NEW YORK CITY TAX APPEALS TRIBUNAL
ADMINISTRATIVE LAW JUDGE DIVISION

In the Matter of the Petition	:	**DETERMINATION**
Of	:	**TAT(H)07-16(GC)**
WM. E. MARTIN & SONS CO., INC.	:	

Schwartz, A.L.J.:

Petitioner, Wm. E. Martin & Sons Co., Inc., filed a Petition for Hearing with the New York City ("City") Tax Appeals Tribunal seeking a redetermination of a deficiency of City General Corporation Tax ("GCT") under Chapter 6 of Title 11 of the City Administrative Code ("Code") for the tax years ending December 31, 2002, December 31, 2003, December 31, 2004 and December 31, 2005 ("Tax Years").

A hearing was held and various documents were admitted into evidence. Petitioner was represented by James H. Tully, Jr., Esq. of DeGraff, Foy, Kunz & Devine. The Commissioner of Finance ("Respondent") was represented by Frances J. Henn, Esq., Senior Counsel of the City's Law Department. Both parties filed briefs and reply briefs.

CONCLUSIONS

A. Petitioner established that it had inventory in New Jersey and Virginia in the amounts claimed on its Forms NYC 3L for the Tax

Years. The Business Allocation Percentage for each of the Tax Years is accepted as filed.

B. The Trust was the beneficial owner as well as the record holder of Petitioner's shares, because it had the right to sell or pledge the shares, and it received all dividends, enjoyed the economic benefits and bore any risk of loss with respect to those shares. As Petitioner's president had transferred all of his shares to the Trust prior to the Tax Years, he was not the actual beneficial owner of more than five percent of Petitioner's issued capital stock during the Tax Years. Thus, Petitioner's president's compensation is not included in the alternative tax basis.

C. In his Reply Brief, Respondent first asserted the amount of compensation paid to Petitioner's president in each of the Tax Years that he deemed unreasonable. This is a new factual issue which Respondent is precluded from raising after the record was closed because it prejudices Petitioner. Accordingly, it is not being considered.

FINDINGS OF FACT

Petitioner is a New York corporation that is in the business of importing, selling and distributing spices. During the Tax Years, William E. Martin, III ("Skip") was Petitioner's president and only officer.

Petitioner was founded by Skip's grandfather, William E. Martin ("William"). William's sons, William Jr. and Frank eventually joined the business. When William retired, William Jr.

bought the business from him. Skip eventually bought the business from his father.[1]

Skip caused the business to grow substantially after he purchased it from his father. Gross sales, which were $19 million in 1992, had increased to $26.4 million by 1997.[2] Skip wanted to further increase Petitioner's sales and consequently to cause the value of its shares to rise. However, he was concerned that, in the future, it would not be possible for his children to either purchase his interest in the business or pay the estate taxes that could be imposed as a result of his owning those shares at the time of his death. While he hoped that one or more of his sons would want to enter the business, there was no way to know if any of them would do so.

After several meetings with an attorney to address estate planning issues, Skip took various steps to get his shares of Petitioner out of his estate for federal Estate Tax purposes. One step was the establishment of the William J. Martin, Jr. Irrevocable Trust (the "Trust"). The beneficiaries of the Trust are Skip's wife, children, issue of children and spouses of children.

On December 31, 1997, Skip transferred 213 shares of Petitioner's stock to the Trust. On January 2, 1998, Skip transferred an additional 213 shares of Petitioner's stock to the Trust. Skip and his wife filed federal and New York State ("State") gift tax returns for 1997 and 1998 which reported these transfers. The gift tax returns reported an aggregate value for the

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[1] Taxpayer's Exhibit ("T. Ex.") 4, 1996 Appraisal, p. 1; Tr. p. 100.

[2] T. Ex. 4, 1996 Appraisal, exhibit A.

shares of $419,184. Skip understood that by transferring his shares in Petitioner to the Trust, he was giving up his equity interest in the business. However, he did so as a way to protect his family. During the Tax Years, record title for all of Petitioner's issued and outstanding shares was in the name of the Trust.[3]

The Trustee has complete discretion as to the amount of distributions to be made from the Trust; except that under certain specified conditions withdrawals from the Trust may be made by Skip's spouse, children, and their descendants. Skip is not a member of the class who may receive distributions or make withdrawals.

