

STATE OF NEW YORK

DIVISION OF TAX APPEALS

In the Matter of the Petitions	:	
of	:	
PATRICK R. BENNETT	:	
AND GWEN K. BENNETT	:	DETERMINATION
for Redetermination of Deficiencies or for Refund of New	:	DTA NOS. 818612 AND
York State Personal Income Tax under Article 22 of the	:	818613
Tax Law for the Years 1991, 1992, 1993, 1994 and	:	
1995.	:	

Petitioners, Patrick R. Bennett, P.O. Box 1000, Otisville, New York 10963, and Gwen K. Bennett, 3837 Peterboro Road, Oneida, New York 13421, filed petitions for redetermination of deficiencies or for refund of New York State personal income tax under Article 22 of the Tax Law for the years 1991, 1992, 1993, 1994 and 1995.

A hearing was held before Jean Corigliano, Administrative Law Judge, at the offices of the Division of Tax Appeals, Riverfront Professional Tower, 500 Federal Street, Troy, New York, on April 23, 2002 at 9:30 A.M., with all briefs submitted by October 20, 2002, which date began the six-month period for the issuance of this determination. Petitioner appeared by Harry L. Hood, C.P.A. The Division of Taxation appeared by Barbara G. Billet, Esq. (Kevin R. Law, Esq., of counsel).

This matter was reassigned to Joseph W. Pinto, Jr., Administrative Law Judge, who renders the following determination.

ISSUES

I. Whether the Division of Taxation properly assessed Patrick R. Bennett additional personal income tax for the years 1991 through 1995, including additional tax asserted at hearing.

II. Whether the Division's audit was performed so as to insure Patrick R. Bennett due process of law.

III. Whether the Division of Taxation has sustained its burden of proof with respect to the imposition of fraud penalty.

IV. Whether petitioner Gwen K. Bennett is entitled to relief from New York State personal income tax for the years 1991 through 1995 as an innocent spouse pursuant to Tax Law § 651.

FINDINGS OF FACT

1. On or about September 17, 1999, the Division of Taxation ("Division") sent petitioner Gwen K. Bennett an appointment letter which informed her that her New York State income tax returns for the years 1996 and 1997 had been selected for audit.

2. By letter dated April 4, 2001, the Division closed the case and issued no deficiency notice.

3. The Division began its audit of petitioner Patrick R. Bennett by consulting with Paul Szlosek, an employee of the Bennett Funding Group and chief witness for the United States Attorney's office in its criminal case against petitioner. Mr. Szlosek shared information with the Division which was used to substantiate the Federal government's case against Mr. Bennett. Based on this information, the Division believed that petitioner owed additional income tax for the years in issue.

4. The Division sent Mr. Bennett appointment letters on December 15, 1999 and February 9, 2000, respectively, to his last known address at 3837 Peterboro Road, Oneida, New York 13421. Mr. Bennett was in a Federal prison at the time awaiting sentencing after his conviction, but his wife was residing at that address. Although there was no response to the appointment letters, as recently as July 6, 2000 Patrick Bennett's address was listed on the U.S. District Court Judgment as 3837 Peterboro Road, Oneida, New York 13421. It was also listed as his address on the tax returns for the years in issue.

5. In order to preserve its rights in Patrick Bennett's pending bankruptcy case, the Division closed its audit case against Patrick Bennett on March 30, 2000 due to the failure of petitioner to respond to the audit appointment letters, either in person or by representative. The Division issued a notice of deficiency, dated April 3, 2000, to Patrick R. Bennett and Gwen K. Bennett for personal income tax for the years 1991, 1992, 1993, 1994 and 1995, setting forth additional tax due in the sum of \$949,239.60, interest of \$608,692.87 and penalty in the amount of \$823,988.82 for a total amount due of \$2,381,921.29. The notice of deficiency was mailed to petitioners at 3837 Peterboro Road, Oneida, New York 13421, by certified mail, but delivery was "refused." At hearing, the Division conceded that the year 1995 was no longer in issue and it has canceled the liability due for that year. However, as discussed below, the Division introduced a notice of claim for additional tax due at the hearing based upon further investigation of the diversions of monies by Patrick Bennett.

6. Petitioner Patrick R. Bennett was the chief financial officer, director, and shareholder of Bennett Management and Development Corp. ("BMDC") and also an officer and director of Bennett Funding Group ("BFG") from the late 1970s to 1996. BFG was a family business based in Syracuse which leased photocopying machines, primarily to offices in state and local

governments. The leases were often sold to investors who were promised a low-risk stream of cash.

