STATE OF NEW YORK

DIVISION OF TAX APPEALS

In the Matter of the Petition	:	
of	:	
JACK EISNER	:	DETERMINATION
for Redetermination of a Deficiency or for Refund of New York State Personal Income Tax under Article 22 of the Tax Law, Unincorporated Business Tax under Article 23 of the Tax Law and City of New York Personal Income Tax under Chapter 46, Title T of the Administrative Code of the City of New York for the Year 1980.	:	

Petitioner, Jack Eisner, 800 Fifth Avenue, New York, New York 10021, filed a petition for redetermination of a deficiency or for refund of New York State personal income tax under Article 22 of the Tax Law, unincorporated business tax under Article 23 of the Tax Law and City of New York personal income tax under Chapter 46, Title T of the Administrative Code of the City of New York for the year 1980 (File No. 801529).

A hearing was held before Brian L. Friedman, Administrative Law Judge, at the offices of the Division of Tax Appeals, Two World Trade Center, New York, New York, on March 23, 1988 at 10:45 A.M., with additional evidence to be submitted by June 23, 1988. Petitioner appeared by Ira Sarinsky & Company, P.C. (Harvey A. Josephson and Richard A. Clapsaddle, CPAs). The Division of Taxation appeared by William F. Collins, Esq. (Kevin A. Cahill, Esq., of counsel).

ISSUES

I. Whether the Division of Taxation properly disallowed certain deductions and expenses claimed by petitioner and certain adjusting entries made by petitioner on the books and records of Sphinx Import Company for purposes of said petitioner's New York State and City of New York personal income tax and New York State unincorporated business tax returns for the year 1980.

II. Whether the deficiencies of personal income and unincorporated business taxes which resulted from the aforesaid disallowances of certain of petitioner's expenses and adjusting entries were due to negligence, thereby justifying the imposition of an addition to tax imposed pursuant to Tax Law § 685(b), the provisions of which are incorporated into Article 23 (unincorporated business income tax) of the Tax Law by section 722(a) thereof, and also imposed pursuant to Administrative Code former § T46-185.0(b).

FINDINGS OF FACT

1. Pursuant to a field audit of Jack Eisner ("petitioner") and of his business, Sphinx Import Company ("Sphinx"), which commenced in 1983, the Division of Taxation, on September 27, 1984, issued to petitioner three notices of deficiency as follows:

Period	Additional Tax Due	Penalty	Interest	Total
1979, 1980	$355,867.00	$17,793.00	$179,412.41	$553,072.41
1979, 1980	76,264.00	3,813.00	37,443.77	117,520.77
1981	8,922.00	446.00	2,587.97	11,955.97

Prior to the hearing, the parties agreed that deficiencies asserted to be due for the years 1979 and 1981 were to be cancelled and a partial withdrawal of petition and discontinuance of case for said years was executed by petitioner's representative on March 21, 1986. Therefore, the only issues remaining herein concern disallowances relating to petitioner's 1980 personal income and unincorporated business tax returns which were more particularly set forth in a Statement of Personal Income Tax Audit Changes and a Statement of Unincorporated Business Tax Audit Changes, each of which was issued to petitioner on July 15, 1984. The Statement of Personal Income Tax Audit Changes explained that the following items were disallowed as unsubstantiated or personal:

Sales returns & allowances	$252,144.00
Travel & entertainment expenses	36,403.00
Alimony	900.00
Commissions & selling expenses	30,000.00
Depreciation	13,420.00
Commissions salaries paid to wife	12,280.00
Legal fees	23,330.00

The result of these disallowances was the assertion, by the Division of Taxation, of total additional State and City personal incomes taxes due in the amount of $55,440.00, plus penalty and interest, for the year 1980.

The Statement of Unincorporated Business Tax Audit Changes explained that the following items were disallowed as unsubstantiated or personal:

Sales returns & allowances	$252,144.00
Travel & Entertainment expenses	36,403.00
Commissions & selling expenses	30,000.00
Wife's salary	12,280.00
Depreciation	13,420.00
Allocation of income	169,319.00
Consulting fees	50,000.00

Total additional unincorporated business tax in the amount of $22,542.00, plus penalty and interest, was, therefore, asserted to be due from petitioner for the year at issue.

2. With respect to the deficiency of State and City personal income taxes, petitioner conceded that the travel and entertainment expenses of $36,403.00 and the alimony of $900.00 were properly disallowed by the Division of Taxation. Petitioner also conceded that, for purposes of the deficiency of unincorporated business tax, the travel and entertainment expenses of $36,403.00 and the consulting fees of $50,000.00 were properly disallowed.