The Trust provided for the management of a closely held business that would be transferred to it and would be an S Corporation for federal income tax purposes.[4] The Trustee was given the power to manage that business "either directly or by appointing agents, officers, employees . . .." The Trustee also had the power "[t]o engage, compensate or discharge or, as stockholder, to vote to engage, compensate or discharge such managers, agents, employees, attorneys, directors, accountants, consultants . . .." The Trustee also had the power to sell or liquidate any interest in that business as he saw fit.[5]

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[3] City's Ex. A, pp. T17, T38, T57, T77. Prior to the establishment of the Trust, Skip's sons owned 574 shares of Petitioner. (T. Ex. 4, 1994 Appraisal, pp. 1, 5.) The record does not indicate how the sons obtained their shares. The record also does not indicate the circumstances under which the shares owned by the sons were transferred to the Trust, although the Trust does have a provision permitting such transfers. T. Ex. 1, Article 1(B). Nevertheless both parties have accepted the representation on Petitioner's U.S. Income Tax Returns for an S Corporation, Forms 1120S ("Forms 1120S") for the Tax Years that record title to all of Petitioner's shares was in the Trust during the Tax Years.

[4] *See*, *generally* Internal Revenue Code "IRC" §1361 *et. seq*.

[5] T. Ex. 1, Article 8, section AA(V).

John M. McIntyre was the sole trustee (the "Trustee") of the Trust. The Trustee is a CPA with a masters in advanced taxation who is a partner in the accounting firm of Sabino & McIntyre. He has performed Petitioner's accounting work since 1979. As Trustee, he acts for the Trust in its capacity as Petitioner's shareholder. He appointed Skip the president of Petitioner. He set Skip's salary and year-end bonus and the bonuses of other highly paid employees. He physically inspected Petitioner's place of business at least eight times a year to review Petitioner's operations. He performed oversight on major business decisions such as purchasing proposed fixed assets, the possibility of moving the company to a different location, hiring decisions regarding high level employees and the expansion of office staff. After Skip's assistant left Petitioner's employ, Mr. McIntyre convinced Skip's son, Spenser, who recently had obtained an MBA, to join the business and take over some of his father's responsibilities.

The Trust authorized the Trustee to appoint others to actively manage the business. However, it also contemplated that at some point the Trustee might be called upon to take an active roll in managing the business. Under those circumstances, the Trustee would be entitled to additional compensation commensurate with the work performed.[6] During the Tax Years, the Trustee did not receive any fees in excess of the statutory trustee's fees of $8,000 to $9,000 per year.

Petitioner has been an S Corporation for federal income tax purposes since 1989. Petitioner filed a federal Form 1120S, U.S. Income Tax Return for an S Corporation, for each of the Tax Years. Petitioner also filed a City Form NYC 3L, General Corporation Tax

[6] T. Ex. 1, Article 8, section AA(X).

Return, for each of the Tax Years. Because the GCT does not have a regime comparable to the federal S Corporation regime, Petitioner computed its GCT as if it were a C Corporation for federal tax purposes.[7]

Petitioner made distributions to the Trust during the Tax Years in the following amounts:

Year	Amount
2002	$ 0[8]
2003	$ 60,000[9]
2004	$ 70,000[10]
2005	$220,000[11]
Total	$350,000

The Trust's investments were maintained in a Merrill Lynch account which was managed by Thomas E. Sullivan, of Merrill Lynch. Mr. Sullivan took his direction regarding investments for the Trust from Mr. McIntyre. Skip did not get involved in discussions of the Trust's investments as he believed that was Mr. McIntyre's responsibility.

The Trust is an Electing Small Business Trust ("ESBT").[12] The Trust filed federal Form 1041, U.S. Income Tax Return for Estates and Trusts, for each of the Tax Years on which it reported its S

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[7] *See* Code §602.8(ii).

[8] City's Ex. A, p. T16, Schedule M-2.

