

STATE OF NEW YORK
STATE TAX COMMISSION

In the Matter of the Petition :

of

Neil A. & Serena R. McConnell :

AFFIDAVIT OF MAILING

for Redetermination of a Deficiency or a Revision :
of a Determination or a Refund of
Personal Income Tax :
under Article 22 of the Tax Law
for the Years 1971,1973. :

State of New York

County of Albany

Jay Vredenburg, being duly sworn, deposes and says that he is an employee of the Department of Taxation and Finance, over 18 years of age, and that on the 16th day of January, 1981, he served the within notice of Decision by certified mail upon Neil A. & Serena R. McConnell, the petitioner in the within proceeding, by enclosing a true copy thereof in a securely sealed postpaid wrapper addressed as follows:

Neil A. & Serena R. McConnell
c/o Williamson & Green
280 Park Ave.
New York, NY 10017

and by depositing same enclosed in a postpaid properly addressed wrapper in a (post office or official depository) under the exclusive care and custody of the United States Postal Service within the State of New York.

That deponent further says that the said addressee is the petitioner herein and that the address set forth on said wrapper is the last known address of the petitioner.

Sworn to before me this
16th day of January, 1981.

Cornelius P. Hagelund

[Signature]

STATE OF NEW YORK
STATE TAX COMMISSION

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Personal Income Tax :

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for the Years 1971, 1973. :

State of New York

County of Albany

Jay Vredenburg, being duly sworn, deposes and says that he is an employee of the Department of Taxation and Finance, over 18 years of age, and that on the 16th day of January, 1981, he served the within notice of Decision by certified mail upon Edward H. Hein the representative of the petitioner in the within proceeding, by enclosing a true copy thereof in a securely sealed postpaid wrapper addressed as follows:

Mr. Edward H. Hein
Breed, Abbott & Morgan
Citicorp Center, 153 East 53rd St.
New York, NY 10022

and by depositing same enclosed in a postpaid properly addressed wrapper in a (post office or official depository) under the exclusive care and custody of the United States Postal Service within the State of New York.

That deponent further says that the said addressee is the representative of the petitioner herein and that the address set forth on said wrapper is the last known address of the representative of the petitioner.

Sworn to before me this
16th day of January, 1981.

Conrad G. Huguenot

Jay Vredenburg

STATE OF NEW YORK
STATE TAX COMMISSION
ALBANY, NEW YORK 12227

January 16, 1981

Neil A. & Serena R. McConnell
c/o Williamson & Green
280 Park Ave.
New York, NY 10017

Dear Mr. & Mrs. McConnell:

Please take notice of the Decision of the State Tax Commission enclosed herewith.

You have now exhausted your right of review at the administrative level. Pursuant to section(s) 690 of the Tax Law, any proceeding in court to review an adverse decision by the State Tax Commission can only be instituted under Article 78 of the Civil Practice Laws and Rules, and must be commenced in the Supreme Court of the State of New York, Albany County, within 4 months from the date of this notice.

Inquiries concerning the computation of tax due or refund allowed in accordance with this decision may be addressed to:

NYS Dept. Taxation and Finance
Deputy Commissioner and Counsel
Albany, New York 12227
Phone # (518) 457-6240

Very truly yours,

STATE TAX COMMISSION

cc: Petitioner's Representative
Edward H. Hein
Breed, Abbott & Morgan
Citicorp Center, 153 East 53rd St.
New York, NY 10022
Taxing Bureau's Representative

STATE OF NEW YORK

STATE TAX COMMISSION

In the Matter of the Petition	:	
of	:	
NEIL A. McCONNELL	:	
and	:	DECISION
SERENA R. McCONNELL	:	
for Redetermination of a Deficiency or	:	
for Refund of Personal Income Taxes	:	
under Article 22 of the Tax Law for the	:	
Years 1971 and 1973.	:	

Petitioners, Neil A. McConnell and Serena R. McConnell, c/o Williamson and Green, 280 Park Avenue, New York, New York 10017, filed a petition for redetermination of a deficiency or for refund of personal income taxes under Article 22 of the Tax Law for the years 1971 and 1973 (File No. 14981).

