

STATE OF NEW YORK

STATE TAX COMMISSION

In the Matter of the Petition

of

JOSEPH KALINA AND LEE KALINA (DECEASED)

DECISION

for Redetermination of a Deficiency or for
Refund of Personal Income Tax under Article 22 :
of the Tax Law for the Year 1980.

Petitioners, Joseph Kalina and Lee Kalina (deceased), 107 Stonecrest Drive, Dewitt, New York 13214, filed a petition for redetermination of a deficiency or for refund of personal income tax under Article 22 of the Tax Law for the year 1980 (File No. 47426).

A hearing was held before Arthur Bray, Hearing Officer, at the offices of the State Tax Commission, 333 East Washington Street, Syracuse, New York, on October 8, 1985 at 2:45 P.M. Petitioner appeared by Andrew H. Ewanyk, C.P.A. The Audit Division appeared by John P. Dugan, Esq. (James Della Porta, Esq., of counsel).

ISSUES

I. Whether the Audit Division's allowance of fifty percent of petitioner Joseph Kalina's net profit from the operation of his business, as personal service income subject to the maximum tax on personal service income, was proper.

II. Whether petitioners have substantiated the amount of the casualty loss incurred by theft.

III. Whether dividend income received from a mutual fund which dividend was derived from federal obligations qualifies as interest income on obligations of the United States such that petitioners' reported federal adjusted gross income

should be reduced by the dividend income received in accordance with Tax Law §612(c)(1).

FINDINGS OF FACT

1. Joseph Kalina, on behalf of himself and his wife, Lee Kalina, who died on March 10, 1980, filed a New York State Income Tax Resident Return for the year 1980. On this return, petitioner claimed a subtraction modification in the amount of \$2,560.00, of which \$1,350.00 was derived from interest on a United States Treasury Note and \$1,210.00 constituted a dividend received from a mutual fund which dividend was derived from interest on federal obligations. Petitioner also claimed a casualty or theft loss in the amount of \$7,665.00.

2. Mr. Kalina attached a New York State Unincorporated Business Tax Return to his New York State personal income tax return for 1980. He described his business as the "Wholesale of Lumber" on this return. He also attached a Federal Schedule C encaptioned Profit (or Loss) from Business or Profession. On this schedule, Mr. Kalina described his business activity as the "Sale of Lumber" and reported a gross profit of \$64,130.00 and a net profit of \$40,791.00. The Schedule C disclosed that Mr. Kalina had no inventory at either the beginning or end of the year. However, he reported costs for purchases, customs and freight. Mr. Kalina did not claim deductions for depreciation or depletion. In computing their tax liability, petitioners reported the gross profit on the business, less business deductions and payments to an individual retirement account or Keogh plan, as subject to the New York State maximum tax on personal service income.

3. In the course of a field audit, the Audit Division determined that petitioner was not entitled to the subtraction modification claimed on the dividend received from the mutual fund. The Statement of Audit Adjustment

attributed \$1,350.00 as income received from the mutual fund. However, at the hearing, the parties agreed that \$1,210.00 constituted the dividend received from the mutual fund. Further, since Mr. Kalina did not establish the cost basis of items that were stolen from his home, the Audit Division reduced the amount **of** the permitted casualty **loss** to \$1,000.00. Lastly, the Audit Division determined that fifty percent of Mr. Kalina's business income was an appropriate allowance as compensation for personal services subject to the maximum tax on personal service income.

4. On the basis of the foregoing audit, on July 14, 1983, the Audit Division issued a Notice **of** Deficiency to petitioners asserting a deficiency **of** personal income tax in the amount of \$1,214.00, plus interest in the amount of \$336.15, for a balance due of \$1,550.15.

5. During the year in issue, Mr. Kalina engaged in business under the name of Adirondack Lumber Company. **As** the result of years of experience, Mr. Kalina developed the ability to determine the characteristics of the inside of a log from an examination of the exterior surface of the log. This skill was of particular value to overseas **firms** which bought logs in the United States because of the expense involved in importing logs which could not be used.

