

STATE OF NEW YORK

DIVISION OF TAX APPEALS

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In the Matter of the Petition :  
of :  
NESTOR M. & CELIA M :  
SAGULLO, M.D., P.C. :  
for Redetermination of a Deficiency or for :  
Refund of Corporation Franchise Tax under :  
Article 9-A of the Tax Law for the Fiscal :  
Years Ending September 30, 1982 and :  
September 30, 1983. :  
: DETERMINATION

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In the Matter of the Petition :  
of :  
NESTOR AND CELIA SAGULLO :  
for Redetermination of a Deficiency or for :  
Refund of Personal Income Tax under Article 22 :  
of the Tax Law for the Years 1982 and 1983. :

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Petitioner Nestor M. & Celia M. Sagullo, M.D., P.C., 238 Willow Tree Road, Monsey, New York 10952, filed a petition for redetermination of a deficiency or for refund of corporation franchise tax under Article 9-A of the Tax Law for the fiscal years ending September 30, 1982 and September 30, 1983 (File No. 803784).

Petitioners Nestor and Celia Sagullo, 238 Willow Tree Road, Monsey, New York 10952, filed a petition for redetermination of a deficiency or for refund of personal income tax under Article 22 of the Tax Law for the years 1982 and 1983 (File No. 803785).

A hearing was held before Robert F. Mulligan, Administrative Law Judge, at the offices of the Division of Tax Appeals, Two World Trade Center, New York, New York, on June 23, 1988 at 12:15 P.M., with all briefs to be submitted by September 23, 1988. Petitioners appeared by Joseph Berman, C.P.A. The Audit Division appeared by William F. Collins, Esq. (Lawrence A. Newman, Esq., of counsel).

ISSUE

Whether petitioners are entitled to certain deductions taken on the corporation tax reports and personal income tax returns filed for the periods at issue.

FINDINGS OF FACT

1. The White Plains District Office conducted a field audit of the New York State corporation franchise tax reports of Nestor M. & Celia M. Sagullo, M.D., P.C. ("the professional corporation") for the fiscal years ending September 30, 1982 and September 30, 1983 and the New York State personal income tax returns of Nestor and Celia Sagullo for the calendar years 1982 and 1983.

The Audit of the Professional Corporation

2. At a meeting with petitioners' representative on March 18, 1985, the auditor requested a diary to substantiate deductions for business promotion expenses, automobile travel, automobile leasing and automobile depreciation. The auditor subsequently concluded that said deductions had not been fully substantiated by the professional corporation.

(a) Automobile expenses. As no diary or record of mileage was produced, the auditor allowed 15 percent business use on \$7,143.00 in claimed automobile expenses for the fiscal year ending September 30, 1982 and on \$5,351.00 of claimed automobile expenses for the fiscal year ending September 30, 1983. The professional corporation had claimed 100 percent business use on its reports.

(b) Business promotion expenses. The auditor disallowed \$6,824.00 claimed as "business promotion expenses" for the fiscal year ending September 30, 1982 and \$5,857.00 of such expenses claimed for the fiscal year ending September 30, 1983.

(c) Automobile depreciation. The auditor disallowed \$2,372.00 of \$2,790.00 in automobile depreciation taken for each year. The balance, \$418.00 per year (representing 15 percent of the total claim), was allowed.

(d) Automobile leasing expenses. The auditor disallowed \$6,996.00 in automobile leasing expenses taken for the fiscal year ending September 30, 1982 and \$11,934.00 in such expenses taken for fiscal year ending September 30, 1983.

3. On September 11, 1985, the Audit Division issued a Statement of Franchise Tax Audit Changes to the professional corporation stating, in pertinent part, as follows:

"The following adjustments are being made as a result of a field audit.

	<u>9/30/82</u>	<u>9/30/83</u>
Auto expense		6072.00
4549.00		
Promotion expense		6824.00
5857.00		
Auto depreciation		2372.00
2372.00		
Auto leasing expense		6996.00
11934.00		
Section 1085(B) penalty is imposed for negligence		
Net adjustment		22264.00

24712.00"

Tax due for the fiscal year ending September 30, 1982 was calculated at \$2,000.00 with a five percent penalty under Tax Law § 1085(b) of \$100.00. Tax due for the fiscal year ending September 30, 1983 was calculated at \$2,644.03 with a penalty of \$132.20.