3. Sphinx was neither a corporation nor a partnership, but was a trade name used by petitioner to liquidate the assets of Stafford International Corporation ("Stafford"). Stafford sold

glassware, housewares, china, textiles and wooden products, and also imported and distributed certain other consumer products. Stafford was dissolved in 1979 and petitioner, using the name of Sphinx Import Company, spent most of the years 1979 through 1981 liquidating Stafford's assets and inventories.

4. Sales returns and allowances in the amount of $252,144.00 were disallowed by the auditor upon his examination of the cash receipts journal, disbursements journal and adjusting entries of Sphinx for the year 1980. These sales returns and allowances were not reflected on petitioner's personal income or unincorporated business tax returns, but were, instead, entered on the books of Sphinx. The effect of such entries was to reduce the gross sales on the books and records of Sphinx and, therefore, the income reported on the returns. The auditor disallowed the sales returns and allowances because he determined, from the company's accountant and/or bookkeeper, that their entries on the books were based upon estimates and that no documentary substantiation existed therefor. At the hearing, petitioner admitted that the bookkeeper may have estimated some of the entries for these returns and allowances. The auditor requested invoices, receipts for merchandise returned to Sphinx or other evidence of reentry into inventory, but no such substantiation was provided.

5. Sales returns and allowances occurred in instances where the customer claimed that it never received the merchandise; the merchandise was lost, damaged in transit or defective; or the customer claimed that it did not want the merchandise. In some of the aforesaid instances, petitioner received a check from the customer for partial payment of the shipment along with an explanation, on the check, for the failure to remit the full amount due. In instances of damaged or defective merchandise, the customer may have been charged a lower price than the amount originally invoiced. Some customers refused, for various reasons, to pay the full amount of the sales invoice. In such instances, petitioner or another employee of Sphinx often negotiated an allowance with the customer or, in the alternative, considered the feasibility of legal action to collect the full amount of the sales invoice. However, no invoices, credit memos or other documents were presented to the auditor to substantiate the amounts claimed as sales returns and allowances.

6. Out of the total commissions and selling expenses claimed by petitioner on his Federal Schedule C, Profit or (Loss) From Business or Profession, the auditor disallowed the sum of $30,000.00 on the basis that petitioner failed to substantiate his entitlement to this deduction. One-half, or $15,000.00, of said amount represented a selling expense charged to Solomon Development Company. The auditor stated that, while this $15,000.00 was charged to an investment account, the check was paid to the order of petitioner. This expense was disallowed by reason of the fact that petitioner failed to substantiate that such expense was a business rather than a personal expense. The remaining $15,000.00 was for a commission check (also payable to petitioner) charged, on the company's books, as an expense for the warehousing of certain merchandise. No Federal form 1099 (issued to recipients of nonemployee compensation) was issued to the alleged recipients of either of these $15,000.00 expenses claimed.

7. On his Schedule C, petitioner claimed a total depreciation deduction in the amount of $55,608.00, $13,420.00 of which was claimed for the depreciation of transportation equipment allegedly purchased in 1979 for $26,840.00. The auditor disallowed that portion of the total depreciation deduction claimed for transportation equipment on the basis that said transportation equipment was, in fact, petitioner's automobile. In 1980, petitioner owned a Cadillac limousine which he claimed, on his return, as having been used entirely for business purposes. During the year at issue, petitioner resided at 800 Fifth Avenue in New York City while the offices of Sphinx were located in the Empire State Building (Fifth Avenue and 34th Street, New York

City). Petitioner claimed that he walked to work nearly every day and that, while the automobile may not have been used entirely for business purposes, 99 percent of its use was business related. The auditor disallowed the depreciation deduction claimed for this automobile due to the fact that petitioner failed to provide him with a bill of sale for the vehicle and, in addition thereto, petitioner was unable to substantiate, with diaries or any other documentation, that the vehicle was used for business purposes.

8. The auditor disallowed, from the total amount claimed on petitioner's Schedule C as commissions or wages, the sum of $12,280.00 allegedly paid to petitioner's ex-wife, Helen Eisner. Petitioner stated that Helen Eisner performed occasional bookkeeping services for the company. The auditor was presented with a W-2 (wage and tax statement) form allegedly filed for Helen Eisner by Sphinx, but the W-2 form failed to contain Helen Eisner's social security number. The auditor was provided with checks marked "payroll" which were paid to the order of Helen Eisner. Upon an examination of the Federal forms 941, Employer's Quarterly Federal Tax Return, filed by Sphinx during the year at issue, the auditor determined that income and social security taxes had not been withheld and paid over on behalf of Helen Eisner. The auditor thereupon examined the New York State personal income tax filing records of Helen Eisner and determined that she had not claimed as wages the sum of $12,280.00 allegedly paid to her by Sphinx. Based upon the lack of a proper W-2, the failure of Sphinx to report Helen Eisner as an employee on its forms 941 and the auditor's determination that Helen Eisner was legally related to petitioner, he disallowed this claimed deduction. Petitioner and Helen Eisner were divorced in 1978. Pursuant to the decree of divorce, petitioner was obligated to pay alimony in the amount of $2,250.00 per month. Subsequent to the hearing, petitioner's representative submitted an unsigned photocopy of what is purportedly Helen Eisner's 1980 Federal income tax return. On Schedule B (interest and dividend income) thereof, interest income in the amount of $12,280.00 from Sphinx Import Company is set forth. Petitioner alleges that Mrs. Eisner simply listed these payments incorrectly as interest income.

