STATE OF NEW YORK

DIVISION OF TAX APPEALS

In the Matter of the Petition	:	
of	:	
RAYMOND MARQUEZ	:	DETERMINATION DTA NO. 818561
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 1993.	:	

Petitioner, Raymond Marquez, 40 Keats Lane, Great Neck, New York 11023-1818, 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 1993.

A hearing was commenced before Brian L. Friedman, Administrative Law Judge, at the offices of the Division of Tax Appeals, 641 Lexington Avenue, New York, New York, on June 25, 2002 at 10:30 A.M., was continued on June 26, 2002 and was completed on June 27, 2002 before the same administrative law judge at the same location, with all briefs to be submitted by December 10, 2002, which date began the six-month period for the issuance of this determination. Petitioner appeared by R. David Marquez, Esq. The Division of Taxation appeared by Barbara G. Billet, Esq. (Barbara J. Russo, Esq., of counsel).

ISSUES

I. Whether a rational basis existed for the issuance by the Division of Taxation of the Notice of Deficiency to petitioner.

II. Whether petitioner has met his burden of proving by clear and convincing evidence that he did not have a proprietary interest in a gambling organization which was the subject of an audit or whether, by virtue of his guilty plea in a criminal matter, petitioner is collaterally estopped from denying that he controlled and had a proprietary interest in such organization.

III. Whether petitioner has met his burden of proving by clear and convincing evidence that the amount of the deficiencies of New York State and New York City personal income taxes asserted to be due by the Division of Taxation were incorrect.

IV. Whether petitioner has established reasonable cause for abatement of penalties imposed upon the personal income tax deficiencies.

FINDINGS OF FACT

1. Raymond Marquez ("petitioner") along with Alice Marquez (petitioner's wife) and Julia Rojo were the subject of an investigation by the New York City Police Department, Organized Crime Bureau, for alleged illegal gambling activities, to wit: an illegal lottery operation.

2. During the investigation, the New York City and the Broward County (Florida) police conducted searches pursuant to search warrants of several gambling locations and gambling offices as well as two rooms at the Oakland East Motor Lodge in Fort Lauderdale, Broward County, Florida which was owned by Alice Marquez. A number of gambling and financial records were seized by police from these locations. At the time of the seizure of the records, petitioner was not present at any of the locations and the seized records did not indicate thereon that they belonged to petitioner.

3. As a result of the criminal investigation, petitioner was indicted on a charge of enterprise corruption, in violation of Penal Law § 460.20(1)(a), as well as 68 counts of

promoting gambling in the first degree (Penal Law § 225.10[2]), 76 counts of possession of gambling records in the first degree (Penal Law § 225.20[2]) and 6 counts of criminal possession of a weapon in the third degree (Penal Law § 265.02[2], [3]). The indictment further charged petitioner with conspiracy in the fifth degree (Penal Law § 105.05) and offering a false instrument for filing in the first degree (Penal Law § 175.35).

The count of the indictment which charged petitioner (and the other defendants) with enterprise corruption alleged the following:

> The defendants, in the County of New York, from on or about January 1993 to on or about April 1994, having knowledge of the existence of a criminal enterprise, called herein the 'Raymond Marquez Organization,' and of the nature of its activities, and being associated with and employed by the Raymond Marquez Organization, intentionally conducted and participated in the affairs of the Raymond Marquez Organization by participating in a pattern of criminal activity.
>
> The Raymond Marquez Organization was a group of persons sharing a common purpose of engaging in criminal conduct, associated in an ascertainable structure, distinct from the aforesaid pattern of criminal activity, and with a continuity of existence, structure and criminal purpose beyond the scope of individual criminal incidents.
>
> The aforesaid structure of the Raymond Marquez Organization was as follows:
>
> The business of the Raymond Marquez Organization was to operate illegal gambling business through a number of retail betting spots that received wagers and money from bettors, and a number of offices that processed the gambling work and money, paid the employees, paid rents and utility bills for the betting spots and offices, and arranged for the disposition of the illegal gambling proceeds. The Raymond Marquez Organization illegally possessed firearms to protect the proceeds of the illegal gambling bets. The defendants controlled and worked for the Raymond Marquez Organization, and held the following positions;
>
> Raymond Marquez was the boss of the Raymond Marquez Organization;

> Alice Marquez and Julia Rojo worked for Raymond Marquez, and among other things, handled certain financial transactions for the organization.
>
> The defendants' aforesaid common purpose of engaging in criminal conduct was to make money by committing crimes in the course of operating an illegal gambling business.

The count of the indictment which charged petitioner with offering a false instrument for filing in the first degree alleged:

> The defendant, in the County of New York and elsewhere, on or about April 15, 1994, with intent to defraud the State of New York and a political subdivision thereof, and with knowledge that a written instrument, to wit, a New York State Resident Income Tax Return Form IT-201 for Raymond Marquez for the tax year 1993, contained a false statement and false information, to wit, the amount of taxable income and amount of tax due, offered and presented said written instrument to a public office and public servant, to wit, the New York State Department of Taxation and Finance, with knowledge and belief that it would be filed, registered, recorded, and become a part of the records of such public office and servant. Said conduct by the defendant was likely to have and did have, and was performed with intent that it would have, and with knowledge that it was likely to have, a particular effect upon the County of New York, in that it caused the evasion of taxes due and owing to the Comptroller of the City of New York, whose office is in New York County.

