STATE OF NEW YORK

TAX APPEALS TRIBUNAL

In the Matter of the Petition	:	
of	:	
STANLEY AND JUDITH KATZ	:	DECISION DTA No. 811663
for Redetermination of a Deficiency or for Refund of New York State and New York City Personal Income Taxes under Article 22 of the Tax Law and the New York City Administrative Code for the Year 1987.	:	

Petitioners Stanley and Judith Katz, 700 Park Avenue, New York, New York 10021, filed an exception to the determination of the Administrative Law Judge issued on June 16, 1994. Petitioners appeared by DeGraff, Foy, Holt-Harris & Mealey, Esqs. (James H. Tully, Jr., Esq., of counsel). The Division of Taxation appeared by William F. Collins, Esq. (Kenneth J. Schultz, Esq., of counsel).

Petitioners filed a brief on exception. The Division of Taxation filed a brief in opposition. Petitioner's reply brief was received on December 12, 1994, which date began the six-month period for the issuance of this decision. Petitioners' request for oral argument was denied.

Commissioner Koenig delivered the decision of the Tax Appeals Tribunal. Commissioner Dugan concurs.

ISSUE

Whether petitioners have established the existence of reasonable cause and an absence of willful neglect to justify the abatement of penalties imposed herein.

FINDINGS OF FACT

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

Petitioner Stanley Katz was, at all times relevant herein, a shareholder in seven corporations referred to as the Archer Group, which provided courier delivery services in major metropolitan areas. One of the Archer Group corporations was Archer Services, Inc. Petitioner was the sole shareholder of Archer Services, Inc.

On September 22, 1986, Archer Services, Inc. sold its air courier division for the price of $1,390,000.00. The contract of sale called forthe purchase price to be paid in installments of $50,000.00 in 1986, $1,042,002.00 in 1987, $108,517.00 in 1988, $130,245.00 in 1989, and $58,567.00 in 1990. The sale of the air courier division produced a total gain of $1,368,650.00 and was reported by Archer Services, Inc. on an installment basis.

On December 29, 1986, Archer Services, Inc., through its sole shareholder, Stanley Katz, elected to change its status from a C corporation to an S corporation effective January 1, 1987.

Pursuant to the terms of the contract of sale, Archer Services did receive an installment payment of $1,042,002.00 in 1987.

On April 15, 1988, petitioners, Stanley and Judith Katz, filed a Form IT-370, Automatic [4 month] Extension of Time to File their 1987 New York State income tax return. Petitioners' IT-370 indicated tax paid of $45,881.00 and estimated petitioners' total tax liability for 1987 at $45,000.00.

Petitioners subsequently timely filed a Form IT-372 to further extend the time to file their 1987 personal income tax return to October 15, 1988. In explanation of the extension request, the Form IT-372 indicated: "Additional time needed to compile necessary information for this return." The Division of Taxation ("Division") approved petitioners' application for a further extension to file their 1987 return.

On October 15, 1988, petitioners jointly filed their 1987 New York State resident return (Form IT-201). Said return listed total tax due of $223,594.00 along with total tax paid of $45,881.00. Accordingly, petitioners owed an additional $177,713.00 in tax.

Petitioners paid $186,849.00 with their return. The additional $9,136.00 represented petitioners' calculation of late-payment interest due on the balance of the unpaid tax.

On December 30, 1988, the Division issued to petitioners a Notice and Demand for Payment of Income Tax Due which asserted late-filing and late-payment penalty due of $45,316.96 and interest due of $6,531.75. After allowing for petitioners' payment, the notice demanded payment of $42,713.26.

The notice and demand listed the following explanation for the adjustment in petitioners' liability:

> "INVALID EXTENSION-TOTAL PAYMENTS RECEIVED BY DUE DATE LESS THAN 90% OF TAX. PENALTY FOR LATE FILING AND LATE PAYMENT APPLIED."

Following correspondence dated February 9, 1989 from petitioners to the Division requesting abatement of the penalties assessed by the notice and demand, and correspondence dated December 6, 1989 from the Division to petitioners denying petitioners' request, petitioners paid the penalties and interest assessed by the notice and demand by check dated December 28, 1989. By that time, such penalty and interest had accrued to $46,580.46.

