

STATE OF NEW YORK

STATE TAX COMMISSION

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In the Matter of the Petition

of

STEPHEN J. SEIDEL and ELIZABETH B. SEIDEL

DECISION

for Redetermination of a Deficiency or for  
Refund of Personal Income Tax and Unincorporated :  
Business Tax under Articles 22 and 23 of the  
Tax Law for the Years 1979 and 1980.

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Petitioners, Stephen J. Seidel and Elizabeth B. Seidel, Route 9G, Germantown, New York 12526, filed a petition for redetermination of a deficiency or for refund of personal income tax and unincorporated business tax under Articles 22 and 23 of the Tax Law for the years 1979 and 1980 (File No. 44464).

A formal hearing was held before Brian L. Friedman, Hearing Officer, at the offices of the State Tax Commission, Building #9, State Office Campus, Albany, New York, on July 24, 1985 at 1:15 P.M. Petitioners appeared by Leonard Rachmilowitz, CPA. The Audit Division appeared by John P. Dugan, Esq. (Thomas Sacca, Esq., of counsel).

#### ISSUES

I. Whether the Audit Division's allowance of 30 percent of petitioner Stephen J. Seidel's net profit from the operation of a fruit processing business as personal service income subject to the maximum tax on personal service income was proper.

11. Whether the Audit Division properly disallowed a portion of petitioner Stephen J. Seidel's payroll deduction.

FINDINGS OF FACT

1. Stephen J. Seidel (hereinafter "petitioner") and Elizabeth B. Seidel, his wife, timely filed New York State income tax resident returns for the years 1979 and 1980 under the filing status "married filing separately on one return." For each of said years at issue, petitioner filed Form IT-250, New York State Maximum Tax on Personal Service Income, on which he claimed 100 percent of his share of the net profits from his business as personal service income subject to the maximum tax computation. Petitioner timely filed New York State unincorporated business tax returns for 1979 and 1980.

2. On November 15, 1982, as a result of a field audit of petitioner's fruit processing business for the years 1979 and 1980, the Audit Division issued a Statement of Audit Changes to petitioner and Elizabeth B. Seidel, his wife, wherein the Audit Division disallowed a portion of petitioner's payroll as having been unsubstantiated, allowed depreciation on certain equipment purchases not claimed on the original tax returns, recomputed petitioner's maximum tax for 1979 by allowing 30 percent of petitioner's net profit from the operation of his business as personal service income, rather than the 100 percent claimed on petitioner's 1979 return, and disallowed petitioner's 1980 maximum tax computation on the basis that he was ineligible for said benefit in 1980, resulting in additional personal income tax due of \$1,940.57 for 1979,

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1 Since the issues herein relate to the Federal Schedule C, Profit or (Loss) from Business or Profession, New York State income tax and unincorporated business tax returns and New York State maximum tax computation on personal service income, which were filed separately by Stephen J. Seidel for each of the years at issue, the term "petitioner" shall hereafter refer solely to Stephen J. Seidel.

\$405.31 for 1980 and additional unincorporated business tax due of \$155.56 for 1979 and \$24.12 for 1980, plus interest. Accordingly, on April 11, 1983, the Audit Division issued to petitioner and Elizabeth B. Seidel, his wife, a Notice of Deficiency asserting additional tax due of \$2,525.56, plus penalty of \$63.15<sup>2</sup> and interest of \$804.88, for a total due in the amount of \$3,393.59.

3. Petitioner is the only person who works on a full-time basis for the company. For the years at issue, petitioner did hire at least ten part-time workers, some of whom were paid in cash. An examination of petitioner's payroll records and petitioner's Federal Forms 940 (Federal Unemployment Tax) and 941 (Quarterly Federal Income Tax and Social Security Tax) revealed that petitioner's claimed payroll deduction did not agree with the amounts which were reported by petitioner on the said Federal forms. Petitioner was unable to produce for examination by the auditor Federal Forms 1099 (Statements for Recipients of Nonemployee Compensation) to substantiate that these persons received the alleged sums of money from petitioner. In support of his claimed payroll deduction for payments made to these part-time workers, petitioner submitted a handwritten sheet of paper which set forth the names and Social Security numbers of the payees, together with the amounts paid to each for the years at issue.

4. Petitioner operates a fruit processing company, specializing in the production of apple juice. He purchases apples from farmers, processes the apples to produce the juice, packages the juice and ships it to certain vendors.

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2 Since no penalty was asserted in the Statement of Audit Changes issued November 15, 1982, and no basis for said penalty was asserted in the proceeding held herein, it must be presumed that the inclusion of a penalty in the amount of \$63.15 in the Notice of Deficiency is correct.

