STATE OF NEW YORK

TAX APPEALS TRIBUNAL

In the Matter of the Petition	:	
of	:	
PRABHU AND KISHWAR HEMRAJANI	:	DECISION DTA No. 807994
for Redetermination of a Deficiency or for Refund of Personal Income Tax under Article 22 of the Tax Law for the Years 1985 and 1986.	:	

Petitioners Prabhu and Kishwar Hemrajani, 4026 Pawnee Drive, Liverpool, New York 13090, filed an exception to the determination of the Administrative Law Judge issued on November 12, 1992. Petitioners appeared by Bond, Schoeneck & King, Esqs. (George C. Shattuck, Esq., of counsel). The Division of Taxation appeared by William F. Collins, Esq. (Mark F. Volk, Esq., of counsel).

Petitioners filed a brief in support of their exception. The Division of Taxation filed a brief in response. Petitioners then filed a reply brief which was received on March 8, 1992 and began the six-month period for the issuance of this decision. Oral argument, requested by petitioners, was denied.

The Tax Appeals Tribunal renders the following decision per curiam.

ISSUES

I. Whether the Division of Taxation properly used a source and application of funds method of income reconstruction on audit herein.

II. Whether, if so, petitioners met their burden of proving error in the audit method or result.

III. Whether the Administrative Law Judge rendered findings of fact not based on "actual facts," which, in turn, did not support the conclusions of law.

FINDINGS OF FACT

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

below.

On December 23, 1988, following an audit, the Division of Taxation ("Division") issued to petitioners, Dr. Prabhu Hemrajani and Kishwar Hemrajani,[1] a Notice of Deficiency which assessed $3,429.35 in additional personal income tax due, plus penalty pursuant to Tax Law § 685(b) and (c) and interest, for the years 1985 and 1986.

By a Statement of Audit Changes dated October 7, 1988, the Division set forth its computation of the subject personal income tax deficiency summarized as follows:

	1985	1986
Additional Income per Source and Application of Funds Audit	$17,904.00[2]	$16,650.00
Disallowed Business Expenses	1,626.00	(305.00)
Net Adjustment	$19,530.00	$16,345.00
Taxable Income Previously Reported	41,664.00	20,016.00
Taxable Income Per Audit	$61,194.00	$36,361.00
Tax on Above	$ 5,288.23	$ 2,901.12
Tax Previously Reported	3,428.00	1,332.00
Additional Tax Due	$ 1,860.23	$ 1,569.12

Pursuant to a Conciliation Order dated December 29, 1989, the total deficiency of tax herein was reduced to $3,273.81, plus penalty and interest. This adjustment resulted from the correction of a duplication of the Division's disallowance of a business expense of $1,626.00 for 1985. This adjustment reduced the deficiency for 1985 to $1,704.69 and reduced the total deficiency as noted above.

Petitioner is a dentist engaged in the practice of dentistry in Liverpool, New York. During 1985 and 1986, petitioner's practice was in the form of a sole proprietorship under the name Bayberry Dental Center.

As noted above, the Division determined additional tax due based on the results of a

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[1]Kishwar Hemrajani is a petitioner herein solely by reason of having filed a joint return with Dr. Prabhu Hemrajani during the years at issue. Petitioners are no longer married and Kishwar Hemrajani currently resides in India. Accordingly, all references to petitioner herein, unless otherwise indicated, shall refer to Dr. Prabhu Hemrajani.

[2]This figure erroneously includes $1,626.00 of disallowed business expenses. This error was corrected by the Conciliation Order (see below).

source and application of funds audit. Upon review of certain of petitioner's tax returns and records, the Division determined total sources of funds for 1985 and 1986 of $98,455.00 and $157,277.00, respectively. The Division also determined total applications for 1985 and 1986 of $114,733.00 and $174,232.00, respectively. Applications thus exceeded sources by $16,278.00 for 1985 and $16,955.00 for 1986. The Division considered these amounts additional taxable income and calculated the deficiency herein accordingly.