7. As a result of certain dealings in these business operations, an indictment was handed up against Patrick R. Bennett, among others, in October of 1998, which alleged that petitioner sold fictitious leases to investors and sold legitimate leases more than once to different investors. Allegations in the indictment termed this a “pyramid scheme” and utilized the same allegations to support charges of mail and securities fraud. The indictment also alleged that petitioner funneled cash through a shell company, supporting money laundering charges. In addition, petitioner was charged with mischaracterizing BFG’s profitability on its financial statements in order to deceive banks and investors that loaned money to BFG, constituting bank and securities fraud. Finally, the indictment charged that petitioner deceived Securities and Exchange Commission (“SEC”) investigators which supported charges of perjury and obstruction of justice, also known as the “public integrity” counts.

8. After two trials, petitioner was convicted of only a portion of the charges. In the first trial, petitioner was convicted of the “public integrity” crimes of perjury and obstruction of justice, while the jury hung on all other issues. The second jury convicted petitioner of money laundering, bank and securities fraud related to the doctoring of the financial statements, monetary transactions in property derived from specified unlawful activity, conspiracy to obstruct the SEC investigation, obstruction of proceedings before the SEC, perjury and returned a forfeiture verdict of \$109,088,889.11. The jury was hung on all other charges.

9. These convictions, listed in the Judgment issued by the United States District Court, dated June 26, 2000, included references to specific numbered counts in the indictment submitted in evidence by the Division. The convictions were based upon findings that petitioner

Patrick R. Bennett, between 1991 and 1995, had caused checks in the amount of more than 11 million dollars to be made payable to Bennett Finance Group (counts I, II, III and IV), Bennett Leasing Fund and Bennett Leasing Fund II and, although he was not the payee on said checks, caused the proceeds to be deposited to accounts in his name. Additionally, the juries found that Patrick R. Bennett unlawfully, willfully and knowingly executed schemes to defraud various banks in order to obtain money, credits, assets, securities and other property. Further, the juries found that petitioner Patrick R. Bennett willfully transacted in criminally derived property over \$10,000.00 in value and made several deposits of these funds into his personal brokerage account at Cowan and Co.

10. The convictions against Patrick R. Bennett were upheld on appeal but the United States Court of Appeals vacated the sentence imposed by the trial court judge and remanded for resentencing. In *United States v. Bennett* (252 F3d 559 *cert denied* 535 US 932, 122 S Ct 1307), the Court found that the trial judge erred in making an upward departure, i.e., adding time to a defendant's sentence as prescribed in guidelines, based on Gwen Bennett's failure to surrender properties to which she claimed ownership and had a statutory right to contest their forfeiture. Patrick Bennett was resentenced on May 24, 2002, but the terms were not disclosed in the record.

11. As a result of Patrick Bennett's criminal conviction, the Division of Taxation assumed any additional income to petitioner for the years in issue not properly reported on his personal income tax returns was taxable by the State of New York.

12. As more fully set forth in Findings of Fact "4" and "5", the Division made two requests for information and records for the years 1991 through 1995 to which Patrick Bennett made no reply. In order to protect the State's interest, a notice of deficiency was issued to

petitioners on April 3, 2000 for the years 1991 through 1995. The notice of deficiency sent to petitioners' address at 3837 Petersboro Road, Oneida, NY 13421, was returned to the Division of Taxation with a United States Postal Service sticker attached which indicated the letter had been "refused."

13. By letters dated May 10 and May 12, 2000, petitioner's representative, Harry L. Hood, CPA, responded to the Division, informing it that petitioners had received the notice of deficiency and that Patrick Bennett was in jail. Mr. Hood included Patrick Bennett's new address of Box 1000, Otisville, NY. Although some documentation was produced by Mr. Hood, the Division never received any information from petitioners regarding Patrick Bennett's brokerage account which the United States Attorney used in the criminal conviction and the Division of Taxation utilized to generate its deficiency. The Division's auditor, Mr. Greco, received his information from Bennett Funding Group's director of accounting, Mr. Szlosek, who was also instrumental in the government's criminal case against Mr. Bennett. Mr. Greco was informed that the primary brokerage account examined was one with Cowan and Co., a clearing agent used by petitioner's brokers, Jameson, Dewitt & Associates.

