

STATE OF NEW YORK

STATE TAX COMMISSION

In the Matter of the Petition :
of :
Ted & Theresa Sobiech : AFFIDAVIT OF MAILING
for Redetermination of a Deficiency or Revision :
of a Determination or Refund of Personal Income & :
UBT under Article 22 & 23 of the Tax Law for the :
Years 1974 - 1976. :

State of New York }
County of Albany } ss.:

David Parchuck, being duly sworn, deposes and says that he is an employee of the State Tax Commission, that he is over 18 years of age, and that on the 20th day of January, 1984, he served the within notice of Decision by certified mail upon Ted & Theresa Sobiech, the petitioner in the within proceeding, by enclosing a true copy thereof in a securely sealed postpaid wrapper addressed as follows:

Ted & Theresa Sobiech
Pine Island, NY 10969

and by depositing same enclosed in a postpaid properly addressed wrapper in a post office 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
20th day of January, 1984.

David Parchuck

William A. Hagedorn
pursuant to Tax Law section 174

Authorized to administer oaths

STATE OF NEW YORK

STATE TAX COMMISSION

In the Matter of the Petition :
of :
Ted & Theresa Sobiech : AFFIDAVIT OF MAILING
for Redetermination of a Deficiency or Revision :
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UBT under Article 22 & 23 of the Tax Law for the :
Years 1974 - 1976. :

State of New York }
County of Albany } ss.:

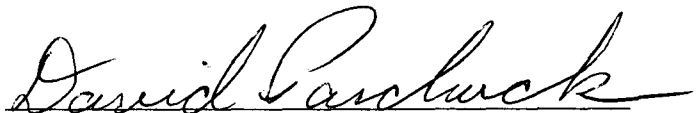
David Parchuck, being duly sworn, deposes and says that he is an employee of the State Tax Commission, that he is over 18 years of age, and that on the 20th day of January, 1984, he served the within notice of Decision by certified mail upon Jack Judelson, the representative of the petitioner in the within proceeding, by enclosing a true copy thereof in a securely sealed postpaid wrapper addressed as follows:

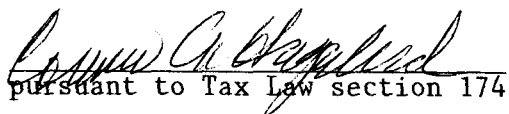
Jack Judelson
12 South St.
Middletown, NY 10940

and by depositing same enclosed in a postpaid properly addressed wrapper in a post office 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
20th day of January, 1984.




pursuant to Tax Law section 174

Authorized to administer oaths

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

January 20, 1984

Ted & Theresa Sobiech
Pine Island, NY 10969

Dear Mr. & Mrs. Sobiech:

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 & 722 of the Tax Law, a proceeding in court to review an adverse decision by the State Tax Commission may be instituted only under Article 78 of the Civil Practice Law 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
Law Bureau - Litigation Unit
Building #9, State Campus
Albany, New York 12227
Phone # (518) 457-2070

Very truly yours,

STATE TAX COMMISSION

cc: Petitioner's Representative
Jack Judelson
12 South St.
Middletown, NY 10940
Taxing Bureau's Representative

STATE OF NEW YORK

STATE TAX COMMISSION

In the Matter of the Petition :
of :
TED and THERESA SOBIECH : DECISION
for Redetermination of a Deficiency or for :
Refund of Personal Income and Unincorporated :
Business Taxes under Articles 22 and 23 of the :
Tax Law for the Years 1974, 1975 and 1976. :

Petitioners, Ted and Theresa Sobiech, Pine Island, New York 10969, filed a petition for redetermination of a deficiency or for refund of personal income and unincorporated business taxes under Articles 22 and 23 of the Tax Law for the years 1974, 1975 and 1976 (File No. 28630).

A formal hearing was held before Dennis M. Galliher, Hearing Officer, at the offices of the State Tax Commission, Building 9, State Office Campus, Albany, New York on May 9, 1983 at 10:45 A.M., with all briefs to be submitted by July 25, 1983. Petitioners appeared by Judelson, Rosen, Sommerstein & Giordano, C.P.A.'s (Jack Judelson, C.P.A.). The Audit Division appeared by John P. Dugan, Esq. (Harry Kadish, Esq., of counsel).

ISSUE

Whether the Audit Division's disallowance of a portion of the deductions claimed by petitioners for salary expenses paid to family members during the years at issue was proper.

FINDINGS OF FACT

1. Petitioners, Ted and Theresa Sobiech, timely filed separate New York State Resident Income Tax Returns (on combined forms) for each of the years 1974, 1975 and 1976. Petitioner Ted Sobiech also timely filed New York State

Unincorporated Business Tax Returns (Form IT-202) for each of the years 1974 through 1976.