6. In the course **of** Mr. Kalina's business, a firm would usually contact Mr. Kalina stating that it wished to purchase a certain quantity of logs. On occasion, the firm contacting petitioner would state the price they wished to pay and at other times the price would be omitted. Thereafter, Mr. Kalina would locate the **logs** which satisfied the customer's specifications and ship them to the customer. In conjunction with the shipment of the logs, Mr. Kalina would prepare a bill of lading and other necessary documents which would be

delivered to his bank. **Mr.** Kalina's bank would then transmit the bill of lading to the customer's bank **in** Europe. The customer's bank would release the bill of lading to the customer upon payment. Thereafter, the funds would be transferred to petitioner's bank and credited to petitioner's bank account.

7. The income earned by Mr. Kalina was a direct result of **his** knowledge of the lumber industry.

8. In **or** about late October **or** early November, 1980, **Mr.** Kalina's home was burglarized. After the burglary, **Mr.** Kalina prepared a brief list of items stolen **or** damaged and submitted it to his insurance company. In response thereto, the insurance company remitted a check to petitioner in the amount of \$8,989.30. When the time came to prepare the tax return, Mr. Kalina, in response to a discussion with his accountant, prepared a more complete list of the items which were stolen. After the audit was completed, **Mr.** Kalina expanded further on the list of items which were lost during the burglary. At the time of the hearing, Mr. Kalina submitted the following list which purported to represent the cost basis of the items listed and the amount which the insurance company agreed to reimburse petitioner.

Joseph Kalina
Schedule of Assets Stolen

	<u>cost</u>	<u>Per Insurance Schedule</u>
18 karat gold ring black onyx	\$ 350.00	
Diamond ring 1/2 karat platinum	850.00	\$ 500.00
Gold bracelet	500.00	
Diamond earrings 1/2 karat	900.00	
Cameo carved set in gold	300.00	
Men's golden watch - 17 jewels	250.00	
Gold pin 14 karat	200.00	
Pearl necklace 3 tier	300.00	
Cash	790.00	100.00
Coins & stamps	7,000.00	500.00
Diamond ring	1,225.00	
Mink collar	550.00	175.00

Diamond ring - 2 stones	5,500.00	
Alarm clock	25.00	20.00
Cameo	250.00	
Sterling silver	1,400.00	2,200.00
Cassettes (10)	60.00	40.00
Shoes	38.00	38.00
Liquor	30.00	30.00
Sweater cashmere	550.00	175.00
Suit cases (2)	250.00	89.95
Leather suit case	180.00	89.95
Boots	85.00	75.00
Repairs - house	725.00	565.28
Calculator	55.00	50.00
Coins & camera (35 millimeter - Son)	500.00	
	<u>\$22,863.00</u>	<u>\$4,648.18</u>
Insurance reimbursement ¹	<u>8,989.82</u>	
	<u>\$13,873.18</u>	

9. **Mr.** Kalina had difficulty determining what jewelry was stolen directly after the burglary because his wife had died before the theft and she was the only person who would have been aware **of** all of the jewelry that she had owned. The boots listed **on** the foregoing schedule were owned by **Mr.** Kalina's **son**. The cassettes on the schedule of assets stolen were **in** Mr. Kalina's **son's** bedroom, although Mr. Kalina paid for them.

10. When Mr. Kalina submitted the list of stolen items to the insurance company, he was advised that they would reimburse him \$500.00 for the coins regardless of their value.

11. **No** evidence was presented as to the limit of reimbursement contained in Mr. Kalina's insurance policy.

12. The only documentary evidence of the cost basis of the stolen items presented at the hearing consisted of proof that one diamond ring cost \$1,250.00 and proof that petitioner purchased between \$6,000.00 and \$8,000.00 worth **of**

1 Petitioners were unable **to** provide a reason why the value of the amounts approved by the insurance company exceeded the value of the amounts submitted to the insurance company.

stamps and coins during the past twenty years. In addition, there is no evidence in the record of the fair market value of the items stolen immediately before the burglary.²

13. When Mr. Kalina invested in the mutual fund, he was told by the sales agent that the income therefrom would not be subject to United States or New York State taxation.

CONCLUSIONS OF LAW

A. That section 603-A(b)(1), in effect for the year 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.

B. That section 1348(b)(1)(A) of the Internal Revenue Code, in effect for the year 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,'."

