

STATE OF NEW YORK

TAX APPEALS TRIBUNAL

In the Matter of the Petition :

of :

TWO KINGS, INC. :

DECISION
DTA NO. 819214

for Redetermination of Deficiencies or for Refund of New York State and New York City Income Taxes under Article 22 of the Tax Law and the New York City Administrative Code for the Period January 14, 1994 through December 25, 1998. :

Petitioner Two Kings, Inc., 3235 Grand Concourse, Bronx, New York, NY 10468, filed an exception to the determination of the Administrative Law Judge issued on June 3, 2004.

Petitioner appeared by Kass & Jaffe, PC (Stephen L. Kass and Jeffrey A. Lander, CPAs) and Morrison & Foerster, LLP (Irwin M. Slomka, Esq., of counsel). The Division of Taxation appeared by Christopher C. O'Brien, Esq. (Peter B. Ostwald, Esq., of counsel).

Petitioner filed a brief in support of its exception and the Division of Taxation filed a brief in opposition. Petitioner filed a reply brief. Oral argument, at petitioner's request, was heard on March 16, 2005 in New York, New York.

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

ISSUE

Whether the Division of Taxation properly assessed Two Kings, Inc. for New York State and New York City withholding taxes for the period January 14, 1994 through December 25, 1998.

FINDINGS OF FACT

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

Petitioner, Two Kings, Inc. (“Two Kings”), was a New York City real estate management company which was operated by its sole shareholder and president, Rexh Xhakli.

Following a field audit of petitioner, the Division of Taxation (“Division”) issued to petitioner ten notices of deficiency, dated January 29, 2001, as more specifically set forth in the table below.

Tax Period and (Article)	Tax Assessed	Interest	Penalty	Total Due
1994 (22)	\$79,538.94	\$60,086.99	\$83,900.26	\$223,526.19
1994 (30)	4,637.10	3,503.07	32,112.34	40,252.51
1995 (22)	77,988.04	47,418.83	73,106.06	198,512.93
1995 (30)	4,622.02	2,810.34	30,236.33	37,668.69
1996 (22)	72,348.12	34,106.81	64,757.92	171,212.85
1996 (30)	4,691.96	2,211.90	29,940.44	36,844.30
1997 (22)	69,585.10	24,100.73	58,926.05	152,611.88
1997 (30)	4,741.10	1,642.07	29,658.19	36,041.36

1998 (22)	69,981.08	16,405.40	55,197.18	141,583.66
1998 (30)	5,096.00	1,194.60	29,452.07	35,742.67

Petitioner was notified by letter dated May 20, 1999 that its New York State and New York City withholding tax returns for the period January 1, 1992¹ through December 31, 1998 (the “audit period”) had been selected for a field audit. An appointment was scheduled for June 21, 1999 at petitioner’s address, at which time petitioner was asked to have available for the period January 1, 1992 through December 31, 1998 all payroll records, Federal and State payroll tax returns for the audit period, including forms W-2, IT-2102, forms W-3, W-4, IT-2104, 1099 and 941, the Employer’s Quarterly Tax Return and Quarterly Combined Withholding and Wage Reporting Returns. After a postponement, the field visit took place on July 20, 1999, at which time petitioner produced only check registers for the years 1994 and 1995. A search of the Division’s records revealed that petitioner had not filed any withholding tax returns for the audit period.

On July 23, 1999, the Division made an additional request for records, seeking Federal and New York corporate tax returns, general ledgers and disbursement journals. An office conference was scheduled for August 22, 1999 for the production of these records, but it was canceled by petitioner. In response, the Division issued a subpoena for petitioner’s records, but once again petitioner submitted no records.

The Division analyzed its transcript of the checks produced by petitioner at the field visit on July 20, 1999 and questioned whether the underlying expenses for which some of the checks were issued were incurred on behalf of petitioner or Mr. Khakli. With no evidence presented to

¹This date was subsequently changed to January 14, 1994.

demonstrate that the checks represented bona fide expenses of petitioner, it was assumed that they were issued to, or on behalf of, Mr. Xhakli and that the sum of the checks, \$920,257.12, was considered wages paid by petitioner to him in 1994. This wage figure was used to calculate petitioner's New York State withholding tax due in the amount of \$79,538.94 and New York City withholding tax due in the amount of \$4,637.10. Lacking any further documentation, the Division used the same wage estimates from 1994 to calculate the withholding tax due from petitioner for the years 1995 through 1998.

After the Division issued a statement of proposed audit changes on September 5, 2000, a conference was held on September 14, 2000 at which petitioner submitted the following documents: partnership returns for the predecessor entity, Two Kings Associates, for the years 1992 and 1994; Federal form 1120 for the years 1994 through 1998; and New York form CT-3 for the years 1994 and 1995. Although these comprised some of the documents the Division sought in its subpoena, they did not substantiate petitioner's claim that checks drawn on the corporate bank account, upon which the assessment was based, were not wages paid to its president, Mr. Xhakli.