[9] City's Ex. A, pp. T36, line 20; T37, Schedule M-2.

[10] City's Ex. A, pp. T55, line 16d; T56, Schedule M-2.

[11] City's Ex. A, pp. T74, line 16d; T75, Schedule M-2.

[12] Pursuant to IRC §1361(c)(2)(A)(v) an ESBT may own stock in an S Corporation.

Corporation flow through income from Petitioner and paid federal income tax on Petitioner's federal taxable income. The Trust's Form 1041 for 2003 was audited by the Internal Revenue Service ("IRS"). The IRS made certain adjustments to the flow-through income from Petitioner which resulted in a tax deficiency. The deficiency was paid by the Trust.

As Petitioner's president and sole officer,[13] Skip was responsible for all aspects of the business, working six or seven days a week. Most of his time was spent identifying sources of spices and purchasing spices. Spices typically come from third world countries such as Egypt, India, China and Vietnam and Skip spent a great deal of time traveling to those countries. Spices are a commodity and the market for them is unregulated. Skip knew how to price spices and what risks to take with respect to pricing. He also handled Petitioner's marketing and established a significant customer base that enabled him to substantially increase the size of the business.

Skip's compensation arrangement with Petitioner called for a fixed salary of $1,000,000 per year plus a bonus based on profits that was computed and paid towards the end of the calendar year. This agreement was oral until June 8, 2005 when a written employment agreement ("Employment Agreement") was entered into between Skip and Petitioner. The Trustee executed that agreement on behalf of Petitioner as its "sole shareholder." The Employment Agreement provided for a three year term and could be terminated prior to the end of the term under various circumstances with the

[13] The record does not indicate who the directors were during the Tax Years. However, the record does indicate that Skip and his wife had been the directors at the time of the September 30, 1999 appraisal, two years after Skip transferred his stock to the Trust. (T. Ex. 4, 1999 Appraisal, p. 5.)

amount of severance pay, if any, depending on the reason for termination.

Skip's compensation for each of the Tax Years was:

2002	$1,756,000
2003	$2,102,000
2004	$2,105,614
2005	$2,361,928

During the earlier Tax Years, Skip had an assistant, Abby Zeifman, who had been with the company for many years and had major responsibilities. Ms. Zeifman's salary, like Skip's, was largely based on profits. A very significant portion of her salary also was in the form of a bonus computed and paid near year end. In 2002, Ms. Zeifman earned $553,350, $477,300 of which was paid in the fourth quarter of the year.[14]

During the Tax Years, Petitioner had between twenty-one and twenty-five other employees. Some of these individuals worked in the warehouse area dealing with shipments received from truckers, handling inventory and loading trucks to fill orders. Other employees worked in the office performing secretarial and/or accounting functions.

In each of the Tax Years, Petitioner required large sums of money to purchase inventory since suppliers expected to be paid in advance. Petitioner had a line of credit with a bank which had restrictions on how Petitioner could operate that made it difficult to carry on business. Mr. McIntyre encouraged Skip to lend his personal funds to avoid these restrictions. With the exception of some short-term borrowings in December of 2005, all of the loans

[14] City's Ex. A, p. A29.

taken by Petitioner during the Tax Years were from Skip rather than a bank. Petitioner paid Skip interest on these loans at the rate of 10 percent simple interest on amounts outstanding. These loans are reflected as "loans from shareholder"[15] on the balance sheet of Petitioner's Forms 1120S. The amounts outstanding at each year end and the amounts of interest Petitioner paid to Skip were:

Year	Loan Outstanding	Interest Paid
2002	$6,150,000	$590,000
2003	$6,570,000	$625,000
2004	$7,516,806	$650,000
2005	$7,929,575	$680,000

Petitioner occupies a 50,000 square foot building in Jamaica, New York that contains office and warehouse space ("Building"). The Building was owned by Skip personally during most of the Tax Years. In 2002 and 2003, the rent Skip charged Petitioner for the Building was $48,000 per year, which was equivalent to the principal and interest payments on the mortgage. This was well below market rent.[16] The rent was adjusted to $450,000 beginning in 2004, which was what the parties believed was market rent, and was increased to $487,000 for 2005. Skip transferred the Building to a single member LLC which he owned and a new lease was entered into between Petitioner and the LLC beginning on June 15, 2005 for the same rent.