4. On August 28, 1996, petitioner appeared in Supreme Court, New York County, and entered pleas of guilty to the crimes of attempted enterprise corruption under count one of the indictment and of promoting gambling in the first degree in full satisfaction of all of the counts of an additional indictment.[1]

[1] Apparently, there was a second indictment for which petitioner entered a plea of guilty to promoting gambling in the first degree. This plea related to activities which occurred in or about January 13, 1995. Petitioner's plea of guilty to attempted enterprise corruption referred to the period from in or about January of 1993 to in or about April 1994.

Petitioner was sentenced to a prison term of three months and five years probation, both sentences to run concurrently. In addition, petitioner was required to make restitution in the sum of $1,000,000.00.

5. The Manhattan District Attorney's Office ("the DA's Office") used the records seized pursuant to the search warrants to determine that petitioner had additional income from the gambling operation and attempted to calculate net profits using the figures from these gambling records which related to "straight action," "single action," "slot machines," "rent" and "telephone."[2] The DA's Office worked with the Office of Tax Enforcement, Revenue Crimes Bureau, to ascertain whether the net profits which it calculated from the gambling records had been reported on petitioner's income tax returns for the year 1993. The Office of Tax Enforcement determined that such net profits had not been reported on petitioner's 1993 income tax returns and, as a result, referred the matter to the Audit Division of the Division of Taxation ("Division").

6. The Division's auditor, Hedda Braun, received the case from the Office of Tax Enforcement on May 9, 1997. She arranged to visit the DA's Office along with Virginia Urzi of the Office of Tax Enforcement, and on August 26, 1997, they met with Assistant District Attorney Ann Rudman about the case. The auditor later met with Ms. Rudman's financial assistant, Evelyn Serrano, and viewed the exhibits which allegedly tied in gross sales, gross profit and expenses. The workpapers and summaries were prepared by a financial analyst, Edwin Santiago. The auditor did not meet with Mr. Santiago because he was no longer working for the DA's Office at that time. The auditor was informed that the summaries were based upon

[2] A "straight action" bet refers to a 3 or 4 digit daily number activity; a "single action" bet is a daily number activity involving a single digit number. "Slot machine" gambling refers to video gambling machines placed on the premises of a store or other location which accepts such wagering.

information obtained from the search warrants. Copies of these summaries and workpapers were provided to petitioner's representatives. The documentation upon which the summaries were based consisted of 53 weeks of records which were made up of one sheet per week per storefront which had been seized pursuant to the search warrants. The auditor then prepared a Statement of Personal Income Tax Audit Changes which was issued to petitioner on September 28, 1998. This Statement of Personal Income Tax Audit Changes asserted additional State tax due in the amount of $115,401.68 and additional City tax due in the amount of $9,494.23, plus penalties (for negligence and substantial understatement) of $44,553.93 and interest of $51,640.27 for a total amount due of $221,090.11 for the year 1993. The deficiencies were based upon a finding that petitioner had additional income from gambling in the amount of $1,460,651.00. When no further conferences were requested by petitioner's representatives and no additional documentation was provided to her, the auditor closed the case and sent the file on for issuance of a Notice of Deficiency.

7. On January 25, 1999, the Division issued a Notice of Deficiency to petitioner asserting a deficiency of State tax in the amount of $115,401.68, a deficiency of City tax in the amount of $9,494.23 (total tax due of $124,895.91), plus penalties and interest, for a total amount due of $228,921.41 for the year 1993.

8. Upon receipt of the weekly storefront sheets from the DA's Office, the auditor's only act was to take a sample to determine if one week tied in to the figures contained on the summaries. To determine revenues from single action bets, the auditor was told to add the totals from columns 1 and 2 of the weekly sheets. To determine revenues from straight action bets, she was told to add the totals from columns 4 and 5 of the sheets. Column 3 which was entitled "ADJ EXP" on the sheets was not reconciled by the auditor; she sought no explanation

from the DA's Office concerning this column. The auditor did not understand the column entitled "claims due" and made no inquiry from the DA's Office as to how or if it factored into columns 1 and 2 or 3 and 4. The auditor indicated that the DA's Office told her which columns were to be used and she relied on the information supplied by the DA's Office. She ignored the remaining columns on the 12-column spread sheets. The auditor had no knowledge as to the meaning of the entries contained on these sheets. The Division did not conduct an independent audit but instead relied solely on the information and documentation supplied to it by the DA's Office.

Nowhere on these weekly sheets is it indicated that they pertained to the year 1993; the name "Raymond Marquez" or "Marquez" does not appear on these sheets. The auditor was unaware as to what records were obtained from the various locations and she did not know which, if any, of the records were obtained from petitioner. She did not ask the DA's Office if any of the records had been taken from petitioner's residence. She had no information that the gambling records belonged to petitioner; the DA's Office did not indicate to her that any of the documents were in petitioner's handwriting or contained petitioner's fingerprints. The auditor was aware that expenses for the office, payroll and miscellaneous expenses had been subtracted by the DA's Office from one type of betting only (straight action), but she did not know why this was the case.

