

STATE OF NEW YORK

STATE TAX COMMISSION

In the Matter of the Petition :
of :
Donald J. & Elizabeth Friedman : AFFIDAVIT OF MAILING
for Redetermination of a Deficiency or for :
Refund of Personal Income Tax under Article 22 :
of the Tax Law for the Year 1981. :

State of New York :

ss.:

County of Albany :

David Parchuck/Janet M. Snay, being duly sworn, deposes and says that he/she is an employee of the State Tax Commission, that he/she is over 18 years of age, and that on the 15th day of September, 1986, he/she served the within notice of Decision by certified mail upon Donald J. & Elizabeth Friedman the petitioners in the within proceeding, by enclosing a true copy thereof in a securely sealed postpaid wrapper addressed as follows:

Donald J. & Elizabeth Friedman
c/o L. F. Rothschild, Unterberg, Towbin
55 Water Street
New York, New York 10041

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
15th day of September, 1986.

David Parchuck
Authorized to administer oaths
pursuant to Tax Law section 174

Janet M. Snay

STATE OF NEW YORK

STATE TAX COMMISSION

In the Matter of the Petition :
of :
David A. & Bonnie L. Kirschenbaum : AFFIDAVIT OF MAILING
for Redetermination of a Deficiency or for :
Refund of Personal Income Tax under Article 22 :
of the Tax Law for the Year 1981. :

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


David Parchuck/Janet M. Snay, being duly sworn, deposes and says that he/she is an employee of the State Tax Commission, that he/she is over 18 years of age, and that on the 15th day of September, 1986, he/she served the within notice of Decision by certified mail upon David A. & Bonnie L. Kirschenbaum the petitioners in the within proceeding, by enclosing a true copy thereof in a securely sealed postpaid wrapper addressed as follows:

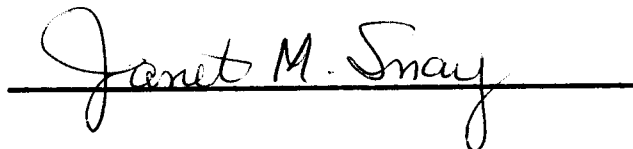
David A. & Bonnie L. Kirschenbaum
c/o L. F. Rothschild, Unterberg, Towbin
55 Water Street
New York, NY 10041

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.

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In the Matter of the Petition :
of :
Donald J. & Elizabeth Friedman : AFFIDAVIT OF MAILING
for Redetermination of a Deficiency or for :
Refund of Personal Income Tax under Article 22 :
of the Tax Law for the Year 1981. :

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

David Parchuck/Janet M. Snay, being duly sworn, deposes and says that he/she is an employee of the State Tax Commission, that he/she is over 18 years of age, and that on the 15th day of September, 1986, he served the within notice of Decision by certified mail upon Michael L. Schler, the representative of the petitioners in the within proceeding, by enclosing a true copy thereof in a securely sealed postpaid wrapper addressed as follows:

Michael L. Schler
Cravath, Swaine & Moore
One Chase Manhattan Plaza
New York, NY 10005

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
15th day of September, 1986.

David Parchuck
Authorized to administer oaths
pursuant to Tax Law section 174

Janet M. Snay

STATE OF NEW YORK

STATE TAX COMMISSION

In the Matter of the Petition :
of :
David A. & Bonnie L. Kirschenbaum : AFFIDAVIT OF MAILING
for Redetermination of a Deficiency or for :
Refund of Personal Income Tax under Article 22 :
of the Tax Law for the Year 1981. :

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

David Parchuck/Janet M. Snay, being duly sworn, deposes and says that he/she is an employee of the State Tax Commission, that he/she is over 18 years of age, and that on the 15th day of September, 1986, he served the within notice of Decision by certified mail upon Michael L. Schler, the representative of the petitioners in the within proceeding, by enclosing a true copy thereof in a securely sealed postpaid wrapper addressed as follows:

Michael L. Schler
Cravath, Swaine & Moore
One Chase Manhattan Plaza
New York, NY 10005

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
15th day of September, 1986.

David Parchuck
Authorized to administer oaths
pursuant to Tax Law section 174

Janet M. Snay

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

September 15, 1986

Donald J. & Elizabeth Friedman
c/o L. F. Rothschild, Unterberg, Towbin
55 Water Street
New York, New York 10041

Dear Mr. & Mrs. Friedman:

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, 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
Audit Evaluation Bureau
Assessment Review Unit
Building #9, State Campus
Albany, New York 12227
Phone # (518) 457-2086

Very truly yours,

STATE TAX COMMISSION

cc: Taxing Bureau's Representative

Petitioner's Representative:
Michael L. Schler
Cravath, Swaine & Moore
One Chase Manhattan Plaza
New York, NY 10005

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

September 15, 1986

David A. & Bonnie L. Kirschenbaum
c/o L.F. Rothschild, Unterberg, Towbin
55 Water Street
New York, NY 10041

Dear Mr. & Mrs. Kirschenbaum:

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, 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.

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Very truly yours,

STATE TAX COMMISSION

cc: Taxing Bureau's Representative

Petitioner's Representative:
Michael L. Schler
Cravath, Swaine & Moore
One Chase Manhattan Plaza
New York, NY 10005

STATE OF NEW YORK

STATE TAX COMMISSION

In the Matter of the Petition	:	
of	:	
DONALD J. and ELIZABETH FRIEDMAN	:	DECISION
for Redetermination of a Deficiency or for	:	
Refund of Personal Income Tax under Article 22	:	
of the Tax Law for the Year 1981.	:	

In the Matter of the Petition	:
of	:
DAVID A. and BONNIE L. KIRSCHENBAUM	:
for Redetermination of a Deficiency or for	:
Refund of Personal Income Tax under Article 22	:
of the Tax Law for the Year 1981.	:

Petitioner, Donald J. and Elizabeth Friedman, c/o L. F. Rothschild, Unterberg, Towbin, 55 Water Street, New York, New York 10041, 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 1981 (File No. 58751).