14. Mr. Szlosek had been retained by the trustee in bankruptcy for the Bennett Funding Group based on his knowledge of the internal affairs of the many companies which made up BFG. Mr. Szlosek's role in the bankruptcy proceedings was to investigate and identify discrepant items. Among items he discovered were checks paid by the BMDC to various Bennett finance companies as directed by petitioner Patrick Bennett. However, many of those checks, although payable to other entities, were actually deposited into Patrick Bennett's personal accounts.

15. Patrick Bennett purportedly executed a nonnegotiable revolving credit facility note on December 10, 1990 which afforded him a credit line of ten million dollars from BMDC.

Pursuant to this agreement, between 1991 and 1994 Patrick Bennett claimed that he borrowed substantial sums of money for which he executed promissory notes totaling over \$10,776,849.00.

16. In his examination of the chart of accounts of BMDC, Mr. Szlosek discovered that an item entitled "Patrick Bennett Loans Receivable" did not exist prior to February 22, 1995 and that all entries which indicated a recording date prior to that date were backdated and actually created on July 11, 1995. Patrick Bennett directed an employee of the company, Lori Moth, to gain access to the computer system using a private code so that his private accountant could input the false information concerning the loans receivable account.

17. Mr. Szlosek's investigation uncovered the fact that checks issued by BMDC to the Bennett finance companies were first entered in the accounting system as a rental expense. These funds were then diverted to Patrick Bennett's own accounts. However, as the Securities and Exchange Commission investigation approached, these bogus rental expenses were converted to loans receivable by the creation of an account on the books of BMDC.

18. Canceled checks revealed that the payments made by BMDC to various Bennett finance companies as payees were endorsed by Patrick Bennett and then deposited into his Cowan and Company investment account at Jameson, Dewitt & Associates. This information was corroborated by the deposits indicated on Patrick Bennett's account statement.

19. Mr. Szlosek prepared a chart which set forth all the checks issued by BMDC to the various Bennett finance companies for "rental expense" and subsequently endorsed by Patrick Bennett and deposited into his personal account at Cowan and Company. The sum of these diversions in 1991, 1992, 1993 and 1994 was \$10,744,471.07.

20. In addition, the chart prepared by Mr. Szlosek indicated that deposits were made to a Cowan and Company account in the names of Patrick Bennett and David Vinciguerra, an account executive at Jameson, Dewitt & Associates. During 1993 and 1994, \$1,017,000.00 was diverted from BMDC into this account, when it was paid presumably to one of the Bennett finance companies. In all, the diversions from BMDC to accounts in Patrick Bennett's name totaled \$11,761,471.00 for purposes of calculating additional income and upon which the notice of deficiency was issued herein.

21. Subsequent to the issuance of the notice of deficiency, additional income was discovered. In addition to the diversions to his Cowan accounts above, Patrick Bennett also diverted funds from BMDC and BFG by checks, cash and wire transfers to himself and entities controlled by him or in which he had an interest in the sum of \$11,532,685.00 during the years 1991 through 1994. These transfers were discovered by Mr. Szlosek in his investigation and documented by him contemporaneously therewith. This additional unreported income to Patrick Bennett became the basis for the notice of claim for additional tax due introduced at the hearing.

22. The following table sets forth the corrected taxable income and recomputed tax liability for each of the years:

	1991	1992	1993	1994
Total Unreported Income	\$3,369,941.77	\$5,940,623.60	\$1,543,194.09	\$12,440,397.20
Corrected Tax	275,996.49	471,028.68	125,908.15	1,030,973.83
Tax Paid	8,452.63	2,486.00	2,214.00	40,410.00
Additional Tax	267,543.86	468,542.68	123,694.15	990,563.83
Penalties				
685(e)(1)	137,998.25	234,271.34	61,847.08	515,486.92

685(e)(2)	146,259.44	218,108.98	50,625.90	355,338.61
685(i)	1,000.00	1,000.00	1,000.00	1,000.00
Interest	283,560.23	436,217.95	101,251.80	682,821.54
Total	\$836,361.78	\$1,358,140.95	\$338,418.93	\$2,545,210.90

23. As part of his investigation, Mr. Szlosek examined various payments received by BFG and the trustee in bankruptcy from Patrick Bennett between 1990 and 1999 in the sum of \$2,197,740.44. In addition, Patrick Bennett caused his residence to be transferred to BMDC in or about 1994. The value ultimately received for this real property was not clearly established in the record.

24. Neither petitioner testified at hearing. Patrick Bennett was incarcerated at the time and Gwen Bennett was unable to get representation suitable to her. Instead, petitioners submitted numerous affidavits through their representative, Mr. Hood. In addition, although Mr. Hood was present at the hearing, he submitted an affidavit of his own following the hearing.

