

STATE OF NEW YORK
TAX APPEALS TRIBUNAL

In the Matter of the Petition :
of :
TRETORN AND SUMARN PUGKHEM : DECISION
for Redetermination of a Deficiency or for : DTA No. 807049
Refund of Personal Income Tax under Article 22 :
of the Tax Law for the Years 1982, 1983 and :
1984 :

Petitioners Tretorn and Sumarn Pugkhem, 130 Sycamore Drive, East Hills, New York 11576 filed an exception to the determination of the Administrative Law Judge issued on October 4, 1990 with respect to their petition for redetermination of a deficiency or for refund of personal income tax under Article 22 of the Tax Law for the years 1982, 1983 and 1984. Petitioners appeared by Kenneth I. Singer, C.P.A. The Division of Taxation appeared by William F. Collins, Esq. (Michael J. Glannon, Esq., of counsel).

Petitioners filed a brief on exception. The Division of Taxation filed a letter in lieu of a brief. Oral argument, requested by petitioners, was denied.

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

ISSUES

I. Whether the Division of Taxation properly characterized transfers of funds from Tretorn Pugkhem M.D.P.C. to Tretorn Pugkhem, petitioner, as taxable dividends for the years 1983 and 1984.

II. Whether the disallowance of certain deductions taken by Tretorn Pugkhem M.D.P.C. because they were personal in nature resulted in constructive dividends taxable to petitioners for the years 1983 and 1984.

III. Whether the Division of Taxation properly disallowed Schedule E rental losses from a certain rental property on Marco Island, Florida for the years 1983 and 1984.

IV. Whether the Division of Taxation properly disallowed a Schedule D capital loss claimed by petitioners for the year 1983 on the alleged sale of a second rental unit located on Marco Island.

V. Whether adequate grounds were presented by petitioners to abate penalties.

FINDINGS OF FACT

We find the facts as determined by the Administrative Law Judge. These facts are set forth below.

On February 27, 1989, the Division of Taxation (hereinafter the "Division") issued to petitioner Tretorn Pugkhem a Notice of Deficiency for the year 1982 which set forth additional tax due in the sum of \$3,711.00, penalty of \$1,949.00 and interest of \$2,342.41, for a total amount due of \$8,002.41. On the same date, the Division issued to petitioner Sumarn Pugkhem a Notice of Deficiency for the year 1982 indicating additional tax due of \$2,368.00, penalty of \$1,243.00 and interest of \$1,494.91, for a total amount due of \$5,105.91. Petitioners did not contest the tax due set forth on these notices of deficiency and concede their accuracy. However, petitioners do contest the assessment of penalty and additional interest and that amount remains in dispute herein.

On February 27, 1989, the Division issued a Notice of Deficiency to Tretorn and Sumarn Pugkhem for the years 1983 and 1984 which set forth additional tax due of \$41,394.00, penalty of \$2,070.00 and interest of \$17,428.26 for a total amount due of \$60,892.26.

For the year 1982, there was no record of a return being filed by petitioners and the amount found due and assessed was taken from a copy of said return provided by petitioners herein.

Prior to the issuance of the notices of deficiency, the Division issued a Statement of Personal Income Tax Audit Changes for all three years in issue. The explanation of the additional tax due was as follows:

	<u>1982</u>	<u>1983</u>	<u>1984</u>	<u>Total</u>
Dividend Income - Tretorn Pugkhem, M.D.P.C. - Adjustment to reflect amounts deemed to be dividends, not loans		\$ 18,064.00	\$43,242.00	
Constructive dividends - Tretorn				

Pugkhem, M.D.P.C. - Corporate deductions disallowed as being personal in nature		76,667.00	48,095.00	
Schedule E - Rental loss disallowed		37,033.00	35,534.00	
Schedule A - Itemized deductions disallowed		50,596.00	55,331.00	
Standard deduction		(2,500.00)	(2,500.00)	
Schedule D - Long-term Capital loss Disallowed		3,000.00		
Net adjustment		182,860.00	179,702.00	
Taxable income previously stated		72,951.00	95,614.00	
Corrected Taxable Income		255,811.00	275,316.00	
Tax on corrected taxable income		28,339.00	29,798.00	
NYC Tax - NYC 203		457.00	482.00	
Corrected Tax Due		28,796.00	30,280.00	
Tax Previously Computed as corrected		7,112.00	10,570.00	
Total Additional Tax Due	6,079.00	21,684.00	19,710.00	47,473.00
Penalty Pursuant to 685(a)(1)	1,368.00			1,368.00
Penalty 685(a)(2)	1,520.00			1,520.00
Penalty 685(b)	304.00	1,084.00	986.00	2,374.00
Interest	3,740.00	10,275.00	6,576.00	20,591.00
Totals	\$13,011.00	\$ 33,043.00	\$ 27,272.00	\$73,326.00

