

STATE OF NEW YORK

STATE TAX COMMISSION

In the Matter of the Petition

of

CHRISTOPHER P. GALLO

DECISION

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

Petitioner, Christopher P. Gallo¹, 41 Clifton Avenue, Kingston, New York 12401, 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. 48497).

A hearing was held before Arthur Bray, Hearing Officer, at the offices of the State Tax Commission, Building #9, W. Averell Harriman State Office Building Campus, Albany, New York, on February 26, 1986 at 2:45 P.M., with all briefs to be filed on or before April 9, 1986. Petitioner appeared by Glenn B. Sutherland, C.P.A. The Audit Division appeared by John P. Dugan, Esq. (Thomas C. Sacca, Esq., of counsel).

ISSUE

Whether the Audit Division's allowance of 30 percent of petitioner Christopher P. Gallo'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.

1 Although the hearing was called in the name of Christopher P. Gallo and Doris E. Gallo, the only asserted deficiency of tax at issue herein pertains to Christopher P. Gallo. Therefore, all references hereafter to

FINDINGS OF FACT

1. During the year in issue, petitioner, Christopher P. Gallo operated an establishment known as Mohican Market which sold fresh fruits and vegetables at wholesale and retail.

2. Petitioner and his wife filed separately on one return, a New York State Income Tax Resident Return for the year 1980. He attached to this return a Federal schedule C, encaptioned Profit or (Loss) From Business or Profession. The Federal schedule C reported that Mohican Market had gross receipts or sales of \$1,081,738.00 and cost of goods sold of \$922,735.00 resulting in total income of \$159,003.00. Mr. Gallo reported total deductions of \$93,626.00 resulting in a net profit of \$65,377.00.

3. The cost of goods sold section of the Federal schedule C reported a beginning inventory of \$17,100.00 and purchases of \$878,302.00. The schedule disclosed an ending inventory of \$28,586.00.

4. The depreciation section of the Federal schedule C disclosed that Mr. Gallo claimed depreciation expense on items such as equipment, trucks, cooler, scales and an air conditioner. The total depreciation expense claimed was \$5,237.00.

5. Mr. Gallo attached to his personal income tax return a form IT-250, encaptioned New York State Maximum Tax on Personal Service Income. On this schedule, Mr. Gallo claimed that the net profit of Mohican Market, that is, \$65,377.00, was income subject to the maximum tax on personal service income.

6. On October 31, 1983, the Audit Division issued a Notice of Deficiency to Christopher P. Gallo asserting a deficiency of personal income tax for the years 1979 and 1980 in the amount of \$1,637.73 plus interest in the amount of \$509.03 for an amount due of \$2,146.76, less an amount paid or credited of

\$581.74, for a balance due of \$1,565.02. After the Notice of Deficiency was issued, petitioner paid a portion of the tax determined to be due thereby reducing the amount of tax in issue to \$1,205.00. To the extent at issue herein, the asserted deficiency of personal income tax was premised upon the Audit Division's position that thirty percent of the net income from petitioner's business constituted a reasonable allowance as compensation for the personal services actually rendered by petitioner and therefore no portion of petitioner's income was eligible for the maximum tax on personal service income.

7. It was Mr. Gallo's practice to work seven days a week. Mr. Gallo would arrive at his store at 6:00 A.M. or 7:00 A.M. and remain at the store until 6:00 P.M. While at Mohican Market, Mr. Gallo would establish pricing and supervise five or six full-time employees. Approximately three days a week, Mr. Gallo would drive a truck to the produce market in New York City and return in the late afternoon with the truck fully loaded with produce.

8. Mr. Gallo maintained an average inventory of approximately \$29,000.00 which represented sufficient produce for about two or three days' sales.

9. Mr. Gallo rents the building used by Mohican Market. He also rents automotive equipment.

10. At the hearing, it was argued that capital was not a material income-producing factor because of the asserted limited amount of inventory, minimal amount of depreciable fixtures and equipment and the fact that the building is rented. It was also maintained that thirty percent of the net profits of the business did not represent a reasonable allowance as compensation for personal services rendered.

CONCLUSIONS OF LAW

A. That section 603-A of the Tax Law provides for a maximum tax rate on New York personal service income. Section 603-A(b)(1), in effect for the years 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 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,'."

C. That during the year in issue Treasury Regulation 1.1348-3(a)(3)(i) provided, 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..."

Treasury Regulation 1.1348-3(a)(3)(ii) provided, in part, 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."

D. That both services and capital were material income-producing factors in petitioner's business. The significance of capital as a material income-producing factor is evidenced by, among other things, the substantial investment in inventory and depreciable assets (Moore v. Commissioner, 71 T.C. 533 [1970]).

determining whether capital is a material income-producing factor (Moore v. Commissioner, supra, p. 539). Since personal services and capital were material income-producing factors in petitioner's business, petitioner was entitled to a reasonable allowance as compensation for the personal services which he rendered to the business.

E. That petitioner has failed to sustain his burden of proof to show that the Audit Division's allowance of thirty percent of petitioner's net profit from the operation of the fruit processing business as personal service income subject to the maximum tax was improper. Therefore, the income petitioner received from his business was not eligible for the maximum tax computation.

F. That the petition of Christopher P. Gallo is denied and the Notice of Deficiency, as modified in Finding of Fact "6", **is** sustained.

DATED: Albany, New York

STATE TAX COMMISSION

NOV 12 1986

Rodriguez Clem
PRESIDENT

COMMISSIONER

COMMISSIONER

1/18/86
I abstain!!
Francis R. Kearney