Subsequent to the September 14, 2000 meeting, petitioner submitted various documents to demonstrate that moneys paid to Mr. Xhakli were not wages upon which petitioner owed withholding taxes. Included in this submission were: a deposit slip, dated 1989, indicating a deposit made to Mr. Xhakli's personal account, and a statement for that account, dated November/December 1989; a brokerage account statement for Mr. Xhakli, dated May/June, 1994; closing documents for 272 Gun Hill Road, Bronx, NY and 3235 Bainbridge Avenue, Bronx, NY; a list of capital improvements made to 3052-54 Kingsbridge Avenue and 3235

Grand Concourse, Bronx, NY; a mortgage closing statement for petitioner, dated 1994; the 1994 rental receipts register for Two Kings Associates; and a filing receipt indicating the incorporation of Two Kings, Inc. After reviewing the documentation, the Division concluded that petitioner had not demonstrated that the deposits and transfers were made to, or on behalf of, Two Kings, Inc., and no modification was made to the statement of proposed audit changes.

Petitioner offered into evidence at hearing several documents to substantiate its claim that the funds found by the Division on audit were not wages to Mr. Xhakli but legitimate business expenses. Included in this offering was a summary statement of expenses paid to Jackly Construction & Renovation Co. for materials and labor expended on projects at the properties owned by petitioner for the years 1987 through 2001. This list, prepared by petitioner, was supplemented by contracts between petitioner and Jackly for specific job proposals.

In addition, petitioner submitted one monthly bank statement of Two Kings Associates from Citibank, N.A., for the period April 23, 1994 through May 10, 1994 and copies of 39 checks drawn on the same account, only 6 of which were reflected on the statement. Of these six checks, all of which were issued prior to April 15, 1994, none had a substantiated purpose related to petitioner's business operations and no explanation was offered to demonstrate otherwise.² The statement also reflects a deposit on May 6, 1994 of \$250,000.00 which was never explained.

Two Kings, Inc. was incorporated on April 15, 1994 as reflected in the Application for Employer Identification Number. The Division was aware of this date, which it noted in the audit file's DO 220.5, or audit log. Thereafter, petitioner received by quitclaim deed, dated April 25,

²The six checks from Citibank were check numbers 4603, 4638, 4602, 4601, 4599 and 4588. They appear on the bank statement submitted into evidence by petitioner and also on the Division's transcript of check registers.

1994, certain real property owned by Mr. Khakli and known as 3052-3054 Kingsbridge Road, Bronx, New York. On the same date, petitioner received a mortgage loan in the sum of \$950,000.00 from the First Federal Savings and Loan Association of Rochester, \$552,379.02 of which was paid directly to petitioner. However, petitioner submitted no documentation to establish receipt or application of these funds.

Petitioner submitted into evidence various miscellaneous documentation which included the following: 1992 U.S. Partnership Return for Two Kings Associates; 1996 and 1997 U.S. corporation income tax returns filed for petitioner; Mr. Khakli's 1992 New York State Resident Income Tax Return and 1998 Nonresident Income Tax Return; and a March 13, 1992 notarized letter from Mr. Khakli to Mihane Mehmeti, reciting a loan from Mihane Mehmeti to Mr. Khakli in the sum of \$150,000.00 payable in "3-4 months" with copies of two bank checks payable to Shpresa Idrizi in the sums of \$65,000.00 and \$85,000.00. No supporting documentation was offered for any of the above submissions. Mr. Khakli testified that he placed corporate funds in his own account for safekeeping and acknowledged that alimony, doctor bills and other personal expenses were written on the Two Kings Associates Citibank account.³

THE DETERMINATION OF THE ADMINISTRATIVE LAW JUDGE

The Administrative Law Judge began with a review of the statutory requirements for an employer to deduct and withhold personal income taxes from employees' taxable wages. Furthermore, the Administrative Law Judge noted that where a taxpayer fails to file a return required by Article 22 of the Tax Law, the Division is, in fact, authorized to estimate a

³From the evidence in the record, it is apparent that this account remained open and active after the date of petitioner's incorporation.

taxpayer's income and the tax due thereon from any information that the Division may obtain and issue a notice of deficiency.

In his analysis of the evidence presented in this case, the Administrative Law Judge determined that the taxpayer clearly did not submit the documents requested by the Division despite the Division having provided petitioner with numerous opportunities to comply with such requests. Thus, the Administrative Law Judge held that the Division's use of the check register provided during a field visit by the auditor was reasonable and provided a rational basis for the tax imposed.

However, the Administrative Law Judge concluded that the record contained sufficient information that warranted modifications to the notices issued in this case. Specifically, the Administrative Law Judge pointed out that the Division was aware that petitioner's date of incorporation was April 15, 1994. As such, the Administrative Law Judge stated that any assessment made for periods prior to April 15, 1994 should be cancelled. Additionally, the Administrative Law Judge reasoned that petitioner submitted copies of six checks used to establish the payment of wages to Mr. Xhakli in 1994 and all of the checks are dated prior to petitioner's date of incorporation. Thus, the Administrative Law Judge directed that the notices be modified to recompute the wage figure for 1994 without including the amounts of the six checks. Other than such modifications, the ten Notices of Deficiency were sustained along with penalty and interest.

