STATE OF NEW YORK

TAX APPEALS TRIBUNAL

In the Matter of the Petition	:	
of	:	
CLAUDE R. McGAUGHEY, III AND MARY J. McGAUGHEY	:	DECISION DTA NO. 814265
for Redetermination of a Deficiency or for Refund of Personal Income Tax under Article 22 of the Tax Law for the Years 1986, 1987, 1988, 1989 and 1990.	:	

Petitioners Claude R. McGaughey, III, 20941 N.E. 38th Avenue, Miami Beach, Florida 33180, and Mary J. McGaughey, 1855 Keene Pike, Nicholas Nille, Kentucky 40356, filed an exception to the determination of the Administrative Law Judge issued on March 13, 1997. Petitioners appeared by Rice & Justice (John Carter Rice, Esq., of counsel). The Division of Taxation appeared by Steven U. Teitelbaum, Esq. (Michael J. Glannon, Esq., of counsel).

Petitioners filed a brief in support of their exception. The Division of Taxation filed a brief in opposition. Oral argument, at petitioners' request, was heard on October 8, 1997 in Troy, New York.

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

ISSUE

Whether reasonable cause exists for cancellation of penalties asserted for the late filing and late payment of petitioners' tax returns for 1986, 1987, 1988, 1989 and 1990.

FINDINGS OF FACT

We find the facts as determined by the Administrative Law Judge, except for findings of fact "1," "2" and "12" which have been modified. The Administrative Law Judge's findings of fact and the modified findings of fact are set forth below.

We modify finding of fact "1" to read as follows:

> Petitioner Claude R. McGaughey, III ("petitioner")[1] is a widely-known trainer of thoroughbred racehorses who has succeeded in a singularly difficult enterprise that requires special knowledge and experience.[2]

We modify finding of fact "2" to read as follows:

> During the years at issue, petitioner was very successful in his position as a private racehorse trainer to the Phipps family of Roslyn, New York. Mr. McGaughey performed his duties as an independent contractor for the Phipps family and his income depended upon the success of the horses he trained:
>
> > "[W]e get a percentage of what the horse makes. What his earning capabilities are are what our earning capabilities are" (tr., p. 54).[3]

Petitioner reported his income as a racehorse trainer for 1986, 1987, 1988 and 1990 as "farm income" on a Federal Schedule F to Form 1040.[4] The respective schedules F show the following amounts for gross income, total deductions and net farm profit:

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[1]Mary J. McGaughey, the former wife of Mr. McGaughey, is a petitioner solely as a result of filing joint tax returns with Mr. McGaughey. Any reference to "petitioner" in this decision is to Mr. McGaughey.

[2]We have modified finding of fact "1" by deleting extraneous material.

[3]We have modified findings of fact "2" by deleting extraneous material.

[4]The Federal schedule F to the 1989 Form 1040 was missing from the 1989 tax return introduced into evidence.

Year	Gross Income	Total deductions	Net farm profit
1986	$2,319,235.00	$2,068,396.00	$ 250,839.00
1987	2,381,902.00	2,162,083.00	219,819.00
1988	2,833,268.00	2,145,530.00	687,738.00
1989	---	---	1,266,358.00[5]
1990	2,745,452.00	2,266,832.00	478,620.00

The amounts shown above for "total deductions" each include a substantial expense for "labor hired": $783,702.00 in 1986, $836,695.00 in 1987, $939,855.00 in 1988, and $727,770.00 in 1990. Mr. McGaughey, in his capacity as an independent contractor, had approximately 50 employees including two assistant trainers, grooms, hot walkers, exercise riders, blacksmiths, and two night watchmen.