Petitioner, David A. and Bonnie L. Kirschenbaum, c/o L. F. Rothschild, Unterberg, Towbin, 55 Water Street, New York, New York 10041, filed a petition for redetermination of a deficiency or for refund of personal income tax under Article 22 of the Tax Law for the years 1981 (File No. 58559).

On July 25, 1985, petitioners advised the State Tax Commission, in writing, that petitioners desired to waive a formal hearing and to submit the case to the State Tax Commission, with all briefs and documents to be submitted by January 3, 1986. After due consideration of the entire file, the State Tax Commission renders the following decision.

ISSUES

I. Whether petitioners' distributive share of expenses should be allocated between personal service income and non-personal service income.

II. Whether the Audit Division properly declined to increase each of petitioners' personal service income by his distributive share of the modifications provided for in Tax Law sections 612(b)(1), (3) and (4).

III. Whether the Audit Division properly reduced each petitioner's personal service income by his distributive share of the modifications provided for in Tax Law sections 612(c)(1), (7) and (10).

IV. Whether the Audit Division properly determined that petitioners' distributive share of the partnership net short term capital gains, interest and dividend income did not constitute personal service income.

FINDINGS OF FACT

Prior to the submission herein, petitioners and the Audit Division entered into the following stipulation of facts which is set forth, in relevant part, as follows:

The Partnership

1. In 1981, L. F. Rothschild, Unterberg, Towbin ("Partnership") was a partnership located at 55 Water Street, New York, New York 10041. It reported income on a calendar year basis and used the accrual method of accounting.

2. The Partnership was and is a securities broker-dealer engaged in investment banking, the trading of securities for customers and for its own account, and miscellaneous other business activities. In 1981, the Partnership had 60 general partners, 8 limited partners, and approximately 1,500 employees.

3. On its 1981 New York State Partnership Return, the Partnership reported an ordinary loss (before New York State modifications) of \$22,399,419.00 computed as follows:

Gross receipts	\$144,824,671.00	
Dividends not qualifying for exclusion under I.R.C. section 116	9,929.00	
Other income not separately reportable on Schedule K	<u>743,433.00</u>	
Total Income		\$145,578,033.00
Salaries and wages	\$63,013,101.00	
Guaranteed payments to partners	21,821,536.00	
Rent	4,056,323.00	
Interest	35,989,309.00	
Taxes	3,969,120.00	
Bad debts	333,891.00	
Depreciation	1,344,744.00	
Amortization	486,244.00	
Retirement plans	1,301,540.00	
Employee benefit programs	932,657.00	
Other deductions	<u>34,728,987.00</u>	
Total Deductions		<u>167,977,452.00</u>
ORDINARY INCOME (LOSS)		<u>(\$ 22,399,419.00)</u>

In addition, on Federal Schedule K-1 attached to the New York State partnership return, the Partnership reported the following separately stated items of income and expense, before New York State modifications:

Interest qualifying for exclusion under I.R.C. sec. 116	\$ 5,304,082.00
Dividends qualifying for exclusion under I.R.C. sec. 116	2,162,260.00
Net short-term capital gain	27,065,691.00
Net long-term capital gain	3,711,988.00
Deduction for charitable contributions	87,725.00
Foreign taxes paid	167,865.00

4. The Partnership also reported the following New York State modifications to its income and deductions as reported for Federal income tax purposes:

Additions to Federal Amounts

New York City Unincorporated Business Tax paid	\$1,080,000.00	
Interest paid to carry bonds exempt from New York State income tax	592,986.00	
Interest received on municipal bonds not exempt from New York State income tax	<u>1,746,225.00</u>	
Total Additions		\$3,419,211.00

Subtractions from Federal Amounts

Interest received on U.S. government bonds	\$ 1,061,705.00	
Interest paid to carry bonds exempt from Federal income tax	1,030,596.00	
Refund of New York State Unincorporated Business Tax	<u>604,206.00</u>	
Total Subtractions		<u>2,696,507.00</u>
NET MODIFICATION		<u>\$ 722,704.00</u>

5. Based on the items of income set forth in paragraph 3 above, municipal bond interest income not exempt from New York State income tax as set forth in paragraph 4 above, and \$124,267.00 of municipal bond interest income exempt from New York State tax, the Partnership's total gross income in 1981 was \$185,692,546.00 computed as follows:

Gross ordinary income other than interest and dividends		
Gross receipts	\$107,071,453.00 ¹	
Other income separately reportable	<u>743,433.00</u>	\$107,814,886.00
Dividends		
Excludable under I.R.C. section 116	\$ 2,162,260.00	
Non-excludable under I.R.C.		