4. On April 29, 1986, the Audit Division issued the following notices of deficiency to the professional corporation:

<u>Period Ended</u>	<u>Tax Interest</u>	<u>Additional Charge</u>		<u>Total Due</u>
9/30/82	\$2,000.00	\$966.41	\$100.00	\$3,066.41
9/30/83	2,240.70	689.34	112.04	3,042.08
9/30/83	403.33*	124.08	20.16	547.57

\*metropolitan transportation business tax surcharge

(The professional corporation had previously executed consents extending the period of limitation of assessment to April 15, 1987.)

The Personal Income Tax Audit

5. At the meeting with petitioners' representative on March 18, 1985, the auditor gave the representative a list of documentation which he requested as substantiation for deductions taken on the individual petitioners' personal income tax returns (in addition to the documents requested with respect to the professional corporation's expenses):

- Proof of Florida mortgage interest
- Proof of Vermont mortgage interest
- Proof of Manufacturer's Hanover Trust Company interest
- Proof of cost of wife's automobile
- Diary for wife's use of automobile
- Proof of broker's commission
- Proof of refund of Medicare fees
- Proof of legal fees
- Proof of rental income and allocation to rental property

6. Most of the documentation requested by the auditor was not submitted. Accordingly, on September 11, 1985, the Audit Division issued a Statement of Audit Changes which made the following adjustments:

1982

	<u>(H)</u> <u>1982</u>	<u>(W)</u> <u>1982</u>
"Section 612(b)(7) pension addback	13378.00	-0-
Section 612(b)(8) social security	1749.60	-0-
Miscellaneous Deductions	4597.00	24553.00
Interest expense (itemized deductions)	10328.00	10328.00

Rental loss	1349.00	1349.00
A.C.R.S. NYS net adjustment	1448.00	1448.00
Constructive dividends from Sagullo M.D. P.C.	22264.00	-0-

Section 685(b) penalty is imposed for negligence.

Net Adjustment	55113.60	37678.00
Taxable Income Previously Stated	38758.00	39236.00
Corrected Taxable Income	93871.60	76914.00
Tax on Corrected Taxable Income	11702.02	9327.96

\* \* \*

Less: Credits Max tax (see attached IT-250)	(2233.93)	(2066.12)
Corrected Tax Due	9468.09	7261.84
Tax Previously Computed	3236.00	3326.00
Total Additional Tax Due	6232.09	3935.84
10167.93		
Penalties: 685(b) .05	311.61	196.79
508.40		
Interest	1589.20	1003.65
2592.85		
Total	8132.90	5136.28
13269.18"		

1983

	(H) <u>1983</u>	(W) <u>1983</u>
"Section 612(b)(7) pension addback	19665.00	-0-
Section 612(b)(8) social security	1927.80	-0-
Miscellaneous deductions	2443.00	-0-
Interest expense (itemized deductions)	19138.00	-0-
Rental loss	5973.00	5973.00
Interest expense - rental property (Vermont)	(2565.00)	(2566.00)
A.C.R.S. NYS net adjustment	3378.00	3378.00
Constructive dividends from Sagullo M.D. P.C.	24712.00	-0-
Net Adjustment	74671.80	6785.00
Taxable Income Previously Stated	60237.00	36157.00
Corrected Taxable Income	134908.80	42942.00
Tax on Corrected Taxable Income	17447.23	4571.88

\* \* \*

Less: Credits Max tax (see attached IT-250)	(4106.90)	( 917.68)
Corrected Tax Due	13340.33	3654.20
Tax Previously Computed	5384.00	2976.00
Total Additional Tax Due	7956.33	678.20
8634.53		
Penalties: 685(b) .05	397.82	33.91
431.73		
Interest	1155.42	98.49
1253.91		
Total	9509.57	810.60
10320.17"		

The explanation for the adjustments was as follows:

"The adjustments are being made as a result of a field audit.

Addbacks must be made to the New York State personal tax return for pension and social security deductions claimed by a professional service corporation.

To allow any legal, insurance repayments as a miscellaneous deduction, complete documentation must be provided, such as court documents, complete explanation of lawyers fees etc.

Since you have not substantiated personal use of Vermont property (owners calendar) the loss is being disallowed as a vacation home.

A modification on the New York state return must be made for the A.C.R.S. depreciation claimed on the federal return.