Included among the applications of funds were personal living expenses of $45,000.00 for 1985 and $40,000.00 for 1986. Such personal living expenses were determined by totaling petitioner's actual personal expenditures made by cash, check or money order during 1985 and 1986 and by adding to that amount certain estimated cash expenditures for food, gifts, entertainment, travel, clothes and other miscellaneous expenses. In its workpapers setting forth its calculations of petitioner's personal living expenses for each year, the Division listed $10,000.00 in such estimated cash expenses for each such year. Using this $10,000.00 figure, the Division's workpapers indicate $44,424.00 in total personal living expenses for 1985 and $38,515.00 in total personal living expenses for 1986. As noted, however, the Division used the personal living expense figures of $45,000.00 and $40,000.00 in calculating petitioner's total applications for the years at issue. The Division thus rounded its calculation of petitioner's personal living expenses upward by $576.00 for 1985 and by $1,485.00 for 1986 in calculating petitioner's total applications for the years at issue.

On its workpapers setting forth its calculations of petitioner's personal living expenses, the Division listed no purchases by check or money order for clothing, food, dining out or entertainment for 1986 and a total of $318.00 in such purchases for 1985.

During 1985 and 1986, petitioner, although filing a joint return, did not reside with Kishwar Hemrajani. Petitioner did reside with Salena Bennett. During this period, Ms. Bennett was employed full time by petitioner in his dental practice as an office manager. Her responsibilities included bookkeeping. Ms. Bennett's total salary for the years 1985 and 1986 was about $4,000.00.

The records reviewed by the Division on audit revealed that Ms. Bennett transferred $2,000.00 to petitioner by check in 1985. Petitioner's records also revealed a subsequent transfer during 1985 of $6,000.00 from petitioner to Ms. Bennett. The Division included this $6,000.00 as an application of funds for petitioner for 1985, and on its workpapers listed this transfer as a payment of a loan to Ms. Bennett in accordance with petitioner's statement to the Division on audit. The Division did not, however, consider this transfer to be, in fact, a loan repayment.

To document the existence of purported loans totaling $6,000.00 from Ms. Bennett in 1985, petitioner introduced certain bank deposit receipts indicating deposits during 1985 into petitioner's business account of $4,000.00, $2,000.00 and $4,119.90. The receipts did not further identify the deposits.

To document the existence of purported loans from his brother and mother, petitioner offered documents purporting to be the functional equivalent of affidavits executed in India. By her affidavit petitioner's mother stated that she had given petitioner a "loan" of $9,000.00 during her visit in 1985. By his affidavit, petitioner's brother stated that he had given petitioner a "loan" of $8,500.00 during his visit in 1986.

To establish that he maintained complete and accurate records of his dental practice petitioner submitted samples of records of individual patients which indicated treatment, charges and payment histories which petitioner maintained during the audit period. The Division did not review such records on audit.

OPINION

In his determination below, the Administrative Law Judge rejected petitioner's assertion that the Division improperly resorted to using the source and application method of audit, holding that, in an income tax audit, the Division was not required to establish the inadequacy of petitioner's records before employing such method.

The Administrative Law Judge determined, in addition, that petitioner has failed to carry the

burden, under Tax Law § 689(e), of proving himself the recipient of nontaxable sources of funds in the forms of loans or gifts from his mother and brother in 1985 and 1986, respectively. Among the reasons cited for this conclusion are the facts that petitioner had no documentation to verify the transfers in question and that petitioner was unable to "establis[h] with any degree of precision the amount of the purported loans . . . " (Determination, p. 7). However, the Administrative Law Judge held that the Division erred in disallowing as a source of funds for petitioner in 1985 a $2,000.00 transfer from Ms. Salena Bennett to petitioner, noting that the record shows that a transfer of this money occurred. On the other hand, the Administrative Law Judge determined that the Division properly disallowed as a source of funds for petitioner in 1985 the claimed $4,000.00 transfer from Ms. Bennett to petitioner because petitioner did not establish that this transfer occurred.

