STATE OF NEW YORK

DIVISION OF TAX APPEALS

In the Matter of the Petition	:	
of	:	
STANLEY AND JUDITH KATZ	:	DETERMINATION 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 a petition 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.

A hearing was held before Timothy J. Alston, Administrative Law Judge, at the offices of the Division of Tax Appeals, Riverfront Professional Tower, 500 Federal Street, Troy, New York, on September 2, 1993 at 9:15 A.M. Petitioners filed a brief on November 1, 1993. The Division of Taxation filed a brief on December 13, 1993. Petitioners filed a reply brief on December 28, 1993. 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).

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

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 for the 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.

CONCLUSIONS OF LAW

A. Tax Law § 685(a)(1) and (2) imposes penalties for failure to file a return and failure to pay tax shown on a return on or before the prescribed date. The New York City Administrative Code contains parallel penalty provisions (see, Administrative Code of City of NY § 11-1785[a][1] and [2]).

B. Tax Law § 651 prescribes the due date for the filing of returns under Article 22. Tax Law § 657 empowers the Division to extend the time for the filing of returns and the payment of tax "on such terms and conditions as it [the Division] may require." During the year at issue,

the relevant "terms and conditions" for extensions of time were set forth in 20 NYCRR former 151.2(a), which provided, in relevant part, the following:

"Requirement to file New York State application form.

"(1) General. (i) Individuals. An individual who is required to file a New York State personal income tax return for any taxable year will be allowed an automatic four-month extension of time to file such return beyond the date prescribed for the filing of such return if the requirements contained in paragraphs (2) through (4) of this subdivision are met.

* * *

"(2)(i) Individuals. Except as otherwise provided by paragraph (1) of subdivision (b) of this section, an application must be prepared on form IT-370, Application for Automatic Extension of Time to File for Individuals, and must be signed by such individual or other person duly authorized by such individual to request such extension.

* * *

"(3) The application must be completed and filed with New York State Income Tax, W.A. Harriman Campus, Albany, NY 12227, on or before the date prescribed for the filing of the New York State income tax return of the individual, partnership or fiduciary.

"(4)(i) In the case of an individual or a fiduciary, the application must indicate thereon the properly estimated amount of the New York State personal income tax liability, the properly estimated amount of the City of New York tax liability and the properly estimated amount of the City of Yonkers tax liability for such taxable year. The amount of the New York State personal income tax liability, the amount of the City of New York tax liability and the amount of the City of Yonkers tax liability for the taxable year will be deemed properly estimated by such individual or fiduciary if the combined amounts indicated thereon are not less than 90 percent of the taxes as finally determined. For purposes of this Part the taxes as finally determined are the amount of total taxes which the New York State income tax return shows to be due or would have shown to be due except for mathematical errors.

"(ii) Where the taxes as finally determined are $1,000 or more, the application must be accompanied by a full remittance of the properly estimated amount of New York State personal income tax, City of New York tax and City of Yonkers tax remaining unpaid as of the date prescribed for the filing of the New York State income tax return . . . .

"(iii) For purposes of this Part, the New York State personal income tax liability means the amount of New York State personal income tax imposed under article 22 of the Tax Law, City of New York tax liability means the City of New York personal income tax imposed under Chapter 17 of title 11 of the Administrative Code of the City of New York . . . .

"(5) Any automatic extension of time for filing a New York State income tax return granted under this subdivision will not operate to extend the time for the

payment of any New York State personal income tax, City of New York tax or City of Yonkers tax due on such return."

C. Penalties under Tax Law § 685(a) and New York City Administrative Code § 11-1785(a) are properly imposed unless the taxpayer establishes that "such failure is due to reasonable cause and not due to willful neglect." During the year at issue, the Division's regulations defined "reasonable cause" at 20 NYCRR former 102.7, in relevant part, as follows:

"(c)(2) A showing of reasonable cause with respect to the addition to tax for failure to pay the amount of tax shown on any New York State income tax return will be presumed, where the taxpayer has obtained a valid automatic extension of time for filing the return pursuant to the provisions of Part 151 of this Title. This presumption of reasonable cause will apply to only that period of time for which a taxpayer has a valid automatic extension of time for filing the New York State income tax return and, if any, the additional extension of time for filing such return.

"(d) The following exemplify grounds for reasonable cause, where clearly established by or on behalf of the taxpayer, employer or other person:

* * *

"(4) 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.

"(e)(1) Except as provided for in subparagraph (2)(ii) of this subdivision, an inability to timely obtain and assemble essential information (including wage and tax statements or returns of information from an employer or payor) required for the preparation of a complete New York State income tax return, shall not be a basis for reasonable cause.

"(2)(i) Where an inability to timely obtain and assemble essential information required for the preparation of a complete New York State income tax return exists and extensions of time for filing such return are available pursuant to section 151.1 of this Title, such extensions of time for filing must be obtained, a return which reflects the known tax liability must be filed on or before the extended due date for filing and any balance of tax must be paid with the return on that portion of the tax liability which can be ascertained and shown on such return. The relevant facts affecting that portion of the tax liability which cannot be ascertained must be fully disclosed with the timely filed New York State income tax return. When such liability is ascertained, an amended New York State income tax return must be immediately filed together with any additional tax due.

