STATE OF NEW YORK

DIVISION OF TAX APPEALS

In the Matter of the Petition of **JAMES AND JANE COURTIEN** for Redetermination of a Deficiency or for Refund of New York State Personal Income Tax under Article 22 of the Tax Law for the Years 1994 and 1995.	DETERMINATION DTA NO. 818053

Petitioners, James and Jane Courtien, 308 Woodland Drive, Brightwaters, New York 11718-1925, 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 for the years 1994 and 1995.

A small claims hearing was held before James Hoefer, Presiding Officer, at the offices of the Division of Tax Appeals, State Office Building, Veterans Memorial Highway, Hauppauge, New York on November 30, 2001 at 10:45 A.M. Petitioners appeared by Lazer, Aptheker, Feldman, Rosella & Yedid, P.C. (Steven B. Aptheker, Esq., of counsel). The Division of Taxation appeared by Barbara G. Billet, Esq. (Philip Sanfedele).

The final brief in this matter was due by January 18, 2002 and it is this date that commences the three-month period for the issuance of this determination.

ISSUES

I. Whether the doctrines of *res judicata* and collateral estoppel preclude the Division of Taxation from raising the issue of whether petitioner Jane Courtien is an independent contractor versus employee of Courtien Communications Ltd., where this exact same issue was raised, and subsequently settled by consent, in a previous audit of said corporation.

II. Whether, if it is determined that the doctrines of *res judicata* and collateral estoppel are not applicable in the instant matter, the Division of Taxation properly determined that petitioner Jane Courtien was an employee, and not an independent contractor, of Courtien Communications Ltd. for the two years at issue.

III. Whether the Division of Taxation properly disallowed a portion of the business expenses claimed as deductions by petitioner Jane Courtien with respect to her activities on behalf of Courtien Communications Ltd.

FINDINGS OF FACT

1. For the two years at issue in this proceeding, petitioner Jane Courtien[1] was president and sole shareholder of Courtien Communications Ltd. ("the corporation"), an entity which was incorporated in New York State on March 1, 1989 and which elected to be treated as an S corporation. The corporation was engaged in the communications consulting business, primarily involved in the review of telephone bills of large corporations to determine if said corporations had been overbilled.

2. On or about September 23, 1996, the Division of Taxation ("Division") commenced a withholding tax audit of the corporation for the period January 1, 1993 through June 5, 1996. As the result of its withholding tax audit, the Division, on March 24, 1997, issued four notices of deficiency to the corporation on the grounds that the compensation it had paid to petitioner should have been treated as wages, and that it had improperly failed to withhold any New York State income taxes from said wage compensation. The notices for the years 1993, 1994 and 1995 asserted that penalties and interest were due, while the notice for the period January 1,

[1] Petitioner James Courtien is involved in this proceeding solely as the result of having filed joint personal income tax returns with his spouse. Accordingly, the use of the term petitioner will, unless otherwise noted, hereinafter refer solely to Jane Courtien.

1996 through June 5, 1996 asserted that $6,200.00 of tax was due together with penalties and interest.

3. The corporation contested the four notices dated March 24, 1997 by filing a Request for Conciliation Conference with the Division's Bureau of Conciliation and Mediation Services ("BCMS"). A conciliation conference was held by BCMS and, pursuant to a letter dated March 17, 1998, the conciliation conferee advised the corporation's representative that "[F]or purposes of resolving the matter, I am proposing to modify the Notice of Deficiency" as issued by the Division. A Consent enclosed with the March 17, 1998 letter provided that the penalties asserted for all four years were canceled and that the $6,200.00 of tax asserted for the period January 1, 1996 through June 5, 1996 was canceled. The Consent also provided that interest of $970.09, $731.18, $2,045.44 and $1,767.59 was due for 1993, 1994, 1995 and 1996, respectively. On March 30, 1998, petitioner, on behalf of the corporation, executed the Consent agreeing to the final disposition of the four notices of deficiency as proposed by the conciliation conferee.

4. Petitioner and her spouse timely filed joint New York State personal income tax returns for the years 1994 and 1995 reporting thereon, *inter alia*, income or loss from the corporation, which amounts were passed through to petitioner, and business income reported on Federal Schedule C. The corporation's Federal income tax returns, filed on Form 1120S, reported the following income and expenses for the years 1994 and 1995:

	1994	**1995**
Gross receipts	$289,536.00	$692,008.00
Cost of goods sold	271,827.00	616,324.00
Other income	-0-	75.00
Total income	17,709.00	75,759.00
Total deductions	37,163.00	60,731.00
Ordinary income or (loss)	($19,454.00)	$15,028.00

The $19,454.00 ordinary loss for 1994 and the $15,028.00 of ordinary income for 1995 were carried over to petitioner's New York State personal income tax returns for the two years at issue and were utilized in computing petitioner's taxable income for said years.

