

STATE OF NEW YORK
STATE TAX COMMISSION

In the Matter of the Petition

of

GERALD R. SMITH and DORIA K. SMITH

For a Redetermination of a Deficiency or :
a Revision of a Determination or a Refund :
of Personal Income :
Taxes under Article (x) 22 of the :
Tax Law for the Year (s) ~~xxxxxx~~ Period (s) 1970. :

AFFIDAVIT OF MAILING

State of New York
County of Albany

Bruce Batchelor , 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 8th day of February , 1977, ~~he~~ served the within
Notice of Decision by (certified) mail upon Gerald R. Smith &
Doria K. Smith (~~representative of~~) the petitioner in the within proceeding,
by enclosing a true copy thereof in a securely sealed postpaid wrapper addressed
as follows: Mr. & Mrs. Gerald R. Smith
169 Old Farms Road
West Simsbury, Connecticut 06092
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

8th day of February , 1977.

Bruce Batchelor

Janet Mack

STATE OF NEW YORK
STATE TAX COMMISSION

In the Matter of the Petition

of

GERALD R. SMITH and DORIA K. SMITH

AFFIDAVIT OF MAILING

For a Redetermination of a Deficiency or :
a Revision of a Determination or a Refund :
of Personal Income :
Taxes under Article (x) 22 of the :
Tax Law for the Year (x) or Period (x) 1970.:
~~(x) or Period (x)~~

State of New York
County of Albany

Bruce Batchelor , being duly sworn, deposes and says that
she is an employee of the Department of Taxation and Finance, over 18 years of
age, and that on the 8th day of February , 19 77, she served the within
Notice of Decision by (certified) mail upon White and Case

(representative of) the petitioner in the within proceeding,

by enclosing a true copy thereof in a securely sealed postpaid wrapper addressed
as follows:

White and Case
14 Wall Street
New York, New York 10005

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

8th day of February , 19 77

Bruce Batchelor

Janet Mack



STATE OF NEW YORK
DEPARTMENT OF TAXATION AND FINANCE

TAX APPEALS BUREAU
STATE CAMPUS
ALBANY, N.Y. 12227

STATE TAX COMMISSION

ADDRESS YOUR REPLY TO

February 8, 1977

TELEPHONE: (518) **457-1723**

Mr. & Mrs. Gerald R. Smith
169 Old Farms Road
West Simsbury, Connecticut 06092

Dear Mr. & Mrs. Smith:

Please take notice of the **DECISION**
of the State Tax Commission enclosed herewith.

Please take further notice that pursuant to
Section(8) **690** of the Tax Law, any
proceeding in court to review an adverse deci-
sion must be commenced within **4 months**
from the date of this notice.

Inquiries concerning the computation of tax
due or refund allowed in accordance with this
decision or concerning any other matter relative
hereto may be addressed to the undersigned. They
will be referred to the proper party for reply.

Very truly yours,

Paul B. Coburn
Paul B. Coburn
Supervising Tax
Hearing Officer

Enc.

cc: Petitioner's Representative:

Taxing Bureau's Representative:

STATE OF NEW YORK

STATE TAX COMMISSION

In the Matter of the Petition	:	
	:	
of	:	
	:	
GERALD R. SMITH and DORIA K. SMITH	:	DECISION
	:	
for Redetermination of a Deficiency or	:	
for Refund of Personal Income Tax under	:	
Article 22 of the Tax Law for the Year	:	
1970.	:	

Petitioners, Gerald R. Smith and Doria K. Smith, residing at 169 Old Farms Road, West Simsbury, Connecticut 06092, timely filed a petition for redetermination of a deficiency for personal income tax for the year 1970. (File No. 00132)

A hearing was duly held on April 29, 1976 and continued on July 14 and 15 of that year at the offices of the State Tax Commission, Two World Trade Center, New York, New York, before Nigel G. Wright, Hearing Officer. The petitioners appeared by White and Case (Gwynne H. Wales, Esq., Emanuel Demos, Esq., Diana Pinover, Esq. and John J. McAvoy, Esq. of counsel). The Income Tax Bureau appeared by Peter Crotty, Esq. (Solomon Sies, Esq. of counsel).

The record of said hearing has been duly examined and considered.

ISSUES

I. The issues in this matter, as agreed to by the parties at the hearing, will be determined in accord with the decision of the State Tax Commission in the Matter of the Petitions of G. H. Walker & Co., and Related Cases, a copy of which is attached hereto. To the extent that there is an increase in that partnership's allocated income, or a decrease in allocated expenses, there would be a corresponding increase in the distributive shares of each of the nonresident partners.