On February 16, 1990, petitioners filed a claim for refund with respect to the penalty assessed in the notice and demand. The amount of petitioners' refund claim was $45,316.96.

By letter dated March 26, 1991, the Division gave notice to petitioners that their refund claim was denied in full.

At all times relevant herein, petitioners used the accounting firm of Perelson, Johnson & Rones, P.C. ("the Perelson firm"). The Perelson firm also provided accounting services for Archer Services, Inc. at all times relevant herein. Petitioners had used the Perelson firm for both their personal and corporate tax accounting for approximately 20 years. At the time of the transactions which gave rise to this matter, the Perelson firm employed about 25 accountants and provided a full range of accounting services to its clients. The record contains no evidence that petitioners had any significant income tax problems prior to the transactions that gave rise to the instant matter.

Following the passage of the Federal Tax Reform Act of 1986, the Perelson firm was broadly recommending that its clients elect a change in status from C to S corporation. The firm so advised Mr. Katz prior to the S election made by Archer Services, Inc. The Perelson firm knew and Mr. Katz knew that the effect of electing S corporation status was that the income and losses from Mr. Katz's S corporation would be passed through to Mr. Katz's personal income tax return.

In late 1987, the Archer Group employed a software company to install a new operations and accounting software program. The Archer Group had outgrown the capabilities of its existing computer system. The installation of the new software system encountered many difficulties. These software system problems resulted in a delay in the production of the Archer Group's 1987 schedule K-1's and its 1987 financial statements. The unavailability of the schedule K-1's and the financial statements resulted, in turn, in the filing of petitioners' automatic extension of time (Form IT-370).

In preparing petitioners' IT-370, the Perelson firm estimated petitioners' tax liability based upon available information. In making this estimate, the Perelson firm did not consider the $1,042,002.00 installment payment received by Archer Services, Inc. in 1987. The Perelson firm advised petitioners that no further New York income tax would be due for 1987. Petitioners and the Perelson firm did not discuss the $1,042,002.00 installment payment and its effect on petitioners' liability.

At the time of the subchapter S election by Archer Services, Inc., no individual associated with the Perelson firm specifically discussed the effects of the subchapter S election on petitioners' personal income tax return in light of the receipt by Archer Services of the $1,042,002.00 installment payment.

In April 1988, at the time of the filing of petitioners' initial extension (Form IT-370), the Perelson firm knew that Archer Services, Inc. had received an installment payment of $1,042,002.00 in 1987.

If the gain resulting from the installment sale had not flowed through to petitioners'

personal income tax return, petitioners would have had a loss from partnerships, estates, trusts and S corporations of $178,374.00.

As a result of certain net operating loss carrybacks from subsequent years, petitioners' tax liability for 1987 was ultimately lowered substantially.

The computer software system problems experienced by the Archer Group commencing in late 1987 and continuing through 1988 had no effect upon either petitioners' or their accountant's ability to determine the proper tax treatment of the 1987 installment payment received by Archer Services, Inc.

Petitioner Stanley Katz did not appear to testify at the hearing in this matter. Petitioners did submit an affidavit of Mr. Katz dated September 1, 1993 which provided, in part:

> "11. During 1986, when Archer Services, Inc. sold the air division, the gain was reported on the installment basis and Archer Services, Inc. was not an S corporation. At the end of 1986 the Company elected S status effective for 1987. During 1987, the Company received an installment payment of $1,042,002. I reasonably assumed that future payments would not be reflected on our personal return because the corporation's loss would have substantially sheltered the income the sale occasioned prior to the election of S status.
>
> "12. I later learned that this assumption was technically incorrect, and that we would be personally responsible for reporting the gain and paying the tax attributable to it.
>
> "13. I believe that the original assumption concerning the corporation's obligation to pay the tax was reasonable in light of the technical and highly complex nature of this issue, and the fact that the corporation elected S status after the sale of the air division.
>
> "14. I did not know, and my accountants did not realize or inform me, that the subsequent filing for sub-chapter S status would affect income from a sale made previous thereto."

Together with its brief, the Division submitted a request for findings of fact which listed nine specific proposed findings of fact numbered "1" through "9". Such proposed findings of fact are accepted and have been incorporated into the Findings of Fact herein.

