners' liability depends solely **on** the facts adduced herein.

C. That petitioners have not sustained their burden of proof under section 689(e) of the Tax Law to show that they were engaged **in** a trade or business other than as employees. Thus, expenses claimed **on** Schedule C may not be deducted under section 62(1) of the Internal Revenue Code.

D. That while it would appear that petitioners may have been entitled to deduct certain employee business expenses under section **62(2)** or 63(f) of the Internal Revenue Code if they had filed a Form 2106, or had itemized their deductions and claimed such expenses as miscellaneous deductions, petitioners nevertheless failed to sustain their burden of proof under

section 689(e) of the Tax Law to show the character **or**, in many cases, the amount **of** the claimed business expenses.

E. That the petitions of Thomas E. Hatch and Margaret M. Hatch are denied and the notices of deficiency dated April 14, 1982 and April 8, 1983, respectively, are sustained, together with such additional interest as may be lawfully owing.

DATED: Albany, New York

STATE TAX COMMISSION

APR 06 1987

PRESIDENT

COMMISSIONER

COMMISSIONER