1 This consists of gross receipts of \$144,824,671.00 reported on the New York State Partnership Return, line 1, reduced by \$37,753,218.00 of interest income included therein.

section 116	9,929.00	2,172,189.00
Interest		
Exempt from Federal income tax	\$ 1,870,492.00	
Excludable under I.R.C.		
section 116	5,304,082.00	
Non-excludable under I.R.C.		
section 116	37,753,218.00	44,927,792.00
Net short-term capital gain		27,065,691.00
Net long-term capital gain		3,711,988.00
TOTAL GROSS INCOME (LOSS)		<u>\$185,692,546.00</u>

6. The Partnership's gross ordinary income (other than interest and dividends) of \$107,814,886.00 in 1981 was principally attributable to the following activities:

Brokerage Commissions -- \$47.6 million (net of \$3.8 million of floor brokerage expense). The Partnership bought and sold securities as the agent of its customers.

Investment Advisory Fees -- \$3.5 million. The Partnership advised corporate and union pension funds on their investments.

Block Stock Trading -- (\$0.3 million). When a customer wished to sell a large block of securities, the Partnership would sell as much as was practicable as agent of the customer and would buy the remainder for its own account for later resale.

Syndicate and Corporate Finance Income -- \$44.8 million. The Partnership received a fee for managing or co-managing underwritings of corporate and municipal securities, and received a selling allowance when it participated in an underwriting syndicate (either as a manager, co-manager or participant). In addition, the Partnership assisted corporations and partnerships in obtaining financing for business transactions.

Market-Making -- \$11.5 million. The Partnership made a market in certain corporate securities. Such market-making activities involved the buying and selling of such securities on the over-the-counter market.

Miscellaneous -- \$0.7 million. Includes other fee income (e.g., deferred annuity income, service charges, etc.) and various other income items.

7. Of the Partnership's \$2,172,189.00 of dividend income in 1981, \$37,844.00 was received on securities held by the Partnership in its dealer accounts and the remainder was received on securities held in the Partnership's own trading accounts.

8. The Partnership's interest income of \$44,927,792.00 in 1981 was earned as follows:

Interest income received on		
retail customer margin accounts		\$37,753,218.00 ²
Interest on securities held in		
Partnership trading accounts		
Exempt from Federal income tax	\$1,652,498.00	
Taxable	<u>5,180,023.00</u>	6,832,521.00
Interest on securities held in		
Partnership dealer accounts		
Exempt from Federal income tax	\$ 217,994.00	
Taxable	<u>124,059.00</u>	<u>342,053.00</u>
TOTAL INTEREST INCOME		<u>\$44,927,792.00</u>

9. The Partnership's capital gains in 1981 were derived almost entirely from the trading of securities for its own account. All such securities generating capital gain and loss were held in the Partnership's trading accounts. Furthermore, with the exception of a small amount of ordinary income generated by option trading by the arbitrage department and noted below, trading activities generated only capital gain and loss. Two divisions of the Partnership, the fixed-income trading area and the arbitrage department, were responsible for all such trading activities.

(a) The fixed-income trading area, composed of the municipal bond, corporate bond and Treasury trading departments, traded fixed income securities

2 As noted in footnote 1 above, this amount was reported as a component of gross receipts on the New York State Partnership Return, line 1.

(i.e., debt instruments and preferred stock) issued by corporations, the Federal government, and state and local governments. Fixed-income trading activities generated a net short-term capital gain of \$16,600,597.00 in 1981.

(b) The arbitrage department traded corporate securities such as common stock, debt convertible into common stock, and options on common stock, generating \$10,465,094.00 of net short-term capital gain and \$3,485,989.00 of net long-term capital gain in 1981. Such trading was the only activity of the arbitrage department.

(c) Miscellaneous non-trading activities of the Partnership generated \$225,999.00 of net long-term capital gain in 1981.

10. Of the Partnership's approximately 1,500 employees in 1981, approximately 50 were traders in the fixed-income trading area or arbitrage department, approximately 900 were directly involved in producing ordinary gross income, and approximately 550 were support and service personnel not in direct income-producing areas.

11. In 1981, the Partnership, pursuant to the Articles of Limited Partnership of L. F. Rothschild, Unterberg, Towbin, effective as of January 1, 1981 ("partnership agreement"), made guaranteed payments to its general and limited partners for the use of contributed capital. The average amount of such capital in 1981 was approximately \$50,000,000.00 and the total amount of such payments in that year was \$8,238,429.00.

12. In 1981, the Partnership made guaranteed payments to its partners totalling \$13,583,107.00 as compensation for services rendered by them to the Partnership. The parties to this stipulation do not agree whether such payments constituted the only compensation paid by the Partnership to its partners in 1981.

13. In addition to guaranteed payments for services and capital, each partner received a distributive share of the Partnership's net book profit for 1981. Generally, partners shared such profit in the percentages ("basic percentages") set forth in the partnership agreement; however, where such profit was attributable to gains or losses arising from the disposition of assets acquired by the Partnership prior to 1981, the portion of such gains or losses attributable to prior years would be shared by the partners in the percentages set forth in the partnership agreements for such years. Pursuant to the partnership agreement, each partner was entitled to different basic percentages of net profit attributable to arbitrage trading and net profit attributable to Partnership activities other than arbitrage; generally, partners working in the arbitrage department were entitled to a greater basic percentage of arbitrage net profit than partners working in other areas of the Partnership. Different types of income (i.e., capital gain, ordinary income, tax-exempt, etc.) were not separated out in determining either type of net profit; instead, only a single "bottom line" figure for each type of net profit was calculated.

14. In 1981, the Partnership incurred \$35,989,309.00 of interest expenses on bank loans and subordinated loans totalling approximately \$210,000,000.00.