Although Mr. McGaughey commenced his duties as the private racehorse trainer for the Phipps family in late 1985, he did not file New York State income tax returns or pay any New York State income tax for the years in issue until early October 1991. Petitioner testified that he "didn't know that I had any liability to New York, because I thought I was a Kentucky resident" (tr., p. 79). Petitioner became aware of his obligation to pay New York State income tax as a nonresident only after the Division of Taxation ("Division") contacted him in 1990. At that time, the Division sent petitioner a questionnaire concerning the applicability of New York income tax on petitioner's income earned within New York. Petitioner responded promptly to the Division's questionnaire. The record is somewhat vague concerning what then transpired. According to letters from petitioner's former accounting firm, Amick & Helm, the Division "then served notice that . . . income earned within the State was taxable to New York." It is unclear whether notices of deficiency or statements of audit adjustment were issued to petitioner. In response, petitioner

[5]This amount is taken from Line 19, "farm income," of the 1989 Federal Form 1040. It appears that 1989 was petitioner's most successful year of the years at issue.

cooperated with the Division, prepared nonresident New York State income tax returns, which were filed in early October 1991, and remitted tax due plus interest.

Petitioner's nonresident income tax returns for the years at issue were all dated September 20, 1991 by petitioner's former accountant, Jimmy W. Monroe of Amick & Helm, a Louisville, Kentucky accounting firm, as the preparer. These returns show the following allocation of petitioner's "farm income" to New York State:

Year	Federal Amount	New York State Amount	Percentage Allocated to New York
1986	$ 250,839.00	$162,418.00	65%
1987	219,819.00	125,473.00	57%
1988	687,738.00	434,857.00	63%
1989	1,266,358.00	787,548.00	62%
1990	478,620.00	280,184.00	59%

Petitioner's income in New York was from his share of the winnings at Belmont, Saratoga and Aqueduct racetracks of the thoroughbreds that he trained for the Phipps family as well as a few horses owned by others.

Petitioner paid New York State income tax plus interest in the following amounts for the years at issue:

Year	Tax	Interest[6]
1986	$14,415.00	$6,534.33
1987	9,841.00	3,422.67
1988	35,328.00	9,456.42
1989	60,930.00	9,623.24
1990	21,145.00	not disclosed in the record

Petitioner attempted to negotiate the cancellation of penalties with the Division. However, by a letter dated April 28, 1993, a tax technician advised that the penalties "must be sustained" and that petitioner's "only recourse" was to pay the penalties and file a claim for

[6]The amounts shown under the column for interest were taken from the notice and demand dated April 9, 1992 and consolidated statement of tax liabilities also dated April 9, 1992 that were attached to the petition.

refund. Petitioner paid the penalties for the late filing and late payment of his tax returns for 1986 through 1990.

Petitioner, by his attorney, filed five refund claims, each dated December 10, 1993, for the five years at issue. Petitioner sought the refund of penalties paid, plus accrued interest on such amounts, as follows:

Year	Amount of refund claim
1986	$ 6,846.90
1987	4,182.25
1988	13,248.00
1989	19,192.95
1990	1,227.46

In response, the Division issued a Notice of Disallowance, dated March 31, 1994, which provided the following explanation for rejecting petitioner's refund claims:

> "Our regulations list specific grounds for establishing reasonable cause for abatement of penalty imposed for failure to comply with the New York State Tax Law. Lack of awareness or ignorance of the Law is not a consideration for establishing reasonable cause."

In managing his racehorse training enterprise which was based in New York, petitioner depended on professionals because he focused almost entirely on rebuilding the Phipps's stable. He retained James E. Hilt as his office manager and bookkeeper. Mr. Hilt had performed similar services for Angel Penna, a racehorse trainer who was petitioner's predecessor as the private racehorse trainer for the Phipps family. In addition, in 1985 petitioner was advised by his friend, Woody Stephens, to retain Mr. Hilt. Petitioner described Mr. Stephens as "the most powerful trainer in racing" at that time (tr., p. 34). In an affidavit dated August 1, 1994, Mr. Hilt described his responsibilities as follows:

> [K]eeping of financial records; preparation of invoices; issuance of checks; advising trainers regarding accounts payable and receivable; management of payrolls, workers compensation,

> unemployment and withholding tax matters; and assembly of records and consultations with accountants for the preparation of federal and state tax returns.