Subsequent to the first hearing in this matter, a representative of the Division met with petitioners' representative. Further substantiation was offered in support of the various items set forth in the explanation of the Statement of Personal Income Tax Audit Changes above. In light of this substantiation provided by petitioners' representative, further reductions in the assessment were made as follows:

<u>Item</u>	<u>1982</u>	<u>1983</u>	<u>1984</u>
Dividend Income - Adjustment to reflect amounts deemed to be dividends, not loans (Tretorn Pugkham, M.D.P.C.)		\$18,064.00	\$43,242.00
Item 2 Constructive Dividend - Tretorn Pugkhem M.D.P.C. - to reflect corporate deductions disallowed as being personal in nature		19,270.00*	23,780.00*
Item 3 Schedule E - Rental loss disallowed	37,033.00	35,534.00	
Schedule A - Itemized deduction Interest Expense - IRS not substantiated			1,107.00
Schedule A - Miscellaneous deductions - disallowance of 50% to reflect additional travel and entertainment and auto expense not allowable		4,317.00	3,532.00
Schedule D - Capital loss disallowed as unsubstantiated		<u>3,000.00</u>	
Revised Audit Adjustments		<u>81,684.00</u>	<u>107,195.00</u>
*Corporate deductions disallowed as personal: Client development (at 50%)		14,614.00	9,939.00
Professional meetings (at 50%)		1,577.00	758.00
Auto Expenses (at 49%)		<u>3,079.00</u>	<u>13,083.00</u>
Total - Deemed constructive dividend		19,270.00	23,780.00

For 1982, there was no record of a tax return being filed. The balance due as per petitioners' copy of the return was therefore asserted at \$6,079.00 plus appropriate penalty and interest.

Tretorn Pugkhem drew a salary from the professional corporation by means of promissory notes, specifically in the years 1983 and 1984. At the end of the corporation's fiscal year, June 30, a determination was made by Tretorn Pugkhem and his accountant as to how much

salary should be recognized for the fiscal year. When this figure was calculated, an equal amount in promissory notes was marked "paid" or forgiven by the corporation and an entry made of that amount in the general ledger under salary. Any outstanding notes were made payable in the next fiscal year.

In support of their system, petitioners submitted promissory notes for the fiscal years ended June 30, 1983 and 1984 which were marked "paid", thus signifying forgiveness of the indebtedness by the corporation. Said notes were issued on preprinted forms issued by the Julius Blumberg Co. entitled "non-negotiable note." The dollar amount was stated in the upper left hand corner. The date of the note was set forth in the upper right hand corner, and each of the notes set forth that the sum of money was payable to "bearer" on demand with no specified location at a set interest of 10% per annum. At the bottom right hand corner each of the notes was signed by Tretorn Pugkhem.

Petitioners disputed the disallowed corporate deductions which were characterized as personal expenses and treated as constructive dividends of Tretorn Pugkhem M.D.P.C. even after reductions were made by the Division prior to the second hearing date. Petitioners did not dispute the Division's finding that the disallowed corporate deductions were not ordinary and necessary business expenses. These expenses were in the areas of client development, professional meetings and automobile expenses.

With regard to Tretorn Pugkhem's interest in unit number 1611, South Seas Northwest IV, Marco Island, Florida, petitioners submitted a letter dated March 6, 1990 from Marco Beach Rentals, Inc., a management company, which stated that it represented Dr. Pugkhem with regard to said unit and alluded to an attached management agreement between the company and Dr. Pugkhem. However, said management agreement was not submitted into evidence and it is not known whether the agreement covered the years in issue.

With regard to unit number 1705, South Seas Northwest IV, Marco Island, Florida, for which petitioners sought to take a capital loss for the year 1983, petitioners submitted only a warranty deed indicating that a property interest in the unit was transferred to Dr. Pugkhem and

two other parties on August 11, 1981 by Marco Island Beach Front, Inc. No evidence with regard to its sale was submitted.

