STATE OF NEW YORK

DIVISION OF TAX APPEALS

In the Matter of the Petition	:	
of	:	
STEVEN AND JAMIE BABEL	:	DETERMINATION DTA NO. 823681
for Redetermination of a Deficiency or for Refund of Personal Income Tax under Article 22 of the Tax Law for the Years 2002 through 2005.	:	

Petitioners, Steven and Jamie Babel,[1] filed a petition for redetermination of a deficiency or for refund of personal income tax under Article 22 of the Tax Law for the years 2002 through 2005.

A hearing was held before Joseph W. Pinto, Jr., Administrative Law Judge, at the offices of the Division of Tax Appeals, One Penn Plaza, New York, New York, commencing at 11:15 A.M. on December 1, 2011. All briefs were submitted by May 29, 2012, which date began the six-month period for the issuance of this determination. Petitioners appeared by Ballon Stoll Bader & Nadler, P.C. (Norman R. Berkowitz, Esq., of counsel). The Division of Taxation appeared by Mark Volk, Esq. (Marvis A. Warren, Esq., of counsel).

ISSUES

I. Whether the Division properly determined additional personal income tax due from petitioner for the years 2002 through 2005.

[1]Jamie Babel's only involvement in this matter is limited to her filing on a joint basis with Steven Babel, and further references to the taxpayer in this matter will be to Mr. Babel.

II. Whether the Notice of Deficiency was barred by the statute of limitations, in whole or in part.

FINDINGS OF FACT

1. Petitioner, Steven Babel, was the president and sole shareholder of MediaBuss Systems, Inc. (MediaBuss), a New York corporation, during the years 2002 through 2005 (audit period).

2. The Division of Taxation (Division) performed sales and use tax and corporation franchise tax audits of MediaBuss, which covered the years in issue here. These audits determined that additional taxes were due and identified the payment of personal expenses of Steven Babel by MediaBuss. These payments, gleaned from the company's operating bank account, formed the basis of a draw account created by the Division. The income tax matter was referred for audit based on the draw account and labor charges appearing on sales invoices, because the Division believed the items represented additional income to petitioner that had not been included by Mr. Babel on his individual tax returns.

3. The Division began its personal income tax audit of petitioner on or about June 21, 2007 with a written request for books and records for the period January 1, 2004 through December 31, 2005. A second request was sent to the business address of MediaBuss on July 16, 2007. On August 28, 2007, the Division sent petitioner's representative, Mr. Norman Berkowitz, an information and document request.

4. The request for records specifically asked whether petitioner had an interest in any S corporations, a description of that business, and all books, records, worksheets and schedules pertinent to the preparation of his tax returns. The request also asked for copies of forms K-1 issued to him by the corporation and substantiation of any loans petitioner claimed he made to the corporation. The request also sought documentation of schedules A and E and any form 2106

deductions for unreimbursed employee business expenses. On December 6, 2007, the Division received federal forms 1040 for the years 2001, 2002, 2003, 2004 and 2005. No other information was ever provided, despite additional oral requests for books and records.

5. Although the Division's auditor presented preliminary findings to petitioner's representative on April 25, 2008 and met with him on June 9, 2008, no further documentation was ever received by the Division.

6. The Division's auditor reviewed the New York personal income tax returns he had on hand, the federal income tax returns produced by petitioner and the MediaBuss draw and operating accounts from the sales and corporation franchise tax audits.

7. In examining the bank reconciliation statement for the operating account that had been produced to the Division on the sales tax audit, it was apparent that many expenses were personal in nature. The Division's auditor (the same auditor in both the franchise and personal income tax audits) created a draw account profile from the information in the bank reconciliation that he believed reflected personal expenses paid by the corporation on behalf of Mr. Babel. Typical expenses included in the draw account were payments for Bloomingdales, bottled water, private schools, ATM withdrawals, Olympia pool service, Lord and Taylor, Capital One, Discover card and T & R Jewelers. Although the Division sought explanations of the payments from petitioner, it received none, either in the franchise tax audit or in the instant personal income tax audit.