25. Petitioners filed joint New York State personal income tax returns for the years 1991 through 1994. During that period, petitioner Gwen Bennett was a full-time housewife raising two children. She had a high school education and generally worked menial jobs. She had very limited knowledge of petitioner Patrick Bennett's business dealings, but was aware of the total New York income listed on the returns for each of the years in issue. Although there was some fluctuation in income during the years in issue, the family lifestyle did not materially change between 1991 and 1994, maintaining homes and cars of comparable value. During the years in issue, Gwen Bennett managed the home and used money deposited into a checking account for payment of expenses.

26. Gwen Bennett did not question, or have the ability to question, the content of the long and complex returns filed on behalf of her and Patrick Bennett during the audited years. She knew very little of her husband's business dealings. The extent of her involvement was to accompany him to company social functions on occasion. She was aware that Patrick Bennett's family was highly visible in the business community.

27. Petitioner Gwen Bennett did not have any authority or control over petitioner Patrick Bennett's account no. 6K-81039 with Jameson, Dewitt & Associates, nor was she an authorized signatory on said account. Patrick Bennett averred in his affidavit, sworn to April 11, 2002, that he maintained and stored the statements for this account at his office.

SUMMARY OF THE PARTIES' POSITIONS

28. Petitioner Patrick Bennett argues that the Division improperly relied on the convictions in the criminal cases against him as a basis for the notice herein. Patrick Bennett contends that the indictment submitted by the Division was from the first trial and contained different allegations from those in the second indictment and should be rejected by this forum. In the alternative, Mr. Bennett argues that the allegations in the indictment were not necessarily proven at the trial and should not be relied upon by this forum. Further, he maintained that he was not convicted of any fraud related counts and, therefore, the Division cannot rely on the criminal cases as a basis for its claim of collateral estoppel.

29. Patrick Bennett contends that the Division has failed to establish a rational basis for the notice of deficiency and appears to have issued the assessment based on newspaper articles. Further, petitioner believes that the Division's "new" theory of a net worth audit is without merit.

30. Patrick Bennett believes that the Division purposely rushed through his assessment and failed to notify him of its pendency so that it could allege his noncompliance, failure to submit documents and lack of cooperation in the audit to support its fraud allegations. He also alleges that the Division's failure breached his constitutional right to due process by not allowing him to fully participate in his hearing.

31. Additionally, Mr. Bennett maintains that the Division has not offered any support for the increased assessment it asserted at the hearing and, as a result, it should be cancelled.

32. Mr. Bennett also alleges that the Division has not demonstrated that the payments diverted into his accounts were constructive dividends. Mr. Bennett claims that the standard of review for this issue demands a finding that the company had earnings and profits sufficient to support such dividends and that the Division has not presented any such evidence. On the other hand, petitioner urges that he has substantiated the fact that what the Division calls constructive dividends are actually loans, for which he has submitted documentation.

33. Petitioner Gwen Bennett contends that she is an innocent spouse. Although she signed the tax returns for the years in issue, she argues that understatements of income alleged by the Division were totally attributable to her husband's items of income. She argues that she had scant knowledge of her husband's business affairs and that Patrick Bennett never discussed the items of income upon which the notice is based. She argues that she has no education past high school and was a full-time housewife during the years in issue. She points out that her standard of living did not change due to the alleged constructive dividends. Further, Mrs. Bennett argues that since her husband did not discuss his business dealings with her and she had no access to his business records or account statements, she could not have known about the

constructive dividends. For all of these reasons, she contends that she should be accorded innocent spouse protection.

34. Gwen Bennett also believes she was denied constitutional due process because she was never notified of the audit for the years 1991 through 1994 and that her first notice of the audit was receipt of a notice of deficiency.

35. The Division of Taxation argues that the notice of deficiency was timely and not barred by the statute of limitations because, for the years 1991 and 1992, it has sustained its burden of showing that the returns filed were false or fraudulent, thereby tolling the statute of limitations indefinitely. For the years 1993 and 1994, the statute of limitations issue does not pertain since the alleged omission of income on the return filed was in excess of 25 percent of the adjusted gross income reported thereon.

36. The Division argues that Patrick Bennett should be collaterally estopped from denying that he diverted funds from BMDC for his personal use or benefit given the outcomes of the criminal cases and the charges contained in the indictment. In addition, the Division believes that it has demonstrated that petitioners received substantial amounts of income due to the fraudulent diversions mentioned above and that the criminal cases and the evidence adduced herein proves that. As a result, the Division believes it has correctly determined the tax due from petitioners.