2. On April 13, 1979, the Audit Division issued to petitioners a Notice of Deficiency asserting additional tax due for the years 1974, 1975 and 1976 in the amounts of \$3,283.70, \$8,217.26 and \$6,847.77, respectively, plus penalty and interest for each year. A validated consent had been previously executed by petitioners' duly authorized representative allowing the assessment of personal income and unincorporated business taxes for the years 1974 and 1975 to be made at any time on or before April 15, 1980.

3. A Statement of Audit Changes also issued to petitioners on April 13, 1979, contained the calculations underlying the aforementioned deficiency together with the explanation that such deficiency resulted from the Audit Division's disallowance of deductions claimed by petitioners for repair and maintenance of buildings and grounds and for salary expenses on payments made to family members. This Statement further specified that the penalty was asserted for each year pursuant to section 685(b) of the Tax Law (deficiency due to negligence).

4. As the result of a pre-hearing conference, at which petitioners submitted evidence in substantiation of the claimed deduction for repair and maintenance expenses, the Audit Division reduced the original deficiency for 1974, 1975 and 1976, and now asserts additional tax due for such years in the amounts of \$1,970.35, \$3,046.25 and \$402.21, respectively, plus penalty and

interest¹. These reduced amounts asserted as due are based solely on the disallowance of claimed deductions for salary expenses on payments made to family members which payments were returned as alleged loans to petitioners' business, in the aggregate amounts of \$13,020.00, \$13,380.00 and \$13,835.00 for the years 1974, 1975 and 1976, respectively.

5. Petitioners own and operate a large farm consisting of approximately 550 acres of land located in Pine Island, New York. Petitioners have operated the farm since the early 1950s, growing and selling, at wholesale, celery, lettuce and onions. The farm is operated as a sole proprietorship with a double entry accounting system maintained on the cash basis. The farm operates year round, with the peak season spanning the months of June, July and August.

6. Both Mr. and Mrs. Sobiech, as well as their three sons, Thaddeus (Ted, Jr.), Tom and Leon, are involved in the farm's operation. Mrs. Sobiech worked primarily in the farm's office, supervising the two or three employees working there, while Mr. Sobiech and the three sons were directly involved in all aspects of the daily physical operation of the farm, including equipment operation and maintenance, supervision of employees, planting, harvesting, etc. During the years at issue, the farm employed approximately seventy persons, of whom approximately one-half were migrant workers. In general, these employees were paid on a weekly basis.

¹ In computing the unincorporated business tax portion of the reduced deficiency, the Audit Division omitted an investment tax credit for 1975 allowed to petitioners in the amount of \$489.08. Accordingly, the asserted deficiency for 1975 is further reduced to \$2,557.17 (\$3,046.25 less \$489.08). Similarly, an investment tax credit of \$533.94 against unincorporated business tax due for 1976 was omitted in the Audit Division's recalculation. Accordingly, said credit is to be applied against the revised unincorporated business tax portion of the deficiency for 1976 (\$439.79), thus reducing such portion of the deficiency to \$-0-.

7. The circumstances by which the disallowed deductions for claimed salary expenses at issue herein arose are as follows:

- a. Toward the end of each year, petitioner Ted Sobiech's accountant would bring the farm's records up to date to determine the "tax picture";
- b. Mr. Sobiech would then confer with his accountant and determine the amounts to be paid to Mrs. Sobiech and to the three sons. It is asserted that these amounts, as determined by Mr. Sobiech, reflected a fair salary in light of the efforts and contributions made by the family members in the operation of the farm;
- c. After determination of the above amounts by Mr. Sobiech, two checks were drawn for each family member, together totalling the amount previously decided to be paid to that particular family member. One such check was kept by the family member, whereas the other check was immediately indorsed over to the business by the family member as an alleged loan for use in the business;
- d. The funds from those checks returned to the business by the family members were then used by the business to purchase fertilizer, supplies, seeds and other items.

8. The issuance of the checks to the family members, the return immediately thereafter of one check by each family member to the business and the subsequent purchase of fertilizer, seeds, etc. by the business all occurred prior to the close of each year. Actual payments, here by the physical issuance of checks, were made because the taxpayers utilized the cash basis of accounting. Accordingly, petitioners' claimed deductions for both the salary expense payments and for the purchase of seeds and fertilizer.

9. The foregoing plan was suggested to petitioners by their accountant, was commenced at the end of 1974 and was continued thereafter during each of the years at issue. Mr. Sobiech determined both the amount to be paid as salary and the amount to be returned to the business by each family member, with no input from the family in the determination of such amounts.

10. Mrs. Sobiech was paid \$7,800.00 during each of the years at issue and included this amount as income subject to tax on each of the New York State Income Tax Returns filed by petitioners. In 1974, Mrs. Sobiech returned to the business \$5,800.00 out of the \$7,800.00 paid to her. In 1975 and 1976, Mrs. Sobiech returned \$4,800.00 out of the \$7,800.00 paid to her.