"(ii) However, where a taxpayer:

"(a) makes a timely application for an extension of time to file the New York State income tax return;

"(b) makes a good faith effort to properly estimate the tax due in

accordance with section 151.2 of this Title; and

"(c) pays with the application for extension of time for filing any unpaid balance of the tax as estimated;

an inability for reasons beyond the taxpayer's control to obtain and assemble essential information may constitute reasonable cause for failure to file a New York State income tax return and for failure to pay the amount shown as tax on such return, where such inability precluded the taxpayer from properly estimating the tax as finally determined (see section 151.2[a][4][i] of this Title) thereby invalidating the extensions of time for filing the New York State income tax return. In support of this ground as a basis for reasonable cause, the taxpayer or the taxpayer's representative must indicate what information was unavailable and explain the reason or reasons why such information was unavailable, despite reasonable efforts by or on behalf of the taxpayer to obtain the missing information. It must further be explained how the original estimation of tax was derived and what, if any, allowances were included in the estimation to provide for the unknown tax liability."

D. Petitioners assert, first, that their reliance on the erroneous advice of their accountants constitutes reasonable cause for their failure herein. Such reliance may, under certain circumstances, constitute reasonable cause:

"In making a determination as to whether reasonable cause exists when a taxpayer has relied on the erroneous advice of a professional, it must be shown that the taxpayer relied in good faith on the advice which he recieved [sic] and it must have been 'reasonable' for the taxpayer to rely upon the particular advice he was given (see, Auerbach v. State Tax Commn., 142 AD2d 390, 536 NYS2d 557, 561; LT & B Realty v. State Tax Commn., 141 AD2d 185, 535 NYS2d 121, 123). 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 for taxes (see, United States v. Boyle, 469 US 241, 85-1 USTC ¶ 13,602 at 88,255). Further, the nature and complexity of the matter giving rise to the dispute should be considered when making a determination as to whether a taxpayer's reliance was reasonable (see, Betson v. Commr., 802 F2d 365, 86-2 USTC ¶ 9826)." (Matter of Erikson, Tax Appeals Tribunal, March 22, 1990.)

E. Petitioners 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 (supra). 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.[1] Furthermore, Mr. Katz, in his affidavit, asserted that the tax treatment of the installment payment was a "technical and highly complex issue." If, as Mr. Katz contends, he believed the issue to be highly complex, while also knowing the effect 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.[2]

As noted, Mr. Katz, in his affidavit, asserted that the tax treatment of the installment payment was highly complex. Petitioners' representative also made this assertion at hearing and on brief without offering any basis for such a conclusion. This contention is rejected. Inasmuch as the proper tax treatment of the installment payment was consistent with the proper tax treatment of any item of S corporation income, i.e., pass-through to the shareholders, it is not at all clear how such treatment can be characterized

as highly complex. It is noted that testimony was presented at hearing which referred to the

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[1]Interestingly, while much of petitioners' case consists of their assertion that they reasonably relied on their accountants' erroneous advice, 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 (see, Finding of Fact "23"). 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.

[2]It is noted that the Division's regulations provide that, in determining whether reasonable cause and good faith exists, the extent of efforts to ascertain the proper tax liability is considered the most important factor (see, 20 NYCRR former 102.7[g][2]).

change of Archer Services, Inc. from C corporation to S corporation status as a complicating factor. As to this point, it may well be that the change of status would prompt some investigation to determine whether this factor would remove the installment payment from the standard "pass-through" treatment of S corporation income. Petitioners have not shown, however, how this circumstance transforms the straightforward question of the tax treatment of S corporation income into a complex matter.

F. Petitioners also contended that the penalties imposed herein should be abated because of an inability beyond petitioners' control to obtain and assemble essential information (see, 20 NYCRR former 102.7[e][2]). Petitioners point to the computer software problems experienced by the Archer Group as preventing the accurate reporting of their tax liability. This contention is rejected. Petitioners' underreporting of their tax liability did not result from their inability to obtain information because of the computer software situation. Indeed, as petitioners have pointed out, absent the installment payment, petitioners would have reported a loss for 1987 with respect to their S corporation income (see, Finding of Fact "20"). Under those circumstances, petitioners' estimates of their tax liability would have been reasonable. The computer software problems, therefore, did not preclude petitioners from properly estimating their tax liability. Petitioners' failure thus results from their failure with respect to the installment payment and not from any problems occasioned by the computer software overhaul. Consequently, petitioners' assertion that reasonable cause existed herein because of their failure to obtain and assemble essential information must be rejected.

G. Petitioners also contended that since certain net operating loss carrybacks from subsequent years reduced their 1987 tax liability substantially, penalties imposed herein should be abated to the extent of this subsequent reduction in tax liability.

The statute under which penalties are imposed herein impose such penalties for failure to file or failure to pay "on or before the prescribed date." Petitioners have cited no 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). Accordingly, petitioners' contention is rejected.

H. The petition of Stanley and Judith Katz is denied and the Division's refund denial, dated March 26, 1991, is sustained.

DATED: Troy, New York
June 16, 1994

/s/ Timothy J. Alston
ADMINISTRATIVE LAW JUDGE