During the Tax Years, Petitioner kept a significant portion of its inventory in a public warehouse in New Jersey and customers picked up their orders from that warehouse. Petitioner was

[15] The record does not indicate why the loans were reflected this way on Petitioner's Forms 1120S as Petitioner was not a shareholder. Perhaps the characterization of these loans was not changed after Skip transferred his shares to Petitioner.

[16] *See* T. Ex. 4, 1999 Appraisal, p. 3.

registered with the New Jersey Division of Revenue during the Tax Years. Petitioner filed New Jersey Corporation Business Tax Returns, Form CBT-1005, for each of the Tax Years. The New Jersey returns for 2003 through 2005 are in the record. William Weiss, the accountant who prepared Petitioner's tax returns, credibly testified that the New Jersey return for 2002 had been filed, but that the copy had been destroyed. Mr. Weiss provided a copy of the pages from the work papers to substantiate the amount claimed on the City 2002 return for inventory in New Jersey and credibly testified as to how the information on that return was obtained from Petitioner's business records.

Skip's uncle Frank owns a company, Fanmarco, Ltd., which is located in Virginia. Fanmarco, Ltd. processes and grinds spices for Petitioner, as Petitioner does not have its own production capability.[17] Petitioner does not file tax returns in Virginia. The work papers provided by Mr. Weiss and prepared from Petitioner's business records indicate the amount of inventory in Virginia that was treated as inventory outside the City for the Tax Years.

Petitioner's City GCT returns for the Tax Years were selected for audit. During the course of the audit, the City's auditor addressed and proposed adjustments only with respect to: (1) whether there was inventory located outside the City; and (2) whether Skip should be deemed a shareholder of Petitioner such that his compensation should be included in the alternative tax computation. The audit report contains no mention of whether Skip's salary was reasonable within the meaning of IRC §162(a).

[17] *See* T. Ex. 4, 1999 Appraisal, p. 3.

Respondent issued a Notice of Determination dated October 20, 2006 asserting the following proposed deficiencies:

Tax Year	Principal	Interest[18]	Total Deficiency
2002	$ 29,381.36	$ 9,426.32	$ 38,807.68
2003	37,110.98	8,944.81	46,055.79
2004	33,636.49	5,406.43	39,042.92
2005	38,449.37	2,683.71	41,133.08
Total	$138,578.20	$26,461.27	$165,039.47

The proposed deficiencies resulted from adjusting the inventory component of the property factor in Petitioner's Business Allocation Percentage ("BAP") to treat all inventory as if it were located in the City and computing the GCT using the alternative tax basis of entire net income ("ENI") plus compensation of officers owning at least five percent of the taxpayer's shares. *See* Code §604.1.E, as modified by Code §604.1.H(2).

Petitioner requested a Conciliation Conference. Following that Conference, a Conciliation Decision dated March 28, 2007 sustaining the Notice of Determination was issued. Thereafter, on April 27, 2007, Petitioner filed a Petition for Hearing with the Tribunal. After the Tribunal's pre-hearing conference process was completed, a Hearing was held on July 23, 2008.

In her opening statement at the beginning of the Hearing, Respondent's representative stated:

> The City will alternatively argue should the [T]ribunal determine that the alternative tax

[18] Computed to November 27, 2006.

> computation was not proper, . . . that the compensation paid to Mr. Martin was unreasonable. If the [T]ribunal determines that the taxpayer has not met its burden of proof, an audit may be necessary to determine what amount of compensation is reasonable.[19]

Respondent made no assertion relating to the amount of compensation he claimed was reasonable either before or during the Hearing.

POSITIONS OF PARTIES

Petitioner contends that the inventory located outside the City was properly reported on its Forms NYC 3L for the Tax Years. Respondent accepts the amounts for New Jersey inventory that are included on the City Forms NYC 3L for 2003, 2004 and 2005.[20] However, Respondent asserts that Petitioner did not meet its burden of proof with respect to the New Jersey inventory for 2002 because the New Jersey return for that year is not in the record. Respondent also does not accept the amounts shown on the work papers for inventory held in Virginia since Petitioner did not file tax returns in Virginia.