ARGUMENTS ON EXCEPTION

In its exception, petitioner acknowledges that it commingled funds and bank accounts for business and personal expenses and, moreover, that it did not provide all of the documentation

requested by the Division. Although petitioner concedes that the Division was within its authority to estimate in this case, it argues that the manner in which the Division estimated was wrong and the tax was not reasonably calculated.

In opposition, the Division states that, in the absence of any evidence sustaining petitioner's burden of proof in this case, the determination should be sustained.

OPINION

Tax Law § 671(a)(1) requires every employer maintaining an office or transacting business in New York and making payment of any taxable wages to a resident or nonresident to deduct and withhold from such wages for each payroll period a tax in an amount substantially equal to the tax reasonably estimated to be due from the employee's New York adjusted gross income or New York source income received during the calendar year. We note that sections 11-1771 and 11-1908 of the New York City Administrative Code require the same from employers with respect to the collection of New York City withholding tax.

In this case, there is no dispute that petitioner failed to withhold and pay over to the State and City the taxes it was required to remit. As we noted in *Matter of Bernstein*, "the question to be asked in determining the validity of an assessment in the first instance is whether the assessment is rational, not whether it is correct" (*Matter of Bernstein*, Tax Appeals Tribunal, December 24, 1992, *confirmed Matter of Bernstein v. Commissioner of Taxation & Fin.*, 200 AD2d 810, 606 NYS2d 445).

Petitioner concedes that the Division has the authority to estimate in this instance. Here, petitioner argues that the Division's estimate is unreasonable for two reasons. First, petitioner claims that the Division included in its computation of wage income certain bona fide

disbursements made by petitioner for legitimate business expenses. Secondly, petitioner alleges that the Division utilized the check register for 1994 and projected the amounts over the next four years which it states is completely inaccurate due to the fact that the 1994 amounts were inflated due to a mortgage petitioner secured that year in excess of \$550,000.00. Thus, petitioner requests that the notices be cancelled as lacking a rational basis for 1995 through 1998.

It is important to note that this case involves the failure of a corporation to file withholding tax returns. This case is not a responsible officer case. Furthermore, there has not been any deficiency issued to Mr. Xhakli for personal income taxes. The audit which provided the basis for the notices issued to the corporation deemed certain checks payable from the corporation to other business entities, to wit, Two Kings Associates and Jackly Construction, as wage income to Mr. Xhakli by Two Kings, Inc. We disagree.

In determining whether a payment constitutes wages for New York State personal income tax withholding purposes, the regulations of the Commissioner of Taxation and Finance direct that the Federal definition of wages applies (*see*, 20 NYCRR 171.3[1]). Internal Revenue Code § 3401(a) defines the term *wages*, in pertinent part, as: “all remuneration . . . for services performed by an employee for his employer, including the cash value of all remuneration (including benefits) paid in any medium other than cash.”

We do not find it reasonable for the Division to include checks numbered 4684, 4686, 1034, 1035 and 1102 issued to Jackly Construction as amounts that should be characterized as wages. We note the unrebutted testimony of Mr. Xhakli concerning the extensive renovations that occurred to the property owned by Two Kings coupled with the proposals for renovations which establish that the five checks outlined above totaling \$236,000.00 were legitimate

business expenses and, as such, were improperly included as wage income by the auditor in this case.

Moreover, we find petitioner has established that the two checks payable to Two Kings Associates in the amount of \$340,000.00 did not represent wages and, as such, should be excluded from the Division's computation of wage income for the year 1994. There is no dispute that Two Kings Associates was a partnership and, thus, the checks cannot be wages by definition.

Therefore, we direct the Division to recompute the estimated wages for the year 1994 by excluding the seven checks set forth above. Such modification necessarily requires a recomputation of the tax due for subsequent years since the 1994 amount provided the basis for the deficiencies issued in the years 1995 through 1998.

Accordingly, it is ORDERED, ADJUDGED and DECREED that:

1. The exception of Two Kings, Inc. is granted to the extent that the seven checks in the total amount of \$576,000.00 be excluded from the amount determined to be wage income for 1994 and projected to the years 1995 through 1998 by the Division of Taxation, but is otherwise denied;

2. The determination of the Administrative Law Judge is modified in accordance with paragraph "1" above, but is otherwise sustained;

3. The petition of Two Kings, Inc. is granted to the extent indicated in conclusion of law "F" of the Administrative Law Judge's determination and paragraph "1" above, but in all other respects, the petition is denied; and

4. The ten Notices of Deficiency dated January 29, 2001, as modified in accordance with paragraph "3" above, are sustained.

DATED: Troy, New York
September 15, 2005

/s/Donald C. DeWitt

Donald C. DeWitt
President

/s/Carroll R. Jenkins

Carroll R. Jenkins
Commissioner

/s/Robert J. McDermott

Robert J. McDermott
Commissioner