15(a). In 1981, the Partnership maintained internal books of account allocating profits and expenses among various departments and branches. The following income and expense figures have been determined from the books of the arbitrage department for 1981:

Income

Interest on securities held in trading accounts	\$ 2,070,114.00
Dividends on securities held in trading accounts	2,147,374.00

Net short-term capital gain	10,465,094.00	
Net long-term capital gain ³	3,485,989.00	
Other ordinary income	<u>94,067.00</u>	
Gross Trading Profit		\$18,262,638.00
<u>Expenses</u>		
Interest charges	\$12,173,104.00	
Guaranteed payments to partners for services	313,351.00	
Employees' compensation-- arbitrage department	1,080,169.00	
Commissions paid to non- arbitrage department partners and employees	681,753.00	
Other direct expenses (including communications, occupancy and equipment expenses, draft charges, etc.)	1,965,205.00	
Indirect expenses (including allocable share of service department expenses and general overhead) ⁴	<u>1,346,826.00</u>	
Gross Deductions		<u>17,560,408.00</u>
NET PROFIT		<u>\$ 702,230.00</u>

(b) The interest charges represent the cost of funds employed by the arbitrage department in maintaining positions in trading securities. Such amounts were specifically charged to the department on the Partnership's books for 1981, and were based on the Partnership's cost of funds (bank loans,

3 Profits from trading put and call options.

4 Indirect expenses equal 33-1/3% of direct expenses excluding interest. This calculation of indirect expenses is based on data compiled by the Partnership in the early 1980's and used for certain internal purposes; such data showed that indirect expenses for both trading and nontrading departments generally equalled 1/3 of those departments' direct expenses other than interest.

subordinated loans, and guaranteed payments for capital) as applied to the total daily net cost of securities held in the department's trading accounts.

(c) In 1981, the Partnership generally borrowed from banks against the securities held in its arbitrage trading accounts to the maximum extent possible; usually the Partnership was able to borrow up to 75-95% of each such security's fair market value.

(d) The expenses for commissions represents payments made to non-arbitrage employees and partners in connection with specific purchases and sales by the arbitrage department.

16. The following income and expense figures attributable to fixed-income trading activities have been determined from the books of the departments composing the fixed-income trading area for 1981:

Income

Interest on securities held in trading accounts	\$ 4,762,407.00	
Dividends on securities held in trading accounts	350.00	
Net short-term capital gain	16,600,597.00	
Gross Trading Profit		\$21,363,354.00

Expenses

Interest charges ⁵	\$ 7,098,672.00
Guaranteed payments to partners for services	567,164.00
Employees' compensation--fixed-income trading departments	967,223.00
Commissions paid to non-fixed-income trading partners and employees	6,343,650.00

5 Interest charges were determined in a manner analogous to that described above for the arbitrage department.

Other direct expenses (including communications, occupancy and equipment expenses, draft charges, etc.) ⁶	1,760,836.00	
Indirect expenses (including allocable share of service department expenses and general overhead) ⁷	<u>3,212,958.00</u>	
Gross Deductions		<u>19,950,503.00</u>
NET PROFIT		<u>\$ 1,412,851.00</u>

17. In 1981, as in prior years, the Partnership made "interestman" payments to certain non-partner employees. Such payments were based on a fixed percentage of the Partnership's net book profit, as determined after excluding 20% of arbitrage net book profit and without deduction for interestman payments. In calculating net profit for interestman purposes, different types of income, i.e., capital gain, ordinary income, tax-exempt, etc., were not separated out, but, rather, only a single "bottom line" figure was calculated. Designed to compensate an employee for his contribution to the Partnership's profitability, interestman payments were generally comparable in amount to non-guaranteed payments (profit shares) allocated to partners and, in some cases, were given to employees who later became partners. Approximately 30 employees received such payments in 1981. Of the seven persons who became partners on January 1, 1981, two had received interestman payments in prior years.

6 \$1,152,045.00 of this amount constitutes expenses directly charged to trading accounts on the Partnership's books. The remaining \$608,791.00 representing 66% of remaining direct expenses of the municipal bond, corporate bond and Treasury trading departments, was allocated to trading activities based on the percentage (66%) that compensation and guaranteed payments paid by those departments to trading employees and partners represented of total compensation paid by those departments to all employees.

7 See footnote 4 above.

Donald J. Friedman

18. Donald J. Friedman was a resident of New York State during the 1981 taxable year, residing at 118 Valley View Road, Chappaqua, New York 10514. Mr. Friedman was a calendar year taxpayer and used the cash method of accounting.

19. During 1981, Mr. Friedman was a general partner of the Partnership.

20. In 1981, Mr. Friedman worked as an arbitrage trader for the Partnership. In that year, two partners, in addition to Mr. Friedman, and twenty-two employees worked in the department. Of these, one partner and three employees were engaged in researching and identifying securities of significant growth potential, two partners and fourteen employees were engaged in actual trading for the department, and five employees were employed in clerical positions. In 1981, Mr. Friedman managed the department's daily trading activities. Typical trading activities might include purchasing the shares of the target company in a tender offer, trading put and call options on corporate stock, or purchasing convertible bonds trading at or below the value of the underlying shares. At the beginning of each business day, Mr. Friedman and the two other partners in the arbitrage department would determine which securities bore watching that day. Mr. Friedman and his colleagues might learn of such securities in a variety of ways. For example, they might notice unusually heavy trading activity in the stock of a particular company, or read of an upcoming tender offer in a trade journal. Once the most promising opportunities had been identified, Mr. Friedman would assume primary responsibility for the daily monitoring of the relevant securities and the directing of the department's traders. Thus, based on his review of market conditions, he might instruct the traders to increase the Partnership's position in the stock of one company or to liquidate its position in options on another company's shares; frequently,

Mr. Friedman's responsibilities would require him to make on-the-spot decisions. Furthermore, Mr. Friedman would actually execute many of the department's trades, sometimes accounting for up to 50% of the volume of arbitrage trades on a given day.