Acceptable records of auto and entertainment expenses (location, purpose etc.) must be provided in order to allow such expenses."

7. On April 10, 1986, the Audit Division issued the following notices of deficiency to Nestor and Celia Sagullo:

(a) 1982 - Deficiency \$10,167.93 (\$6,232.09 husband; \$3,935.84 wife), penalty \$508.40, interest \$3,390.69, for a total of \$14,067.02.

(b) 1983 - Deficiency \$8,634.53 (\$7,956.33 husband; \$678.20 wife), penalty \$431.73, interest \$1,872.16, for a total of \$10,938.42.

#### Automobile Expenses

8. Petitioner Nestor Sagullo is a physician and surgeon with offices in Tuxedo and Monroe, New York. He is affiliated with Tuxedo Hospital and with Good Samaritan Hospital in Suffern, New York. While no diary of his business use was kept, Nestor Sagullo's credible and uncontroverted testimony shows that he used his automobile for 175 miles per week for travel between and among the two offices and the two hospitals. Allowing three weeks for vacation, this amounts to 8,575 miles per year. Nestor Sagullo was also a member of the Orange County

Medical Society and attended meetings four to six times per year during the years at issue. In 1981, he was a member of the executive committee, which met once each month in Goshen. Approximately 420 business miles were substantiated for such meetings for the fiscal year ending September 30, 1982 and 240 miles for the fiscal year ending September 30, 1983. Accordingly, Nestor Sagullo showed 8,995 business miles for the fiscal year ending September 30, 1982 and 8,815 business miles for the fiscal year ending September 30, 1983.

9. Petitioner Celia Sagullo is also a physician and works in the field of anesthesiology. During 1982 she worked part time at Saint Barnabas Hospital in The Bronx. She was also employed by the State of New York at an undisclosed location. During 1983 she apparently did not work at Saint Barnabas, but was still employed by the State of New York. Celia Sagullo did not attend the hearing, but Nestor Sagullo testified that late in 1982 his wife started working at Helen Hayes Hospital in Haverstraw, New York. There is nothing in the record to show that Celia Sagullo's automobile use was anything but commuting or some other personal use.

10. On December 13, 1979, the professional corporation purchased an automobile for \$11,162.00. The automobile was depreciated at 25 percent per year. The sum of \$2,790.00 was deducted for each of the fiscal years ending September 30, 1982 and September 30, 1983.

11. On May 14, 1982, the professional corporation leased a 1982 Mercedes Benz for 58 months with an initial monthly payment of \$2,862.00 and subsequent monthly payments of \$954.00 per month.

12. After the hearing, petitioners' representative conceded that depreciation should not have been taken for the fiscal year ending September 30, 1983, as the leased car had been acquired prior to the beginning of said year.

#### Promotional Expense

13. The only substantiation submitted with respect to the corporation's claimed promotional expense was a list of expenses for luncheons, dinners, gifts, etc. for the fiscal year ending September 30, 1982 totalling \$4,706.00. No diary, receipts or other documentation was offered. Nothing at all was offered for the fiscal year ending September 30, 1983.

#### Medicare/Medicaid Reimbursement and Legal Fees

14. Petitioner Celia Sagullo was a defendant in a criminal matter in Supreme Court, Rockland County, involving excess Medicare/Medicaid payments received by her. In connection with said matter, Celia Sagullo agreed to make restitution and, on February 26, 1982, paid \$4,478.00 to the United States Department of Health and Human Services and \$2,575.00 to the Rockland County Department of Social Services.

15. On their 1982 return, petitioners had deducted \$8,053.00 for refund of Medicare fees and \$16,500.00 in legal fees. After the hearing, the Audit Division took the position that the deduction of refunds should not be allowed, as petitioners did not show that said amounts had originally been reported in income. Petitioners' representative contends that the Medicare/Medicaid refunds were of previously reported income.

16. In connection with the aforementioned criminal matter, petitioner Celia Sagullo

incurred \$15,000.00 in legal fees payable to her counsel, Howard D. Stave, Esq., during 1982. After the hearing, petitioners submitted cancelled checks substantiating payment of \$14,000.00 to Mr. Stave and the Audit Division conceded that \$15,000.00 in legal fees were deductible.

