

STATE OF NEW YORK

DIVISION OF TAX APPEALS

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| In the Matter of the Petition                     | : |                       |
| of  | : |                       |
| <b>ESTATE OF GALINA FILIPOW</b>                   | : | <b>DETERMINATION</b>  |
|   |   | <b>DTA NO. 821085</b> |
| for Redetermination of a Deficiency or for Refund | : |                       |
| of New York State and New York City Personal      | : |                       |
| Income Tax under Article 22 of the Tax Law and    | : |                       |
| the Administrative Code of the City of New York   | : |                       |
| for the Fiscal Years Ended October 31, 2000,      | : |                       |
| October 31, 2001 and October 31, 2002.            | : |                       |

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Petitioner, the Estate of Galina Filipow, filed a petition for redetermination of a deficiency or for refund of New York State and New York City personal income tax under Article 22 of the Tax Law and the Administrative Code of the City of New York for the fiscal years ended October 31, 2000, October 31, 2001 and October 31, 2002.

A hearing was held before Joseph W. Pinto, Jr., Administrative Law Judge, at the offices of the Division of Tax Appeals, 641 Lexington Avenue, New York, New York, on January 11, 2007 at 10:30 A.M., with all briefs to be submitted by May 18, 2007, which date began the six-month period for the issuance of this determination. Petitioner appeared by Poe & Freireich (Harvey R. Poe, Esq., of counsel). The Division of Taxation appeared by Daniel Smirlock, Esq. (Kevin R. Law, Esq., of counsel).

***ISSUES***

I. Whether the Notice of Deficiency, dated January 23, 2006, adequately informed petitioner of the Division of Taxation's underlying legal theories and facts for its assertion of additional tax, and, if not, whether such inadequacy rendered the notice invalid.

II. Whether the moneys paid to Helen Jeffers were properly deducted by Galpow Realty as a wage expense, subsequently inuring to the benefit of petitioner, and if not, whether such amount should be characterized as a distribution to beneficiaries and treated as income distribution deductions of the estate.

III. Whether the Division of Taxation properly calculated petitioner's basis in its shares of stock of Galpow Realty.

IV. Whether the Division of Taxation properly considered the deductions for attorney, accounting and preparer's fees, real estate commissions and bank service charges taken by petitioner on its fiduciary income tax return for the fiscal year ended October 31, 2001.

V. Whether petitioner has demonstrated reasonable cause for the abatement of penalty imposed by the Division of Taxation.

#### ***FINDINGS OF FACT***

1. Petitioner, the Estate of Galina Filipow (the "Estate"), was a New York State resident estate created subsequent to the death of Ms. Filipow on November 24, 1999.

2. This matter originated when the Division of Taxation ("Division") discovered that the Estate had failed to file a fiduciary income tax return for the year 2001. On July 6, 2004, the Division requested that the Estate forward to it a copy of the 2001 New York and federal fiduciary returns. On August 31, 2004, the Estate complied and provided New York and federal fiduciary returns for the periods November 1, 2001 to October 31, 2002 and November 1, 2003 to October 31, 2004.

3. The two fiduciary returns filed by the Estate led the Division to discover that other returns had not been filed, specifically those for the fiscal years ended October 31, 2000, October 31, 2001 and October 31, 2003. In November 2004, in letters addressed to the Estate and its

representatives, the Division requested copies of these returns and the federal forms 1041 for the same periods. In addition, the Division requested information on the Estate, the real property owned by the decedent, sales of real property, involvement in a subchapter S corporation known as Galpow Realty, Inc., and estate beneficiary information, including New York personal income tax returns for said beneficiaries. One of the assets the Estate received from the decedent was 100 percent of the shares of Galpow Realty, Inc., a New York corporation with its principal offices located at 40 East 94<sup>th</sup> Street in New York City. For this reason, the Division closely scrutinized the income, expenses and deductions of Galpow Realty since its income flowed through to the Estate, thereby directly impacting the Estate's income and fiduciary tax returns.

4. By facsimile transmission, dated November 29, 2004, and a letter, dated December 4, 2004, the Estate provided information and documents in response to the Division's request. In addition to the beneficiary information, petitioner provided a copy of the federal estate tax return (form 706), the New York Estate Tax Return (form ET 90), and some of the federal fiduciary tax returns.

