

STATE OF NEW YORK

TAX APPEALS TRIBUNAL

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In the Matter of the Petition	:	
	:	
of	:	
	:	
<b>ROBERT C. FRIEDMAN</b>	:	<b>DECISION</b>
	:	<b>DTA NO. 802070</b>
for Redetermination of a Deficiency or for	:	
Refund of Personal Income Tax under Article	:	
22 of the Tax Law for the Years 1980 through	:	
1983.	:	

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Petitioner, Robert C. Friedman, Krumkill Road, R.D. #1, Slingerlands, New York 12159, filed an exception to the determination of the Administrative Law Judge issued on December 3, 1987 with respect to his petition for a redetermination of a deficiency or for refund of personal income tax under Article 22 of the Tax Law for the years 1980 through 1983 (File No. 802070). Petitioner appeared by Urbach, Kahn and Werlin, P.C. (David Evans, Esq.). The Division of Taxation appeared by William F. Collins, Esq. (Thomas C. Sacca, Esq., of counsel).

The petitioner filed a brief on exception and requested oral argument. The Division did not respond to petitioner's brief. Oral argument was heard on June 9, 1988.

After reviewing the entire record in this matter, the Tax Appeals Tribunal renders the following decision.

***ISSUES***

I. Whether it was necessary for the Division of Taxation to provide an evidentiary foundation in order for the April 12, 1985 Notice of Deficiency to be introduced into evidence at the hearing.

II. Was the petitioner, during the years in issue, a “shareholder” of a professional corporation within the meaning of Tax Law section 612(b)(7) (8) and (9) such that the petitioner was required to increase his Federal adjusted gross income to reflect certain benefits paid by the corporation on his behalf?

***FINDINGS OF FACT***

We find the facts as stated in the determination of the Administrative Law Judge and such facts are incorporated herein by this reference except that finding of fact "5" is modified as stated below. These facts can be summarized as follows.

On or about April 27, 1984, petitioner filed New York State amended resident income tax returns for the years 1980 through 1983. The amended returns claimed refunds on the basis of petitioner's position that he erroneously made the professional corporation modifications pursuant to Tax Law section 612(b)(7), (8) and (9) since he was not a shareholder of a professional corporation. The claim for refund for the years 1980 through 1983 were mailed to the Albany District Office of the Department of Taxation and Finance on or about April 27, 1984. The amended return for the year 1980 reported that a return had previously been filed for 1980 and that tax was paid during 1980 through withholding of New York State tax. The return for 1980 was filed pursuant to a grant of an extension of time for petitioner to file his Federal

income tax return to October 15, 1981. The Division of Taxation did not respond to petitioner's claims for refund.

On March 29, 1985, the Division issued a Notice of Deficiency to petitioner, Robert C. Friedman, asserting a deficiency of personal income tax as follows:

Year	<del>Tax</del> Interest	Total	
1981	\$1,592.00	\$ 567.31	\$2,159.31
1982	1,015.00	208.56	1,223.56
1983	<u>3,212.00</u>	<u>321.26</u>	<u>3,533.26</u>
	\$5,819.00	\$1,097.13	\$6,916.13

On April 12, 1985, the Division issued a second Notice of Deficiency to petitioner asserting the same deficiency of personal income tax which had been asserted on March 29, 1985.

Finding of fact "5" is modified to read as follows:

Each of the foregoing notices of deficiency were received in evidence without requiring a foundation. The March 29, 1985 Notice of Deficiency was introduced as part of the Division's exhibit D, as an attachment to the petitioner's petition.

The Statement of Audit Changes, which was issued on December 31, 1984, explained that the notices of deficiency were based on adjustments of petitioner's liability in five areas. First, the Division took the position that the amount of the professional corporation modifications made on petitioner's original income tax returns for the years 1981 and 1983 were inadequate. Secondly, the Division disallowed 85 percent of the claimed travel and automobile expenses on the basis of lack of substantiation. The Division also disallowed claimed professional education and entertainment expenses because of lack of substantiation. Lastly, the Division disallowed certain rental expenses on the ground that the property involved was not rental property.

At the hearing, the Division conceded the accuracy of the tax returns with respect to the travel and automobile expenses and the professional education expenses.

In 1971, petitioner became the Chief of Radiology at Memorial Hospital in Albany, New York. In time, he developed a private practice in radiology.

During the years in issue, petitioner was employed as the president of Capital Radiology Associates, P.C. ("the corporation"). There were from five to six physicians associated with the corporation.

All of the stock of the corporation was owned by the Andrew J. Friedman Trust ("Trust"). Petitioner was the grantor of the Trust which was structured with the intention of being a Clifford Trust in accordance with the provisions of subchapter J of the Internal Revenue Code of 1954. Petitioner's son was designated as the income beneficiary of the Trust.

The Trust was designed to last for a period of ten years and ten days or until the death of the grantor or income beneficiary, whichever came first. The instrument creating the Trust expressly made the Trust irrevocable. Each trustee of the Trust was licensed to practice medicine.