C. That Treasury Regulation 1.1348-3(a)(3)(i) provides, in part, 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...".

D. That Treasury Regulation 1.1348-3(a)(3)(ii) provides, in part, that:

2 A letter from a jeweler was offered stating that the replacement values of two rings owned by Mrs. Kalina in 1977 were, respectively, **\$6,200.00** and **\$650.00**. In addition, the record contains an undated document stating that the market value of the sterling silver was **\$6,200.00**.

"[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 Internal Revenue Code §911(b), as effective for the year in issue, provided:

"Definition of Earned Income. -- For purposes of this section, the term 'earned income' means wages, salaries, or professional fees, and other amounts received as compensation for personal services actually rendered, but does not include that part **of** the compensation derived by the taxpayer for personal services rendered by him to a corporation which represents a distribution of earnings or profits rather than a reasonable allowance as compensation for the personal services actually rendered. In the case of a taxpayer engaged in a trade or business in which both personal services and capital are material income-producing factors, under regulations prescribed by the Secretary, a reasonable allowance as compensation for the personal services rendered by the taxpayer...shall be considered as earned income."

F. That it **is** clear from an examination of Mr. Kalina's tax return as well as the uncontradicted testimony that the gross income of Mr. Kalina's business consisted principally of fees, commissions or other compensation for personal services. Mr. Kalina neither maintained an investment in plant, machinery or other equipment nor did he maintain a substantial investment in inventory. Accordingly, Mr. Kalina properly considered his business income as subject to the maximum tax rate on personal service income.

G. That section 165(c)(3) of the Internal Revenue Code permits individuals to deduct losses caused by theft of nonbusiness property to the extent that the loss from the theft exceeds \$100.00 and **is** not reimbursed (Henry Jenny v. Comm., 36 T.C.N. 607 [1977]). "The proper measure of the loss sustained **is** the lesser of (1) the fair market value **of** the property immediately before the theft or

(2) the adjusted basis of the property." (Citations omitted) (Henry Jenny v. Comm., supra.)

H. That it **is** recognized in a proper case that judgment may be exercised to approximate the amount of the casualty deduction allowable (see, e.g., Jack R. Olken v. Comm., 41 T.C.M. 1255 [1981]). However, the absence of supporting records will "...bear heavily' against the taxpayer 'whose inexactitude **is** of his **own** making'" Jack R. Olken v. Comm. at 1257 citing Cohan v. Comm., 39 F.2d 540, 544 (2nd Cir. 1930). In this instance an estimate of the amount of the allowable deduction would not be proper. The difference between the amount of the insurance reimbursement per the insurance schedule and the amount which the insurance company reimbursed petitioner renders the accuracy of petitioner's "Schedule of Assets Stolen" questionable. **In** addition, there **is** no evidence **in** the record as to the fair market value of the items stolen immediately before the burglary. Accordingly, the Audit Division's allowance of \$1,000.00 as a casualty loss deduction **is** found to be proper under the circumstances.

I. That petitioner properly reduced the amount of his federal adjusted gross income by \$1,350.00, representing the amount of the interest received **on** the Treasury note (Tax Law §612[c][1]).

J. That petitioner properly reduced the amount of his Federal adjusted gross income by \$1,210.00, representing the dividends paid by the mutual fund which were attributable to interest on Federal obligations (Matter of Johnson v. New York State Tax Commn., 117 AD2d 867).

K. That the petition of Joseph and Lee Kalina (deceased) is granted to the extent of Conclusions of Law "F", **"I"** and "J", and the Audit Division **is** directed to modify the Notice of Deficiency, dated July 14, 1983, accordingly;

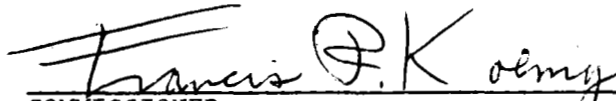
the petition is, in all other respects denied, and, as modified, the Notice of Deficiency is sustained.

DATED: Albany, New York

STATE TAX COMMISSION

APR 17 1987.


PRESIDENT


COMMISSIONER


COMMISSIONER