8. In the corporation franchise tax audit, the Division added the unreported additional income it calculated for each year to entire net income reported by the corporation on the returns it filed. The Division then added other income discovered in the sales tax audit and the disallowed expenses contained in Mr. Babel's draw account to find entire net income as adjusted. The calculated business allocation percentage was applied to this figure to arrive at allocated income,

which, in each of the years audited, equaled the entire net income base to which the tax rate was applied to determine the tax due. The following chart illustrates this for the years in issue[2]:

Year	Income Reported	Adjusted ENI	BAP	ENI Base	Tax Rate	ENI Base Tax
2002	0	$1,597,633	65.0672	$1,039,535	7.5	$77,965
2003	$71,010	$1,605,156	77.0250	$1,236,372	7.5	$92,728
2004	$139,343	$1,380,908	68.9439	$952,052	7.5	$71,404
2005	0	$893,425	76.6780	$685,060	7.5	$51,380

9. The disallowed expenses contained in Mr. Babel's draw account, as determined on audit, were as follows:

YEAR	Disallowed Draw Expense
2002	$220,182.00
2003	$322,842.00
2004	$370,404.00
2005	$754,182.00

Also relevant to petitioner's legal argument with regard to the Division's assertion of constructive dividends is the profit computed for MediaBuss in the franchise tax audit:

YEAR	Gross Profit
2002	$1,365,035

[2]Official notice is being taken of the record of another matter before the Division of Tax Appeals pursuant to State Administrative Procedure Act § 306(4), which provides that "official notice may be taken of all facts of which judicial notice could be taken and of other facts within the specialized knowledge of the agency." Courts of the State of New York may take judicial notice of their own record of the proceeding of the case before them, the records of cases involving one or more of the same parties or the records of cases involving totally different parties (***Berger v. Dynamic Imports, Inc.***, 51 Misc 2d 988, 274 NYS2d 537; 57 NY Jur 2d, Evidence and Witnesses, § 47). The record of the proceeding before the Division of Tax Appeals of which official notice is being taken is ***Matter of MediaBuss Systems, Inc***, (Division of Tax Appeals, November 29, 2012) and ***Matter of MediaBuss Systems, Inc.,*** (Division of Tax Appeals, November 29, 2012), copies of which were duly served on petitioner's representative (***Matter of Kolovinas***, Tax Appeals Tribunal, December 28, 1990).

2003	$1,233,082
2004	$754,321
2005	$55,693

10. The auditor was presented with no evidence that any part of the disallowed draw expenses was reported on petitioner's tax returns, and no documentary or testimonial evidence was produced at hearing, despite Mr. Babel's presence thereat.

11. MediaBuss had misfiled as an S corporation during the years in issue, but the Division determined that it did not reflect any of the draws on the schedules K-1 for the years in issue. Since the corporation was deemed a Tax Law Article 9-A corporation, the Division concluded that the payment of Mr. Babel's personal expenses amounted to constructive dividends, and although not argued by petitioner, the additional income was not claimed as salary from MediaBuss on his personal income tax returns for the years in issue.

12. The Division calculated additional income by adding the amounts treated as constructive dividends to petitioner's income.[3] For each of the years in issue, the audited adjusted gross income (AGI) indicated that omitted income totaled more than 25% a year.

13. Despite the reference to a consent for extension of the period of limitations on assessment in the auditor's log for the year 2004, the Division never submitted a consent into evidence.

14. The Division issued a Notice of Deficiency to petitioner, dated October 20, 2008, for the years 2001 through 2005, which asserted additional personal income tax due in the sum of $198,569.00, penalties of $134,096.47 and interest of $70,681.96 for a total amount due of

[3]Originally, the figure for constructive dividends included labor charges taken from sales invoices. This amount was excluded by the conferee. Labor charges were $147,356.00 for 2002, $52,811.00 for 2003, $53,720.00 for 2004 and $23,375.00 for 2005.

$403,347.43. Fraud penalty was imposed pursuant to Tax Law § 685(e)(1) and (2) on the basis of the Division's determination that petitioner consistently and substantially understated New York income in ignoring the payment of his personal expenses by Mediabuss.

15. At the Bureau of Conciliation and Mediation Services conference, the conferee canceled the tax, penalties and interest for the year 2001 and modified the tax due for the remaining years by eliminating the labor charges taken from sales invoices. The conferee also canceled the fraud penalty and imposed penalties pursuant to Tax Law § 685(b)(1), (2) and (p) for negligence and substantial understatement of liability.

Recomputed tax pursuant to the conciliation order, dated April 2, 2010, was $132,542.00, plus the penalties mentioned above and statutory interest.

SUMMARY OF THE PARTIES' POSITIONS

16. Petitioner contends that the Notice of Deficiency was not timely issued for all years except 2005, since the notice was issued after the expiration of more than three years from the date of filing the return. Further, petitioner argues that the Division provided no proof that the notice was mailed by registered or certified mail, as required by statute.

17. Petitioner argues that the draw account expenses may not be treated as constructive dividends because dividends may only be declared or paid out of surplus, which term is more fully described by the Internal Revenue Code as accumulated earnings or profits. Further, any distributions by a corporation that has no current or accumulated earnings and profits are not taxable as a dividend. Since Mediabuss had no surplus, based on the Division's own computations, it could not have issued dividends.