11. In 1974, the three sons were ages 19, 17 and 15, and were paid \$4,680.00, \$3,640.00 and \$2,600.00, respectively. The eldest son, Ted, Jr., returned to the business \$3,280.00 out of the \$4,680.00 paid to him. Individual amounts returned by the two younger sons in 1974 were not specified, nor were individual amounts paid to (and the portion thereof returned by) the three sons in 1975 and 1976 specified.

12. Wage and Tax Statements (Forms W-2) were prepared for each of the three sons during the years at issue and were attached to New York State Income Tax Returns filed by the sons during those years.²

13. In 1974, Ted, Jr. was out of school and worked on the farm all year long. The two younger sons presumably were still in school during the major portion of that year. It was noted that the year-end payments to the three sons increased each year as the sons grew older. In this regard, petitioners assert that the three sons' spending needs were more limited in the earlier years.

14. The amounts returned to the business by the family members were reflected as loans on the books of the business. No formal loan agreements, notes or other documents evidencing the amounts returned to the business were executed.

² Petitioner's representative noted that the children were not subject to withholding tax or social security requirements due to their ages and the fact that they were working on a farm and were employed by their family.

15. During the years at issue, there was no agreement or discussion as to when the loans would be repaid, nor was any portion of the loans repaid to the family members. No interest rate was specified on the loans nor was any interest paid on such loans during the years at issue. Petitioners' accountant noted that no interest was paid in 1974 because the first loans back to the business by the family did not occur until the end of 1974 (hence there was no debt during 1974 on which to compute interest), and testified that no interest was calculated or paid in 1975 and 1976 because the accumulated amounts of money loaned (\$13,020 in 1975; \$26,400 in 1976) were felt to be not material. Finally, it was asserted that interest has been paid to the family members for each year after 1976. Petitioners' 1979 year-end statement of financial condition (for the business) reflected as a liability \$78,000.00 "owed to family". No such statements reflecting the loans during the years at issue were provided at the hearing.

16. The amounts paid to Mrs. Sobiech and the three sons were determined by Mr. Sobiech at each year's end, and no records were maintained as to the hours worked and efforts expended by the family members on the farm during the years at issue.

17. Petitioners' representative admitted that the farm's (projected) profit was a "consideration" in determining the amounts paid to the family members as salaries, but asserted the salaries had very little to do with the farm's bottom line.

18. Petitioners assert that the farm was operated by the family unit and that the entire family, including Mrs. Sobiech and the three sons were directly involved in working on the farm. In view of this, petitioners assert that there was nothing wrong with a portion of the salary payments being loaned back

to the business to contribute to its successful operation. Finally, it is asserted that petitioners could have achieved the same end result by borrowing from banks or financial institutions.

19. The Audit Division does not raise issue with or question the reasonableness of the amounts paid to the family members as salaries, but rather questions the propriety of the deductions in light of the entire circumstances as detailed.

CONCLUSIONS OF LAW

A. That the propriety of deducting bona fide salaries paid to family members is not disputed. However, the ultimate determination concerning the tax consequences of petitioners' actions (i.e. the propriety of deducting as salary expense the amounts paid to family members which were subsequently returned by them to the business), "...must turn upon (the) economic substance of the transaction and not upon the time sequence or form of the transaction, and the courts will look beyond the superficial formalities of the transaction to determine the proper tax treatment. (citations omitted)". Parkhill v. United States, 385 F. Supp. 204 (1974). In short, the substance and not the form of the transaction must govern (see Commissioner v. Danielson, 378 F.2d 771 [3rd Circuit, 1967]).

B. That under the facts and circumstances presented herein, the Audit Division's disallowance of a portion of petitioners' claimed deductions for salary expense was proper (see McClellan, Jr. v. Tomlinson, 18 A.F.T.R.2d 5720, aff'd. 394 F.2d 513 (5th Circuit, 1968); see also Parkhill, supra.). It is noted that the total salary amounts as well as the portions thereof to be returned by each family member were determined solely by Mr. Sobiech, that the portions of payment to be returned to the business, while in check form payable


to the individual family members, were indorsed and returned to the business immediately following payment to the family members, and that no interest was booked or paid on the loans during the years at issue nor was any provision for repayment discussed or set up. It is apparent that no substantive control was exercised by the individual family members over the amounts labelled as salary but returned to the business. Accordingly, the circumstances herein do not support, as asserted, the payment of bona fide salaries, but rather indicate a plan whereby funds, but not control thereover, changed hands solely for the purpose of enabling petitioners to claim a deduction.

C. That the petition of Ted and Theresa Sobiech is hereby denied and the Notice of Deficiency issued on April 13, 1979, as reduced in accordance with Finding of Fact "4" and Footnote "1", together with such interest and penalty as may be lawfully owing, is sustained.


DATED: Albany, New York

STATE TAX COMMISSION

JAN 20 1984


PRESIDENT


COMMISSIONER


COMMISSIONER