5. By letter, dated December 27, 2004, the Division requested very specific information with respect to the fiduciary returns for the five fiscal years ended October 31, 2000, 2001, 2002, 2003 and 2004, in addition to the personal income tax returns of the executrix, the fiduciary returns for the trust created for the benefit of the beneficiaries of the Estate, wage information, and substantiating information for sales of real property held by Galpow Realty, Inc.

6. A meeting took place between the auditor and petitioner's representatives on January 13, 2005, and it was determined that there was not enough information to perform an audit. Due to petitioner's difficulty in retrieving records from its accountant, the Division extended the time for petitioner to produce documentation until May of 2005, but adequate documentation was

never received. Over the course of the next several months, the New York State fiduciary returns for each of the fiscal years listed above were discussed on a line-by-line basis, but missing information on the incomplete returns prevented the Division from determining the tax due. The Division analyzed information sent in by petitioner with respect to entries on the fiduciary returns and requested additional information throughout the year in letters dated June 3, 2005, July 11, 2005 and October 20, 2005. Ultimately, the Division summarized the issues remaining in dispute in a letter to petitioner's representative, dated December 1, 2005.

7. The Division identified three fiscal years in which it found discrepancies: the years ended October 31, 2000, October 31, 2001 and October 31, 2002. For the year ended October 31, 2000, the Division rejected and recharacterized Galpow Realty's wage expense deduction because it did not find credible the fact that the executrix could receive both a commission and a salary for ostensibly doing the same job. Further, for the same reason, the Division did not accept the wage expense as ordinary and necessary. As a result, the wage expense was added to line 49 of the fiduciary return which reflected "other income" from Galpow Realty. In fact, the executrix treated the income as wages on her 2000 federal income tax return, indicating \$100,000.00 in wage income from Galpow Realty.<sup>1</sup>

8. For the year ended October 31, 2000, the Division also identified what it believed was an erroneous entry for petitioner's exemption as listed on line 59 of the return and its failure to state Galpow Realty's franchise tax on line 63 in the sum of \$3,248.00.

9. For the year ended October 31, 2001, the Division once again rejected and recharacterized Galpow Realty's wage expense, this time in the sum of \$30,000.00 because it

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<sup>1</sup>Galpow's New York franchise tax return for the fiscal year ended September 30, 2000 indicated a wage expense of \$72,500.00 and a deduction of \$30,000.00 for the fiscal year ended December 31, 2000.

was not deemed an ordinary and necessary expense. The Division reflected its determination by modifying lines 46 and 49 of the fiduciary income tax return. It also added back Galpow Realty's franchise tax on line 63.

10. For the year ended October 31, 2002, the Division modified the fiduciary tax return by accounting for interest, capital gain and income that passed through from Galpow Realty and utilizing information on the New York Estate Tax Return, form ET-90, to ascertain fair market values of the real properties, choosing to ignore the adjustments to valuations of real property made by the Internal Revenue Service ("IRS") and reported in its Estate Tax Closing Letter, dated November 4, 2003. In addition, the Division added back franchise tax of Galpow Realty in the sum of \$165,645.00. The Division was aware that a capital gain was claimed by Mrs. Jeffers on her 2002 federal income tax return, dated January 7, 2005. However, from the schedule D attached to the return, it was impossible for the Division to determine if the real property was the same as that included in the Division's analysis, based upon Galpow Realty documentation and included in the Statement of Fiduciary Income Tax Audit Changes. It was the Division's determination that Mrs. Jeffers's return included other property, a fact the auditor testified to at hearing.

11. The Division requested additional information from petitioner's representatives in the December 1, 2005 letter. Specifically, it requested information on additional properties listed in the estate tax return and information with respect to the personal tax returns of the executrix. The final paragraph of the letter directed petitioner not to make any payments and that the Division would prepare a "Statement of Audit Findings to reflect the [contents of the letter] . . . ," and that any basis for abatement of penalties should be submitted in writing.

12. The Division prepared and sent to petitioner's representative a waiver to extend the period of limitations on assessment, which extended the time for issuance of a notice of deficiency for the period November 1, 1999 through October 31, 2003 to April 15, 2007.

13. By letter, dated December 15, 2005, petitioner's representatives notified the Division that all available information had been submitted and that no further waivers would be provided, thereby mandating that a notice of deficiency be issued by the Division on or before February 15, 2006, to be timely for the periods in issue.