21. In 1981, broker-dealers similar to the Partnership commonly paid nonpartner employees holding positions comparable to that of Mr. Friedman total compensation on a par with Mr. Friedman's total profit from the Partnership in 1981 of \$697,264.00. Such compensation would normally include a profit sharing component determined on a basis comparable to Mr. Friedman's share of Partnership items. For example, Mr. Guy P. Wyser-Pratte, executive vice-president in charge of Bache Halsey Stuart Shields Inc.'s arbitrage department, received total compensation, including profit sharing, commissions and director's fees of \$1,611,321.00 for the fiscal year ending July 31, 1981, the last full fiscal year for which such information is publicly available, as reported on Form 10-K for the calendar year 1980 filed with the SEC. Moreover, around 1981, Mr. Friedman himself received a number of offers from competitors of the Partnership offering employment in their arbitrage departments at an annual compensation level, including expected profit sharing, in excess of \$700,000.00.

22. Mr. Friedman's basic percentages of Partnership income and loss for 1981, as set forth in the partnership agreement, were 5.36% of net book arbitrage profit and 1.98% of net book non-arbitrage profit. The following table sets forth Mr. Friedman's distributive share of the Partnership's 1981 income and loss, plus his guaranteed payments from the Partnership in 1981.

Guaranteed payments:

Guaranteed payment for services	\$116,117.00	
Guaranteed payment for the use of capital	<u>202,656.00</u>	\$318,773.00

Partnership		
ordinary income (loss) ⁸	(\$748,237.00)	
Net short-term capital gain	915,623.00	
Net long-term capital gain	<u>211,105.00</u>	<u>378,491.00</u>
TOTAL PROFIT (LOSS) FROM PARTNERSHIP		<u>\$697,264.00</u>

23. Mr. Friedman timely filed a New York State income tax return for the year 1981. The return was filed jointly with Mr. Friedman's wife, Elizabeth Friedman. On the return, Mr. Friedman reported his distributive share of Partnership income and loss and his guaranteed payments from the Partnership, as set forth in Paragraph 22 and footnote 8 above.⁹ He also reported the following distributive shares of New York State modifications, as set forth in paragraph 4 above, which are reported on the New York State Partnership Return:

8 Mr. Friedman's distributive share of Partnership ordinary income or loss, as reported on his Federal Schedule K-1, was (\$1,043,650.00). This represents (a) Partnership ordinary income or loss of (\$748,237.00), as shown in the table above, minus (b) \$115,245.00 of dividends and \$174,896.00 of interest income qualifying for exclusion, and \$37,017.00 of interest income exempt from Federal income tax, all of which were included as a gross income component of Partnership ordinary income or loss in the table above but which were either separately stated on the K-1 or exempt for Federal income tax purposes, plus (c) \$31,745.00 of items that were deducted in computing Partnership ordinary income or loss in the table above but that were nondeductible in computing ordinary income or loss on the K-1 (i.e., \$20,395.00 of interest paid to carry tax exempt bonds; \$427.00 of insurance premiums paid by the Partnership on behalf of Mr. Friedman; \$8,643.00 of foreign taxes paid [treated as a credit for Federal income tax purposes]; \$544.00 of political contributions [same]; and the \$1,736.00 of charitable contributions [separately stated on the K-1]).

9 On the statements attached to the return, Mr. Friedman reported his total ordinary income or loss from the Partnership, not including separately stated items, as (\$727,816.00). Such reported loss was derived from the numbers reported on the K-1 as follows: Share of Partnership ordinary income or loss of (\$1,043,650.00) + total guaranteed payments of \$318,773.00 = net Partnership income or loss of (\$724,877.00). Net Partnership income or loss - unreimbursed business expenses of \$2,939.00 = total income or loss from Partnership of (\$727,816.00).

Additions to Federal Amounts

New York City Unincorporated Business Tax paid	\$ 20,542.00	
Interest paid to carry bonds exempt from New York State income tax	11,735.00	
Interest received on municipal bonds not exempt from New York State income tax	<u>34,558.00</u>	
Total Additions		\$ 66,835.00

Subtractions from Federal Amounts

Interest received on U.S. government bonds	\$ 21,011.00	
Interest paid to carry bonds exempt from Federal income tax	20,395.00	
Refund of New York State Unincorporated Business Tax	<u>14,220.00</u>	
Total Subtractions		<u>55,626.00</u>
NET MODIFICATION		<u>\$ 11,209.00</u>

24. On the personal income tax return, Mr. Friedman reported personal service income for 1981 in the amount of \$280,091.00. Such personal service income was in effect calculated as follows:

Total profit (loss) from Partnership (as calculated in Paragraph 22 above)		\$697,264.00
Less: Guaranteed payment for the use of capital	\$202,656.00	
Net long-term capital gain	211,105.00	
Dividends and interest received on securities that generated long-term capital gain or loss on sale or exchange	473.00	
Unreimbursed business expenses	<u>2,939.00</u>	<u>417,173.00</u>
PERSONAL SERVICE INCOME		<u>\$280,091.00</u>

25. On the personal income tax return, Mr. Friedman subtracted \$1,500.00 representing a contribution to an individual retirement account, from personal

service income, resulting in reported personal service net income of \$278,591.00 for 1981.