Further, in spite of petitioner's arguments to the contrary, the Administrative Law Judge found reasonable the Division's estimates of $10,000.00 per year at issue for petitioner's personal cash living expenses. However, the Administrative Law Judge admonished the Division for disregarding its own workpapers in calculating additional tax due by rounding petitioner's total personal living expenses upward, from $44,424.00 to $45,000.00 for 1985 and from $38,515.00 to $40,000.00 for 1986. The Administrative Law Judge ordered the Division to adjust these calculations to reflect the numbers set forth in its own workpapers. The Division was directed to modify the Notice of Deficiency in accordance with these determinations.

On exception, petitioner challenges both the audit procedure -- stating that it violated New York State law and was illegal and void -- and the Administrative Law Judge's findings of fact which, according to petitioner, do not support the conclusions of law because they "were not findings at all but [were] for the most part merely references to what the Division contended at trial. Actual facts were not found" (Petitioner's exception, p. 1; brief on exception, p. 1).

As for the audit procedure, petitioner takes exception to the Administrative Law Judge's ruling that the Division was not required to review petitioner's books and records, nor establish their inadequacy, before resorting to an indirect method of audit assessment. Petitioner urges

that "[i]n light of the Supreme Court's concern about the fairness of the use of such indirect methods from the taxpayer's perspective, the auditor should have demonstrated the unreliability or unavailability of the taxpayer's records" (Petitioner's brief on exception, Exhibit "C," citing Greenway v. Commissioner, T.C. Memo. 1987-4, 52 TCM 1283 [in turn, citing Holland v. United States, 348 US 121, 129, rehearing denied 348 US 932]; Matter of Gun Hill Plumbing Supply Co. v. Chu, 145 AD2d 769, 535 NYS2d 497; Matter of Giuliano v. Chu, 135 AD2d 893, 521 NYS2d 883; Matter of Jacobson v. State Tax Commn., 129 AD2d 880, 514 NYS2d 145; Matter of Hennekens v. State Tax Commn., 114 AD2d 599, 494 NYS2d 208). Petitioner argues that the Division's failure to review his books and records rendered resort to the source and application method of assessment improper, and "the whole deficiency procedure," as well as the outcome of the audit, "void" (Petitioner's brief on exception, Exhibit "C"; Petitioner's exception, attached rider to p. 1, p. 2). Petitioner contends that the Division's failure to follow its own rules regarding the review of books and records shifted the burden of proof to the Division.

Petitioner further challenges the Administrative Law Judge's determination that petitioner failed to carry his burden of proving that he had nontaxable sources of income in the form of gifts or loans from his mother in 1985 and his brother in 1986. Petitioner maintains that his business records confirm his reported income and any alleged extra cash available was attributable to the nontaxable gifts from his mother and brother. Petitioner stresses that his testimony and the evidence presented were uncontradicted by any review of the books and records or any finding that the books and records were inadequate. Petitioner asserts that, in any case, the auditor's worksheets do not identify any alleged source of unreported taxable income.

Petitioner requests that the deficiency be cancelled, or, at the least, that a new hearing be granted "in which findings of fact are made and stated and the Division has the burden of proof" (Petitioner's brief on exception, p. 6).

In response, the Division asks that petitioner's exception be denied and the Administrative Law Judge's determination affirmed.

As for petitioner's allegations regarding the Administrative Law Judge's rendering of the findings of fact, the Division asserts that "petitioners received a fair hearing before an impartial fact finder who allowed both sides to present their cases and based his determination upon the evidence presented" (Division's brief in opposition, p. 4). In view of this, stresses the Division, petitioner should not be granted a new hearing.