In determining these office expenses, the DA's Office included rent, Con Ed (electricity) and telephone. They determined the expenses for the month of December and then multiplied the total by 12 to arrive at the total expenses for the year. While all of the alleged gambling locations were included on the sheets (both front and back) utilized by the DA's Office, the only figures used by the DA's Office in determining expenses for rent, electricity and telephone were

those on the back of the sheets. The auditor did not add up the expenses on both sides of the sheets to see if the totals tied in to the work sheets prepared by the DA's Office and was, therefore, unaware that the figures on the front of the sheets had not been included. The auditor admitted that she did not perform an independent audit but, pursuant to instructions from the Office of Tax Enforcement and her supervisors at the time, prepared a statutory notice based upon the figures supplied by the DA's Office. With respect to the sheets allegedly referring to payroll, such sheets do not say "payroll" but instead indicate "pay" which the auditor was unable to state conclusively related to moneys paid to or paid by the persons indicated thereon.

9. At the conciliation conference held by the Division's Bureau of Conciliation and Mediation Services ("BCMS"), petitioner's representative at that conference denied that the records utilized by the DA's Office belonged to petitioner.

10. After the events of September 11, 2001, the case was assigned to a new auditor, Frank Mastrianni, because the case files had been placed with the Division's Office of Counsel. Mr. Mastrianni conducted a sampling of three weeks of the supporting documentation to determine if the calculations of the DA's Office were correct. He selected three entire weeks, one at the beginning (week 10), one in the middle (week 26) and one at the end (week 43) of the period. Mr. Mastrianni had the worksheets prepared by the DA's Office which represented profits for the year made up of bets known as straight action and single action. The summaries were further broken down into weekly totals for each of the stores.

There was activity shown on some of the workpapers which indicated that there was income from rent and telephone. These figures were projected out over the course of the year to arrive at yearly totals. For single action bets, he used the first two columns (day and night) and used the total thereof which, in all but three instances, were tied to the weekly total for each

store. For straight action bets, Mr. Mastrianni used columns 4 and 5 ("RIB DY" and "RIB NT"). For straight action bets, deductions were made for a variety of expenses. The DA's Office calculated payroll information which totaled approximately $19,000.00, rounded up this figure to $20,000.00 and projected it forward for the entire year. Since there is a difference between the gross and net figures for single action bets in the audit file, Mr. Mastrianni was able to determine that expenses and payouts (totaling approximately $9.5 million) had been deducted from gross profits in determining the net profits of the operation. However, he was unable to explain how these expenses had been calculated.

For slot machine bets, two columns had been utilized, columns 5 and 6 which appear under a larger column labeled "ganancia" or profits. Rent and telephone was included as income for slot machine bets, but Mr. Mastrianni was unaware as to the source of the figures used for rent and telephone.

Three stores ("HAM", "ST NICK" and "7 UP") did not tie in to the figures of the DA's Office (the numbers of the DA's Office were off by 50%) for single action bets. Therefore, Mr. Mastrianni made an adjustment which increased the income of these stores by $291,899.00. To arrive at this adjustment, Mr. Mastrianni doubled the loss if a negative number was reflected on the sheets for a particular week or doubled the profit if a positive number was indicated on the sheets for these stores.

Except for these three stores, the figures of the DA's Office appeared to be correct as they pertained to single action; for straight action bets, with "some nominal variance" the figures of the DA's Office appeared to be correct.

In his review of the supporting documentation, Mr. Mastrianni saw no cash withdrawals or payouts to petitioner. The records which he reviewed did not indicate who was in charge of

the operation. None of the records indicated to Mr. Mastrianni that the owner of the gambling enterprise was a sole proprietorship, a partnership or other entity and none of the records contained the identity of the owner. Mr. Mastrianni admitted that he had no basis for concluding that the gambling operation was a sole proprietorship; he stated that it was not his job to make that determination. Despite this fact, the Division attributed all of the net profit of the organization to petitioner.

Mr. Mastrianni was unable to determine what expenses, if any, were deducted to arrive at the conclusion reached by the DA's Office that the figures in columns 1 and 2 of the sheets represented net profit. He did not know whether the column indicating "ADJ EXP" was taken into account in arriving at net profit. He admitted that the sheets do not indicate whether entries for rent and telephone were properly attributed to profits rather than to expenses.

While columns 1 and 2 (single action) and 4 and 5 (straight action) were used to determine revenues, columns on the sheets indicating claims due, pay drawn and cash were not used by the DA's Office in making its calculations. Mr. Mastrianni attempted only to ascertain how the figures were derived; he did not know what factors the DA's Office used in determining that only the numbers in columns 1 and 2, and 3 and 4 were to be used and that numbers in 8 other columns were not to be utilized. Nowhere on the sheets was it indicated that the figures in columns 1, 2, 4 and 5 represented gross or net amounts. While certain expenses (office, payroll and miscellaneous) were deducted by the DA's Office from straight action bets, no expenses were deducted from single action bets; Mr. Mastrianni was not certain of the reason for this disparity. The records provided by the DA's Office were the first policy gambling records ever reviewed by Mr. Mastrianni.