Petitioner owns the equipment used to produce the juice and rents the building which houses his business from his mother at an annual rental of \$24,000.00 per year.

5. The Audit Division determined that the major portion of petitioner's income was derived from the production of goods, i.e., apple juice, for consumption and was not derived from personal services. The Audit Division contends that petitioner did not sell to the consumer a management service, but instead sold a unit consisting of raw materials, labor and equipment and that, under the facts and circumstances herein, a 30 percent allowance for personal services rendered by petitioner was a reasonable allowance.

6. It is petitioner's position that the success of his business is directly and substantially related to the marketing of the product offered for sale. In support of this position, petitioner cites the fact that the profitability of the company increased significantly since petitioner joined his father's business and, subsequently, took over the company from his father. Petitioner also maintains that the apples used in production of apple juice are not inventoried but rather are quickly processed and sold. Petitioner's representative testified that petitioner's apple juice business is seasonal and that, in season, petitioner works from 70 to 100 hours per week.

#### CONCLUSIONS OF LAW

A. That petitioner failed to sustain his burden of proof imposed by sections 689(e) and 722 of the Tax Law to substantiate that the Audit Division's disallowance of a portion of his payroll deduction for the years 1979 and 1980 was erroneous. Accordingly, the audit adjustments arising out of said disallowance of petitioner's payroll deduction are hereby sustained.

B. That section 603-A of the Tax Law provides for a maximum tax rate on New York personal service income. Section 603-A(1)(1) is as follows:

at issue, defined the term "New York personal service income" to mean, in part, items of income includible as personal service income for purposes of section 1348 of the Internal Revenue Code.

C. That section 1348(b)(1)(A) of the Internal Revenue Code, in effect for the years at issue, defined the term "personal service income" as:

"...any income which is earned income within the meaning of section 401(c)(2)(C) or section 911(b) or which is an amount received as a pension or annuity which arises from an employer-employee relationship or from tax-deductible contributions to a retirement plan. For purposes of this subparagraph, section 911(b) shall be applied without regard to the phrase ', not in excess of 30 percent of his share of net profits of such trade or business,'."

D. That Treasury Regulation 1.1348-3(a)(3)(i) provides that:

"[i]f an individual is engaged in a trade or business...in which both personal services and capital are material income-producing factors, a reasonable allowance as compensation for the personal services actually rendered by the individual shall be considered earned income..."

Treasury Regulation 1.1348-3(a)(3)(ii) provides that:

"[c]apital is a material income-producing factor if a substantial portion of the gross income of the business is attributable to the employment of capital in the business, as reflected, for example, by a substantial investment in inventories, plant, machinery or other equipment. In general, capital is not a material income-producing factor where gross income of the business consists principally of fees, commissions, or other compensation for personal services performed by an individual."

E. That, for the years at issue, the gross income of petitioner's business did not consist principally of fees, commissions or other compensation for personal services. Petitioner had a substantial investment in equipment used to produce the apple juice which was sold to various vendors. He paid an annual rent of \$24,000.00 per year for the building which houses said equipment. He employed at least ten part-time workers to assist him in the production of the apple juice. Both personal services and capital were material income-producing

reasonable allowance as compensation for the personal services which he rendered to the business.

F. That sections 689(e) and 722 of the Tax Law place the burden of proof on the petitioner in all cases before the Tax Commission, with certain exceptions not applicable herein. Petitioner has failed to sustain his burden of proof to show that the Audit Division's allowance of 30 percent of petitioner's net profit from the operation of his fruit processing business as personal service income subject to the maximum tax was improper.

G. That, in light of Conclusion of Law "F", petitioner was not eligible for the maximum tax computation for the year 1980, since **30** percent of petitioner's net profit from the operation of his business was less than \$19,000.00.

H. That the Audit Division is hereby directed to remove the name of Elizabeth B. Seidel from the Notice of Deficiency dated April 11, 1983 in accordance with the footnote to Finding of Fact "1", supra. The Audit Division is further directed to cancel the penalty asserted in said Notice of Deficiency in accordance with the footnote to Finding of Fact "2", supra.

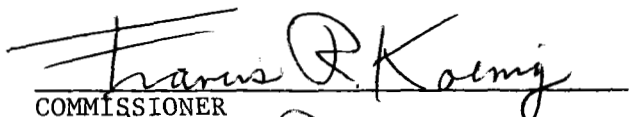
I. That the petition of Stephen J. Seidel and Elizabeth B. Seidel is granted to the extent indicated in Conclusion of Law "H", supra, and, except as **so** granted, is in all other respects denied.

DATED: Albany, New York

STATE TAX COMMISSION

JAN 17 1986

  
PRESIDENT

  
COMMISSIONER

  
COMMISSIONER