Petitioner contends that the Trust, which is the record owner of Petitioner's shares, also is the beneficial owner of those shares and, as a result, Skip's compensation may not be included in the alternative tax basis. Respondent asserts that notwithstanding that record title to the shares Skip transferred to the Trust is in the name of the Trust, Skip is the owner of those shares for purposes of the alternative tax basis because Skip controlled the

[19] Tr. pp. 13-14.

[20] Respondent's Brief, p. 13.

operations of the business and was the recipient of virtually all of its profits.

In his Reply Brief, Respondent asserted, for the first time, that fifty-six percent of Skip's compensation should be disallowed as being unreasonable under IRC §162(a). Petitioner did not address this specific assertion.

DISCUSSION AND ANALYSIS

Inventory Allocation

A corporation may allocate its ENI to the City by a BAP, one component of which is the property factor. Code §11-604(3)(a)(1). Property that is in transit is not taken into account. GCT Rule §11-64(3). The auditor treated all inventory that was not located in the City as if it were in transit. As a result, the auditor adjusted Petitioner's BAP on its City Forms NYC 3L by treating 100 percent of its inventory as if it were located in the City.

The documentary evidence in the record and Petitioner's witnesses' credible testimony establish that Petitioner had property in New Jersey and Virginia during the Tax Years in the amounts reflected on the Forms NYC 3L. Petitioner's accountant, William Weiss, credibly testified that the New Jersey tax return for 2002 was filed, but that the copy had been destroyed. He provided pages from his work papers to substantiate the amount claimed on the NYC 3L for 2002. The record establishes that Petitioner had inventory in Virginia because the Fanmarco plant, located in Virginia, was used to grind and process Petitioner's spices. There is nothing in the record to indicate that Petitioner

was obligated to file tax returns in Virginia. Accordingly, Petitioner's BAP is accepted as filed for all Tax Years.

Alternative Tax Basis

Code §11-604.1.E, as modified by Code §11-604.1.H(2), provides an alternative tax basis for the GCT that is calculated by adding to ENI the salaries and other compensation paid to a corporation's officer if that officer owns in excess of five percent of the corporation's issued capital stock. Respondent asserts that notwithstanding that record title to the shares Skip transferred to the Trust is in the name of the Trust, Skip is the beneficial owner, and thus the owner of those shares for purposes of the alternative tax basis.[21]

Petitioner asserts that Skip is not treated as the owner of the shares for federal tax purposes.[22] Respondent does not contest this assertion but claims that it is irrelevant because he contends that the GCT Rules deem Skip to be the owner of the shares.

The pertinent Rule, GCT Rule §11-34(d), defines a stockholder as a person who is the "beneficial owner" of that stock and provides that "[r]ules for determining the beneficial ownership of stock are set forth in Section 11-46(a) [now, Rule §11-46(2)],'subsidiary,' *infra*." GCT Rule §11-46(2) provides, in pertinent part, that "[t]he test of ownership is actual beneficial ownership, rather than mere record title as shown by the stock

[21] The GCT does not contain a provision like IRC §318 which, under certain circumstances, attributes stock ownership from a family member or a trust to someone who is not the record owner.

[22] *See* IRC §674.

books of the issuing corporation." Record title, therefore, does not necessarily indicate actual beneficial ownership. Rule §11-46(3) indicates that one can be the actual beneficial owner even though one "has conferred the right to vote such stock on others, by means of a proxy, voting trust agreement or otherwise."

Rule §11-46(4) provides that "where the record holder of shares of voting stock of a corporation is not the actual beneficial owner thereof, or where the right to vote such stock is not possessed by the record holder or by the actual beneficial owner thereof, a full and complete statement of all relevant facts must be submitted."