II. Whether the State Tax Commission had jurisdiction over this matter.

FINDINGS OF FACT

1. Petitioners, Gerald R. Smith and Doria K. Smith, filed New York State nonresident income tax returns for the taxable year in question.

2. Petitioner, Gerald R. Smith's share, as a partner, of partnership income earned by G. H. Walker & Co. for the year in question is contingent on the State Tax Commission decision in the Matter of the Petitions of G. H. Walker & Co., and Related Cases, and the "Findings of Fact" in that decision are hereby adopted.

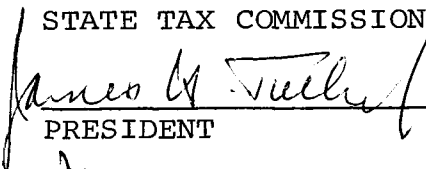
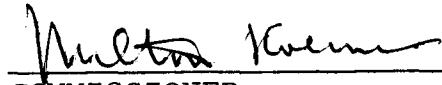
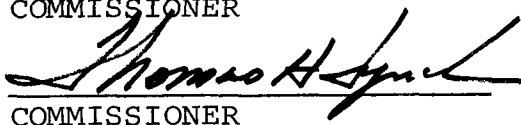
3. Petitioners, Gerald R. Smith and Doria K. Smith, did not receive a Notice of Deficiency for the taxable year in question, although they did file a timely "protective petition" for said year (see Department of Taxation and Finance Exhibit 16, pp. 4-6, which is stated to be a stipulation).

CONCLUSIONS OF LAW

A. That the "Conclusions of Law" stated in the State Tax Commission's decision in the Matter of the Petitions of G. H. Walker & Co., and Related Cases, a copy of which is attached hereto, are hereby adopted.

B. That petitioners, Gerald R. Smith and Doria K. Smith, cannot petition the State Tax Commission for redetermination of a deficiency, and confer jurisdiction on the Commission, in the absence of a Notice of Deficiency, which petitioners did not receive, nor can any tax liability be asserted in the absence of said Notice.

DATED: Albany, New York
February 8, 1977

STATE TAX COMMISSION

PRESIDENT

COMMISSIONER

COMMISSIONER

STATE OF NEW YORK

STATE TAX COMMISSION

In the Matter of the Petitions	:	
of	:	
G. H. WALKER & CO., and	:	DECISION
Related Cases	:	
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 1960 through 1970.	:	

Petitioner, G. H. Walker & Co., filed two petitions for redetermination of a deficiency or for refund of unincorporated business tax, one for the years 1960 and 1961 and a separate petition for the years 1962 through 1970. (File No. 00111)

A formal hearing was held before Nigel G. Wright, Hearing Officer, at the offices of the State Tax Commission, Two World Trade Center, New York, New York, on April 29, 1976 and continued on July 14 and 15 of that year. The petitioner appeared by White and Case (Gwynne H. Wales, Esq., Diana Pinover, Esq., Emanuel Demos, Esq. and John J. McAvoy, Esq. of counsel). The Income Tax Bureau appeared by Peter Crotty, Esq. (Solomon Sies, Esq. of counsel).

ISSUES

I. Whether petitioner, G. H. Walker & Co., an underwriter and dealer in securities, properly allocated primary or underwriting profits where petitioner, as a member of an underwriting syndicate managed by a New York based underwriter, entered into a commitment for the purchase of securities of an issuing corporation or bonds of a municipality.

II. Whether, in the alternative, petitioner, G. H. Walker & Co., can allocate based on the three factor formula.

III. Whether petitioner, G. H. Walker & Co., properly allocated commissions earned from the execution of stock purchase or sale orders on the New York and American Stock Exchanges, where such orders originated in petitioner's offices outside New York.

IV. Whether petitioner, G. H. Walker & Co., properly allocated profit sharing contributions.

V. Whether petitioner, G. H. Walker & Co., properly allocated interest income and interest deductions.

VI. Whether petitioner, G. H. Walker & Co., should have properly allocated to New York income from bookkeeping services performed in New York, such income to be computed as five percent of the total commissions on orders originating outside New York.

VII. Whether the surcharge on commissions received by petitioner, G. H. Walker & Co., in 1970 constituted additional commission income allocable to New York.

VIII. Whether net operating losses sustained in 1969 and 1970 could be claimed by petitioner, G. H. Walker & Co., for the years 1966 and 1967 respectively.

IX. Whether sufficient grounds exist for granting petitioner, G. H. Walker & Co.'s, motion for summary judgment, based on alleged protracted delay.