37. The Division also maintains that the evidence submitted by petitioners should be accorded little if any weight. The Division argues that evidence submitted to corroborate loans was partly fabricated, unreliable, vague and deceptive.

38. The Division contends that petitioner Gwen Bennett has not established an entitlement to innocent spouse status, arguing that she has failed to meet the requirements of Tax Law § 651 (former[b][5][A]).

39. The Division believes it has properly imposed the fraud penalty based on Patrick Bennett's conviction on securities fraud, bank fraud, money laundering, perjury and obstruction of justice and their impact on his filing of tax returns with New York State. The consistent and substantial understatement of tax convinced the Division that the fraud penalty was appropriate in this case.

40. Finally, the Division dismisses petitioners' charge that it has violated their constitutional right to due process. The Division claims it gave petitioners ample notice of the audit and an opportunity to participate but received no cooperation. The Division argues that it is not required to make a request for income tax records prior to issuance of a notice of deficiency, but insists the requests were made and that petitioners chose to ignore them. Further, the Division contends that its use of a net worth audit was proper and provided a rational basis for the notice, especially in light of petitioners' failure to submit any credible or verifiable evidence to dispute the diversion of funds. The Division also notes that petitioners were afforded full due process by virtue of their hearing before the Division of Tax Appeals.

CONCLUSIONS OF LAW

A. Because the criminal convictions are central to the Division's case against petitioners, and petitioners challenge the Division's reliance thereon, an examination of that issue is of primary importance.

Petitioners have argued that the Division erroneously submitted the indictment from the first criminal case, wherein Patrick Bennett was convicted of the "public integrity" crimes of

perjury and obstruction of justice, while the jury hung on all other issues. Petitioners believe that reliance on the charges and underlying allegations in that indictment is erroneous because there was a second indictment which contained different terms. However, petitioners did not submit any evidence to substantiate their claims. Also militating against accepting petitioners' characterizations of the first indictment is the judgment rendered by the District Court on June 26, 2000, which specifically listed the offenses and counts on which Patrick Bennett was convicted. References to counts and offenses are to those in the indictment introduced in evidence by the Division. Therefore, it is concluded that the indictment submitted by the Division accurately reflects the counts and offenses on which Patrick Bennett was convicted in his second jury trial. In addition, the judgment was upheld on appeal, although the sentencing was remanded to the District Court.

Petitioners' objection to the Division's reliance on the specific allegations contained in the indictment is rejected. They argue that there is no assurance that the allegations supporting the individual counts were ever proven at trial. However, they submitted no evidence, testimonial or documentary, to prove their claim, even though they sat through two trials and had, at least with respect to Mr. Bennett, intimate knowledge of all the facts established by the prosecution. To generally deny, at this juncture, that the allegations in the indictment may not have been established at trial is disingenuous.

Finally, petitioners have maintained that the Division's reliance on the convictions was misplaced because none of the offenses of which Patrick Bennett was convicted involve tax or fraud which can be applied in this tax matter. Having concluded that the Division's reliance on the indictment and the allegations contained therein was reasonable, it follows that the convictions were based on actions by Patrick Bennett which demonstrated his receipt of

additional income that was not reported on his New York State personal income tax returns for the years in issue. The fact that there were no tax-related counts in the criminal cases does not insulate petitioners from claims for additional personal income tax which emanated from the same deeds which led to Mr. Bennett's conviction on charges of bank fraud, securities fraud, money laundering, monetary transactions in property derived from specified unlawful activity and forfeiture of \$109,088,889.11.

B. Tax Law § 683(a) provides that, generally, tax shall be assessed within three years after the return was filed. In this case, both the notice of deficiency and the assertion of additional tax due at hearing were beyond the three-year statute of limitations. However, Tax Law § 683(c)(1)(B) provides that an assessment may be made at any time where a false or fraudulent return has been filed with the intent to evade tax. Therefore, in order for the Division's assessment for tax years 1991 and 1992 to be timely, it must prove fraud.

For the years 1993 and 1994, the Division need prove only that there was an omission of income exceeding 25 percent of New York adjusted gross income. By doing so, its assessment at any time within six years after the return was filed would be timely. (Tax Law § 683[d][1].) Further, the burden of proving that the notice is erroneous rests with petitioners for 1993 and 1994, since the taxpayer bears the burden of showing that the six-year limitations period does not apply (*see, Matter of Bach*, Tax Appeals Tribunal, January 20, 1989).