14. On January 6, 2006, the Division generated a detailed, five-page form AU-251.1, Statement of Fiduciary Income Tax Audit Changes, as promised in its letter of December 1, 2005, wherein it was referred to as a "Statement of Audit Findings." The statement set forth an explanation of the adjustments made by the Division to the fiduciary returns for each of the three years in issue and a recomputation of the tax due for each year and the applicable penalty and interest asserted. The statement also contained a "Consent to Findings" option located on the bottom of the first page which provided:

Pursuant to Section 681[f] of the Tax Law, the restrictions provided in Section 681[c] of the Tax Law are waived and consent to the assessment and collection of the above deficiency(s), together with interest thereon, as provided.

15. For the fiscal year November 1, 1999 through October 31, 2000, the Division disallowed the pass-through income from Galpow Realty due to its inclusion of a deduction taken by Galpow for wage expense paid to the executrix, Helen Jeffers, in the sum of \$72,500.00, which the Division considered excessive and not ordinary or necessary given the history of its employment expenses and Mrs. Jeffers's simultaneous role of executrix. In fact, the New York Estate Tax Return listed commissions paid to Mrs. Jeffers in the sum of \$101,601.00. The Division also made adjustments to the exemption claimed and the add-back for taxes paid by

Galpow. These adjustments yielded a New York taxable income of \$111,129.00, New York State tax thereon of \$7,299.00, New York City tax of \$4,080.00 and negligence penalty and interest. The total amount asserted was \$21,066.00.

16. For the fiscal year November 1, 2000 through October 31, 2001, the Division once again refused to accept the pass through of income from Galpow Realty because it was computed using a wage expense deduction of \$30,000.00 paid to Helen Jeffers, the executrix. Adjustments for the exemption claimed and the add-back for income taxes paid were also made to the fiduciary return for this fiscal year. All the adjustments resulted in New York taxable income to the Estate of \$96,268.00, New York State tax thereon of \$6,197.00, New York City tax of \$3,237, plus negligence penalty and interest, for a total amount due of \$16,167.00.

17. For the fiscal year November 1, 2001 through October 31, 2002, the Division included interest income and a large capital gain from Galpow Realty which it discovered on the form K-1 issued by the corporation. The capital gain was computed using an adjusted basis in the stock of the corporation as determined by the Division. In addition, the Division allowed a pass through of a loss from Galpow and added back franchise taxes paid, as reflected on the form K-1. The resulting New York taxable income was determined to be \$415,575.00, New York State tax thereon of \$28,467.00, New York City tax of \$15,042.00, plus negligence penalty and interest, for a total amount due of \$58,231.00.

18. The Statement of Fiduciary Income Tax Audit Changes, form AU 251.1, was accompanied by an undated letter prepared by the auditor, and referred to in her Tax Field Audit Record next to the date "01/06/2006," where part of the entry for that date read, "Prepared cover letter for bill." The letter referenced the same case number that appeared on the audit report and Statement of Fiduciary Income Audit Changes, X-380250839, although the letter referred to the

Statement as “the audit report explaining the adjustments we propose.” However, the letter also referred to the “Consent to Findings” section on the bottom of the statement and correctly indicated the full amount due as stated on the statement, i.e., \$95,464.00.

At the bottom of the letter, a provision stated that if petitioner disagreed with the findings, it could avail itself of the following:

We would like to offer you the opportunity to discuss the audit findings in detail. Please contact me or my supervisor, Ms. Diane R. Marzec, by January 6, 2006 for an appointment. You may also submit any additional information or documentation you would like us to consider before the conference date or date stated above, whichever is later.

19. The Division of Taxation issued to petitioner a Notice of Deficiency, dated January 23, 2006, assessment number L-026587219-9, for the fiscal years ended October 31, 2000, October 31, 2001 and October 31, 2002, which asserted additional tax due of \$64,322.00, interest of \$15,460.74 and penalty of \$16,256.86. On the notice, directly above a table indicating the tax, penalty and interest due was a statement which read:

Field Audit of your books and records disclosed additional tax due. Please refer to the previously issued Consent to Field Audit Adjustment.

20. Petitioner opted to forego a conference in the Bureau of Conciliation and Mediation Services and filed a petition with the Division of Tax Appeals on April 14, 2006.

21. At hearing, petitioner agreed to certain adjustments made by the Division:

a) For each of the fiscal years ended October 31, 2000 and October 31, 2001, petitioner conceded that the disallowance of the federal exemption in the amount of \$400.00 was correct;

b) For the fiscal years ended October 31, 2000 and October 31, 2001, petitioner conceded that the add-back of Galpow Realty’s franchise tax in the respective sums of \$3,248.00 and \$800.00 was correct; and



c) For the fiscal year ended October 31, 2002, petitioner conceded that the adjustment for interest from Galpow Realty in the sum of \$418.00 was properly passed through to petitioner.