Relying on Mr. Hilt, petitioner felt comfortable directing his energies away from the business aspects of his operation to the actual training of the 45 horses that the Phipps family boarded at a barn at Belmont racetrack. Beginning his lengthy workdays at 5:30 A.M., petitioner could focus on producing winners.

We modify finding of fact "12" to read as follows:

> Mr. Hilt stated that petitioner's accountants, Amick & Helm, failed to advise him that petitioner was required to file New York State nonresident income tax returns. Mr. Hilt, in his affidavit, noted as follows:
>
> > "In communicating with the accountants [Amick & Helm], I was assured that all necessary state and federal tax returns had been filed on behalf of Mr. McGaughey for the 1986 through the 1991 tax years."[7]

In contrast, a letter dated January 10, 1992 of J.W. Monroe, a partner of Amick & Helm, and a letter dated April 17, 1992 of Eugene A. Gilles, II, a certified public accountant associated with the firm, do not accept responsibility for petitioner's failure to file the required New York tax returns. The accountants merely noted petitioner's ignorance of the law without taking responsibility for his lack of knowledge, both utilizing the same careful language:

> [Petitioners] were not cognizant of the fact that they should file New York income tax returns on the portion of their income which had been earned within the State of New York. Consequently, for the years in question, they reported all their income to the State of Kentucky for taxation and payment.

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[7]We modified finding of fact "12" by deleting reference to statements in Mr. Hilt's affidavit where he makes statements regarding what petitioner knew or was told by his accountants, Amick & Helm. This material has been deleted since there is nothing in the affidavit to show the basis for Mr. Hilt's knowledge of what petitioner knew or was told by the accountants.

After studying business for two years at the University of Mississippi, petitioner, at the age of 19, started to work with racehorses in the Midwest in the capacity of an apprentice. In 1979, at the age of 28, petitioner became a racehorse trainer in Kentucky after having worked as an apprentice in the business in New York for about five years. By 1981 or 1982, as the result of a growing business as a racehorse trainer, petitioner hired Amick & Helm as his accountants. This firm was highly recommended by petitioner's mentor, Warner Jones, chairman of the board of Churchill Downs, who also utilized their professional accounting services.

Up to 1985, petitioner trained racehorses exclusively out of Kentucky. Petitioner had a large public stable with up to 90 horses in training from many different owners. Mr. McGaughey traveled extensively with the racing circuit and, in 1985, raced horses in Illinois, Arkansas, and occasionally in California, Louisiana, Florida, Ohio, as well as in Saratoga, New York, thereby earning income in different states. Nonetheless, petitioner did not pay income tax as a nonresident to any state. Rather, he paid income tax as a resident to Kentucky on all of his income apparently based upon the advice of Amick & Helm. Petitioner, did not question the advice and, in good faith, believed that his only state income tax liability was to Kentucky since he was a resident of Kentucky. He maintained this belief during the years at issue while conducting his horse-training operation based in New York.

Petitioner lived rent-free in a house owned by the Phipps located on their estate on Long Island. Petitioner maintained his primary home in Kentucky until 1989, when he sold his residence in Louisville and bought a home in Florida. Nonetheless, it is observed that petitioner spent a major part of each of the years at issue in New York. During May, June and most of July, he raced horses at Belmont on Long Island, in late July and August he was at Saratoga, during September and a portion of October he raced horses at Belmont, and spent the balance of the year

at Aqueduct. In the winter months and in April, he raced horses in Florida and Kentucky, respectively.

THE DETERMINATION OF THE ADMINISTRATIVE LAW JUDGE

The penalties in this matter were assessed for failure to timely file returns and failure to timely pay withholding tax pursuant to Tax Law § 685(a)(1) and (2). Pursuant to these statutory provisions, penalties may be abated if a taxpayer is able to show that the failure to timely file and pay was due to reasonable cause and not due to willful neglect.