The Division maintains that the source and application of funds audit was proper and that petitioner has the burden of proving that the audit or the resulting deficiency was inaccurate. The Division notes that in personal income audits, among others, there is no requirement that the Division first review, and then establish as inadequate, a taxpayer's books and records. Furthermore, contends the Division, when a deficiency is determined by the cash expenditures method (otherwise known as the source and application of funds method), a presumption of correctness attaches to the deficiency and the taxpayer has the burden to overcome this presumption, which, the Division asserts, petitioner has not done (Division's brief in opposition, p. 6, citing Devenney v. Commissioner, 85 T.C. 927, 930-931).

The Division stresses that in conducting a source and application of funds audit, the Division was obligated to "'either present evidence of a likely source of currently taxable income or negate nontaxable sources of income and track down leads which might show alternative sources of nontaxable income if such leads are reasonably susceptible to being checked'" (Division's brief in opposition, p. 7, citing Lopez v. Commissioner, T.C. Memo 1990-450, 60 TCM 574, 577 [in turn, citing United States v. Massei, 355 US 595; Holland v. United States, supra, at 138; Hoffman v. Commissioner, 298 F2d 784, 62-1 USTC ¶ 9218; DeVenney v. Commissioner, supra, at 931]). Following the guidelines of Holland, maintains the Division, the auditor attempted to determine the source and substantiate the claims made by petitioner regarding nontaxable income, but was unsuccessful due to petitioner's lack of proof to support the claims. Thus, states the Division, the auditor, unable to verify all of the items on the return,

tried to locate all sources and applications of income, and in so doing, determined that the records were not complete.

Finally, avers the Division, although petitioner presented testimony and affidavits in attempts to verify certain alleged nontaxable sources of income -- the loans or gifts supposedly given petitioner by his mother and brother, and $4,000.00 worth of a supposed $6,000.00 loan[3] given petitioner by Selena Bennett -- no credible evidence was submitted to support this testimony and, therefore, petitioner did not meet his burden of proof under Tax Law § 689(e).

We affirm the determination of the Administrative Law Judge.

In addition, because we find that the Administrative Law Judge completely and adequately addressed the issues before him, we see no reason to analyze these issues further; nor do we see any reason to hold otherwise and, therefore, affirm the Administrative Law Judge based on his determination.

We do, however, find it necessary to address petitioner's claim that the Administrative Law Judge erred in not finding "actual facts" which, in turn, do not support his ultimate determination.

The facts criticized by petitioner were those where the Administrative Law Judge found that:

> "the Division determined additional tax due based on the results of a source and application of funds audit . . . . [that] the Division determined total sources of funds for 1985 and 1986 of $98,455.00 and $157,277.00, respectively . . . . [that] [t]he Division also determined total applications for 1985 and 1986 of $114,733.00 and $174,232.00, respectively . . . . [that] [a]pplications thus exceeded sources [of funds] by $16,278.00 for 1985 and $16,955.00 for 1986 . . . . [and that] [t]he Division considered these amounts additional taxable income and calculated the deficiency . . . . accordingly" (Determination, p. 3, emphasis added).

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[3] As discussed above, the Administrative Law Judge concluded that petitioner was able to establish that a $2,000.00 loan had been given him by Ms. Bennett.

Petitioner argues that:

> "[t]o say 'the Division determined total sources of funds for 1985 --- of $98,455.00 --' is not the same as saying 'I, the Judge, find as a fact that total sources of funds for 1985 were $98,445.00.' After a contested hearing of fact, a Judge must make his or her own finding. A recitation of what the Division contended at trial or on audit is not a finding unless the Judge specifically finds as a stated fact that the Division's contention is correct -- which he did not do" (Petitioner's brief on exception, pp. 2-3).

Petitioner has urged, in effect, that the Administrative Law Judge's seemingly perfunctory "reporting" of the Division's determinations is in error as: (1) the Administrative Law Judge has an obligation to act as more than a mere conduit of the parties' allegations; (2) the Administrative Law Judge must provide critical analysis of the allegations, making independent fact findings; and (3) the findings of fact section of a determination is the proper place for such a critical analysis and independent fact findings.