22. The Division conceded that, for the fiscal year ended October 31, 2002, of the \$165,645.00 in franchise tax reported on the form K-1, \$147,784.00 represented New York City franchise tax and should not have been added back to petitioner's income. Only \$14,576.00 should have been added back.

23. For the fiscal year ended October 31, 2000, the Division conceded that it incorrectly disallowed a payment of \$2,500.00 in wages to Galina Filipow prior to her death and incorrectly increased the income of the Estate by the same amount. The actual amount of disallowed wages was \$100,000.00.

24. Petitioner deducted attorney, accountant and preparer fees in the amount of \$44,002.00 and real estate commissions on property sales and bank service charges in the sum of \$22,357.00 on its federal fiduciary income tax return for the fiscal year ended October 31, 2001.

Petitioner could not relate these expenses to any source documentation it provided on audit. In a letter from petitioner's representative to the Division, dated November 8, 2005, in discussing its computation of capital gain on the sale of 333 W. 56<sup>th</sup> Street and 40 E. 94<sup>th</sup> Street, it was disclosed that the statements of closing title for both sales took into account various expenses. A review of the statements provided indicated payment of legal fees and broker's commissions, leaving little doubt that they were included in the calculation of capital gain. In addition, service fees were claimed on the New York Estate Tax Return as well, with no way of verifying if they were part of the fees claimed on the federal fiduciary return for the fiscal year ended October 31, 2001. This issue had not been raised on audit and the deductions were not claimed on petitioner's returns.

***SUMMARY OF THE PARTIES' POSITIONS***

25. Petitioner contends that it was not given fair warning of the Division's theories of law and fact. It relies on the statement in the Notice of Deficiency's computation section which indicated that a Consent to Field Audit Adjustment had been previously issued that explained the basis for the notice. Since no document with that title appears in the record, petitioner claims it was forced to guess the reasoning underlying the Division's Notice of Deficiency. In addition, petitioner cites the Division's issuance of a document entitled "Statement of Fiduciary Income Tax Audit Changes," dated January 6, 2006, as further evidence of a failure to warn petitioner of the basis for the assessment. It was forwarded to petitioner with a cover letter that invited petitioner to discuss the matter with the Division by contacting it by the same date, January 6, 2006, to arrange for an appointment, an impossibility that petitioner contends prevented it from discerning the Division's theories of law and fact underlying the assessment.

26. Petitioner argues that its fiduciary income for the fiscal years ended October 31, 2000 and October 31, 2001 should not be increased, regardless of whether wages paid by Galpow Realty to Helen Jeffers were properly deductible by Galpow. Petitioner argues that the Division erred in disallowing the wages and then compounded its error by not allowing the Estate to pass the income to a beneficiary and claim an income distribution deduction therefor.

27. Petitioner maintains that the Division erred in not conforming the basis in the stock of Galpow Realty with the basis utilized by the Internal Revenue Service. Petitioner believes that the Division had no reason not to make the same adjustments made by the IRS in the absence of evidence that the IRS had made an error in its determination. Further, regardless of the basis in the stock, petitioner argues that the gain on the sale was passed through directly to the beneficiaries and petitioner recognized no taxable income.

28. Petitioner urges that the deductions for attorney, accounting and preparer's fees, real estate commissions and bank service charges claimed on the federal fiduciary income tax returns for the fiscal year ended October 31, 2001 be allowed on the New York return.

29. Finally, petitioner contends that, by reason of Division's errors, there is no additional tax due from petitioner and it is not liable for any of the penalties asserted by the Division.

30. The Division maintains that petitioner had ample notice of the Division's basis for the additional tax determined to be due, primarily due to the Statement of Fiduciary Income Tax Audit Changes and several pieces of correspondence between the Division and petitioner's representatives which included explanations of proposed adjustments. In addition, the Division points out that petitioner would not have been able to set forth what it believed to be errors in the Division's adjustments without an awareness and understanding of the Division's position.

31. The Division contends that petitioner has not demonstrated that its disallowance of the wage deduction by Galpow Realty, which had an impact on petitioner's fiduciary income tax returns for the fiscal years ended October 31, 2000 and October 31, 2001, was improper since it was not shown that such expense was ordinary and necessary. The Division reasoned that Ms. Jeffers was petitioner's executrix and presumably receiving a fee for rendering the same services to Galpow, which in prior years had little or no wage expenses.