FINDINGS OF FACT

1. Petitioner, G. H. Walker & Co., timely filed New York State partnership returns and unincorporated business tax returns for the years 1960 through 1970.

2. The Income Tax Bureau issued a Statement of Audit Changes to the partnership for unincorporated business taxes for the taxable years 1960 and 1961 on July 11, 1966, in the sum of \$15,016.10 and \$15,336.22 respectively, plus interest, and, accordingly, timely issued a Notice of Deficiency therefor. On April 12, 1974, the Income Tax Bureau issued a Statement of Audit Changes to the partnership for unincorporated business income taxes for the taxable years 1962 through 1970 in the sums of:

1962	\$20,667.24 plus interest
1963	21,027.32 plus interest
1964	24,599.76 plus interest
1965	27,361.40 plus interest
1966	31,589.84 plus interest
1967	34,536.52 plus interest
1968	51,883.53 plus interest
1969	17,250.27 plus interest
1970	14,265.14 plus interest

Accordingly, a Notice of Deficiency was issued.

3. On August 1, 1966, petitioner, G. H. Walker & Co., timely filed a petition for redetermination of a deficiency or for refund for the years 1960 and 1961, and filed a similar petition on June 26, 1974 with respect to the years 1962 through 1970. In addition, petitioner, G. H. Walker & Co., filed claims for credit or refund for the years 1966 and 1967 on January 10, 1972. A Notice of Disallowance of these two claims was sent to petitioner on April 13, 1973.

4. Petitioner, G. H. Walker & Co., was a partnership engaged in business as investment bankers and stockbrokers in New York, Missouri, Rhode Island, Connecticut, Illinois and Pennsylvania during the taxable period 1960 through 1970. During those years, the partnership was organized into three regional centers, with respective main offices in New York, New York; St. Louis, Missouri; and Providence, Rhode Island. The New York group included an office in New York City, as well as offices in White Plains, New

York; Hartford and Bridgeport, Connecticut; and Philadelphia, Pennsylvania. The St. Louis group included the main office in St. Louis and an office in Kansas City, Missouri. The Providence group included offices in Providence and Pawtucket, Rhode Island. During the period from 1960 through 1970, the partnership was a member of the New York Stock Exchange, held a seat on such exchange and had a partner on the floor of the exchange. The partnership was also an associate member of the American Stock Exchange.

5. A partnership agreement of December 15, 1962, representative of the partnership agreements in effect in the years 1960 through 1970, was signed by 27 general partners. A committee of seven managing partners, each of whom managed regional group offices, determined the additional salary payments for partners, based on the profit performance of the regional group of offices where the partners were employed.

6. The capital of the partnership was allocated to the three regional offices as follows:

	<u>1960-1969</u>	<u>1970</u>
New York	50%	65%
St. Louis	25%	25%
Providence	25%	10%

The allocation stated above for 1960 through 1969 was contained in the 1962 partnership agreement.

7. As a matter of operating practice, pursuant to the December 15, 1962 partnership agreement, the underwriting participations and selling group allotments were to be divided between the regional offices of the firm as follows (although the testimony of Frederick Wonham, the New York syndicate partner, indicates that these percentages were not constant throughout the period):

	<u>Bonds and Preferred Stocks</u>	<u>Common Stocks</u>
New York	50%	45%
St. Louis	30%	37%
Providence	20%	18%

Variation of the percentages could be made by mutual agreements between offices.

8. The books of account of petitioner, G. H. Walker & Co., were maintained on a basis which accounted for the activities of each of the three regional groups of offices separately, so that the profit or loss of each of these regional centers could be separately determined. In addition, separate accounts were maintained for each branch office within each of the three regional groups, showing the amount of income and deductions attributable to each.

9. During the years in issue, the petitioner was a member of underwriting syndicates. The underwriting agreements entered into by such members of the syndicate were retained by the

underwriting managers. Petitioner, G. H. Walker & Co.'s participation in such an underwriting syndicate would usually begin with a telephone call from the managing underwriter to petitioner's New York syndicate partner, inviting such participation. The managing partners in New York, St. Louis and Providence would then be contacted by the New York syndicate manager to discuss the particular underwriting. A refusal by a managing partner would normally result in the petitioner declining the invitation to participate in the underwriting.

10. The underwriting agreements were entered into for the purpose of facilitating the sale to the public of securities issued by an issuing corporation, and were subject to the regulations of the Securities and Exchange Commission. The difference in price between that at which the shares are issued and purchased from the issuing corporations, and the price at which they are to be offered to the public is called the "spread". Of the spread, a certain portion is to be returned to the managing underwriter or underwriters as their underwriting fee. Another portion is retained by the underwriter as his underwriting profits, as compensation for being part of the underwriting syndicate. The balance of the spread, namely the "secondary profits", is retained by the sellers of the stock to the public whether the sellers of

the stock are the underwriters selling through their branch offices, or a selling group of which the underwriter may or may not be a part, or any dealers invited by the managing underwriter to participate.