It is prudent to review the audit performed and the results thereof to understand the notice of deficiency and subsequent proposed increase in the deficiency at hearing before looking at the issue of fraud.

In *Matter of R&J Automotive* (Tax Appeals Tribunal, June 15, 1989), the Tribunal noted:

Audits involving the imposition of tax on income concern the receipt of income which cannot easily be verified by reference to books and records (*Matter*

of Hennekens v. State Tax Commn., supra). The standard articulated by the courts of New York concerning audits of income is that indirect auditing methods are proper where the taxpayer's income is not accurately reflected in his books and records (*see, Matter of Giuliano v. Chu, supra; Matter of Hennekens v. State Tax Commn., supra; Matter of Checho v. State Tax Commn.*, 111 AD2d 470, 488 NYS2d 859).

The New York State reconstruction of income cases have their genesis in the Federal law and cases. In particular, the case of *Holland v. United States* (348 U.S. 121), is recognized as the cornerstone of the law concerning reconstruction procedures. In *Holland* the Court recognized that reconstruction methods in income tax cases serve two primary purposes. First, they serve as a means of testing the accuracy of the books and records that have been presented. Second, they are cogent evidence of the amount of income which has been unreported. Further, *Holland* gave rise to the well settled principle that the fact that books and records appear to be adequate on their face does not preclude the use of reconstruction methods (*see, Schwarzkopf v. Commr.*, 246 F2d 731, citing *Holland v. United States, supra*, at 131-132).

In the instant matter, the Division mailed two letters addressed to Patrick Bennett at his permanent home address at 3837 Peterboro Road, Oneida, New York. This address was used on all the tax returns filed by petitioners and was listed on the docketed judgement of the Federal District Court on June 26, 2000. The auditor testified credibly that he mailed these notices and received no reply. The auditor also said he had communicated with Mr. Hood, petitioners' representative, but Mr. Hood has denied this. It is concluded that adequate notice of the audit was provided. There is no statutory or regulatory requirement that audit appointment letters be mailed by any other means than first class mail. (*See, Matter of Trusnovec*, Tax Appeals Tribunal, April 10, 1997.) Weighing in the decision is the fact that the Notice of Deficiency, which was sent by certified mail to the same address, was "refused" and returned to the Division several months later, calling into question the allegations which contend that no letters from the Division concerning the Patrick Bennett audit were ever received at the Peterboro address.

With no response from the taxpayers, the Division sought information from the Federal prosecutors and were directed to Mr. Szlosek, Bennett Funding Group's director of accounting,

who was instrumental in the government's criminal case against Mr. Bennett. The information provided by Mr. Szlosek with regard to the Cowan & Company account of Patrick Bennett and the records of BMDC and Bennett Funding Company are, in the words of the Court in *Holland*, (*supra*), "cogent evidence of the amount of income which [had] been unreported." Through his testimony and documentation, Mr. Szlosek described the elaborate scheme employed by Patrick Bennett to divert monies into his personal accounts by causing BMDC to issue checks to various Bennett finance companies and then endorsing the checks so that the funds would instead go to him. Although Patrick Bennett alleges that these "rental expenses" (later recharacterized as loans) were valid loans extended under a revolving credit agreement with BMDC, which were substantiated by numerous promissory notes, the fact remains that the chart of accounts of BMDC was altered to include loans to Patrick Bennett long after they were extended and backdated to look like they were original entries, contemporaneously recorded. The canceled checks in evidence demonstrated that Patrick Bennett endorsed checks from BMDC, and the information from his account statements indicates that the funds were deposited there. Patrick Bennett has not refuted this strong evidence against him.

Several counts in the criminal indictment of which Patrick Bennett was found guilty specifically referred to instances where he endorsed checks payable to the Bennett Finance Group and deposited them into at least two of his personal accounts at Cowan and Company. The District Court listed this offense as "monetary transactions in property derived from specified unlawful activity." This confirmed criminal behavior forms a strong foundation for the conclusion herein that the additional tax found due by the Division's auditor and Mr. Szlosek was valid. Since the methodology was merely extended for the assertion of additional tax at hearing, the Division has met its burden of proof on that claim as well. (Tax Law § 689[e][3].)