26. On September 19, 1984, the Audit Division issued to Mr. Friedman a Statement of Audit Changes challenging his claim of \$278,591.00 of net personal service income. On the Statement, the Department alleged that Mr. Friedman had no net personal service income in 1981. The Audit Division's redetermination was based on the following calculation:

Net partnership income (loss):		
Partnership ordinary income (loss) as reported on Schedule K-1 ¹⁰	(\$1,043,650.00)	
Total guaranteed payments from the Partnership	<u>318,773.00</u>	(\$724,877.00)
Less: Interest received on U.S. government bonds	\$ 21,011.00	
Interest paid to carry bonds exempt from Federal income tax	20,395.00	
Refund of New York State Unincorporated Business Tax	14,220.00	
Contribution to individual retirement account	1,500.00	
Unreimbursed business expenses	<u>2,939.00</u>	<u>60,065.00</u>
TOTAL		<u>(\$784,942.00)</u>

Because the total was negative, the Audit Division concluded that Mr. Friedman's net personal service income for 1981 was zero and, consequently, asserted that Mr. Friedman owed \$10,230.66 in additional tax and interest.

27. On January 9, 1985, the Audit Division issued a Notice of Deficiency, for the reasons set forth in the Statement of Audit Changes, asserting that, as

¹⁰ See footnote 8 above.

a result of the continued accrual of interest on the alleged deficiency, Mr. Friedman owed \$10,549.41 in additional tax and interest.

David A. Kirschenbaum

28. Mr. David A. Kirschenbaum was a resident of New York State during the 1981 taxable year, residing at 149 Columbia Heights, Brooklyn, New York 11201. Mr. Kirschenbaum was a calendar year taxpayer and used the cash method of accounting.

29. Until December 31, 1980, Mr. Kirschenbaum was an employee of the Partnership in the public finance department. As compensation for services performed in 1980, Mr. Kirschenbaum received \$230,328.00 from the Partnership, \$150,202.00 of which was received in 1980¹¹ and \$80,126.00 of which was received in 1981,¹² all treated as employee wages for tax purposes. Mr. Kirschenbaum's interestman payment was calculated at a rate of 0.325% of Partnership net book profits, determined as described in paragraph 17 above.

30. On January 1, 1981, Mr. Kirschenbaum was admitted to the Partnership as a general partner, working in the public finance department. His responsibilities as a partner were the same as his responsibilities as an employee.

11 In 1980, Mr. Kirschenbaum also received an interestman payment of \$29,511.00 for services rendered in 1979.

12 Of this amount, \$62,012.00 represents Mr. Kirschenbaum's interestman payment for 1980. The remaining \$18,114.00 represents Mr. Kirschenbaum's share of unrealized appreciation as of December 31, 1980 on the Partnership's assets; such amount was in part compensation for services rendered in 1980 and in part compensation for services rendered in prior years.

31. The public finance department underwrites tax exempt bonds issued by state and local governments and governmental authorities. In addition to Mr. Kirschenbaum, one general partner and approximately twenty employees worked in the department in 1981. Mr. Kirschenbaum was responsible for obtaining underwriting business for the department, primarily in the area of tax exempt health care financing. Typically, Mr. Kirschenbaum would approach a municipality or authority interested in financing a health care facility and offer to assist it in structuring a bond issue to be underwritten by the Partnership. As part of his efforts, Mr. Kirschenbaum might make an oral or written presentation to the authority's or municipality's officials. If successful, Mr. Kirschenbaum would continue to work closely with those officials in planning and executing the new issue. For example, Mr. Kirschenbaum would frequently be involved in negotiating with banks or insurance companies for guarantees or letters of credit for the bonds. He might also enter into discussions with the bond rating agencies in an effort to obtain the best possible rating for the issue, or help the issuer's and the Partnership's counsel draft the offering documents for the bonds. Mr. Kirschenbaum, however, would not be responsible for the actual selling of the issue; rather, Partnership departments other than the public finance department would arrange for institutional and retail sales of the bonds.

32. In 1981, nonpartner employees employed by broker-dealers similar to the Partnership in positions comparable to that of Mr. Kirschenbaum frequently received total compensation on a par with Mr. Kirschenbaum's total profit from the Partnership in 1981 of \$180,680.00. Such compensation in some cases would include a profit sharing component comparable to Mr. Kirschenbaum's share of Partnership items.

33. Mr. Kirschenbaum's basic percentages of Partnership income and loss for 1981, as set forth in the partnership agreement, were 0.274% of net book arbitrage profit and 0.371% of net book non-arbitrage profit. The following table sets forth Mr. Kirschenbaum's distributive share of the Partnership's 1981 income and loss, plus his guaranteed payments from the Partnership in 1981.

Guaranteed payments:

Guaranteed payment for services	\$125,127.00	
Guaranteed payment for the use of ¹³ capital	8,678.00	\$133,805.00
Partnership ordinary income (loss)	(\$ 38,309.00)	
Net short-term capital gain	\$ 81,548.00	
Net long-term capital gain	<u>3,636.00</u>	<u>46,875.00</u>
TOTAL PROFIT (LOSS) FROM PARTNERSHIP		<u>\$180,680.00</u>

34. Mr. Kirschenbaum timely filed a joint New York State income tax return for the year 1981 with his wife, Bonnie Kirschenbaum. On the return, Mr. Kirschenbaum reported his compensation as an employee, his distributive share of Partnership income and loss and his guaranteed payments from the Partnership,