9. On petitioner's New York State resident return for 1980, among the itemized deductions claimed, was the sum of $23,330.00 which was listed under the category of "miscellaneous deductions". Upon audit, the auditor was advised that this sum represented legal fees paid. No bills, checks or other documents were presented by petitioner to substantiate this deduction. At the hearing, petitioner could not recall to whom these legal fees were allegedly paid.

10. On his unincorporated business tax return for 1980, petitioner calculated a business allocation percentage of 60.39 percent which, when applied to net business income of $422,465.00, resulted in net income from business allocated to New York State in the amount of $253,146.00. The balance, or $169,319.00, was allocated to business carried on outside the State. On his business allocation schedule, petitioner stated that storage and handling were performed at various warehouses in the United States (outside of New York State) and overseas. On this business allocation schedule, petitioner did not claim that any real property located outside the State was either owned or rented from others by said petitioner. For this reason and for the additional reason that it was his interpretation of the Tax Law and the regulations promulgated thereunder that a warehouse does not qualify as a regular place of business for purposes of allocation of unincorporated business income, the auditor disallowed petitioner's allocation and deemed his entire net business income subject to the New York State unincorporated business tax.

CONCLUSIONS OF LAW

A. Section 689(e) of the Tax Law (and section 722[a] which incorporates the provisions of

this section for purposes of the New York State unincorporated business tax) and section T46-189.0(e) of the Administrative Code of the City of New York impose upon petitioner the burden of refuting the Division of Taxation's disallowances of certain deductions and expenses and certain adjusting entries made on the books of his business which affect the amount of income reported therefrom and of establishing that he is properly entitled to claim such deductions and expenses and to make such entries on the books for the year at issue.

B. Under certain circumstances, if a taxpayer has no records to prove the amount of a business expense deduction but can establish that some expense was incurred, an allowance may be based on an estimate. However, the absence of supporting records will "'bear heavily' against the taxpayer 'whose inexactitude is of his own making'" (Olken v. Commissioner, 41 TCM 1255, 1257 [1981]). Furthermore, where the Division of Taxation has allowed part of a deduction, the Division's determination will not be altered "unless facts appear from which a different approximation can be made" (Nowland v. Commissioner, 15 TCM 368, 375 [1956]. See also, Masters v. Commissioner, 243 F2d 335 [3d Cir 1957]).

C. With respect to the commissions and selling expenses, automobile depreciation and legal fees claimed, petitioner has clearly failed to provide any evidence to substantiate his entitlement to the amounts claimed and, as such, the Division of Taxation's disallowance of each was, therefore, proper.

D. In the type of business engaged in by Sphinx, it is quite possible that sales returns and allowances did, in fact, occur. As indicated in Conclusion of Law "B", supra, such allowances may be based upon an estimate. In the present case, no supporting records were presented to substantiate the amounts which were entered on the books to reduce the business income reported on the returns. Moreover, the lack of records did not permit the auditor to make a different approximation or, for that matter, any approximation at all. While petitioner contends that it was not the practice, in this type of business, to issue invoices or credit memos for returns or allowances, he failed to present checks and original sales invoices to substantiate that certain customers did not pay the full amount set forth on a particular invoice. Without some supporting documents, the Division of Taxation quite properly disallowed petitioner's entries, on the company's books, of amounts allegedly attributable to sales returns and allowances and properly included said amounts claimed as income for purposes of petitioner's personal income and unincorporated business tax liability for the year at issue.