Rental Loss

17. On December 23, 1982, Nestor and Celia Sagullo acquired one-half interest in a furnished condominium at Killington Village Condominiums, Killington, Vermont. Killington Village rental statements show the following for the unit with respect to the year 1983:

<u>Dates</u>	<u>Amount</u>
January 2-7	\$ 446.40
January 23-30	234.28
February 6-13	421.20
February 14-20	--
February 20-25	279.60
March 4-6	156.00
March 13-18	446.40
April 2-8	340.20
April 22-24	--
August 1-31	324.00
October 7-10	70.73
October 15-16	--
Total	\$2,718.81

Killington Village received 40 percent of gross rentals for its services. It is unclear whether the above figures are gross or net rentals.

18. Nestor Sagullo testified that his family occupied the condominium 10 to 12 days per year. There is nothing in the record as to the amount of time the co-owner used the property.

Interest

19. (a) On Nestor and Celia Sagullo's 1982 return, they deducted \$1,144.00 in home mortgage interest, credit card interest of \$293.00, Bank of New York interest of \$665.00, Internal Revenue Service interest of \$41.00, Merrill Lynch interest of \$3,952.00, Florida mortgage interest of \$7,658.00, Rutland (Vermont) Bank interest of \$1,526.00 and Manufacturer's Hanover Trust Company interest of \$19,131.00, for a total of \$34,410.00 in interest expense. As indicated in Finding of Fact "6", the Statement of Audit Changes disallowed \$10,328.00 each for husband and wife for total disallowed interest expense of \$20,656.00. The auditor's workpapers indicate that the \$20,656.00 was comprised of the Vermont mortgage and the Manufacturer's Hanover Trust Company loan.

(b) On Nestor and Celia Sagullo's 1983 return, they deducted \$19,138.00 in home mortgage interest expense, credit card interest of \$146.00, Merrill Lynch margin account interest of \$4,316.00, Citibank interest of \$529.00 and Bank of New York interest of \$665.00, for a total of \$24,794.00 in interest expense. As noted in the Statement of Audit Changes, the auditor disallowed \$19,138.00, which was the home interest expense.

20. On December 4, 1981, Nestor and Celia Sagullo obtained a mortgage loan from Manufacturer's Hanover Trust Company in the amount of \$100,000.00 at 17.70 percent interest with payments at \$1,556.76 per month for 15 years. Payments were made for all of 1982 and up to and including June of 1983. The mortgage was satisfied on June 17, 1983.<sup>1</sup>

21. After the hearing, petitioners submitted copies of the following checks payable to the Dime Savings Bank:

<u>Check No.</u>	<u>Date</u>	<u>Amount</u>
3233	1/11/82	\$651.00
3245	2/7/82	651.00
3266	3/15/82	651.00
3348	8/10/82	651.00
3429	12/18/82	639.00
3467	2/18/83	639.00
3496	4/20/83	639.00

Several of the checks bore a memorandum indicating they were "For #167838-2". No other document or explanation was offered in connection with said checks.

22. After the hearing, petitioners submitted copies of the following checks payable to Carold Corporation:

<u>Check No.</u>	<u>Date</u>	<u>Amount</u>
3559	7/24/83	\$1,704.00
3575	8/28/83	1,725.00
3584	9/27/83	1,725.00
3602	10/29/83	1,725.00

Check number 3559 bore the memorandum "Payment #1 Account #054-82065", while number 3575 stated "#2 # 750054-0008 2065". Check 3584 showed the same account number and check number 3602 had no memorandum notation. No other document or explanation was offered with respect to said checks.

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<sup>1</sup>The auditor, in reviewing the documents related to the Manufacturer's Hanover Trust Company loan, apparently did not understand the difference between the mortgage note, which was the document dated December 4, 1981, and the satisfaction, which was the document dated June 17, 1983. His comment was "it looks as if someone wrote in the December 4, 1981 date". To confuse matters even further, petitioners' representative, in his post-hearing memorandum, referred to the Manufacturer's Hanover Trust loan as being for \$280,160.00. The representative, however, was apparently alluding to the total of the principal and finance charges projected over a period of 15 years, which was \$280,216.80. The loan clearly was for \$100,000.00.



Pension and Social Security Add-Backs and A.C.R.S. Adjustment

23. The pension addbacks under Tax Law § 612(b)(7) and the social security addbacks under Tax Law § 612(b)(8), as well as the A.C.R.S. New York State net adjustments are not at issue and appear to have been conceded by petitioners.