All of the cases addressing the meaning of "actual beneficial owner" are cases where the taxpayer asserts that the "actual beneficial owner" is not the record owner. *Matter of Racal Corp. and Decca Elecs., Inc.*, 1993 N.Y. Tax LEXIS 208, DTA 807361 (State Tax Appeals Tribunal, 1993); *Matter of Ribner, Kluft & Berger, P.C.*, TAT(E) 93-958 (GC) *et. al* (City Tax Appeals Tribunal, 1997), *aff'g* TAT(H) 93-958(GC), *et. al* (City Tax Appeals Tribunal, ALJ determination, 1995); *Matter of Bankers Trust N.Y. Corp.*, DTA 811316 (State Tax Appeals Tribunal, 1996), *Matter of Bankers Trust Corp.*, TAT(H) 04-36(BT) (City Tribunal, ALJ Determination, 2008).[23] In those cases, the State and City Tribunals grappled with the question of how much entitlement to the profits of the business and/or control over the corporation the person who was not the record owner had to possess for that person to be the "actual beneficial owner" of that corporation's stock. In contrast, here, the Commissioner, not the taxpayer, is asserting that the record owner is not the "actual beneficial owner," notwithstanding that

[23] City ALJ determinations are not precedential.

the IRS considers the record owner to be the actual owner for federal tax purposes.

Respondent relies on *Ribner Kluft*, *supra*, which analyzed the cases that preceded it to determine which factors constituted actual beneficial ownership. *Ribner Kluft* stated that:

> [b]eneficial ownership, therefore, potentially consists of two groups of rights: one involving control over the corporation and the other involving entitlement to the profits from the business.
>
> . . .
>
> {I]t is not entirely clear that to be a beneficial owner under section 11-604.1.E of the Code, a stockholder must not only enjoy the profits from the business but also have some control over the corporation.[24]

After *Ribner Kluft* was decided, GCT Rule §11-46(2) was amended in 1997 to address the problem raised by *Racal*, *supra*, which dealt with whether a particular corporation in a chain of corporations was the "actual beneficial owner" of a lower-tiered subsidiary corporation.[25] Respondent asserts that because this portion of the Rule was amended specifically to address subsidiary capital in the context of the *Racal* decision, it has no applicability here. However, there is nothing in the Basis and Purpose of Amendments to indicate that the new examples contained in the 1997 amendments should not be used to provide guidance for determining actual beneficial ownership even where the corporation is not part of a tiered structure. This is demonstrated by Example 1 of GCT Rule

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[24] *Ribner Kluft*, *supra*. (ALJ Determination.)

[25] *See* "Basis and Purpose of Amendments" published in the City Record, September 4, 1997, pp. 2445-6.

§11-46(2), as amended, which provides that where a brokerage house holds record title in street name for its customers, the customers are the "actual beneficial owners." This example has nothing to do with the tiered corporate structure found in *Racal*.

Example 2 of that Rule addresses the issue of which corporation in a multi-tiered corporate structure is a particular corporation's actual beneficial owner. In that example, the direct parent is the actual beneficial owner because that shareholder has the right to sell or pledge the stock, receive all dividends, enjoy the economic benefits and bear the risk of loss from the sale of the stock. The grandparent corporation was found not to be the actual beneficial owner of its second-tier subsidiary by virtue of the fact that, through its ownership of the voting stock of its immediate subsidiary it had practical control of its second-tier subsidiary. This example establishes that the right to sell or pledge the stock, receive dividends, enjoy the economic benefits and bear the risk of loss from the sale of the stock are key components of actual beneficial ownership. These rights are relevant here.

Respondent does not dispute that the Trust has the right to sell or pledge the stock and will bear the risk of loss or enjoy the benefit of any gain. However, Respondent asserts that while the Trust was entitled to the profit from the business, there was very little profit because of the large amounts that Petitioner paid Skip for compensation, rent and interest. Respondent claims that the only dividend Petitioner paid to the Trust during the Tax Years was $70 in 2004[26] and concludes that Skip, not the Trust, enjoyed the economic benefits of the business. However, the record

[26] Respondent's Brief, p. 8.

does not support Respondent's assertion. The $70 dividend in 2004 to which Respondent refers is simply a dividend that Petitioner received on some investment that was required to be separately stated as a pass-through item on the Trust's Form 1041. It has nothing to do with any distributions that Petitioner made to the Trust.[27]