11. A single action bet is a one-digit number with relatively low odds of 8 or 9 to 1. A straight action bet involves the selection of a three or four-digit number with odds of winning of from 600 to 750 to 1. There are various numbers which can be played. The "New York Number" is published one digit at a time throughout the day as races are run at a predetermined track. The digits are based on a calculation involving the win, place and show figures. The first digit is ascertained after the third race, the second digit after the fifth race and the third digit after the seventh race. The "Bronx Number" is a four digit number which includes the ninth race. The "Brooklyn Number" is known only after all nine races are run for the day and is based on the total amount wagered (the "handle") for a given day. The most common policy bets are the straight bet in which the customer bets on all three digits in a specific order and the combination bet in which the customer bets on all three digits irrespective of order. The "bolita" bet allows a customer to bet on two digits, either the first two or last two digits.

Betting locations, or "spots," are generally serviced by a central "bank" which enables the spots to spread out the risk of a large payout. It is standard practice for a policy operation in New York City to consist of a large number of betting spots operating through a series of banks. A bank generally has a crew of pick-up men and women who transport the cash proceeds and betting records from the spots to the bank. The records received from the spots are generally referred to as the "work" (the individual betting slips and the spots' tally or control sheets). The bank often makes up its own tally sheet, summarizing all bets placed and amounts of money wagered at all of the locations controlled by the bank. Banks also record cash revenues alone, spot by spot, on adding machines with printout tapes called "banker's ribbons." Individuals who work at the bank are referred to as controllers.

The taking of straight action bets often lead to losses sustained by the gambling operation because such bets are random bets, i.e., payouts are not from a pool where the actual payout is based upon the amount of the pool. If the winning number is one which is heavily played, the payout which is at odds predetermined can lead to substantial losses which can keep the operation in debt for weeks, months or even years.

12. The Marquez Family has been involved in the control of a substantial part of the illegal policy business in Upper Manhattan for many years. Lionel Marquez, Sr., ran the business in the 1940s. The operation was then split into three parts run by each of Lionel's three sons, petitioner Raymond Marquez, Robert Marquez, Sr., and Lionel Marquez, Jr. Petitioner was involved in the operation for more than 50 years. After the death of Robert Marquez, Sr., and the incarceration of Lionel Marquez, Jr., the business was realigned into two separate organizations. Robert Marquez, Jr., and Peter Marquez were in control of one of the operations while petitioner controlled the other. Together these operations had approximately 66 spots and business offices including a central bank at 65 St. Nicholas Avenue, New York, New York.

13. The affidavit of Detective Walter T. Huthansel of the New York City Police Department, Organized Crime Control Bureau, Manhattan North Vice Investigation Division, sworn to on January 12, 1995, indicates that petitioner was involved in the policy gambling enterprise known as the "Marquez Operation" at least through the year 1994.

14. Some of the expenses of the policy gambling operation are paid at the store level while others are paid by the bank. From his experience in policy gambling and upon his review of the gambling records which are part of the Division's audit file, petitioner was able to determine that "ADJ EXP" represented adjusted expenses, "PAY DRAWN" indicated money

taken by the numbers writer, the lookout or the store manager and "CLAIMS DUE" represented claims which had to be paid but which had not yet been approved by the bank to the store or gambling location. Petitioner indicated that moneys passed to the bank are minus the adjusted expenses. These expenses which are daily or weekly in nature are paid in cash from the stores and include salaries and other items such as coffee, doughnuts, newspapers, tout cards and promotional items which were given to customers. Fixed expenses such as rent, phone and electricity are paid from the central office or bank.

When single action bets are due or claims are due from these bets, the adjusted expenses come out of the single action moneys at the store level. Straight bets are paid from the bank level but adjusted expenses and payroll are still paid from the store moneys.

15. With respect to slot or video game machine gambling, the attendant at the store pays the winnings and then erases the machine and reports the winnings to the owner of the machine when he comes in to collect the money from the machine. The owner of the store was rarely the owner of the machine. Solicitors or brokers seek to have people install machines in their locations and both the solicitors/brokers and store operators receive a commission. Utilizing petitioner's exhibit "5" which has attached thereto a weekly sheet for the week of 1/12 - 1/19/93, petitioner explained that the figure of 1006 in the lower left quadrant of the sheet represented the commission to the broker for all of the stores for the week. The figure of 900 in the lower right quadrant which indicates "machine JM" indicates that the machine was replaced and that 900 was a portion of the cost charged to the gambling location. The money to replace a machine, the broker's commission and a service fee of approximately $40.00 per week are deducted from the moneys taken in by the store. The figure of $3,710 in the lower right corner of the sheet represents one-half of the moneys taken in by the store since the operator also

receives this amount. Therefore, in this particular instance, the store's share ($3,710) is then reduced by the expenses of $1,006 (broker's commission), $900 (machine replacement cost) and $40 (fee for machine service), leaving a balance of $1,764.00 for the store.

16. Pursuant to his plea arrangement, petitioner agreed to a forfeiture stipulation in the amount of $1,000,000.00. At that time and for some time previous thereto, petitioner's wife operated a hospitality business comprised of three hotels which were acquired in 1976, 1980 and 1986. The wage income which petitioner reported on his 1993 tax return was from Showcase, Inc., the central holding company of the Commack Motor Inn, one of the hotels owned by his wife. In order to pay off the $1,000,000.00 as agreed in the forfeiture stipulation, petitioner's wife sold one of her hotels (the Grand Mar Motor Lodge in Connecticut) as well as a yacht.