5. The cost of goods sold as reported by the corporation on Federal Form 1120S represented amounts paid to petitioner and other individuals which were reported as nonemployee compensation on Federal Form 1099-MISC. The corporation issued forms 1099-MISC to petitioner reporting that she had received nonemployee compensation of $89,763.00 for 1994 and $209,033.91 for 1995. Petitioner reported the nonemployee compensation shown on Federal forms 1099-MISC as gross receipts on Federal Schedule C, Profit or Loss From Business. The following represents the amounts reported by petitioner on Federal Schedule C for the years 1994 and 1995:

	1994	**1995**
Gross income	$89,763.00	$209,034.00
Less expenses:		
Car and truck	10,656.00	9,076.00
Insurance	-0-	1,740.00
Legal	-0-	150.00
Office	835.00	6,424.00
Supplies	-0-	290.00
Travel	19,503.00	28,140.00
Meals and entertainment	3,988.00	4,599.00
Utilities	-0-	1,240.00
Gifts	2,664.00	3,043.00
Postage	-0-	332.00
Telephone	-0-	5,242.00
Mailing costs	-0-	20,000.00
Net profit	$52,208.00	$128,758.00

6. On February 5, 1997, petitioner's personal income tax returns for the years 1994 and 1995 were assigned to the Division's Nassau District Office for audit. Although the withholding tax audit of the corporation was also performed by the Nassau District Office, the audit of petitioner's personal income tax returns was assigned to a different auditor. The first notation in

the auditor's log was made on March 7, 1997 and stated "Discussed case with T/L [team leader]. Will check Schedule C expenses and if documented will revise to Schedule A treatment as another exam determined that T/P's were employees and not Schedule C filers."

7. The audit of petitioner's personal income tax returns for 1994 and 1995 continued over the next year and on April 1, 1998, one day after petitioner signed the consent settling the corporation's withholding tax audit, the auditor made the following notation in his log:

> Called rep as T/P's corporation did not prevail in BCMS proceeding on withholding taxes. Informed rep that, as stated in my 2/26/98 letter, I will have to disallow the Schedule C format due to this result and that Schedule C expenses deducted would have to be reclassified as Miscellaneous Itemized Deductions.

8. On December 18, 1998, the Division issued a Notice of Deficiency to petitioner and her spouse asserting that $1,783.26 and $6,865.31 of additional New York State personal income tax was due for the years 1994 and 1995, respectively, together with interest. The additional tax due for each year at issue was based on reclassifying petitioner's compensation from the corporation as wages and requiring the Schedule C expenses to be claimed as miscellaneous itemized deductions. The Division also did not allow a portion of the expenses claimed on Schedule C to be carried over as miscellaneous itemized deductions on the basis that these expenses were unsubstantiated.

9. For the 1994 tax year the Division's audit increased petitioner's reported taxable income by $22,631.00, which amount was comprised of the following items:

Item	**Amount**
Expenses disallowed as unsubstantiated	$13,895.00
Expenses lost due to 2% of income limitation	1,954.00
Medical expenses lost due to 7½ % of income limitation	3,093.00
Disallowance of adjustment to income for ½ of self employment tax	3,689.00
Total	$22,631.00

Except for the expenses disallowed as unsubstantiated, the remaining three adjustments are computational in nature or, in the case of the disallowance of the adjustment to income for ½ of self employment tax, the result of reclassifying petitioner from a self-employed individual to a wage earner.

10. The Division's audit for the 1995 tax year increased petitioner's reported taxable income by $86,159.75 and this amount included the following items:

Item	Amount
Expenses disallowed as unsubstantiated	$33,078.00
Rental loss disallowed	7,440.00
Expenses lost due to 2% of income limitation	4,694.00
Medical expenses lost due to 7½ % of income limitation	2,754.00
New York itemized deduction adjustment	13,374.75
Disallowance of adjustment to income for ½ of self employment tax	5,519.00
Disallowance of adjustment to income for Keogh self-employed plan	19,300.00
Total	$86,159.75

As was the case for the 1994 tax year, all of the adjustments for 1995 are, except for the expenses disallowed as unsubstantiated, computational in nature or the result of reclassifying petitioner from a self-employed individual to a wage earner.

11. The record herein is sparse concerning those expenses claimed on Schedule C which were found by the Division to be unsubstantiated and, as such, not allowed to be deducted as miscellaneous itemized deductions. There were no workpapers or other evidence submitted into the hearing record to show which deductions claimed by petitioner on Schedule C had been adequately substantiated and which deductions had been found to be unsubstantiated. Petitioner submitted no documentary evidence or other credible evidence with respect to any of the deductions claimed on Schedule C. Petitioner's ability to document the expenses claimed on Schedule C was hindered by the fact that her automobile, which contained many of her business

records, was stolen on May 4, 1996, and also by the fact that her spouse suffered a serious illness which, notwithstanding several serious operations, left him totally and permanently disabled.