The Administrative Law Judge noted that the Division's income tax regulations state the following with regard to what constitutes "reasonable cause":

> Any other cause for delinquency which would appear to a person of ordinary prudence and intelligence as a reasonable cause for delay and which clearly indicates an absence of willful neglect may be determined to be reasonable cause. Ignorance of the law, however, will not be considered as a basis for reasonable cause (20 NYCRR 107.6[d][4]).

Petitioner argued below that the Division can assess penalty only if the taxpayer cannot show reasonable cause and fails to demonstrate a lack of willful neglect. The Administrative Law Judge rejected this argument noting that, under the statute, imposition of penalty is mandatory by the Division. The Administrative Law Judge referred to our language in ***Matter of MCI Telecommunications Corp.*** (Tax Appeals Tribunal, January 16, 1992, ***confirmed Matter of MCI Telecommunications Corp. v. New York State Tax Appeals Tribunal***, 193 AD2d 978, 598 NYS2d 360) where we stated: "By first requiring the imposition of penalties (rather than merely allowing them at the Commissioner's discretion), the Legislature evidenced its intent that filing returns and paying tax according to a particular timetable be treated as a largely unavoidable obligation."

The Administrative Law Judge concluded that the penalties were correctly imposed against petitioner in the first instance as a result of his failure to file returns and pay tax in a timely fashion, and that the burden is on petitioner to prove that his failure was due to reasonable cause and not willful neglect (***see***, ***Matter of Philip Morris, Inc.***, Tax Appeals Tribunal, April 29, 1993).

On the issue of reasonable cause, petitioner argued below that his reliance on an office manager/bookkeeper, Mr. Hilt, and the Kentucky accounting firm, Amick & Helm, both highly regarded by prominent individuals in thoroughbred racing, was sufficient to establish reasonable cause for his failure to file and pay on a timely basis.

In determining whether penalties should be abated, the Administrative Law Judge was guided by our decision in ***Matter of Koether*** (Tax Appeals Tribunal, December 15, 1994). In ***Koether***, we indicated that a careful weighing of facts and circumstances is necessary to determine whether a taxpayer "acted with ordinary business care and prudence in attempting to ascertain his tax liability and that penalties should be abated." The Administrative Law Judge concluded that Mr. McGaughey did not shoulder his burden of proving that he acted with ordinary business care and prudence in attempting to ascertain his tax liability. Therefore, the Administrative Law Judge concluded that petitioner failed to establish reasonable cause for his failure to file and pay New York income tax and denied the petition.

ARGUMENTS ON EXCEPTION

Petitioner takes exception to the Administrative Law Judge's determination to the extent that it concludes petitioner has not established reasonable cause for the abatement of penalties. Petitioner makes the same arguments on exception as he did below. Petitioner claims that he acted reasonably to ensure that he handled his tax obligations correctly by hiring James E. Hilt,

as his office manager and bookkeeper, and the Kentucky firm of Amick & Helm as his accountants. Petitioner continues to characterize his late filing and late payment of New York tax returns as an innocent mistake and contends that penalties are not justified where no intention to evade or neglect existed.

OPINION

. The penalties in this case were assessed in accordance with Tax Law § 685(a)(1) and (2) which provides, in relevant part, as follows:

> (1) Failure to file tax return.--
>
> > (A) In case of failure to file a tax return . . . on or before the prescribed date . . . unless it is shown that such failure is due to reasonable cause and not due to willful neglect, there shall be added to the amount required to be shown as tax on such return five percent of the amount of such tax if the failure is for not more than one month, with an additional five percent for each additional month or fraction thereof during which such failure continues, not exceeding twenty-five percent in the aggregate.
>
> * * *
>
> (2) Failure to pay tax shown on return.-- In case of failure to pay the amounts shown as tax on any return required to be filed . . . unless it is shown that such failure is due to reasonable cause and not due to willful neglect, there shall be added to the amount shown as tax on such return one-half of one per cent of the amount of such tax if the failure is not for more than one month, with an additional one-half of one per cent for each additional month or fraction thereof during which such failure continues, not exceeding twenty-five per cent in the aggregate. . . .