17. Robert Marquez, Jr., a nephew of petitioner, became involved in policy gambling in 1991 and took over his father's operation upon the death of his parents in 1992.

In 1995, Robert Marquez, Jr., had three partners, Peter Marquez, Hilton Roundtree and Angel Colon. In that same year, the Manhattan District Attorney's Office filed a Superior Court information charging Robert Marquez, Jr., with promoting gambling in the first degree, a class E felony. On August 1, 1995, he withdrew his plea of not guilty and entered a guilty plea to the information.

18. Vito LaMonica is a tax manager for Michael J. Berger & Company, CPAs. He was previously employed by the Internal Revenue Service ("IRS") for approximately 15 years. As an IRS agent, his duties included fraud detection which included gambling investigations. He frequently was required to perform audits which required the reconstruction of records.

According to a letter to Mr. LaMonica from Conciliation Conferee Judith Clark dated November 27, 2000 which attempted to explain the audit methodology employed by the Division, straight action profits were determined by using the 4th and 5th columns (DY RIB and NT RIB) from the daily sheets for each store. The total receipts from straight action bets was computed to be $2,181,322.00 from which the following expenses were deducted:

Office Expense	$161,585.00
Office Payroll	1,060,000.00
Miscellaneous	371,000.00
	$1,592,585.00

In reviewing the amount determined by the Division to be office expense, Mr. LaMonica discovered first that the Division utilized only the figures for December (and then multiplied the resulting total by 12) which were set forth on Exhibit "2" despite the fact that the sheets contained figures for January through April as well. His only possible explanation for the Division's use of only the December figures was that perhaps the auditors thought that the succeeding months represented 1994.

In addition, Mr. LaMonica found that the Division had used only the reverse sides of the three pages constituting Exhibit "2" despite the fact that the reverse sides contained the rent, phone and electric (Con Ed) expenses for 10 stores while the front sides contained these expenses for 40 additional stores. Therefore, Mr. LaMonica totaled the rent, phone and electric for the stores listed on the front sides of Exhibit "2" for the month of December and when annualized, these expenses totaled $577,032.00.[3] Accordingly, the total rent, phone and electric expenses were $765,269.00 ($161,585.00 + $603,684.00).

[3] Mr. LaMonica's annualization of the expenses for all of the stores contained an error. His result, $577,032.00 should be $603,684.00 which results in an increase in rent, phone and electric expenses in the amount of $26,652.00.

Using the 1st and 2nd columns which Ms. Clark's letter indicated were used by the Division to calculate the profit from single action bets, net of payouts, and using the 4th and 5th columns which the letter indicated were used to calculate straight action profits, Mr. LaMonica examined each of the 53 weeks of sample sheets, and despite the fact that the 3rd column on the sheets set forth adjusted expenses, he determined that these adjusted expenses had not been taken into account by the Division in arriving at its net profit from all operations (which was attached to Ms. Clark's letter) which was calculated by the Division as follows:

NET PROFIT FROM SINGLE ACTION:	$439,910.00
NET PROFIT FROM STRAIGHT ACTION:	$588,757.00
NET PROFIT FROM SLOT MACHINES:	$319,770.00
RENT 1993:	$107,285.00
TELEPHONE:	$4,829.00
NET PROFIT FROM ALL OPERATIONS:	$1,460,551.00

In calculating the total of these adjusted expenses, Mr. LaMonica included only those amounts which appeared in the 3rd column on the sheets, i.e., if nothing appeared in the column or if the number was illegible, no amount was included in his calculation. The total of these adjusted expenses (Exhibit "4") was $1,946,448.00.

While the weekly sheets also included columns for claims and claims due, Mr. LaMonica did not take these figures into consideration when making his calculations despite the fact that he believed that such amounts represented additional moneys which had to be paid out.

It must be noted that included in the calculation of net profits from all operations was $112,114.00 in rent and telephone revenue. It is Mr. LaMonica's opinion that the amounts for rent and telephone were actually expenses, not revenues since there is no basis for concluding that the operation received moneys for rent and telephone but rather incurred these expenses to maintain its stores.

With respect to slot machine bets, Mr. LaMonica reviewed with petitioner all of the weekly sheets provided by the Division and determined that the Division had made no allowances for expenses associated with slot machine gambling. Based upon his discussions with petitioner, he determined that the figures in the left quadrant of the sheets (on the weekly sheet for the week of 1/12 - 1/19/93 which was attached to Exhibit "5", this was denoted as "% 1006") represented commissions paid out to owners of the video machines. The total of these commissions were calculated by Mr. LaMonica to be $73,666.00 for the year. The figures in the right quadrant (on the weekly sheet attached to Exhibit "5", it indicated "Machine JM 900"), were explained to Mr. LaMonica by petitioner to represent payments made when a video machine had to be replaced as a result of its having been impounded, broken, etc. The total of these replacement costs was $43,200.00 for the year. In addition, Mr. LaMonica was informed that three people, each earning approximately $500.00 per week or a total of $1,500.00 per week, checked and adjusted the meters on the machines after hits, as well as to make sure that the machines were operational at all times. For the year, these payouts totaled $78,000.00. Therefore, pursuant to Mr. LaMonica's calculations, additional expenses for slot machine gambling totaled $194, 866.00 ($73,666.00 + $43,200.00 + $78,000.00).