SUMMARY OF PETITIONERS' POSITION

12. Petitioner primarily argues that the Division had ample opportunity in the Courtien Communications matter to litigate the issue of whether she should be classified as an independent contractor or employee of said corporation, and that the Division ultimately reached a final disposition of that controversy without making a determination adverse to her. Having had a full and fair opportunity in the prior matter to litigate the propriety of her status as an independent contractor or employee, petitioner maintains that the Division "is precluded by the doctrine of *res judicata* and collateral estoppel from now raising the issue of how Mrs. Courtien's income should be reported on her personal tax returns."

13. Petitioner also maintains that it was proper for her to be classified as an independent contractor of the corporation and not an employee. Petitioner asserts that when she formed the corporation she sought the advice of several accountants as to the proper procedure for reporting her income from the corporation and was advised that as long as all withdrawals were reported on the Form 1099-MISC she was in compliance. Furthermore, petitioner alleges that the Internal Revenue Service examined her returns for years prior to those at issue herein and that her status as an independent contractor of the corporation was reviewed and accepted by the Internal Revenue Service.

14. Finally, petitioner argues that circumstances beyond her control prevented her from being able to fully substantiate all of the deductions claimed on Schedule C and that given these circumstances said deductions should be allowed as claimed.

CONCLUSIONS OF LAW

A. Petitioner's argument that the Division is precluded by the doctrines of *res judicata* and collateral estoppel from raising the issue of how her income should be reported on her personal tax returns must be rejected. In ***Matter of Planit*** (Tax Appeals Tribunal, February 7, 1991), the Tribunal stated:

> The doctrine of collateral estoppel precludes a party from relitigating in a subsequent action an issue clearly raised in a prior action and decided against that party or those in privity with that party (***Matter of Choi v. State of New York***, 74 NY2d 933, 550 NYS2d 267, 269; ***Ryan v. New York Tel. Co.***, 62 NY2d 494, 478 NYS2d 823, 826). In order to invoke this doctrine there must be an identity of issue which has necessarily been decided in the prior action and is decisive of the present action and there must have been a full and fair opportunity to contest the prior decision (***Staatsburg Water Co. v. Staatsburg Fire Dist.***, 72 NY2d 147, 531 NYS2d 876, 878; ***Schwartz v. Public Adm'r of County of Bronx***, 24 NY2d 65, 298 NYS2d 955, 960). The party seeking the benefit of collateral estoppel must meet the burden of showing the identity of the issues in the present litigation and the prior determination (***Kaufman v. Eli Lilly & Co.***, 65 NY2d 449, 492 NYS2d 584, 588).
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> In this case, the record reveals that in the course of prior bankruptcy proceedings, the court issued orders expunging certain claims filed by the State Tax Commission. Based on the transcript of those proceedings and petitioner's testimony at the hearing below, the most that can be established was that in that previous action, the bankruptcy court ordered those claims be expunged upon the State's failure to respond to its order to show cause for the same. There is nothing in the record to indicate that any factual issues related to the validity of the claims had actually been litigated or determined in the prior proceeding. This State's highest court had consistently held that "an issue is not actually litigated if, for example, there has been a default, a confession of liability, a failure to place a matter in issue by proper pleading or even because of a stipulation" (***Kaufman v. Eli Lilly & Co., supra***, 492 NYS2d 584, 589, citing Restatement [Second] of Judgments § 27 comments d, e, at 255-257; ***see, Matter of Halyalkar v. Board of Regents of State of New York***, 72 NY2d 261, 532 NYS2d 85, 88). Where, as here, the issue has not been litigated at all, there can be no identity of issues between the present action and the prior determination (***Matter of Halyalkar v. Board of Regents of State of New York, supra; Kaufman v. Lilly & Co., supra***). Absent a showing that specific factual issues had been litigated and necessarily decided in the previous bankruptcy proceedings and that those same issues are decisive in determining the outcome of the instant action, we hold that the

> doctrine of collateral estoppel may not be invoked to bar the State from relitigating any issues of facts in the present proceeding. Accordingly, we conclude petitioner has failed to meet the burden of proving that the rule of collateral estoppel was invoked properly to refute the asserted deficiency.

B. Tax Law § 170(f) provides that "Conciliation conference orders . . . shall not be considered as precedent or be given any force or effect in any subsequent administrative proceeding with respect to the person who requested the conference or in any other proceeding." The Consent form executed by petitioner settling the withholding tax audit of the corporation is a form used by BCMS to settle a dispute where there is no need to issue a conciliation order. Like a conciliation order, the Consent cannot be considered as precedent or given any force or effect in subsequent proceedings brought by the taxpayer or in any other proceeding. The conciliation conference is, by its very nature, a settlement negotiation. It cannot be considered a process which provides the parties with a full and fair opportunity to litigate a dispute. It is also clear from the language of Tax Law § 170(f) that the Legislature intended the conciliation conference process to be binding only with respect to the taxpayer who requested the conference and only for the year or period in dispute.