In general, even though they may be treated as dividends for state corporate law purposes, distributions made by S Corporations to their shareholders are not treated as dividends for federal income tax purposes. Rather (with exceptions not relevant here), all items of income reflected on the S Corporation's federal Forms 1120S are passed through to the shareholders and are reflected on the shareholders' federal income tax return (in this case, the Forms 1041, because the shareholder is a trust). The S Corporation does not pay federal income tax on its income. Instead, the shareholders pay the tax on the S Corporation's income, whether or not any amounts are distributed to them from the S Corporation in the year in which the income is earned, and generally the shareholders' bases in their stock are increased accordingly.

When an S Corporation makes a distribution to its shareholders, generally this is reflected as reductions in the bases of the shareholders' shares and not as items of dividend income to the shareholders. Those distributions could be out of current earnings or earnings from a prior period. In actuality, Petitioner distributed $350,000 to the Trust during the Tax Years. This is not to say that a corporation must make distributions each year to its shareholders in order for its shareholders to be

[27] *See generally* Bittker and Eustice, Federal Income Taxation of Corporations and Shareholders ¶6.06.

considered the actual beneficial owners. However, here, the Trust clearly did enjoy the economic benefits (both current and future) of stock ownership.

Respondent also contends that Skip is the actual beneficial owner of the shares because he controlled Petitioner. Respondent asserts, "while sometimes seeking the advice of Mr. McIntyre [the Trustee] Mr. Martin [Skip] made all the important decisions on how to run the company."[28] However, even in the case of an arm's-length sale of a business, it is not unusual for a high level executive of the corporation to remain on to run the business under new ownership. In fact, sometimes it is a condition of the sale.

The type of control that both *Ribner Kluft* and the GCT Rules were concerned about was not the day-to-day control of operations of the business, but the voting control that the shareholders of a corporation would be expected to possess. It is the right of a shareholder to elect corporate directors and to vote in extraordinary situations such as mergers and dissolutions.[29] In a closely held business, as a practical matter, shareholders may, of course, be consulted about major decisions, since they hold the ultimate power, which is the ability to vote management out of office if they are unhappy with the decisions management makes.

The corporate directors, who are elected by the shareholders, are charged with managing the corporation.[30] Among the directors' responsibilities are the appointment of corporate officers to

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[28] Respondent's Brief p. 11.

[29] *See* N.Y. Bus. Corp. Law ("BCL") §§614, 901, 1001.

[30] *See* BCL §701.

handle the day-to-day business of the corporation.[31] Respondent has not asserted that corporate formalities were disregarded here.

The Trust contemplated that the Trustee could manage the business "either directly or by appointing agents, officers, employees. . .."[32] The Trustee's compensation would have been increased above the statutory trustee's fees in the event the Trustee actively managed the business. It is conceivable that it was contemplated that the Trustee might have to take an active role in the event Skip was no longer available to manage the business, until such time as one or more of Skip's children could take over the management of the business, or another manager could be found or until the business could be sold. Here, however, the Trustee exercising his authority under the Trust, appointed Skip to run the business. As a result the Trustee was entitled only to the statutory trustee's fees and that was all Mr. McIntyre was paid. The Trust had all the control that an actual beneficial owner was expected to have under the GCT Rules and under *Ribner Kluft*, *supra*. Accordingly, Skip was not the actual beneficial owner of any shares in Petitioner and the alternative tax basis is inapplicable.

Reasonable Compensation

Respondent asserts that if Skip was not the beneficial owner of at least five percent of the shares of Petitioner, fifty-six percent of his compensation should be found to be unreasonable and therefore not deductible.[33] This determination will not address the

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[31] *See* BCL §715.

[32] *See* n. 5, *supra*.

[33] Respondent's Brief p. 12. See also IRC §162(a).

substantive issue of reasonable compensation because Petitioner is entitled to a fair hearing in which all elements of due process are satisfied[34] and there are procedural and due process difficulties raised by the timing of Respondent's assertion.