The underwriting agreement provides for a commitment by each underwriter to purchase a certain amount of the issued securities. The underwriting agreement may provide that a certain portion of the securities to which the underwriting member has committed himself may be reserved by the management to be sold to members of a selling group who are not parties to the underwriting agreement and who would be entitled only to secondary profits. Members of the selling group may either be invited by the underwriting manager or they may request the manager to allow their participation. Each such member may enter into a legal commitment to purchase issued shares. In certain instances, a member of the underwriting group may also request to become a member of the selling group which usually occurs when such member is able to sell more than the shares allotted to it. By so doing, the underwriter gains the advantage of being both an underwriter, receiving underwriting profits as a member of the underwriting group, and a member of the selling group selling directly to the public, thereby also separately receiving secondary profits.

11. The notices of deficiency herein add the "primary" or underwriting profit derived from underwritten securities to New York income, less an amount for certain expenses. The attribution of profit was based on the New York location of the underwriting syndicate manager, whose activities resulted in "primary" profits. Petitioner, G. H. Walker & Co., had allocated such "primary profits" based on the location of the office of the partnership which actually sold the underwritten security.

12. Petitioner, G. H. Walker & Co.'s offices outside New York paid the New York office 35% of gross commissions for New York clearing services with respect to trades executed in New York which originated in such outside offices. This 35% charge was agreed on among the managing partners of the three regional offices as the result of negotiations concerning the profit-base of each office, for purposes of determining the partners' compensation. This percentage was maintained for the entire tax period in question.

13. Petitioner, G. H. Walker & Co., borrowed primarily from New York banks to provide working capital for the entire firm, and to finance the margin accounts of customers.

a) The interest cost of the working capital loans was allocated to each regional office of the partnership in proportion to the securities inventory of each regional office, which inventory was used as the collateral for the loans. The interest was charged to each regional office on the basis of the weighted average monthly interest cost of carrying the loan.

b) Margin accounts, whereby customers borrowed from petitioner, G. H. Walker & Co., for the purpose of financing a portion of the cost of securities in the customers' accounts, were financed in turn by the petitioner borrowing from banks using the securities of the customers as collateral. Petitioner, G. H. Walker & Co., paid interest to the banks at the "broker call rate", which varied, and in turn charged the customer interest at a rate one-half percent above the "broker call rate". Each regional office of petitioner was charged the broker call rate, in accordance with its proportion of money loaned in margin accounts, based on average monthly customer balances and interest rates. Each office also reflected the one-half percent above the broker call rate charged to margin customers on its own books.

14. Petitioner, G. H. Walker & Co., apportioned and allocated profit sharing, pensions and other similar "employee-type" costs on the basis of a percentage of employees in each regional office with other factors (e.g. length of service) also being considered. This "unit basis" approach employed by petitioner, G. H. Walker & Co., resulted in a smaller deduction for such expenses than that of the Income Tax Bureau adjustment, which was based on a higher attribution of profits to the New York office. Reallocation of partnership services for the years 1962 through 1970 by the Income Tax Bureau also increased the deduction regarding New York operations.

15. For portions of the period from 1960 to 1970, each regional office maintained its own bookkeeping. Additional bookkeeping on transactions executed in New York for clients of the partnership was performed in New York. Furthermore, a switch to computerized operations in approximately the middle of this period, which operations were conducted in New York, increased the bookkeeping services performed in New York. In the Income Tax Bureau audit and the subsequent notices of deficiency, five percent of outside commissions was charged against the offices outside New York and treated as income allocable to New York or as a reduction of expenses allocable to New York, thereby increasing income allocable to New York.

16. In 1970, petitioner, G. H. Walker & Co., charged its customers a commission surcharge, pursuant to stock exchange requirements, but did not allocate any portion of this increased commission to New York.

17. Petitioner, G. H. Walker & Co., filed two claims for refund for the years 1966 and 1967, based on net operating loss carrybacks from the years 1969 and 1970. Such claims were disallowed by the Income Tax Bureau on the grounds that the interests of the partners in G. H. Walker & Co. for the years 1969 and 1970 (the loss years), who also had an interest in the partnership during the years 1966 and 1967 (the carryback years), do not equal 80 percent of the interest in the partnership in such loss years.

18. The books and records of the petitioner, G. H. Walker & Co., clearly disclose the income and expenses of its New York operation.