Petitioners have attempted to piece together a coherent defense through their affidavits, the affidavit of their representative and of their former account executive at Jameson, Dewitt & Associates. However, no credible or relevant evidence was submitted by which one could discern whether the information provided was associated with the various accounts or projects to which it was alleged it was related. The affidavits were vague or confused in their attempts to demonstrate how Mr. Szlosek's reconstruction of events was incorrect and the inability to cross-examine the affiants assured that the allegations could not be clarified, elaborated upon or challenged. Therefore, very little weight may be accorded to them. Petitioners' allegations that the loans to Comfort Associates, Inc. were valid were not tied to any specific diverted funds such that an accommodation or offset can be made in the notice of deficiency. In addition, the court-ordered forfeiture of \$109,088,889.11 magnifies the scope of Patrick Bennett's criminal behavior and underscores the problem of not tying the diversions pinpointed by Mr. Szlosek to any monies flowing back to BMDC.¹

Patrick Bennett submitted a revolving credit agreement and promissory notes he executed pursuant to same in the sum of \$10,776,849.00. However, given that these documents were manufactured years after the fact, and the assertion by Mr. Hood that these "loans" were originally characterized as "rental expense," little weight can be ascribed to them. If they were rental expenses initially, then there would not have been contemporaneously executed promissory notes. The two assertions are mutually exclusive.

Further, the Division's characterization of the diversions of funds into Patrick Bennett's accounts as constructive dividends was proper. It was established that Patrick Bennett, a

¹There were restitution payments made by Patrick Bennett but it could not be ascertained from the record if the payments were taken into consideration by the Division, and petitioners have not articulated an argument for any accommodation on account of said payments.

director, shareholder and chief financial officer of BMDC, diverted funds of the corporation to his personal use. This has been found to be taxable to a taxpayer as a constructive dividend. (*Pittman v. Commissioner of*, 69 TCM 2799 *affd* 100 F3d 1308.) Further, it is of no moment that the corporation was operating without a profit during the years he was diverting these funds, as if the rules applying to a dividend would apply to such fraudulent conduct. It is true that dividends are usually issued to shareholders out of earnings and profits and are taxable to the recipient. (*See, Commissioner v. Gordon*, 68-1 US Tax Cas ¶ 9383.) However, dividends are also authorized by the board of directors and petitioners' argument that his diversions of funds to his own use cannot be constructive dividends because they do not comport with the traditional issuance of same by corporations is baseless and specious.

As mentioned above, the Division bears the burden of proving fraud for the years 1991 and 1992. In *Matter of Drebin* (Tax Appeals Tribunal, March 27, 1997) the Tribunal stated:

For the Division to establish fraud by a taxpayer, it must produce 'clear, definite and unmistakable evidence of every element of fraud, including wilfull, knowledgeable and intentional wrongful acts or omissions constituting false representation, resulting in deliberate nonpayment or underpayment of taxes due and owing' (citation omitted).

In addition, the Division does not have to prove fraud by direct evidence. It can establish it by circumstantial evidence which looks at the taxpayer's conduct on the whole in the context of the events in issue and draw inferences from said conduct. (*Matter of Cinelli*, Tax Appeals Tribunal, September 14, 1989.) A consistent and substantial understatement of income has been found to constitute strong evidence of fraud. (*Merritt v. Commissioner*, 301 F2d 484.)

In addition, Patrick Bennett consistently failed to make books and records available (even though two years passed between the issuance of the Notice of Deficiency and the formal hearing) and was found guilty of offenses which involve the diversion of funds to himself or for his benefit which were not accounted for on his New York State income tax returns for each of the years in issue. The Division is not precluded from using the facts adduced in the criminal proceedings to show fraudulent behavior and intent for the years in issue. Given the counts upon which Patrick Bennett was convicted and the facts underlying those counts, there was ample, clear and compelling proof that monies were illegally diverted into his personal account that should have been going elsewhere, and Patrick Bennett did not account for this income on his personal income tax returns. Based on these facts the Division's assertion of the fraud penalty is sustained.

It is noted that since the criminal convictions were not tax-related offenses, it is not proper to invoke the doctrine of estoppel. For collateral estoppel to apply, petitioner must have had a fair opportunity to litigate the issue of his liability for the income tax at the criminal proceeding (*see, Kuriansky v. Professional Care*, 158 AD2d 897, 551 NYS2d 695). Clearly, this was not the case in Patrick Bennett's criminal matters. Further, the identical issue must have been decided in the prior action and be decisive of the present action, and the party to be precluded from relitigating the issue must have had a full and fair opportunity to contest the prior determination. (*Kaufman v. Eli Lilly and Co.*, 65 NY2d 449, 492 NYS2d 584, 588.) This also was not the case in the instant matter.