32. The Division maintains that petitioner's position that it should be allowed an income distribution deduction is flawed because it never claimed the deductions for the fiscal years ended October 31, 2000 and October 31, 2001 in the amounts of the wage income paid by Galpow Realty. The Division contends that both the federal and state fiduciary returns contain conflicting information, rendering them unreliable for purposes of determining the actual amount of income recognized by petitioner for the fiscal years in issue.

33. The Division contends that it properly determined the basis in petitioner's Galpow Realty stock and that its adjustments were proper. The Division does not believe that it was bound by the IRS audit results with respect to the federal estate tax return since petitioner never filed an amended New York estate tax return.

34. The Division argues that its disallowance of attorney, accountant and preparer's fees, real estate commissions and bank service charges was proper even though petitioner claimed them on its federal fiduciary return for the fiscal year ended October 31, 2001. It is the Division's position that the fees and charges were already accounted for in the calculation of capital gain.

35. Finally, the Division believes that petitioner has not established a basis for the abatement of penalties, noting that its returns were filed late and did not accurately state the income tax due.

### ***CONCLUSIONS OF LAW***

A. Petitioner argues that it did not receive fair warning of the Division's theories of law and fact in the January 23, 2006 Notice of Deficiency. Although the "Consent to Field Audit Adjustment" was referenced in the computation section of the notice, petitioner contends that this reference was not a clear reference to the Statement of Fiduciary Income Tax Audit Changes ("Statement"), which contained a "Consent to Findings" provision on the bottom of the first page. Unfortunately, the Division's failure to accurately describe this important document did not end with its reference in the Notice of Deficiency.

The Division referred to the Statement as the "statement of audit findings" in its December 1, 2005 letter to petitioner's representative; as a "bill" in the auditor's log entry for January 6,

2006; and as the “audit report” in the undated cover letter which accompanied the Statement, which was mailed to both petitioner and its representative.

As unfortunate as the Division’s inarticulate descriptions were, they did not deprive petitioner of fair warning of the Division’s theories of law and fact. Petitioner and its representative were mailed the Statement of Fiduciary Income Tax Audit Changes on January 6, 2006, as indicated in the auditor’s log for that date, and neither denied receiving it. This is further supported by the fact that the undated letter, which accompanied the Statement, referenced the case number appearing on the Statement and the income tax audit file, and also recited the precise amount of tax that was set forth in the Statement as due and owing following the adjustments made therein. Further, the computation of tax and line-by-line adjustments set forth in the January 6, 2006 Statement were directly related to the audit findings set forth in the letter sent to petitioner’s representative on December 1, 2005, which was the culmination of an ongoing discussion between the Division and petitioner’s representative that began on July 6, 2004, some 17 months earlier.

Numerous letters were sent by the Division to petitioner’s representative, which requested very specific information for individual lines of the fiduciary income tax returns for the years in issue. Petitioner responded to these letters with some, but not all, information requested. Finally, the Division sent the December 1, 2005 letter, which summarized its findings and rationale therefor. Petitioner’s response to this last letter advised the Division that no further information would be submitted and that it would not provide any further waivers of the period of limitation on assessment. Not surprisingly, with a narrow window of time within which to issue a notice of deficiency, the December 15, 2005 letter from petitioner’s representative was followed quickly by the Statement on January 6, 2006.

The reference to the “Consent to Field Audit Adjustment” in the computation section of the Notice of Deficiency was an unfortunate reference to the Statement of Fiduciary Income Tax Audit Changes, which also contains a “consent to findings” section on its first page. Regardless of the title of the form used by the Division in the Notice of Deficiency, the Statement is a summary of the adjustments made by the Division in petitioner’s fiduciary income tax returns for the fiscal years in issue and an explanation of the reasons for those adjustments set forth on three separate pages, which petitioner addressed almost line by line in its petition filed with the Division of Tax Appeals on April 14, 2006. Therefore, petitioner’s claim that it was not given fair warning of the Division’s theories of law and fact underlying the Notice of Deficiency is disingenuous and contrary to the facts in the record.