Petitioner claims, as a basis for reasonable cause, that he did everything he could to ensure that his tax obligations were timely filed and paid by hiring Mr. Hilt as his bookkeeper and Amick & Helm as accountants to handle his tax matters. In spite of his "best efforts," petitioner says, he received "bad advice" (Petitioners' brief, p. 10).

We disagree with petitioner and we affirm the determination of the Administrative Law Judge. Petitioner's claim that he did everything he could to ensure compliance with New York's Tax Law by hiring Mr. Hilt and Amick & Helm does not constitute reasonable cause. It is a well-settled principle that each taxpayer has a nondelegable duty to prepare and file timely tax returns with payment and the mere assertion, without more, of reliance upon professional advisors or employees does not constitute reasonable cause (***see, Logan Lumber Co. v. Commissioner***, 365 F2d 846; ***see also, Sanderling, Inc. v. Commissioner***, 571 F2d 174).

In making a determination as to whether reasonable cause exists when a taxpayer has relied on the advice of a professional, it must be shown that the taxpayer relied in good faith on the advice he received and it must have been "reasonable" for the taxpayer to rely upon the particular advice he was given (***see***, ***LT & B Realty Corp. v. New York State Tax Commn.***, 141 AD2d 185, 535 NYS2d 121). When determining whether the taxpayer has shown that his reliance was reasonable, the burden is on the taxpayer to demonstrate that he acted with ordinary business care and prudence in attempting to ascertain his liability, if any, for taxes (***see***, ***United States v. Boyle***, 469 US 241; ***Matter of Koether, supra***).

Petitioner says he received bad advice, which resulted in withholding taxes being paid to the wrong state. He does not say who gave him this bad advice and there is no evidence in the record to show the advice, if any, he received. This record is devoid of any detail concerning the interactions between petitioner and his accountant concerning tax matters.

Unlike the petitioner in ***Matter of Koether (supra)***, this petitioner has offered no evidence to show that his reliance on Mr. Hilt or Amick & Helm was reasonable, e.g., evidence to show that the people he was relying on had the necessary training and experience in tax matters such that his reliance was justified. There is no evidence that Amick & Helm advised petitioner that

he did not owe New York taxes and, more significantly, there is no evidence that petitioner ever made an inquiry as to his potential New York tax liability. We know that Mr. Hilt was withholding New York taxes from the amounts petitioner was paying his employees. Petitioner would have us believe he was paying withholding taxes for his employees based on monies earned in New York, but it never occurred to him that he had any similar New York tax liability.

We know petitioner studied business at the college level for two years. We find it unlikely that petitioner could study business for two years and not realize that income taxes may be owed to the state where the income is earned. It is stretching credulity to believe that petitioner could live approximately six months in New York during each of the subject years, work here, earn substantial income here and not believe he may owe some taxes here. We find it significant that the evidence shows no inquiry by petitioner to determine whether he had any liability for New York taxes. Based on the paucity of evidence presented, we conclude petitioner has failed to demonstrate that he acted with ordinary business care and prudence with regard to his New York taxes and has failed to establish reasonable cause for the abatement of penalties (***see, United States v. Boyle***, ***supra***; ***Matter of Antique World***, Tax Appeals Tribunal, February 22, 1996; ***Matter of Koether, supra***; ***Matter of Erikson***, Tax Appeals Tribunal, March 22, 1990).

The remainder of petitioner's arguments are rejected for the reasons stated in the determination of the Administrative Law Judge.

Accordingly, it is ORDERED, ADJUDGED and DECREED that :

1. The exception of Claude R. McGaughey, III and Mary J. McGaughey is denied;

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

3. The petition of Claude R. McGaughey, III and Mary J. McGaughey is denied; and

4. The Notice of Disallowance dated March 31, 1994 is sustained.

DATED: Troy, New York
March 19, 1998

_____
Donald C. DeWitt
President

_____
Carroll R. Jenkins
Commissioner

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Joseph W. Pinto, Jr.
Commissioner