18. Petitioner contends that the tax calculation by the Division was flawed because it failed to account for income from MediaBuss that had already been declared by petitioner. Petitioner

notes that the auditor admitted he failed to adjust for the MediaBuss income previously included in AGI, and that the draw account could have contained loan repayments by Mediabuss as well.

19. Petitioner argues that the testimony of the Division's witness at hearing was not credible because of long, vague answers and lack of recall and the need to be instructed by the administrative law judge on several occasions.

20. The Division argues that the Tax Law gives it the authority to examine and determine the amount of tax due from information in its possession if a return is not filed. Given the lack of books and records available for review, the Division contends that it properly determined additional tax due using a reasonable methodology, and it was petitioner's burden to show that the determination was erroneous.

21. With respect to the timely issuance of the Notice of Deficiency, the Division notes that Tax Law § 683(d) provides that tax may be assessed at any time within six years after a return is filed if a return is filed which omits income by more than 25%. Since the Division believes it has demonstrated such an omission for each of the years in issue, it submits the notice was timely.

22. The Division objects to petitioner's argument that no proof of mailing was presented to establish timely mailing of the notice on the grounds that it was a factual issue that had not been raised at any time prior to submission of briefs, thus precluding the Division from submitting any proof on the matter.

23. The Division contends that petitioner had ample opportunity to submit documentation or testimony to first shape and then refute the audit findings but chose not to do so. It argues that the strongest negative inference be made against petitioner, the 100% shareholder and president of the company, who attended the hearing and chose not to testify, because he was in the best position to explain loan repayments, personal expenses and provide substantiating documentation.

CONCLUSIONS OF LAW

A. Initially, it is noted that the validity of multi-audits has been confirmed (***Matter of Costa***, State Tax Commission, June 28, 1985; ***Matter of Giuliano v. Chu***, 135 AD2d 893, 521 NYS2d 883 [1987]; ***Matter of Cousins Service Station, Inc.***, Tax Appeals Tribunal, August 11, 1988). In this matter, in light of the numerous requests for petitioner's books and records, not required in income tax audits, and petitioner's failure to satisfy said requests, the Division's reliance on its audit work and conclusions in its sales tax audit was appropriate. It is also appropriate for this forum to take notice of that audit and its results, since the record in that matter is one of which official notice may be, and is, taken.[4]

B. Tax Law § 681(a) provides, in part, as follows:

> If upon examination of a taxpayer's return under this article the tax commission determines that there is a deficiency of income tax, it may mail a notice of deficiency to the taxpayer.

As the statute suggests, there is a profound difference between the audit methodologies required in sales tax and corporation franchise and income tax. In ***Matter of Mountain Star Company, Inc.*** (Tax Appeals Tribunal, March 13, 2008), the Tribunal stated:

> However, this argument ignores the critical distinction between section 1138(a)(1) and its franchise tax counterpart, section 1081(a). Section 1081(a) provides that if a taxpayer required to file a franchise tax return fails to do so, "the [Division] is authorized to estimate the taxpayer's New York tax liability from <u>any information in its possession</u>" (emphasis added). Unlike section 1138(a)(1), section 1081(a) contains no preconditions to the Division's use of estimate techniques. In our view, if the Legislature's intention was to require a complete examination of a non-filing corporation's records before estimation techniques are permitted, it would have stated this intention within section 1081(a).

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[4]See footnote 2 above.

Similarly, in ***Matter of R & J Automotive*** (Tax Appeals Tribunal, June 15, 1989), the Tax Appeals Tribunal sustained a franchise tax deficiency and held that the audit standards required in sales and use tax cases was inapplicable, stating as follows:

> This standard, requiring demonstrably inadequate records before an indirect auditing technique may be used, has been explicitly rejected in audits of income for personal income, non-resident earnings and unincorporated business taxes (Matter of Giuliano v. Chu, 135 AD2d 893 [1987]; Matter of Hennekens v. State Tax Commn., 114 AD2d 599 [1985]). The distinction between an income tax audit and a sales tax audit centers on the type of tax being imposed (Hennekens v. State Tax Commn., supra). While sales tax audits seek recovery of taxes imposed directly upon verifiable receipts as evidenced by books and records which are required to be maintained (Matter of Licata v. Chu, 64 NY2d 873, 874 [1985]) 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).

In this matter, although not required to do so, the Division made requests for petitioner's records in an attempt to determine the accuracy of the returns filed for the years in issue. Petitioner supplied only copies of his federal individual income tax returns. Petitioner failed to produce any further evidence at hearing and, thus, did not meet his burden of proof. (Tax Law § 689[e]; ***Matter of Suburban Restoration Company, Inc. v. Tax Appeals Tribunal***, 299 AD2d 751 [2002].) That meant overcoming the deficiency by clear and convincing evidence, showing that the methodology utilized by the Division and the deficiency itself were erroneous (***Matter of Giuliano v. Chu***; Tax Law § 1089[e]). Petitioner has failed on both counts.