Mr. LaMonica then prepared his own summary of profit and loss (Exhibit "6") utilizing the net profit figures from Ms. Clark's letter which, as previously noted, totaled $1,460,551.00. Mr. LaMonica, however, included the additional expenses for rent, phone and electric for the betting locations which he determined had been omitted by the Division in the amount of $577,032.00 (as previously indicated, this amount should have been $603,694.00), the additional adjusted expenses from the sheets in the amount of $1,946,448.00 and the slot machine expenses of $194,866.00 which, when totaled, equal $2,718,346.00. When these expenses are added to

the Division's calculations of the net profit from all operations ($1,460,551.00), a loss of $1,257,795.00 is realized for the year 1993.

19. Wallace Musoff was formerly employed as a special agent with the Intelligence Division of the U.S. Treasury Department which subsequently became the Criminal Investigation Division. He was specifically assigned to investigate gambling activities and to determine whether there were criminal violations of the Internal Revenue Code such as income tax evasion. Mr. Musoff enrolled in courses in wagering and gambling activities at the New York City Police Academy. He was a team leader, worked undercover and conducted numerous raids on activities such as policy operations. Mr. Musoff's educational background includes a bachelor's degree in business administration (with a major in accounting) from City College of New York and a juris doctor degree from New York University. He has been qualified as an expert witness in the area of gambling and taxes related to gambling in Federal District Courts in the Southern and Eastern Districts of New York as well as in Federal Court in Boston, Massachusetts.

Mr. Musoff has performed forensic accounting, i.e., he has been asked to reconstruct books and records for gambling operations. In the course of his employment, he has seen large scale policy operations with a large gross volume of bets which still lost money. For example, when too many people play a straight action number at odds of from 600 to 750 to 1, the operation can sustain substantial losses. If a banker feels that too many people will bet on a particular number, he will "cut the number" or reduce the odds for winning bets on that particular number. Policy bankers, unlike other forms of bookmaking, cannot lay off the bet, i.e., they cannot place some of the wagers with other bookmakers.

Mr. Musoff analyzed the gambling records which were provided by the Division with respect to the policy operation at issue in this matter and he determined that all of the data had not been taken into account by the Division because the auditors merely checked the numbers which had been provided to them by the DA's Office and did not perform an independent audit.

Mr. Musoff then reviewed the schedules which were prepared by Vito LaMonica (Exhibits "1", "3", "4", "5" and "6") as well as Exhibit "2" which was the source document for Exhibit "1". In reviewing Exhibits "1" and "2" (the rent, phone and electric expenses), Mr. Musoff indicated that such expenses for more than 40 locations and 10 offices were usual and necessary expenses of a policy operation which must be taken into account when calculating the net profit. In his review of the gambling records with petitioner, Mr. Musoff concluded that the 10 locations on the reverse side of the sheets (those locations for which the Division allowed these expenses) were the bank offices while the 40 locations on the front side of the sheets for which no allowance was given were the stores where the bets were made. Since each location had to pay rent as well as have electricity (to operate lights, computers, adding machines and other gaming paraphernalia) and a telephone, it was an error to omit these expenses from the 40 store locations. Despite the fact that it was an illegal business, it was nonetheless a business operation with expenses inherent to any type of business operation.

The column on the weekly sheets for single action and straight action betting pertaining to adjusted expenses includes supplies, refreshments such as coffee and doughnuts given to customers, tout sheets, moneys paid for snow removal and payouts to those who did not come in to collect winnings on the day of the hit. While the weekly sheets contained columns for claims and claims due which were not taken into account by the Division, Mr. Musoff and Mr. La

Monica did not factor these payouts into their computations because the inclusion of the additional expenses alone revealed that the operation suffered a loss for the year.

As to slot machine expenses, it was Mr. Musoff's experience that there are commissions which must be paid to the individuals who broker the deal between the owners of the machines and the locations in which the machines are placed. This commission consists of a percentage of the revenues generated by the machines; the owner and the store normally divide the proceeds equally, and while it is often decided between the owner and the store as to which party pays the commission to the broker, the normal practice is for the store to pay this commission. Since the commission was included on the sheets provided by the Division, it is apparent that the stores paid the commission. The fees for servicing the machines are paid to convert the machines into gaming machines, to service the machines and to take meter readings.

Based upon his experience, Mr. Musoff determined that this gaming operation incurred a substantial loss for the year at issue. Even had the operation earned a profit for the year, it was not reasonable to attribute all of the profit to petitioner as if he had operated a sole proprietorship.