A formal hearing was held before Edward Goodell, Hearing Officer, at the offices of the State Tax Commission, Two World Trade Center, New York, New York, on March 20, 1979 at 9:15 A.M. Petitioners appeared by Breed, Abbott & Morgan, Esqs., (Edward H. Hein, Esq., of counsel). The Audit Division appeared by Peter J. Crotty, Esq. (William Fox, Esq., of counsel).

ISSUE

Whether interest expenses which are reasonable in amount and paid during the years at issue for the production of income constitute allocable expenses under section 623(b) of the Tax Law.

FINDINGS OF FACT

1. Petitioners, Neil A. McConnell and Serena R. McConnell, were New York State residents during 1971 and 1973. They filed joint New York State resident income tax returns for the aforementioned years.

2. The Income Tax Bureau issued a Statement of Audit Changes against petitioners on February 25, 1974 for personal income tax due for the year 1971, recomputing their New York minimum income tax by including in allocable expenses interest of \$927,545.56. In accordance with the aforesaid Statement of Audit Changes, a Notice of Deficiency was issued against petitioners for \$9,237.95, plus interest of \$1,031.32. Since the Income Tax Bureau did not receive a petition within the statutory time provided therefor, it issued a Notice and Demand for Payment of the deficiency. On October 8, 1974, petitioners paid the Income Tax Bureau \$10,269.27, plus additional interest of \$269.57. Petitioners filed a claim for refund of said amount on October 25, 1974.

3. On January 27, 1975, the Income Tax Bureau issued a Statement of Audit Changes against petitioners for 1973 which provided, in part, that:

"As total interest expense in the amount of \$1,152,361.67 was claimed as an itemized deduction on your New York return, this amount must be used in the recomputation of section 615(c)(4) modification. Therefore, we have recomputed the modification as follows:

Modification for Allocable Expenses

Interest		\$1,152,361.67
Taxes		72,465.86
Contributions		<u>1,831,206.79</u>
TOTAL ALLOCABLE EXPENSES		<u>\$3,056,034.32</u>
N.Y. Adjusted Gross Income	\$4,174,427.31	
Total Items of Tax Preference	<u>2,108,069.63</u>	
TOTAL	<u>\$6,282,496.84</u>	
Less: Specific Deduction	5,000.00	
Balance	<u>\$6,277,496.84</u>	
Less:		
	$\frac{\$4,174,427.21}{\$6,277,496.84} \times \$3,056,034.32 =$	<u>\$2,032,210.11</u>
Modification for Allocable Expense		<u>\$1,023,824.11</u>

Accordingly, a Notice of Deficiency was issued therefor, imposing additional income tax of \$53,934.03, with interest of \$3,180.48, for a total of \$57,114.51. Petitioners timely filed a petition for redetermination of said deficiency.

4. During 1971, petitioner Neil A. McConnell paid interest of \$477,291.71 to Bankers Trust Company on his promissory note bearing interest at 1/4 of 1 percent over prime, representing his indebtedness incurred to acquire a \$10,000,000.00, 8 percent convertible note of Pan Ocean Oil Corporation, on which he received \$600,000.00 interest during 1971. During 1973, he received \$732,055.00 in interest income from Pan Ocean Oil Corporation on the convertible note and paid \$725,090.14 in interest expense to Bankers Trust Company on his note.

5. Petitioner Neil A. McConnell's interest payments referred to in Finding of Fact No. "4", above, were ordinary and necessary expenses incurred for the production of interest income received by him on the convertible note of Pan Ocean Oil Corporation and for the possibility of income or gain resulting from an increase in the market price of the Pan Ocean Oil Corporation's common stock, into which such note was convertible.

6. During 1971 and 1973, Mr. McConnell paid interest of \$32,678.35 and \$407,816.38, respectively, on other indebtedness incurred by him to acquire corporate securities and real property which he held as investments. Such interest payments were ordinary and necessary expenses for the production of income.

7. During 1971 and 1973, petitioner Neil A. McConnell paid interest of \$115,697.23 and \$9,330.92, respectively, on loans incurred by him to purchase jet aircraft held and used principally for the production of rental or charter income.