E. The auditor's disallowance of the $12,280.00 allegedly paid to petitioner's ex-wife, Helen Eisner, was based upon his determination that a proper form W-2 had not been issued, that the company had failed to report the amount as wages on its form 941 and that Mrs. Eisner had failed to report this amount as wages on her New York State personal income tax return for 1980, and his categorization of Helen Eisner as being legally related to petitioner. On the copy of her Federal form 1040 for 1980, Helen Eisner incorrectly reported the $12,280.00 received from Sphinx as interest income rather than wages. It must be noted that she also reported alimony received in the amount of $27,000.00 (12 x $2,250.00), so it cannot be inferred that the wages were paid to satisfy petitioner's alimony obligation. While petitioner did not keep accurate records, i.e., the W-2 form was not complete and forms 941 did not reflect Mrs. Eisner as an employee for purposes of the withholding of income and social security taxes, the auditor was presented with payroll checks issued to her and the amount was reported as income (interest rather than wages) on her Federal form 1040. Mrs. Eisner's New York State income tax return was not offered into evidence, but the fact that this income was improperly categorized as interest may well explain the auditor's assumption that the payments from Sphinx were not reported as wages on her State return for 1980. Moreover, the auditor's statement that Helen Eisner was

legally related to petitioner is incorrect based upon an examination of a valid decree of divorce entered in 1978. Therefore, petitioner has met his burden of proving that the sum of $12,280.00 was an ordinary and necessary business expense paid to Helen Eisner for services performed and, as such, the Division of Taxation improperly disallowed from the total amount claimed as commissions or wages paid (for personal income and unincorporated business tax purposes) the sum of $12,280.00 paid to Helen Eisner.

F. Tax Law former § 707(a) provides that:

> "If an unincorporated business is carried on both within and without this state as determined under regulations of the tax commission, there shall be allocated to this state a fair and equitable portion of the excess of its unincorporated business gross income over its unincorporated business deductions. If the unincorporated business has no regular place of business outside this state, all of such excess shall be allocated to this state."

20 NYCRR 207.2(a) provides, in pertinent part, as follows:

> "In general, an unincorporated business is carried on at any place either within or without New York State where the unincorporated business entity has a regular place of business. A regular place of business is any bona fide office, factory warehouse or other place which is systematically and regularly used by the entity in carrying on its business. Where, as a regular course of business, property of an unincorporated business is stored by it in a public warehouse until it is shipped to customers, such warehouse is considered a regular place of business...."

The auditor's disallowance of petitioner's allocation of unincorporated business income to business carried on outside the State for 1980 ($169,319.00) was based primarily on his incorrect conclusion that a warehouse is not a regular place of business for purposes of the unincorporated business tax. In addition, since petitioner's return, on the business allocation schedule thereof, indicated that the values set forth for real property owned and rented inside and outside the State were identical to New York State amounts, the auditor concluded that petitioner maintained no warehouses outside the State for the year at issue. It must be noted, however, that on Schedule U-D of his unincorporated business tax return, petitioner claimed warehouse charges of $37,470.00. The regulation (20 NYCRR 207.2[a]) does not state that the taxpayer must rent the entire warehouse; evidence of public warehouse charges incurred on a systematic and regular basis is sufficient to meet the criteria set forth therein. It appears that substantiation of the warehouse charges was not raised as an issue by the Division of Taxation, but, instead, petitioner's allocation to business carried on outside the State was simply rejected on the basis of the auditor's incorrect conclusions relative to warehouses as regular places of business and lack of claimed rentals of real property. It must, therefore, be concluded that the Division of Taxation improperly disallowed petitioner's allocation of unincorporated business income to business carried on outside the State and the sum of $169,319.00 is to be deducted from taxable business income subject to the unincorporated business tax.

G. Tax Law § 685(b) and Administrative Code former § T46-185.0(b) imposed, for the year at issue, an addition to tax equal to five percent of the deficiency if any part of the deficiency is due to negligence or intentional disregard of the provisions of the New York State and City of New York personal income tax law, rules or regulations, but without the intent to defraud. Such addition to tax was imposed by the Division of Taxation on the deficiency at issue herein.

The additions to tax imposed herein are analogous to the addition to tax imposed pursuant to Internal Revenue Code § 6653(a). In Yee v. Commissioner (50 TCM 551), negligence was found where the taxpayer's recordkeeping, reporting and bookkeeping methods were inadequate and the taxpayer took a substantial amount of unsubstantiated and improper deductions. In Van Skiver v. Commissioner (41 TCM 466), the negligence penalty was held to have been properly imposed where a taxpayer, having inadequate records, made exaggerated claims of deductions which he could not substantiate.

In the present matter, petitioner's claimed expenses and deductions and his adjusting entries on the books and records of Sphinx which resulted in his failure to report the proper amount of income for the year at issue were unsubstantiated. While not necessarily due to bad faith, such claims were the result of inadequate or improper recordkeeping and the negligence penalty was, therefore, properly imposed.

H. The petition of Jack Eisner is granted to the extent indicated in Finding of Fact "1" and Conclusions of Law "E" and "F", supra; the Division of Taxation is directed to modify the notices of deficiency issued September 27, 1984 accordingly; and, except as so granted, the notices of deficiency are hereby sustained.

DATED: Albany, New York
November 3, 1988

/s/ Brian L. Friedman
ADMINISTRATIVE LAW JUDGE