Among other things, the trustees had complete custody of the Trust corpus and were directed to hold, manage, invest and reinvest the Trust corpus. The trustees were also directed to pay all of the ordinary income in the nature of interest and dividends to the income beneficiary.

During the years in issue, the corporation paid dividends to the Trust and the Trust, in turn, claimed an income distribution deduction.

During the years in issue, petitioner spent about twenty percent of his time practicing medicine, interpreting films and fluoroscopy. The balance of petitioner's time was consumed by managing the Memorial Hospital's Department of Radiology and in handling the business aspects of his medical practice.

### ***OPINION***

The Administrative Law Judge determined that a foundation was not necessary for the admission into evidence of the Notice of Deficiency of April 12, 1985, the Division properly required petitioner to make the professional corporation's modifications, petitioner did not prove his entitlement to entertainment expenses claimed in 1983, and that the Division improperly disallowed the rental expenses claimed by petitioner.

On exception to the Tribunal, the petitioner argues:

1. that the Administrative Law Judge's decision to admit into evidence the Notice of Deficiency was arbitrary and capricious because the Division failed to lay a proper foundation, and
2. that the Administrative Law Judge improperly concluded that the petitioner, for the years in issue, was subject to the add-back modifications of Tax Law section 612(b)(7)(8) and (9).

We will deal first with the issue of the admissibility of the Notice of Deficiency.

The petitioner argues that it was an error for the Administrative Law Judge to admit the Notice of Deficiency dated April 12, 1985 into evidence without a foundation. A similar argument was made to this Tribunal in Matter of Hugo Matson and Joan Matson (Tax Appeals Tribunal, March 10, 1988), a case in which we held that the Division does not have to go behind

the Notice of Deficiency to explain its basis nor provide evidence of timely and proper mailing before such a notice may be admitted into evidence at the hearing. We observed in Matson that an administrative agency need not observe the strict rules of evidence observed by the courts (SAPA § 366). As such, the introduction of the Notice of Deficiency is hardly an "extreme violation of the rules of evidence" as argued by petitioner; rather, it is no violation at all. Furthermore, we noted in Matson that a taxpayer is not deprived of a fair hearing by such an introduction since procedures are available to him to inspect documents, offer evidence in rebuttal and cross examine witnesses. We affirm the reasoning of Matson and find, on the facts before us, that the Administrative Law Judge's decision to introduce into evidence the Notice of Deficiency dated April 12, 1985 was proper.

Finally, we note that for unexplained reasons the Division introduced two Notices of Deficiency at the hearing; the March 29, 1985 notice introduced into evidence as part of the petition itself and the April 12, 1985 notice which is the object of petitioner's procedural objection. While the introduction of the April 12, 1985 notice may have served only to confuse the procedural issues at the hearing, we do not agree with the petitioner that the Division would be stripped of its ability to assert a deficiency were we to rule that the April 12, 1985 notice was inadmissible. This is because the hearing related to the adjudication of the March 29, 1985 Notice of Deficiency which was introduced into evidence attached to the petition. The result is the anomalous situation of the petitioner objecting to the introduction of the April 12, 1985 notice, a document whose admission benefits the petitioner by preventing any possible collection action by the Division of Taxation on the otherwise apparently unpetitioned April 12, 1985 Notice of Deficiency,

In any event, we agree with the conclusion of the Administrative Law Judge that the April 12, 1985 Notice of Deficiency was merely duplicative of the March 29, 1985 Notice of Deficiency.

We now turn to the substantive issue of whether the petitioner, as a grantor into a short term "Clifford" trust of shares of a professional corporation, is immune from the add-back modifications of Tax Law section 612(b)(7)(8) and (9).

Tax Law section 612(b)(7)(8) and (9) requires that Federal adjusted gross income be modified:

"in the case of a taxpayer who is a shareholder of a corporation organized under Article fifteen. . ."

The thrust of petitioner's argument is that since shares of the professional corporation were held in trust during the years in issue, he is not a "shareholder" within the meaning of Tax Law section 612(b)(7)(8) and (9). The decision below did not directly address the question whether the petitioner was a shareholder. Instead, the Administrative Law Judge determined that the grantor who transfers shares in a professional corporation into an irrevocable, short-term "Clifford" trust is not relieved from the obligation of making the section 612(b) professional corporation modifications to Federal adjusted gross income because the amendments to the Business Corporation Law which allow such transfers to a trust were not intended to allow this method of tax avoidance.

The Administrative Law Judge found support in the decision of Becker v. State Tax Commn. (89 AD2d 707 [3d Dept 1982]), a case that upheld a State Tax Commission determination that the establishment of a revocable, passive trust, the corpus being comprised of shares in a professional corporation, does not relieve the grantor from the professional

corporation modification provisions of section 612(b). The basis of the Becker decision, however, is that "because petitioners had retained all incidents of ownership of the shares of stock, such as the right to withdraw property from the trust at anytime and to revoke the trust at any time, and because the trustee had no active duties to perform other than to do as directed by the grantor-beneficiaries, the trust was passive, not active, the trustee took nothing, and legal and equitable title remained vested in petitioners." (Becker v. State Tax Commn., *supra*, at 707.) Thus, we find from Becker that section 612(b)'s professional corporation modification provisions are triggered by legal or equitable ownership of shares in a professional corporation. Where a taxpayer has given up all incidents of ownership, both legal and equitable, in shares of a professional corporation, we cannot say as a matter of law that this is an impermissible method of tax avoidance.