8. During 1971, he paid \$301,878.27 on indebtedness assumed or incurred by him as his contribution to the capital of (or in connection with distribution of assets to him from) partnerships in which he was a general partner. Petitioner Neil A. McConnell's general partnership interest and the assets distributed with respect thereto were held by him for the production of income.

9. None of the interest expense paid by him and referred to above was interest on indebtedness incurred or continued in order to purchase or carry obligations or other property, the income from which was exempt from Federal or New York State income taxes.

10. Petitioner argues that interest paid or incurred in the production of income is deductible under section 212 of the Internal Revenue Code as well as section 163 of the Internal Revenue Code.

CONCLUSIONS OF LAW

A. That section 615(a) of the Tax Law provides that the New York itemized deductions of an individual shall be the total amount of his deductions from Federal adjusted gross income with certain enumerated modifications. During the year at issue, one of the subtractions from a taxpayer's Federal itemized deductions was:

"the deductions for allocable expenses attributable to items of tax preference, as defined in subsection (a) of section six hundred twenty-three, if the sum of the items of tax preference of the taxpayer for the taxable year, as defined in subsection (b) of section six hundred twenty-two, exceed the applicable specific deduction described in subsection (c) of such section." [N.Y. Tax Law §615(c) (4) repealed by L. 1978 Ch.70].

B. That during the year at issue, allocable expenses were defined in section 623(b) to include:

"interest deductible solely by reason of section one hundred sixty-three of the internal revenue code of nineteen hundred fifty-four as modified by the applicable additions provided for in subsection (d) of section six hundred fifteen." [repealed by L. 1978 Ch. 70].

C. That the amount of deduction is to be computed pursuant to the formula contained in section 623(a) of the Tax Law.

D. That the statutory formula makes the enumerated Federal itemized deductions subject to reduction, whether or not the associated expenses have any relation to the item of tax preference subject to the minimum tax.

E. That "there shall be allowed as a deduction all interest paid or accrued within the taxable year on indebtedness". Section 163(a) of the Internal Revenue Code (emphasis added).

That "in the case of an individual, there shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year -

(1) for the production or collection of income;..."

Section 212 of the Internal Revenue Code.

Since all interest paid or accrued is deductible under section 163(a) of the Internal Revenue Code, except interest expenses paid or incurred in carrying on any trade or business which is deductible under section 162(a) of the Internal Revenue Code, no deduction for interest expense is allowed under section 212 of the Internal Revenue Code.

Section 212 of the Internal Revenue Code had neither the purpose nor the effect of enlarging the area of allowable deductions; it provides for a class of deductions coextensive with "business" deductions except for the requirement that the income-producing activity be a trade or business.

Walton O. Hewett, 47 T.C. 483. Since the purpose of the section was not to enlarge the area of allowable deductions but to allow investors to deduct other expenses which were not already provided for in the Code for non-business income, interest expense deductions would not be deductible under section 212. Further, section 163(d) of the Code provides for a limitation on interest on investment indebtedness and a deduction of interest under section 212 of the Code would circumvent this limitation.

F. That in the context of sections 623 and 622 of the Tax Law considered as a whole, the word "solely" is intended to distinguish interest which relates to business or rental income that is deductible in computing adjusted gross

income from interest deductible only as an itemized deduction.

G. That the Audit Division is directed to recompute the modification for allocable expenses by reducing the interest expense by the interest amounts shown in Finding of Fact "7", supra, since these interest amounts are related to the production of rental or charter income.

H. That the interest expense, other than the interest expense referred to in Finding of Fact "7", supra, constituted allocable expenses attributable to items of tax preference within the meaning and intent of sections 623(b) and 615(c) of the Tax Law.

I. That the claim of petitioners for a refund for 1971 is allowed to the extent determined under Conclusion of Law "G", supra, and in all other respects is denied; and that the petition of Neil A. McConnell and Serena R. McConnell for 1973 is granted to the extent determined under Conclusion of Law "G", supra, and in all other respects is denied.

DATED: Albany, New York

JAN 16 1981

STATE TAX COMMISSION


PRESIDENT


COMMISSIONER


COMMISSIONER