Petitioner Tretorn Pugkhem executed an employment agreement with Tretorn Pugkhem M.D.P.C. on September 10, 1975, which provided in section 4(h) that any benefits provided the employee by employer which were disallowed by any taxing authority would be considered a loan payable with interest to the employee from the employer and would be repaid as soon as Notice of Disallowance was given by the appropriate taxing authorities to the employer.

OPINION

In the determination below, the Administrative Law Judge found that since petitioners were not able to substantiate that certain expenses were ordinary and necessary business expenses of Tretorn Pugkhem M.D.P.C., and were personal in nature, the Division properly assessed additional income to petitioners pursuant to its theory of constructive dividends. The Administrative Law Judge also found that since petitioners have not established the validity of alleged loans, the Division properly disallowed the alleged loans and determined same to be dividends paid by the corporation to Tretorn Pugkhem. As to the issues relating to the rental losses and the capital loss claimed by petitioners on two separate properties on Marco Island, Florida, the Administrative Law Judge held that petitioners have not established ownership of the rental property and failed to substantiate that a sale of the other property ever took place. Thus, the Division was correct in disallowing the Schedule E rental losses and the claimed capital loss. On the remaining issue relating to penalties, the Administrative Law Judge held that once again petitioners had the burden of proof and failed to come forth with any evidence indicating that such penalty should not be imposed.

On exception, petitioners argue that the penalties for the year 1982 should be abated as they relied on tax professionals to prepare their returns, they were not given their 1982 returns, and the failure to file was due to an oversight and not willful neglect. For the years 1983 and 1984, petitioners again argue that the penalties should be abated as they relied on tax professionals for advice as to the reporting of certain transactions and the additional tax is due to a difference of interpretation of the rules and regulations and not due to lack of support or

documentation. Petitioners also argue against the classification of the loan balance from Tretorn Pugkhem to Tretorn Pugkhem M.D.P.C. as dividends to the taxpayer, and allege that, due to an employment agreement with the corporation, the disallowed deductions should not be considered dividends. Further, petitioners state that they will attempt to obtain additional information that will assist the examiner in determining that the rental losses reported in 1983 and 1984 were proper. Petitioners' undated brief, received by the Secretary to the Tax Appeals Tribunal the first week of July 1991, included a letter dated January 23, 1991 relating to the issue of the disallowed rental losses for the years 1983 and 1984.

The Division agrees with the findings of fact and conclusions of law of the Administrative Law Judge and requests that the determination be sustained in its entirety and that the exception be denied. Further, the Division argues that since the letter dated January 23, 1991 was included as part of petitioners' undated brief and was not accepted into evidence by the Administrative Law Judge, it should not now be considered by the Tax Appeals Tribunal.

We affirm the determination of the Administrative Law Judge.

With the exception of the issue raised by the Division relating to the matter of the January 23, 1991 letter, which issue we will address below, we find no basis in the record before us for modifying the Administrative Law Judge's determination in any respect.

The Administrative Law Judge granted petitioners 30 days after the close of the hearing held on March 21, 1990 to submit documentation relating to the employment contract (Tr., p. 60) and also anything further with regard to the lease or rental situation of the Marco Island property (Tr., p. 60). Further, at the close of the hearing (Tr., p. 62), the 30 day limit for submission was again pointed out to both parties.

Since petitioners failed to insert into the record below the information contained in the January 23, 1991 letter filed with this Tribunal, we cannot now consider same in our decision (see, Matter of Modern Refractories Serv. Corp., Tax Appeals Tribunal, December 15, 1988).

For the reasons stated in his determination, we sustain the determination of the Administrative Law Judge.

Accordingly, it is ORDERED, ADJUDGED and DECREED that:

1. The exception of petitioners Tretorn and Sumarn Pugkhem is denied;
2. The determination of the Administrative Law Judge is affirmed;
3. The petition of Tretorn and Sumarn Pugkhem is granted to the extent indicated in conclusion of law "F" of the Administrative Law Judge's determination but is otherwise denied;
and
4. The Division of Taxation is directed to modify the notices of deficiency issued February 27, 1989 in accordance with paragraph "3" above, but such notices are otherwise sustained.

DATED: Troy, New York
January 23, 1992

/s/John P. Dugan
John P. Dugan
President

/s/Francis R. Koenig
Francis R. Koenig
Commissioner

/s/Maria T. Jones
Maria T. Jones
Commissioner