Petitioner is operating under too narrow a conception of the definition of "actual facts" in an administrative determination. There are different types of "actual facts" which an Administrative Law Judge can find. The Administrative Law Judge's finding of fact "5" to which petitioner specifically takes exception is, despite petitioner's contentions, composed of legitimate "actual facts." The purpose of a fact such as this is to record the Division's calculations of petitioner's deficiency, including the methods of calculation used and, possibly, the purported reasoning behind the utilization of these methods.

This type of fact is extremely relevant to the issue before the Administrative Law Judge here -- indeed, petitioner even notes that "all of the rest of the case depends on Finding #5 . . ." (Exception, p. 3) -- because this fact conveys the basis of the Division's assessment, and the assessment must have a rational basis (see, Matter of Donahue v. Chu, 104 AD2d 523, 479 NYS2d 889, 892). The Division does not have an affirmative burden to establish the rational basis for its assessment (see, Matter of Metzger, Tax Appeals Tribunal, February 11, 1993). Rather, as we explained in Matter of Metzger (supra):

> "[a] presumption of correctness attaches to an assessment issued by the Division which, in itself, provides the rational basis, so long as no evidence is introduced challenging the assessment (Matter of Leogrande v. Tax Appeals Tribunal, 187 AD2d 768, 589 NYS2d 383, leave denied 81 NY2d

> 704, 595 NYS2d 398; see, Matter of Tavolacci v. State Tax Commn., 77 AD2d 759, 431 NYS2d 174). Our cases establish that the Division has the obligation, in response to the petitioner's inquiry at the hearing, to describe the audit methodology used and that the method as described must be rational (see, Matter of Atlantic & Hudson, Ltd. Partnership, Tax Appeals Tribunal, January 30, 1992)."

In order to successfully challenge an assessment that has been properly issued, a taxpayer must prove by clear and convincing evidence that the Division's ultimate assessment and its method of assessment are erroneous or irrational (see, Matter of Giuliano v. Chu, supra; Matter of Scarpulla v. State Tax Commn., 120 AD2d 842, 502 NYS2d 113). Accordingly, in assessing whether petitioner has sustained his burden of proof, the Administrative Law Judge must necessarily review the Division's calculations and methodology, both of which he must include in his findings of fact. At this point, the Administrative Law Judge is not reporting what the Division has determined for the truth of the matter asserted; rather, he is taking the necessary first step in assessing whether he will ultimately sustain the Division's assessment.

Because this ultimate conclusion involves a legal question, the Administrative Law Judge reserves this conclusion for the conclusions of law section. It is in the conclusions of law section that the Administrative Law Judge can explain why he has come to his decision based on his objective review of the facts.

In view of the above, and as opposed to what petitioner contends on exception, i.e., that the Administrative Law Judge did not find "actual facts" and, therefore, that his conclusions of law were not supportable, we find that the Administrative Law Judge properly set out "actual facts" in his findings of fact section and then reviewed these facts and corrected the Division's calculations where necessary, in his conclusions of law. In short, the Administrative Law Judge made findings "sufficient to inform a court [or this Tribunal] upon judicial review, of the basis of the findings" (Matter of Rochdale Mall Wines & Liqs. v. State Liq. Auth., 29 AD2d 647, 286 NYS2d 559, affd 27 NY2d 995, 318 NYS2d 747).

Accordingly, it is ORDERED, ADJUDGED and DECREED that:

1. The exception of petitioners Prabhu and Kishwar Hemrajani is denied;

2. The determination of the Administrative Law Judge is affirmed;

3. The petition of Prabhu and Kishwar Hemrajani is granted to the extent indicated in conclusions of law "C" and "F" of the Administrative Law Judge's determination, but is otherwise denied; and

4. The Notice of Deficiency issued December 23, 1988, as modified in accordance with paragraph "3" above, and as adjusted by the Conciliation Order, dated December 29, 1989, is sustained.

DATED: Troy, New York
August 19, 1993

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

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

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