Unlike the situation in Becker where the trust document itself failed to establish a valid trust under New York law, the trust here was active, not passive, since the trustees of the Robert C. Friedman Trust had active duties or obligations to perform with respect to the trust corpus. (See, EPTL 7-1.1, 7-1.2, Matter of Estate of Gagliardi, 55 NY2d 109 [1982].) Reading the factual findings as a whole, the Administrative Law Judge found, and we agree, that the petitioner established at the hearing the existence of an active trust under New York law.

Therefore, the crucial issue is whether the petitioner transferred into the trust his entire present interest in the shares such that the petitioner would have held neither legal nor equitable title in the shares during the years in issue.

The meaning of the word "shareholder", which is used in the statute, is well settled. A "shareholder" is one who owns a share of stock (Matter of Irving D. Friedman, 184 Misc 639).



A share of stock is merely the intangible property interest of the shareholder, whereas it is the stock certificate that constitutes a representation of such interest and a muniment of title evidencing the right of ownership of the shares (60 NJ Jur § 5). For purposes of transfer, the shares are identified with the certificate, and a transfer of the certificate transfers the shares. On the facts before us, not only do we find that a transfer of the stock certificate to the trustees took place, but, more importantly, the trustees had presented the certificate to the corporation for registration and subsequently the shares were re-issued to them in their capacity as trustees of the Robert C. Friedman trust. Thus, the trustees, and not the petitioner, were listed on the books of the corporation as the owners of the entire one hundred shares of stock outstanding in Capital Radiology Associates, P.C. It is clear that the petitioner did not hold legal title to the shares during the years in issue.

We now turn to the question whether the petitioner retained beneficial ownership of the shares. The petitioner would be the beneficial owner of the shares if he exercised such control over the shares that the benefits of ownership accrued to him. Article III of the trust document provided that it was for the trustees to exercise complete custody and control of the trust corpus which was comprised solely of the shares. The Division did not produce any evidence showing that the shares were managed in a manner inconsistent with the trust document. The Division having failed to adduce evidence tending to show petitioner's control of the shares after the transfer in trust, we cannot find that the petitioner retained a beneficial ownership in the shares for the years in issue.

We find then that the petitioner retained no present interest in the shares during the years in issue and, hence, was not a shareholder subject to section 612(b)'s professional corporation modification provisions.

The Division argues that we should look behind the clear language of the statute in order to carry out its legislative intent because the "shareholder" requirement of section 612(b)(7)(8) and (9) reflected the stringent restrictions which existed in Article 15 of the Business Corporation Law when the add-back provisions were enacted into the Tax Law in 1970 (L 1970, ch 974). As originally enacted, Article 15 of the Business Corporation Law did not permit professional corporation shares to be held in trust. Section 1511 of the Business Corporation Law was amended in 1971 (L 1971, ch 1022) to permit the transfer of professional corporation shares in trust. The Division argues that the intent behind section 612(b) add-back which was to protect the State from revenue loss resulting from favorable Federal tax treatment of professionals as shareholders of a corporation is frustrated when, as here, no professional in the corporation is subject to professional corporation add-back. We agree but this is a situation created not by the petitioner but by the Legislature when it amended section 1511 of the Business Corporation Law to allow the transfer of professional corporation shares in trust. The fact that the Legislature may not have intended or even been aware that the amendment to section 1511 of the Business Corporation Law would adversely impact on the Tax Law section 612(b) professional corporation add-back provisions cannot operate against the petitioner. Having transferred the shares in a manner which the Legislature by statute has expressly allowed, the petitioner is entitled to the tax consequences that follow. The Legislature expressly imposed the professional corporation add-back provisions on only shareholders and the Division

is simply not entrusted with the discretion to impose its own criteria in determining shareholder status.

Accordingly, it is ORDERED, ADJUDGED and DECREED that:

1. The exception of the petitioner, Robert C. Friedman, is granted to the extent that we find that petitioner was not a "shareholder" of a professional corporation within the meaning of section 612(b)(7)(8) and (9) of the Tax Law and was not required to make the modifications required by such section, but except as so granted is in all other respects denied;

2. Conclusion of law "D" of the Administrative Law Judge's determination is reversed but except as so modified the determination is affirmed; and

3. The petition of Robert C. Friedman is granted to the extent indicated in paragraph "1" above and in conclusions of law "B", "F" and "G" of the Administrative Law Judge's determination and the Division of Taxation is directed to modify the Notice of Deficiency dated March 29, 1985 accordingly and the claims for refund are granted, but except as so granted the petition is in all other respects denied.

Dated: Albany, New York  
December 08, 1988

/s/ John P. Dugan  
President

/s/ Francis R. Koenig  
Commissioner