OPINION

In the determination below, the Administrative Law Judge reviewed the Tax Law relating to the imposition of penalties for failure to file a return and failure to pay tax shown on a return on or before the prescribed date, the section of the Tax Law prescribing the due date for the

filing of returns under Article 22 as well as Tax Law § 657 which empowers the Division to extend the time for the filing of returns and the payment of tax.

The Administrative Law Judge also reviewed 20 NYCRR former 151.2(a), the relevant "terms and conditions" for extensions of time to file.

The Administrative Law Judge then discussed the imposition of penalties under section 685(a) of the Tax Law as well as the relevant part of the Division's regulations defining "reasonable cause" at 20 NYCRR former 102.7.

After such review and discussion, the Administrative Law Judge held that:

> "[p]etitioners have failed to show that their reliance on the erroneous advice given them by their accountants constituted reasonable cause within the standards articulated by the Tribunal in Matter of Erikson (Tax Appeals Tribunal, March 22, 1990). Specifically, petitioners have failed to show that they acted with 'ordinary business care and prudence' in attempting to ascertain their tax liability. The record is clear that Archer Services, Inc. received the $1,042,002.00 payment in 1987 and that Mr. Katz was aware of this payment. The record is also clear that Mr. Katz knew that the effect of electing subchapter S corporation status was the pass-through of income and losses from his S corporation to his personal income tax return. And yet, notwithstanding these facts, the record clearly shows petitioners made no inquiry of their accountants as to whether the $1,042,002.00 payment was reflected in the calculation of their estimated tax liability or whether such payment should have been so reflected" (Determination, conclusion of law "E").

The Administrative Law Judge also rejected petitioner's contention that: 1) the tax treatment of the installment payment was highly complex; 2) penalties should be abated due to an inability beyond petitioners' control to obtain and assemble information; and 3) the computer software problems precluded petitioners from properly estimating their tax liability.

The Administrative Law Judge, in sustaining the Division's denial of petitioners' refund request, further held that petitioners have failed to cite any authority in "support of their position that the 'fortuitous circumstances' of the net operating loss carryback should serve to abate penalties which were otherwise properly imposed (see, Manning v. Seeley Tube and Box Co., 338 US 561)" (Determination, conclusion of law "G").

On exception, petitioners argue that they relied in good faith on their professional accountants' erroneous advice relating to the treatment of the 1987 gain from the 1986

installment sale of Archer Services' air division and, further:

> "[t]he record, therefore, is clear that the failure to show the $1 million gain from this money received in 1987 as part of the installment sale of the air division in 1986 was made in good faith in reliance upon the Katzes' experienced accountants' view that those sums would not be included on the personal income tax return" (Petitioners' Brief, p. 13).

Petitioners also argue that "[t]he law was well stated by the Tribunal in the Erikson case (supra) as cited by the Administrative Law Judge's decision in this matter" (Petitioners' Brief, p. 4), and their reliance upon the erroneous advice was reasonable in that the Perelson firm had prepared Mr. Katz's tax returns for 20 years and there had never been a problem. Further, even though Mr. Katz knew the air division was sold in 1986 and that Archer became a Subchapter S corporation in the beginning of 1987, petitioner Stanley Katz argues: 1) as a layman he would not be expected to realize that such an election was retroactive to the sale made the previous year; 2) if his accountants did not realize it, how could he be expected to realize it; 3) this was a technical and complex matter; and 4) petitioners were acting with ordinary business care and prudence.

The Division, in reply, commented on petitioners' eleven proposed findings of fact and argues that neither of petitioners' arguments, namely the reliance upon the advice of their tax accountants and an alleged inability to obtain essential information, constitutes reasonable cause or the absence of willful neglect.

The Division also argues: 1) the view that consulting with and following the advice of a tax professional will, by itself, constitute reasonable cause has been rejected by New York courts; 2) petitioner Stanley Katz, a sophisticated businessman, owned and controlled numerous S corporations prior to the events in issue and knew that the income and losses from said corporations would be passed through to his personal income tax return; 3) knowing of the "pass through" and the $1,042,002.00 payment should have prompted a discussion of the issue by petitioner Stanley Katz with his accountants; and 4) against petitioners' claim that the "pass through" issue was "extremely complex" and "highly technical" by referencing the pertinent language of the Internal Revenue Code.