SUMMARY OF THE PARTIES' POSITIONS

20. Petitioner contends:

a. There is no evidence which connects petitioner to the gambling records used as the basis of the deficiency. None of the records contain his name and there is no evidence that they were seized from him directly;

b. In 1989, petitioner's brother, Robert Marquez, Sr., proposed that petitioner turn over his operation to him as his other brother, Fernando, had done one year earlier. Petitioner agreed to do so with the provision that he could recapture his investment capital at a rate

of $3,000.00 per week with petitioner serving as a consultant to Robert Marquez, Sr., to assist him in acquiring the business and to help verify the audits. Petitioner continued to take his draw until 1994 when he was arrested (none of these amounts were reported on his income tax returns because it was a recapture of invested capital);

c. In 1993, petitioner acted as a consultant to his nephew, Robert Marquez, Jr., who acquired the operation in 1992 upon the death of his parents. In 1993, Robert Marquez, Jr., had three partners, Peter Marquez, Hilton Roundtree and Angel Colon. In 1993, Robert Marquez, Jr., and his partners controlled 87 betting locations and approximately 12 offices;

d. There is no indication in the gambling records that petitioner received any sums of money from the gambling enterprise in 1993;

e. There is no rational basis to sustain the Division's assertion that the gambling records show that the gambling enterprise realized a net profit for 1993;

f. Petitioner has met his burden of proving that the Division's assertion of a personal income tax deficiency for 1993 was erroneous. There was a critical omission of usual and necessary business expenses by the Division which petitioner has shown to be in the amount of $2,718,346.00 as computed by Vito La Monica. The Division and the DA's Office failed to consider relevant entries in the gambling records that represented usual and necessary expenses which should have been reconciled in determining whether the enterprise realized a net profit or sustained a loss;

g. Petitioner did not plead guilty to any of the facts stated in any of the charges framed in the indictment, but rather pleaded guilty only to attempted enterprise corruption under one count of the indictment. He did not admit to owning the criminal enterprise or to

possessing the gambling records utilized by the Division. Since there was no issue litigated in the prior criminal proceedings concerning his alleged constructive possession of the gambling records, petitioner should not be collaterally estopped from raising the authentication issue surrounding the records in this administrative proceeding;

h. The Division's determination that a deficiency of personal income tax existed for 1993 was based solely on documents prepared by a financial analyst in the DA's Office who never spoke to the Division's auditors. No one from the DA's Office testified at the hearing. The Division's auditors conducted no independent review and had no firsthand knowledge of where the underlying summaries came from. As did the DA's Office, the Division determined the deficiency by simply adding up columns 1 and 2 and 4 and 5 of the 12-column spread sheets and ignored all other columns including column 3 relating to adjusted expenses. The auditors did this because they were told to do so and took no action to determine whether the instructions from the DA's Office were appropriate or accurate. The Division's auditors also admitted that they had no idea what the various entries meant on the records supplied to them by the DA's Office. Accordingly, since the Division's deficiency must be supported by substantial evidence, this deficiency must be canceled;

i. Petitioner's introduction of the affidavit from Detective Huthansel is not an adoptive admission because petitioner's witness, Robert Marquez, Jr., took exception to various portions of the affidavit, most notably the sequence as to when petitioner relinquished his part of the enterprise to Robert Marquez, Sr. There were also a number of errors in the affidavit as to the amount of gross profit of the enterprise which has been refuted by both documentary evidence and the testimony of witnesses; and

j. Since petitioner has shown that he did not have a proprietary interest in the gambling enterprise, that the gambling records have not been authenticated as belonging to him and that the Division's interpretation of the gambling records and its analysis that it realized a net profit are incorrect, there has been no showing that petitioner ever received any unreported income. Therefore, since no tax or interest is owed, there can be no penalties imposed.

21. The position of the Division is as follows:

a. By virtue of his guilty plea, petitioner is collaterally estopped from denying that he controlled and had a proprietary interest in the gambling organization;

b. Petitioner's introduction of the affidavit of Detective Huthansel is an adoptive admission that he controlled the gambling organization;

c. The Division's use of information from the DA's Office to determine the amount of tax due was reasonable;

d. The record in this proceeding shows that the records used to determine the deficiency were seized from petitioner's gambling organization; and

e. Petitioner has failed to establish reasonable cause for abatement of penalties imposed.

CONCLUSIONS OF LAW

A. The first issue which must be addressed is whether the notice of deficiency had a rational basis. In ***Matter of Atlantic & Hudson Ltd. Partnership*** (Tax Appeals Tribunal, January 30, 1992), the Tribunal stated as follows:

> Although a determination of tax must have a rational basis in order to be sustained upon review (***see***, ***Matter of Grecian Sq. v. New York State Tax Commn.***, 119 AD2d 948, 501 NYS2d 219), the presumption of correctness raised by the issuance of the assessment, in itself, provides the

> rational basis, so long as no evidence is introduced challenging the assessment (***see***, ***Matter of Tavolacci v. State Tax Commn***., 77 AD2d 759, 431 NYS2d 174; ***Matter of Leogrande,*** Tax Appeals Tribunal, July 18, 1991 [***affd*** 187 AD2d 768, 589 NYS2d 383, ***lv denied*** 81 NY2d 704, 595 NYS2d 398]). Evidence that both rebuts the presumption of correctness and indicates the irrationality of the audit may appear: on the face of the audit as described by the Division through testimony or documentation (***see***, ***Matter of Snyder v. State Tax Commn.,*** 114 AD2d 567, 494 NYS2d 183; ***Matter of Fortunato*** (Tax Appeals Tribunal, February 22, 1990); from factors underlying the audit which are developed by the petitioner at hearing (***see***, ***Matter of Ristorante Puglia, Ltd. v. Chu***, 102 AD2d 348, 478 NYS2d 91; ***Matter of Fokos Lounge***, Tax Appeals Tribunal, March 7, 1991); or in the inability of the Division to identify the bases of the audit methodology in response to questions posed at the hearing (***see***, ***Matter of Basileo***, Tax Appeals Tribunal, May 9, 1991; ***Matter of Fokos Lounge*** [***supra***]; ***Matter of Shop Rite Wine & Liqs.***, Tax Appeals Tribunal, February 22, 1991; ***Matter of Fashana***, Tax Appeals Tribunal, September 21, 1989).