C. With regard to the limitation on assessing tax for the years 1993 and 1994, it is concluded that the Notice of Deficiency was timely. Tax Law § 683(d)(1) provides that the period of limitation on assessment is six years where the Division asserts omissions of income in

excess of 25 percent of New York adjusted gross income. Given the conclusions herein, the Division has demonstrated that there was such an omission on the personal income tax returns of petitioners for the years 1993 and 1994. The burden of proof in such cases is on the taxpayer, and petitioners herein have not met it.

D. The next issue is whether petitioner Gwen Bennett has established her claim to relief under Tax Law § 651(former [b][5][A]) as an innocent spouse. For tax years prior to 1999, New York's innocent spouse rule provided that a spouse was not liable for tax, penalties or interest on a joint return if: (1) the return contained a substantial understatement of tax attributable to grossly erroneous items of the other spouse; (2) the innocent spouse established that he or she did not know and had no reason to know of the substantial understatement; and (3) it would have been inequitable to hold the innocent spouse liable for the deficiency attributable to the substantial understatement.

First, it is noted that the criminal case against Patrick Bennett has no bearing on Gwen Bennett's liability herein. There were no criminal charges against her and the remarks made by Judge Martin concerning her complicity were dicta and of no value herein. Further, the Court of Appeals in *United States v. Bennett* (252 F3d 559, *cert denied* 535 US 932, 122 S Ct 1307), specifically noted that Gwen Bennett had a right to contest the forfeiture order regarding the family home and was pursuing those rights. The Court of Appeals disagreed with Judge Martin's attempt to force her to forego her rights by threatening to add ten years to her husband's sentence. The Court said enhancement of Patrick Bennett's sentence because Gwen Bennett "stood her ground" was impermissible, even though such enhancement would have been proper if based solely on Patrick Bennett's conduct.

With regard to the elements set forth in Tax Law § 651(former [b][5][A]), it is concluded that the record contains ample proof that Gwen Bennett was an innocent spouse. From the audit results, it is clear that the entire notice of deficiency is based upon diversions of funds into private brokerage accounts of Patrick Bennett from corporations about which Patrick, not Gwen, had intimate knowledge. Therefore, the additional income was wholly attributable to the secret endeavors of Patrick Bennett, the records for which were kept by Patrick Bennett at his place of business.

Gwen Bennett averred that she had a high school education and was a housewife during the years in issue, spending most of her time raising her young children. She attended business functions with her husband on occasion and knew only that Patrick's family maintained a high profile in the business community. She signed the joint returns and did not question or understand the complex documents containing numerous attachments.

During the years in issue, Gwen Bennett managed the home and used money deposited into a checking account for payment of expenses. There was no significant change in her lifestyle during the period in issue, although this alone would not support denying innocent spouse relief. (*See, Matter of Sabatine*, Tax Appeals Tribunal, August 25, 1988.)

In consideration of these circumstances, and the fact that the Division has provided no independent evidence of Gwen Bennett's liability for the tax other than its reliance on Judge Martin's dicta, it is concluded that it would be inequitable to hold Gwen Bennett liable for the substantial understatement of income for which her husband was fully liable and which he sought to keep secret from all. (*Matter of Sabatine, supra.*)

E. Finally, it is concluded that petitioners were not denied their constitutional right to due process by virtue of the Division's requests for information and the hearing held in this

matter. It was concluded above that requests for information were mailed to petitioners and they failed to answer. Ultimately, after issuance of the notice, petitioners were afforded additional time to comply, received a conference in the Bureau of Mediation and Conciliation Services and a formal hearing in the Division of Tax Appeals. Petitioners had over two years from the issuance of the notice of deficiency to their formal hearing but failed to produce evidence proving the Division's notice of deficiency erroneous. Petitioners have received their full measure of due process guaranteed by the Constitution.

E. The petition of Patrick R. Bennett is granted with respect to 1995 (*see*, Finding of Fact "5") but is otherwise denied and the Notice of Deficiency, dated April 3, 2000, and additional tax asserted at hearing are sustained as to him for the years 1991, 1992, 1993 and 1994. The petition of Gwen K. Bennett is granted and the Notice of Deficiency, dated April 3, 2000, is cancelled as to her for all periods.

DATED: Troy, New York
April 3, 2003

/s/ Joseph W. Pinto, Jr.
ADMINISTRATIVE LAW JUDGE