Once the Division issued a notice of deficiency, a presumption of correctness attached to it and it was incumbent upon petitioner to demonstrate that the notice was erroneous. (*See Welch v. Helvering*, 290 US 111, 115 [1933].) As succinctly stated in *Matter of Tavolacci v. State Tax Commn.* (77 AD2d 759, 431 NYS2d 174 [1980]):

[Tax Law § 689(e)] makes it then incumbent upon the taxpayer to proceed to demonstrate the incorrectness of the deficiency, for the burden of proof is upon the taxpayer . . . . The petitioner, through his complete failure to present any proof as to the incorrectness of the statement of deficiency, has surrendered to the statutory presumption of correctness and the determination must be sustained (*Matter of Tavolacci v. State Tax Commn.*, *supra*, 431 NYS2d, at 175; *see also, Kourakos v. Tully*, 92 AD2d 1051, 461 NYS2d 540, *appeal dismissed* 59 NY2d 967, 466 NYS2d 1030, *cert denied* 464 US 1070, 79 L Ed 2d 215).

Petitioner seeks to avoid its burden of proof by arguing that it was not given fair warning of the theories of law and fact underlying the notice of deficiency. However, as plainly evident from the facts, the notice adequately identified and incorporated the Statement of Fiduciary

Income Tax Audit Changes, especially in the context of the audit and communications between the Division and petitioner, and the explanation of the Division's theories and reasoning underlying its adjustments. (*Bernuth v. Commissioner of Internal Revenue*, 470 F2d 710 [1969].)

Petitioner argues in the alternative that the Division failed to give fair warning by virtue of the fact that the Statement of Fiduciary Income Tax Audit Changes was sent to petitioner on January 6, 2005, but the cover letter contained an invitation to discuss the audit findings if requested by the same date, January 6, 2006, thereby precluding petitioner of an opportunity to discuss the findings.

As mentioned above, petitioner clearly ended its discussions with the Division of Taxation by letter of December 15, 2005, when its representatives informed the Division that it would not submit any further information to help the Division resolve the remaining issues and refusing to sign additional waivers, which forced the Division to issue a notice of deficiency by February 15, 2006. Petitioner had made its decision with full knowledge of the bases for the tax asserted as set forth in the Division's letter of December 1, 2005, and it is not likely it was disadvantaged by the misstated deadline for an appointment to discuss the audit findings. In fact, the undated letter issued on January 6, 2006 also extended an invitation to petitioner to submit additional documentation or information at a later date - - an offer petitioner chose not to accept.

B. The Division refused to recognize the wage income paid to Helen Jeffers, executrix of the Estate, by Galpow Realty in the year 2000. As a result, the wage income deduction in the sum of \$100,000.00 was added back to the income of Galpow Realty and then passed through to petitioner, the sole shareholder. The basis given for the disallowance by the Division was that the wage expense paid by the corporation to the executrix of the estate was not ordinary and

necessary in nature. The Division noted that the corporation had not made wage expenditures like this in prior years and questioned the necessity to begin paying wages in 2000, especially since the executrix received a commission of \$101,601.00, and additional wages appeared to be double payment for the same services. Petitioner offered no evidence to dispute the Division's contention.

In the alternative, petitioner argues that the wages were actually a de facto distribution from the Estate, and that the Estate would have been entitled to an income distribution deduction on the payment to Mrs. Jeffers. Petitioner reasons that since the funds were ultimately received by Mrs. Jeffers, how they were distributed was of no importance.

This argument fails on several grounds. First, petitioner chose the form of the transaction and it decided that Galpow Realty would pay wages to Mrs. Jeffers and deduct the sum from the company's income. It was reported by Galpow Realty to account for this payment and W-2 wage statements were issued. Mrs. Jeffers reported the income on her 2000 federal income tax return as wage income. Since the form of the transaction was chosen by petitioner, which at the time was controlled by Mrs. Jeffers, petitioner is bound by that choice and its ramifications. "The choice of form did not rest with the tax authorities but with the taxpayer. If he unfortunately chose a form which was taxable instead of an equally available form which was non-taxable, he must bear the consequences" (*Matter of Sverdlow v. Bates*, 283 App Div 487, 129 NYS2d 88, 91-92 [1954]; *see also, Matter of North Shore Cadillac v. Tax Appeals Tribunal*, 13 AD3d 994, 787 NYS2d 463 [2004], *lv denied* 5 NY3d 704, 801 NYS2d 1 [2005]). The fact that petitioner now realizes that it would have been more advantageous to characterize this transaction as an income distribution by the estate is an equitable appeal that is untenable.