The Division rejects petitioners' argument that computer problems caused essential information to be unavailable, thus, establishing reasonable cause, further arguing:

1) "[i]t is impossible to tell with any degree of certainty from this record 'how the original estimation of tax was derived and what, if any, allowances were in [sic] included in the estimation to provide for the unknown tax liability'" (Division's Brief, pp. 5-6).

2) "the facts of this case militate against a finding that Petitioners made 'a good faith effort to properly estimate the tax due in accordance with section 151.2'" (Division's Brief, p. 6).

3) penalties should not be abated by reason of petitioners' subsequent net operating loss; and

4) the Administrative Law Judge correctly concluded that petitioners failed to establish reasonable cause and the absence of willful neglect.

Petitioners' reply memorandum of law, again referencing Matter of Erikson (supra), reargues that reasonable cause exists for the abatement of penalties due to petitioners' reliance in good faith upon the erroneous advice of their accountant.

The thrust of petitioners' argument is that:

> "[n]either the petitioners' nor their accountants' knowledge of the rudimentary tax status of an S corporation or its taxpayers is at issue here. Rather, the complex question presented to the petitioners and their accountant was whether an S corporation election for Archer Services in 1987 would have a retroactive effect upon the installment sale transaction, which began in 1986 while Archer Services was a C corporation" (Petitioners' Reply Brief, p. 2).

Petitioners also argue: 1) due to the 1986 changes upon installment sales, great uncertainty existed among tax professionals; 2) for the tax year in question, 1987, relevant revisions took effect in the tax code regarding S corporations; 3) tax experts have consistently criticized the complexity of the Internal Revenue Code § 453 and its implementing regulations, as the installment sales provisions have been modified over the years; and 4) authors of articles on tax law address the confusion caused by the amendment to the electing out provisions for installment sales transactions.

Finally, petitioners, citing Betson v. Commissioner (802 F2d 365), argue that they acted with "ordinary business care and prudence" in seeking professional accounting assistance due to the complex provisions regarding installment sales and, further, "[i]ndeed, it would have been wilful neglect not to consult and rely upon the well-experienced and long trusted tax professional. United States v. Boyle, 469 U.S. 241 (1985) ('Most taxpayers are not competent to discern error in the substantive advice of an accountant or attorney')" (Petitioners' Reply Brief, p. 5).

A review of the record in this case must lead one to question how petitioners could claim they used "ordinary business care and prudence" when they were fully aware of the tax implications of the change from subchapter C to subchapter S status, i.e., that the income and losses from Mr. Katz's S corporation would be passed through to Mr. Katz's personal income tax return.

We emphasize that, as the Administrative Law Judge noted:

> "Mr. Katz's affidavit indicates that he knew that the installment payment was not reflected in the estimate of his tax liability on the IT-370 and that he assumed that the exclusion of the installment payment from such estimate was proper . . . . In other words, Mr. Katz was aware of the facts and made an independent judgment based on those facts. The accountants' erroneous advice was consistent with Mr. Katz's erroneous judgment. Unfortunately, Mr. Katz made no inquiry of his accountants and had no discussion with them regarding this point. Such an inquiry might have corrected this error at a much earlier point" (Determination, fn. 1).

Further, as the Administrative Law Judge pointed out:

> "[i]f, as Mr. Katz contends, he believed the issue to be highly complex, while also knowing the efffect of electing subchapter S status, then his assumption that the installment payment would not be reflected on his return coupled with his failure to inquire of his accountants regarding the proper treatment of the payment constitutes a failure to exercise 'ordinary business care and prudence' in attempting to ascertain his proper tax liability" (Determination, conclusion of law "E").

We find no basis in the record before us for modifying the determination of the Administrative Law Judge in any respect. Therefore, we affirm the determination of the Administrative Law Judge for the reasons stated in said determination.

Accordingly, it is ORDERED, ADJUDGED and DECREED that:

1. The exception of Stanley and Judith Katz is denied;

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

3. The petition of Stanley and Judith Katz is denied; and

4. The Division of Taxation's denial of petitioners' refund request is sustained.

DATED: Troy, New York
June 8, 1995

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

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