13 Mr. Kirschenbaum's distributive share of Partnership ordinary income or loss, as reported on his Federal Schedule K-1, was (\$62,059.00). This represents (a) Partnership ordinary income or loss of \$38,309.00, as shown in the table above, minus (b) \$5,757.00 of dividends and \$17,461.00 of interest income qualifying for exclusion, and \$6,940.00 of interest income exempt from Federal income tax, all of which were included as a gross income component of Partnership ordinary income or loss in the table above but which were either separately stated on the K-1 or exempt for Federal income tax purposes, plus (c) \$6,408.00 of items that were deducted in computing Partnership ordinary income or loss in the table above but that were nondeductible in computing ordinary income (loss) on the K-1 (i.e., \$3,824.00 of interest paid to carry tax-exempt bonds; \$1,687.00 of insurance premiums paid by the Partnership on behalf of Mr. Kirschenbaum; \$470.00 of foreign taxes paid [treated as a credit for Federal income tax purposes]; \$102.00 of political contributions [same]; and \$325.00 of charitable contributions [separately stated on the K-1]).

as set forth in Findings of Fact 29 and 33 and footnote 13.¹⁴ He also reported the following distributive shares of New York State modifications, as set forth in paragraph 4 above:

Additions to Federal Amounts

New York City Unincorporated Business		
Tax paid	\$5,411.00	
Interest paid to carry bonds exempt from New York State income tax	2,200.00	
Interest received on municipal bonds not exempt from New York State income tax	<u>6,478.00</u>	
Total Additions		\$14,089.00

Subtractions from Federal Amounts

Interest received on U.S. government bonds	\$ 3,939.00	
Interest paid to carry bonds exempt from Federal income tax	3,824.00	
Refund of New York State Unincor- porated Business Tax	<u>2,176.00</u>	
Total Subtractions		<u>9,939.00</u>
NET MODIFICATIONS		<u>\$ 4,150.00</u>

35. On the personal income tax return, Mr. Kirschenbaum reported personal service income for 1981 in the amount of \$239,175.00. Such personal service income was, in effect, calculated as follows:

Compensation as employee	\$ 80,126.00	
Total profit (loss) from Partnership (as calculated in paragraph 33 above)	<u>180,680.00</u>	\$260,806.00

14 On the statements attached to the return, Mr. Kirschenbaum reported his total ordinary income or loss from the Partnership (not including separately stated items) as \$62,453.00. Such reported income was derived from the numbers reported on the K-1 as follows: Share of Partnership ordinary income or loss of \$62,059.00 + total guaranteed payments of \$133,805.00 = net Partnership income or loss of \$71,746.00. Net Partnership income or loss - unreimbursed business expenses of \$9,293.00 = Total income or loss from Partnership of \$62,453.00.

Less: Guaranteed payment for the use of capital	\$ 8,678.00	
Net long-term capital gain	3,636.00	
Dividends and interest received on securities that generated long-term capital gain or loss on sale or exchange	24.00	
Unreimbursed business expenses	<u>9,293.00</u>	<u>21,631.00</u>
PERSONAL SERVICE INCOME		<u>\$239,175.00</u>

36. On the return, Mr. Kirschenbaum reported no deductions from personal service income, resulting in reported personal service net income of \$239,175.00 for 1981.

37. On September 10, 1984, the Audit Division issued to Mr. Kirschenbaum a Statement of Audit Changes challenging his claim of \$239,175.00 of net personal service income. On the Statement, the Audit Division alleged that Mr. Kirschenbaum had only \$132,640.00 of net personal service income in 1981. The Audit Division's redetermination was based on the following calculation:

Compensation as employee		\$ 80,126.00
Net partnership income (loss):		
Partnership ordinary income (loss) as reported on Schedule K-1 ¹⁵	(\$ 62,059.00)	
Total guaranteed payments from the Partnership	<u>133,805.00</u>	<u>71,746.00</u>
Total		<u>\$151,872.00</u>
Less: Interest received on U.S. government bonds	\$ 3,939.00	
Interest paid to carry bonds exempt from Federal income tax	3,824.00	
Refund of New York State Unincorporated Business Tax	2,176.00	
Unreimbursed business expenses	<u>9,293.00</u>	<u>19,232.00</u>
NET PERSONAL SERVICE INCOME		<u>\$132,640.00</u>

15 See footnote 13 above.

Based on its redetermination of net personal service income, the Audit Division asserted that Mr. Kirschenbaum owed \$2,053.17 in additional tax and interest.

38. On December 14, 1984, the Audit Division issued a Notice of Deficiency, on the basis set forth in the Statement of Audit Changes, asserting that, as a result of the continued accrual of interest on the alleged deficiency, Mr. Kirschenbaum owed \$2,107.30 in additional tax and interest.

CONCLUSIONS OF LAW

A. That the Tax Law §603-A(c), as in effect during the period in issue, defined "New York personal service net income" as meaning "...New York personal service income reduced by any deductions allowable under section sixty-two of the internal revenue code which are properly allocable to or chargeable against such New York personal service income." (Emphasis supplied.)

B. That, in view of the express language of section 603-A(c) of the Tax Law, it is clear that there should have been an allocation of partnership expenses between partnership personal service income and partnership non-personal service income. A proper allocation of partnership expenses to partnership personal service income would be based upon the particular taxpayer's partnership income constituting personal service income divided by the total receipts of the partnership multiplied by the expenses incurred by the partnership. This method has the advantage of conforming the interpretation of section 603-A(c) of the Tax Law with practice under the Internal Revenue Code during the period when there was a maximum tax on personal service income for Federal income tax purposes (see e.g. Rev. Rul. 78-64, 1978-1 C.B. 271). It is noted that for the purposes of this allocation of expenses, guaranteed payments to partners are not included as an expense of the partnership since doing so would result in a double counting of the guaranteed payments.