19. Petitioner, G. H. Walker & Co., made a motion for summary judgment based on alleged protracted and deliberate delay which not only made it difficult for petitioner to prepare for trial, but also constituted a denial of due process and equal protection of the law under the constitutions of both the United States and the State of New York.

CONCLUSIONS OF LAW

A. That although the total profits made from the underwriting, distribution and sale of securities and bonds include both underwriting profits and secondary profits, the underwriting profits are separate and distinct from the secondary profits. Each of the profits is required to be allocated to the source of such profits. The source of the primary or underwriting profits was the principal office of the managing underwriter of the underwriting syndicate, and not the offices of the taxpayer where shares of securities or bonds were sold. Thus, the Income Tax Bureau properly allocated to New York all underwriting profits received by petitioner, G. H. Walker & Co., as a member of an underwriting syndicate managed by a New York underwriting manager.

B. That the net business income of petitioner, G. H. Walker & Co., was properly determinable from the books and records of petitioner. Tax Law § 707(b), 20 NYCRR 207.3(c) (substantially the same as preceding State Tax Commission Regulation 20 NYCRR 287.1) Direct accounting is the preferred method and the use of the three factor formula contained in §707(c) to allocate the income of the petitioner would not be

warranted (Piper, Jaffray and Hopwood v. State Tax Commission, 42 AD2d 381, affd. _____ NY2d _____).

C. That the use of the percentage allocation of commissions to New York employed by the Income Tax Bureau is expressly authorized by the State Tax Commission in its regulations (20 NYCRR 207.5(c)(1) and (2), 20 NYCRR 287.1 Q82-a) and is thus not discriminatory or arbitrary.

D. That the profit sharing allocation made by the Income Tax Bureau, which resulted in favorable tax consequences to petitioner, was proper.

E. That the interest income and deduction adjustments contained in the notices of deficiency, and the underlying computation thereof, lack sufficient basis, and that such adjustments must be deleted from the notices of deficiency. The books and records of petitioner, G. H. Walker & Co., are to be followed in this regard. Such books and records of petitioner indicate, however, that New York interest expense is deducted for the entire "New York group" which includes offices in Philadelphia, Pennsylvania and Bridgeport and Hartford, Connecticut. All such interest expenses from these out-of-state offices in the New York group must be allocated to sources outside New York State. That the Income Tax Bureau is accordingly

directed to recompute the allocation of interest expense consistent with the above.

F. That the five percent bookkeeping charge described in Findings of Fact 15, supra, is determined to be an unwarranted audit change to the extent that it reflects any bookkeeping performed by the New York office of petitioner concerning the sale or purchase of stocks or bonds, since any such activities are deemed to be included in the computation of the Commission's allocation contained in Conclusions of Law, C, supra. Furthermore, the bookkeeping adjustment determined as a percentage of commissions earned outside New York State constitutes an effort to apportion bookkeeping expenses attributable in part to the production of income to the sources of such income. This measure is arbitrary, and the Income Tax Bureau is directed to delete such adjustments from the notices of deficiency.

G. That the surcharge on commissions received by petitioner, G. H. Walker & Co., in 1970 constituted income allocable to New York and should be so allocated, consistent with the regulations of the State Tax Commission cited in Conclusions of Law, C, supra.

H. That the disallowance of the claims for refund issued by the Income Tax Bureau (Findings of Fact, 17, supra), for the

years 1966 and 1967, which claims were predicated on net operating loss carrybacks from 1969 and 1970, was proper. That no evidence was adduced to establish that the interests of partners in G. H. Walker & Co. during 1969 and 1970 (the loss years), which partners also had an interest in G. H. Walker & Co. during 1966 and 1967 (the carryback years), amounted to at least 80 percent of the interest in the partnership during these loss years.

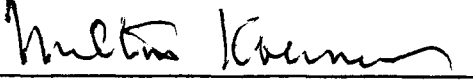
I. That the motion for summary judgment made by petitioner, G. H. Walker & Co., is denied, there being material issues of fact to require a hearing. The memorandum of law in support of the motion raises possible constitutional violations over which this Commission has no jurisdiction.

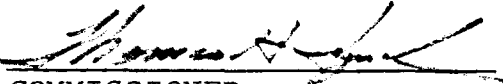
J. That the petitions of G. H. Walker & Co. are granted to the extent indicated in Conclusions of Law E and F and that except as so granted, the petitions are in all other respects denied.

DATED: Albany, New York
February 8, 1977

STATE TAX COMMISSION


PRESIDENT


COMMISSIONER


COMMISSIONER