In her opening statement at the Hearing, Respondent's representative stated with respect to reasonable compensation: "[i]f the tribunal determines that the taxpayer has not met its burden of proof, an audit may be necessary to determine what amount of compensation is reasonable."[35] With exceptions not relevant here, Respondent has no authority to issue a further notice of deficiency for the same year once a taxpayer has filed a petition with the Tribunal. Code §11-680(d). Once a determination including any appeals is final, the matter is final for the years at issue and Respondent does not have the power to reaudit the matter and assert a new deficiency based on a different theory. However, this is all that Respondent placed in the record as to his position on this issue.

Furthermore, Respondent's audit report makes no mention of the issue of whether Skip's compensation was reasonable. The sole manner in which the audit report and the Notice of Determination addressed Skip's compensation was as an add-back under the alternative tax basis of Code §11-604.1.E(a)(3). Although Respondent's representative first asserted in her opening statement at the Hearing that Skip received an unreasonable amount of compensation, at no time before the Hearing record was closed did Respondent assert the amount of compensation that he believed was

[34] City Charter §§169, 1046.

[35] Tr. p. 14.

unreasonable and therefore should be disallowed.[36] Accordingly, Petitioner was not on notice as to the amount of the compensation that Respondent wished to disallow or how he arrived at that proposed amount in order to know what facts Petitioner needed to submit into the record to challenge that assertion. Due process requires notice of what is at issue at a Hearing. *Matter of Diamond Terminal Corp. v. Dept. of Taxation and Finance,* 158 A.D.2d 38 (3rd Dept. 1990), *lv. denied* 76 N.Y.2d 711 (1990).

The first time that Respondent asserted how much of Skip's compensation should be disallowed and explained the rationale he used for arriving at those figures was in his Reply Brief,[37] which was filed well after the record was closed. Whether an amount deducted as compensation is reasonable under IRC §162(a) is a question of fact that must be decided on the basis of the particular facts and circumstances. *Paula Constr. Co., v. Commissioner,* 58 T.C. 1055, 2058-89(1972), *aff'd.* without published opinion 474 F.2d 1345 (5th Cir. 1973). A hearing on this issue can be complex, fact specific and require expert testimony about the compensation paid to employees of other companies and entail an analysis of whether an independent investor would find the challenged compensation acceptable in light of the facts during the year at issue. *See, e.g., Dexsil Corp. v. Commissioner*, 147 F.3rd 96 (2nd Cir. 1998); Owensby & Kritikos, Inc. v. Commissioner, 819 F.2nd 1315 (5th Cir. 1987). It is unreasonable to expect a taxpayer to incur that kind of expense without knowing the amount of compensation the taxing authority seeks to disallow. Because this

[36] On occasion, Respondent has proposed an alternative theory in this forum after a Notice of Determination has been issued. However, this must be done with adequate notice to the taxpayer/petitioner.

[37] Respondent's Reply Brief p. 12.

is a new factual issue, it may not be raised after the record is closed if the party bearing the burden of proof on the issue would be prejudiced. *Matter of Marquez*, TAT(E) 97-107(UB) (City Tax Appeals Tribunal, 2007). Accordingly, Respondent's position on this issue will not be addressed.

For all the reasons noted above, there will be no adjustment to the amount of compensation paid to Skip for the Tax Years.

ACCORDINGLY, IT IS CONCLUDED THAT:

A. Petitioner had inventory in New Jersey and Virginia in the amounts claimed on the Forms NYC 3L for the Tax Years. The Business Allocation Percentage for each of the Tax Years is therefore accepted as filed.

B. Because Skip was not the actual beneficial owner of in excess of five percent of Petitioner's issued capital stock during the Tax Years, his compensation may not be included in the alternative tax basis.

C. The issue of whether a specified amount of the compensation paid to Skip was reasonable is a new factual issue which may not be raised after the record is closed as it would prejudice Petitioner.

For the reasons set forth above, the Petition of Wm. E. Martin & Sons Co., Inc. is granted and the deficiencies asserted in the Notice of Determination dated October 20, 2006 are cancelled.

DATED: July 20, 2009
New York, New York

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MARLENE F. SCHWARTZ
Administrative Law Judge