Mrs. Jeffers, as executrix of petitioner receiving commissions for her services, had Galpow Realty pay her wages of \$100,000.00. This action took the funds out of the stream of distributable income, i.e., beyond the reach of the beneficiaries of the Estate, since it is money paid directly to Mrs. Jeffers from the corporation and never passed through to the Estate where it would have been distributed subject to the terms of the last will and testament. Further, the funds never passed to the Estate as income and, therefore, were not subject to New York fiduciary income tax, which created a significant savings for petitioner, which only allocated a small percentage of its income to New York. This created the appearance of a tax plan intended to avoid New York taxation with absolutely no justification offered by petitioner.

The Division recited the rules for deducting wages contained in Internal Revenue Code (“IRC”) § 162(a) and the interpretation of “ordinary” and “necessary” expenses by various courts, concluding that Galpow Realty’s payment of wages to Mrs. Jeffers was not ordinary and necessary. Petitioner did not submit any evidence to support Galpow’s payment of wages to Mrs. Jeffers and therefore has not demonstrated that the wages were ordinary and necessary as set forth in IRC § 162(a). Since petitioner failed to carry its burden of showing that these expenses were in fact for compensation for personal services actually rendered and that the payment was reasonable (Treas Reg § 1.162-7[a]) the Division properly disallowed the wage deduction and added the amount back to Galpow’s income, with the resulting impact on petitioner’s income. Since petitioner did not demonstrate that any of this income was actually distributed by the Estate, it was proper to assume it was retained by petitioner and properly taxed.

In urging this forum to disregard the form of the transaction chosen, petitioner has also failed to demonstrate that it ever intended for the wage payment to be an income distribution by the Estate to Mrs. Jeffers. In fact, it appears that its only reason for asserting this theory was the

Division's disallowance. Therefore, this is not similar to those matters where the Division has improperly disregarded the substance of the transaction in an arbitrary and capricious exercise of its power. (*Matter of Riluc Co. v. Tax Appeals Tribunal*, 169 AD2d 988, 565 NYS2d 265 [1991]). It merely asked for substantiation of the ordinary and necessary nature of the wage payments which petitioner was unable to provide.

C. Petitioner contends that the Division erred in not adjusting its basis, \$1,300,000.00, in the Galpow Realty stock for the fiscal year ended October 31, 2007, resulting in an inflated capital gain for that year. The critical factor involved the valuation of the Estate's real property, which had been reported to be \$1,259,900.00 on the original federal estate tax return, form 706. Petitioner asserted, and the Division conceded, that the basis in the stock of Galpow Realty was adjusted during an audit of petitioner's federal estate tax return by the IRS and stated in the November 4, 2003 Estate Tax Closing Letter sent to petitioner's representative. Specifically, the Division was aware that the IRS had reduced the fee of the executrix by \$20,081.00 and increased the value ascribed to Galpow's real property by \$101,136.00 but did not conform its audit results to accommodate for these modifications.

Tax Law § 961(a) provides that a final federal determination as to the value of any item of property or item claimed as a deduction shall also determine the value for New York purposes unless shown by a preponderance of the evidence to be erroneous. Tax Law § 961(b) provides that a final federal determination includes a final disposition by the secretary of the treasury. Therefore, the results of the audit by the IRS, known to the Division at the time of its audit of the Estate and embodied in the Estate Tax Closing Letter, dated November 4, 2003, is binding to the extent that the value of items which comprised the basis in Galpow Realty stock were identical. The Division has not demonstrated that the audit adjustments made by the IRS were erroneous.

It only asserted that the failure to file an amended New York estate tax return precluded petitioner from getting the advantage of the modified basis in the real property and, ultimately, in the stock of the company. Therefore, it is determined that the Division's assertion of additional tax based on the lower value for Galpow's real estate was in error and the New York Fiduciary Income Tax Return for the fiscal year ended October 31, 2002 should be modified to include the two adjustments noted by the auditor with respect to the commission of the executrix (if applicable) and the adjusted basis in the real property. (*See Matter of Weaver's Estate*, 97 Misc 2d 72, 410 NYS2d 777, *affd* 74 AD2d 678, 424 NYS2d 789 [1980].)