C. Assuming, *arguendo,* that the conciliation conference process constituted a full and fair opportunity to litigate a dispute, I agree with the Division that by executing the Consent agreeing to the assessment of interest charges against the corporation, an inference is warranted that petitioner agreed to an underlying withholding tax liability and the determination that her income from the corporation should have been treated as wages. Accordingly, I would find that the issue concerning whether petitioner was an independent contractor or an employee was decided against petitioner at the conciliation conference. Petitioner suggests that the corporation was the prevailing party at the conciliation conference on the basis that the more than $20,000.00 due as asserted in the four notices of deficiency was reduced to $5,514.30. The reductions made at the

conciliation conference pertained to canceling penalties and to canceling the $6,200.00 of tax due for 1996, since petitioner had paid tax into her individual estimated tax account for 1996. Although these adjustments produced substantial reductions in the deficiencies, they did not pertain to and were in no way dispositive of the issue concerning petitioner's status as an independent contractor or employee of the corporation.

D. Turning next to petitioner's argument that it was proper for the corporation to consider her as an independent contractor and not an employee, I find that this position is without merit. In ***Matter of Imaging Management Services of America, Inc.*** (Tax Appeals Tribunal, March 7, 2002), the Tribunal held that the corporation's president and sole shareholder was an employee pursuant to section 3121(d)(1) of the Internal Revenue Code and that compensation it paid to said president, which compensation was reported via Form 1099-MISC, constituted wages from which the appropriate taxes should have been deducted and withheld. The facts presented herein are essentially identical and the precedent set in ***Matter of Imaging Management Services of America, Inc.*** must be followed.

E. With respect to the expenses which were disallowed as unsubstantiated, it must be noted that Tax Law § 689(e) places the burden of proof on petitioner to show wherein the deficiency is erroneous. Petitioner has failed to produce any documentary or other credible evidence to support the deductions which were disallowed on audit as unsubstantiated and therefore these adjustments are sustained.

I do note, however, that certain adjustments made by the Division can be modified. Petitioner in good faith and with no tax avoidance motivation reported the compensation she received from the corporation on Schedule C. According to petitioner this was the industry standard and I do not see any tax advantage she may have gained by reporting her income and expenses on Schedule C. The substantiated deductions claimed by petitioner on Schedule C

could have just as easily been claimed by the corporation on its tax returns had petitioner been aware of the fact that her compensation should have been reported as wages and not as Schedule C business income. Had the corporation claimed the substantiated deductions on its returns, there would be no adjustment for the 2% of adjusted gross income limitation that occurs when the substantiated deductions are considered as miscellaneous itemized deductions. Also, the corporation would have been allowed to deduct as an expense the employer's share of the social security tax paid on behalf of petitioner. This would eliminate the Division's disallowance of the adjustment to income for ½ of self-employment tax. Finally, the $19,300.00 that petitioner paid into a Keogh self-employed plan could also just as easily have been paid by the corporation into a pension plan or defined benefit plan on behalf of petitioner, its sole employee. This would eliminate the Division's disallowance of the adjustment to income for petitioner's Keogh self-employed plan.

Accordingly, since petitioner is the sole employee and only shareholder of the corporation, I believe that it is fair and equitable (Tax Law § 2012) to adjust the amount of income or loss which petitioner reported on her personal income tax return as a pass through from the corporation. Specifically, the Schedule C deductions which the Division found to be substantiated for 1994 and 1995 are to be incorporated into the computation of income or loss received from the corporation and are not to be considered as miscellaneous itemized deductions subject to the 2% of adjusted gross income limitation. Furthermore, for the 1994 tax year petitioner's reported pass through loss from the corporation is to be increased by the sum of $3,689.00, which amount represents the employer's share of the social security taxes. For the 1995 tax year petitioner's reported pass through income from the corporation is adjusted for, in addition to the substantiated deductions, the sum of $4,694.00 for the employer's share of the social security taxes and $19,300.00 for amounts which could have been paid to a pension plan

or defined benefit plan. Since the above adjustments will impact the computation of adjusted gross income for both years, the Division may also be required to modify its adjustments to medical expenses, rental loss and New York itemized deduction adjustment.

F. The petition of James and Jane Courtien is granted to the extent indicated in Conclusion of Law E; the Division of Taxation is directed to recompute the Notice of Deficiency dated December 18, 1998 consistent with the determination rendered herein; and, except as so granted, the petition is in all other respects denied.

DATED: Troy, New York
April 18, 2002

/s/ James Hoefer
PRESIDING OFFICER