CONCLUSIONS OF LAW

A. That Tax Law §§ 689(e) and 1089(e) provide, in effect, that the burden of proof with respect to substantiation of deductions disallowed upon audit is upon petitioners.

B. That this case illustrates the difficulty of resolving a substantiation audit involving numerous issues at the hearing level. It is clear that petitioners' returns were incorrect and inaccurate when filed. It is also apparent that much documentation was not presented either upon audit or at the prehearing conference, and it is unfortunate that some of the issues herein were not settled prior to the hearing. As may be seen from the Findings of Fact, some evidence remains lacking even after the hearing. Based upon testimonial and documentary evidence offered by petitioners, it is determined that petitioners have sustained their burden of proof to the following extent:

(1) The corporation franchise tax deficiencies.

(a) Automobile related expenses. The 15 percent business use allowed by the auditor is as unrealistic as the 100 percent business use claimed by the professional corporation on its reports. As noted in Finding of Fact "8", the professional corporation is entitled to 8,995 business miles for the fiscal year ending September 30, 1982 and 8,815 business miles for the fiscal year ending September 30, 1983. Unfortunately, total mileage driven for said year is not shown in the record. Judging from the evidence submitted, however, it is reasonable to conclude that said business miles amounted to 50 percent of the use of one automobile for each year. Depreciation should not have been taken after May 1982, when the professional corporation leased the Mercedes Benz used by Nestor Sagullo and the deductions for automobile depreciation must also be modified. Accordingly, the deductions of the professional corporation for automobile related expenses are to be recalculated as follows:

(i) The 15 percent business use allowed on \$7,143.00 in automobile expenses for the fiscal year ending September 30, 1982 and \$5,351.00 in claimed automobile related expenses for fiscal year ending September 30, 1983 is increased to 50 percent.

(ii) Fifty percent of automobile depreciation is permitted for the first eight months of the fiscal year ending September 30, 1982 ( $8/12 \times \$2,790.00 \times 50\% = \$930.00$ ).

(iii) Fifty percent of automobile leasing expense is allowed.

(b) Business promotion expenses. Petitioners did not sustain their burden of proof to show that the professional corporation was entitled to any business promotion expenses for the periods at issue.

(2) The personal income tax deficiencies.

(a) Automobile related expenses. As petitioner Celia Sagullo showed no business

use of an automobile, no automobile expenses are allowed for a second vehicle.

(b) Medicare/Medicaid reimbursement and legal fees. Petitioners sustained their burden of proof to show that petitioner Celia Sagullo refunded \$4,478.00 to the United States Department of Health and Human Services and \$2,575.00 to the Rockland County Department of Social Services in 1982. It is noted that upon audit, petitioners were asked to substantiate the refund of Medicare payments, not to show that the payments had been included in income for some earlier year. Accordingly, the refunds are deductible in 1982. A total of \$15,000.00 in legal fees was income related and, as conceded by the Audit Division after the hearing (Finding of Fact "16"), should be allowed.

(c) Rental loss. Petitioners Nestor and Celia Sagullo did not sustain their burden of proof to show that they are entitled to deductions for rental losses in connection with the Vermont property.

(d) Interest. Petitioners sustained their burden of proof to show that they paid interest to Manufacturers Hanover Trust Company on an initial principal balance of \$100,000.00 at 17.70 percent with payments of \$1,556.76 representing principle and interest over the period January 1982 through June 1983. The amount of interest may readily be ascertained from an amortization table and will not be calculated in this determination. Petitioners did not sustain their burden of proof to show how much, if any, interest was paid to Dime Savings Bank, Carold Corporation, or any other lending institution during the periods at issue.

(e) Constructive dividends from the professional corporation. The constructive dividends from the professional corporation are to be reduced in accordance with Conclusion of Law "B(1)", supra.

C. That the petitions of Nestor M. & Celia M. Sagullo, M.D., P.C. and Nestor and Celia Sagullo are granted to the extent indicated in Conclusion of Law "B"; and, except as so granted, the petitions are denied and the notices of deficiency issued April 10, 1986 and April 29, 1986 are otherwise sustained.

DATED: Albany, New York  
January 6, 1989

/s/ Robert F.

Mulligan \_\_\_\_\_

ADMINISTRATIVE LAW JUDGE