Petitioner contends that the capital gain assigned to petitioner by the Division was passed through directly to the beneficiaries and claimed on the 2002 federal personal income tax return of Helen Jeffers, dated January 7, 2005. Thus, there remained no taxable income to be recognized on the New York fiduciary income tax return for the fiscal year ended October 31, 2002. However, from the schedule D attached to the 2002 federal income tax return of Mrs. Jeffers, it is not discernible if the property sold was the same as that included in the Division's analysis in its Statement of Fiduciary Income Tax Audit Changes. In fact, in answer to petitioner's representative's question whether the sale of properties inherited from the estate was reflected on the 2002 1040 of Helen Jeffers, the auditor stated that "there was other property." Petitioner did not attempt to clarify this answer or correct the witness and it is concluded that petitioner, in the absence of evidence to the contrary, conceded its accuracy.

Since there was no further evidence offered by petitioner to prove its theory, it has not met its burden of proof. (Tax Law § 689[e].)

D. Petitioner claims that the Division erred in not permitting it to deduct attorney, accountant and preparer fees in the amount of \$44,002.00 and for real estate commissions on

property sales and bank service charges in the sum of \$22,357.00, which it had taken on its federal fiduciary income tax return for the fiscal year ended October 31, 2001. As the Division noted, petitioner did not claim these expenses on its New York fiduciary return for the fiscal year ended October 31, 2001.

Further, it is not possible to trace these expenses to any source documentation provided by petitioner during the audit. In a letter from petitioner's representative to the Division, dated November 8, 2005, in discussing its computation of capital gain on the sale of 333 W. 56<sup>th</sup> Street and 40 E. 94<sup>th</sup> Street, it was disclosed that the statements of closing title for both sales took into account various expenses. A review of the statements provided indicated payment of legal fees and broker's commissions, leaving little doubt that they were included in the calculation of capital gain and making it all but impossible to verify the amounts listed on the federal fiduciary returns, or permit petitioner to include them on the New York returns. In addition, service fees were claimed on the New York Estate Tax Return as well, with no way of verifying if they were part of the fees claimed on the federal fiduciary return for the fiscal year ended October 31, 2001.

With so much confusion over the amounts paid, the conflicts apparent on the returns submitted by petitioner and the inability of petitioner to succinctly and clearly substantiate the deductions it sought to claim, the deductions for attorney, accountants and preparer's fees and for real estate commissions and bank service charges were properly excluded by the Division. Petitioner simply did not meet its burden of proving entitlement to them, regardless of what it claimed on the federal returns for the same period.

E. Petitioner contends that many of the adjustments made or omitted by the Division were contrary to the mission and vision of the agency, i.e., to provide a fair system of tax administration and add to a favorable economic climate. In reviewing this matter, it was evident

that the Division worked diligently for over 18 months to determine the correct amount of tax that was due in the context of complex factual circumstances. The audit would have been even longer except petitioner decided not to waive the period for limitations on assessment after February 2006. Given the information provided, the many communications with the taxpayer and its representatives, both oral and written, and the time taken to study the returns of multiple taxpayers, it can be said with confidence that the Division fulfilled its vision and mission in this case. It was petitioner that failed to provide adequate documentation to support its positions and chose to end discussions with the Division with requests for further documentation outstanding, and with the knowledge that the Division would be forced to quickly issue a notice of deficiency based upon less than adequate documentation.

F. Penalties were assessed based on petitioner's failure to file returns and pay its tax liability in a timely manner due to negligence or intentional disregard of the statute and regulations. (Tax Law § 685[a][1];[b][1], [2].) Petitioner's only argument in support of abating the penalties asserted is that they are not warranted because there is no tax due.

Petitioner did not file timely New York fiduciary income tax returns for the fiscal years ended October 31, 2000 or October 31, 2001, and only came forward after the Division discovered the returns had not been filed. The return filed for the fiscal year ended October 31, 2002 was found to be inaccurate. Further, given the tax determined to be due for these periods and petitioner's failure to pay it, this failure was due to petitioner's negligence. Penalties may be abated if petitioner demonstrates that the failure was due to reasonable cause and not willful neglect. (Tax Law § 685[a][1][A]; *Matter of McCauley v. State Tax Commission*, 67 AD2d 51, 415 NYS2d 118 [1979].) Petitioner has failed to demonstrate reasonable cause for its failure to

file and pay the taxes due, and the imposition of penalties by the Division was justified. (*Matter of Miller v. State Tax Commission*, 94 AD2d 841, 843, 463 NYS2d 306, 307 [1983].)

G. The petition of the Estate of Galina Filipow, as amended, is granted to the extent set forth in Conclusion of Law “C”, but in all other respects is denied, and the Notice of Deficiency, dated January 23, 2006, is sustained.

DATED: Troy, New York  
November 15, 2007

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