In ***Matter of Metzger*** (Tax Appeals Tribunal, February 11, 1993), the Tribunal stated that:

> Our cases establish that the Division has the obligation, in response to the petitioner's inquiry at the hearing, to describe the audit methodology used and that the method as described must be rational (***see***, ***Matter of Atlantic & Hudson, Ltd. Partnership***, Tax Appeals Tribunal, January 30, 1992).

In ***Matter of Basileo*** (Tax Appeals Tribunal, May 9, 1991), the Tribunal explained the reason for imposing this obligation upon the Division, stating:

> We also conclude that the Division must at hearing, through witnesses or documents, be able to respond meaningfully to inquiries regarding the nature of the audit performed. Such information is necessary in order to provide petitioner with an opportunity to meet its burden of proving such methodology unreasonable (***Matter of Fokos Lounge***, Tax Appeals Tribunal, March 7, 1991).

B. In the present matter, the Division was unable to describe the audit methodology used. This is true for a number of reasons. First, neither of the auditors assigned to the case had any understanding of how the DA's Office arrived at the amount of the deficiency and no one from the DA's Office appeared at the hearing to offer any explanation. The auditors neither

understood the source documents, i.e., the gambling records, upon which the deficiency was based nor made any inquiries of the DA's Office which, perhaps, could have enabled them to understand these records. Obviously, since the auditors did not understand what the personnel in the DA's Office did to determine the deficiency against petitioner and did not perform an independent audit of their own, they quite logically were unable to describe the audit methodology used and could not testify, of their own knowledge, whether the calculations of the DA's Office were an accurate reflection of income. For example, while the weekly spread sheets pertaining to single action and straight action bets contained 12 columns, the record reveals that the DA's Office chose to consider just columns 1 and 2 (which the auditors were told represented single action bets) and columns 4 and 5 (which they were told represented straight action bets). The auditors were not told what the numbers in the other columns meant or the reasons that the DA's Office chose to ignore these numbers, and the record is clear that the Division's auditors made no independent inquiries of their own. The auditors could not explain what expenses, if any, were deducted to arrive at the conclusion reached by the DA's Office that the figures in columns 1 and 2 represented net profit. Apparently, the auditors were told to just take a sample from the weekly sheets to see if the numbers tied in to the summaries prepared by the DA's Office.

The auditors did not know what records were obtained from which locations pursuant to the search warrants or whether any of the records were, in fact, obtained from petitioner or from his residence since none of the records in any way indicated thereon that they belonged to petitioner. The auditors could not be certain that the records pertained to 1993 since the sheets for single action and straight action bets were undated.

The auditors could not explain why all of the profits (assuming that profits were, in fact, realized for 1993) from the operation were attributed solely to petitioner.

The auditors could not explain why expenses were allowed from straight action bets, but not from single action or slot machine bets. Even in allowing some expenses for rent, electricity and telephone, it is clear that the DA's Office allowed expenses only for those 10 stores (or offices) which appeared on the reverse side of the gambling records while ignoring the other 40 stores which appeared on the front side. No one on behalf of the Division could provide a rational explanation as to why this was done, i.e., whether it was an oversight or a conscious choice to ignore the expenses of these 40 locations.

In calculating net profits from all operations, the sum of $112,114.00 in rent and telephone was included as additional revenue. Since it seems rather unlikely that the gambling operation would receive rather than expend moneys for rent and telephone, some explanation for this position taken by the DA's Office (which was then accepted by the Division) is warranted. Yet none was forthcoming.

In conclusion, the Division has wholly failed to fulfill its obligation to describe the audit methodology used in this case and to respond meaningfully to inquiries made by petitioner's representative as to the nature of the audit performed and, accordingly, it must be found that petitioner has been denied his opportunity to meet his burden of proving that the audit methodology employed was unreasonable or irrational. Since it is well established that a notice of deficiency that has no rational basis must be set aside (***Matter of Donahue v. Chu,*** 104 AD2d 523, 479 NYS2d 889, 892; ***Rosenthal v. State Tax Commn.,*** 102 AD2d 325, 477 NYS2d 767, 769; ***Welch v. State Tax Comn.***, 89 AD2d 683, 453 NYS2d 802, 803), it is clear that this notice of deficiency must be annulled.

C. By virtue of Conclusion of Law "B", Issues II through IV are hereby rendered moot.

D. The petition of Raymond Marquez is granted and the Notice of Deficiency issued by the Division of Taxation on January 25, 1999 is canceled.

DATED: Troy, New York
June 5, 2003

/s/ Brian L. Friedman
ADMINISTRATIVE LAW JUDGE