C. That Tax Law Section 603-A(c) provides, in part, that:

"... 'New York personal service net income' means New York personal service income reduced by any deductions allowable under section sixty-two of the internal revenue code which are properly allocable to or chargeable against such New York personal service income."

D. That the unincorporated business tax amounts are not deductions which are "properly allocable or chargeable against *** personal service income" within the meaning of Tax Law section 603-A(c) (Matter of Wolfe et al v. State Tax Comm., __ AD2d __ [May 22, 1986]). Accordingly, the Audit Division should increase each petitioner's personal service income by his distributive share of the modification provided for in Tax Law section 612(b)(3).

E. That the items of income set forth in Tax Law sections 612(b)(1) and 612(b)(4) are neither derived from nor connected with personal service income. Therefore, the Audit Division properly excluded from each petitioner's personal service income the amount of his distributive share of the modifications provided for in Tax Law sections 612(b)(1) and 612(b)(4).

F. That the items in dispute, i.e., the subtraction modifications set forth in sections 612(c)(1), 612(c)(7) and 612(c)(10) of the Tax Law, were included in the calculation of petitioners' ordinary loss which was reported for Federal purposes on the respective Federal schedule K-1. The reported ordinary losses were, in turn, utilized by the Audit Division to determine the amount of each petitioner's personal service income. During the year 1981, section 603-A(b)(1) of the Tax Law defined "New York personal service income", in part, as "... items of income includible as personal service income for purposes of section one thousand three hundred forty-eight of the internal revenue code, to the extent such items of income are includible in New York adjusted gross income...". Inasmuch as the modifications set forth in sections

612(c)(1), 612(c)(7) and 612(c)(10) are neither items of personal service income nor includible in New York adjusted gross income, the Audit Division properly reduced each petitioner's personal service income by the amount of said modifications.

G. That the Audit Division properly determined that petitioners' distributive shares of the partnership net short term capital gains, interest and dividend income did not constitute personal service income. During the year in issue section 603-A(b)(1) of the Tax Law provided that New York personal service income meant "...items of income includible as personal service income for purposes of section one thousand three hundred forty-eight of the internal revenue code...". Section 1348(b)(1)(A) provided, in turn, that "'personal service income' means any income which is earned income within the meaning of section 401(c)(2)(C) or section 911(b)...". Section 1.1348-3(a)(1)(A) of the Treasury Regulations, in effect during the year in issue, provided that "earned income" meant:

"Wages, salaries, professional fees, bonuses, amounts includible in gross income under section 83, commissions on sales or on insurance premiums, tips, and other amounts received, actually or constructively, as compensation for personal services actually rendered regardless of the medium or basis of payment."

Paragraph (D) of section 1.1348-3(a)(1) of the Treasury Regulations went on to provide, in part, that "earned income" included:

"Gains (other than gain which is treated as capital gain under any provision of chapter 1) and net earnings derived from the sale or other disposition of, the transfer of any interest in, or the licensing of the use of property (other than good will) by an individual whose personal efforts created such property."

The term does not include such income as dividends (including an amount treated as a dividend by reason of section 1373(b) and §1.1373-1), other distributions of corporate earnings and profits, gambling gains, or gains which are treated as capital gains under any provision of chapter 1."

In view of the foregoing, it is clear that interest income does not fall within the purview of earned income as contemplated by Treasury Regulation 1.1348-3(a)(1)(A). Similarly, dividend income and capital gains are expressly excluded from the definition of earned income by Treasury Regulation 1.1348-3(a)(1)(D). Accordingly, the Audit Division properly concluded that each petitioner's share of the partnership net short term capital gains, interest and dividend income did not constitute personal service income.

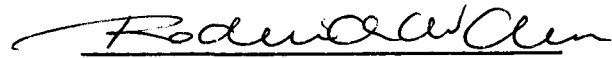
It is noted that neither Robidia v. Commissioner, 29 T.C.M. 407 (1970), aff'd. 460 F.2d 1172 (9th Cir. 1972) nor Tobey v. Commissioner, 60 T.C. 227 (1973) supports petitioners' position. In Robidia v. Commissioner, supra, the taxpayer derived income from the manipulation of slot machines and in Tobey v. Commissioner, supra, the taxpayer was an artist who received most of his income from the sale of his paintings, on consignment, at galleries. In each instance, it was held that the income in issue was "earned income" within the meaning of section 911 of the Internal Revenue Code since the income was derived from the respective taxpayers' personal efforts. In contrast, petitioners' distributive shares of the partnership net short term capital gain, interest and dividend income were not derived from the personal efforts of the respective petitioners but were obtained by the partnership from the efforts of those entities in which the partnership invested.

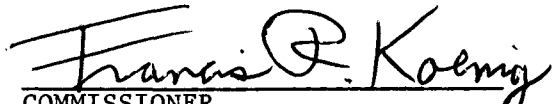
H. That the petitions of Donald J. and Elizabeth Friedman and David A. and Bonnie L. Kirschenbaum are granted to the extent of Conclusions of Law "B" and "D" and the Audit Division is directed to recompute the notices of deficiency accordingly; as modified, the notices of deficiency are sustained.

DATED: Albany, New York

STATE TAX COMMISSION

SEP 15 1986


PRESIDENT


COMMISSIONER


COMMISSIONER