It is true, as petitioner argues, 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 [1984]; ***Matter of Rosenthal v. State Tax Commission***, 102 AD2d 325, 477 NYS2d 767 [1984]). However, he has not carried his burden of establishing that this was the case herein (***Matter of Leogrande v. Tax Appeals Tribunal***, 187 AD2d 768, 589 NYS2d 383 [1992] ***lv denied*** 81 NY2d 704, 595 NYS2d

398 [1993]). It is concluded that both the audit methodology and the notice of deficiency had rational bases and are sustained.

The most obvious source of support for his petition would have been credible testimony. Instead, petitioner failed to testify in his own behalf, which must be held and construed most strongly against him (***cf. Matter of Meixsell v. Commissioner of Taxation***, 240 AD2d 860, 659 NYS2d 325 [1997], ***lv denied*** 91 NY2d 811, 671 NYS2d 714 [1998], ***Matter of Greenwald***, Tax Appeals Tribunal, November 24, 1993). As the record reveals, Mr. Babel was in the best position to provide an explanation of the draw account and provide the proof necessary to establish that the Division's audit assumptions and methodology were erroneous. Instead, although present in the hearing room, he chose to remain silent, and that silence is deafening.

C. The primary legal argument raised by petitioner is his contention that the draw account expenses may not be construed as constructive dividends. In support of his argument, petitioner cites Business Corporation Law § 510(b), which provides that dividends may only be paid out of surplus. He believes this is further supported by IRC § 316, which provides that a dividend is any distribution by a corporation to its shareholder out of accumulated earnings or profits.

It is well settled that corporate funds diverted by an individual for his own use and not returned to the corporation, or its creditors, in that year constitute taxable income (***Rutkin v. United States***, 343 US 130 [1952]). A crucial concept in finding a constructive dividend is that a corporation has conferred a benefit on the shareholder in order to distribute available earnings and profits without the expectation of repayment (***Noble v. Commissioner***, 368 F2d 439 [1966]).

Initially, it is noted that petitioner never denied that the expenses were paid or that he benefitted from the payment of expenses in his behalf. He also did not dispute the amount of the expenses paid. What petitioner now maintains is that the corporation could not have paid the

constructive dividends out of surplus or accumulated earnings or profits because the Division's own computations indicate that MediaBuss did not have any surplus for the years in issue. This allegation is unsupported by petitioner and in direct conflict with the gross profit figures calculated in the franchise tax audit set forth in Finding of Fact 9. For each of the years 2002, 2003, 2004 and 2005, in accordance with the Division's calculations for determining franchise tax, MediaBuss had profits for all years left in issue here. With the exception of 2005, the constructive dividends attributed to petitioner were within the gross profit values set forth in Finding of Fact 9. For the year 2005, the constructive dividend would be limited to $55,693.00, the value of the calculated gross profit, "taking into account accrued corporate taxes resulting from the diverted income." (IRC § 316[a][2]; ***Pittman v. Commissioner of Internal Revenue***, 69 TCM 2799 ***affd*** 100 F3d 1308 [1996].) Since petitioner provided no evidence of accrued corporate taxes resulting from the draw account diverted income, it is assumed that there was none. The Division is directed to recompute the constructive dividend for 2005, limiting the constructive dividend to the amount of the gross profit. (***See Matter of Demmon v. United States***, 321 F2d 203 [7th Cir 1963].)

D. Petitioner maintains that the auditor who testified at hearing was not credible, noting his failure to recall details, give direct answers to questions and requiring the administrative law judge to instruct him on several occasions. This was not the case. Although there were certainly times he could not recall specific details from a complicated audit trail, the substantial portion of his testimony is corroborated by the audit log and documentary evidence, i.e., audit workpapers, audit reports and schedules contained in this matter and the sales and franchise tax audits, the latter of which was conducted by this same auditor. In addition, any answers that petitioner contends were abstract and vague, were often the result of vague and abstract questions. In sum,

the auditor's testimony was credible and adequately supported by the audit documentation. While it is true that the administrative law judge instructed the witness to answer more concisely, these interjections were meant to create a clear record. When a witness has trouble focusing or understanding questions in the context of litigation, it is within the authority of the administrative law judge to assist the witness in presenting himself in a clear and concise manner. The transcript of proceedings fully supports this procedure in this matter.

E. Petitioner has raised a new factual issue for the first time in his brief concerning the issuance of the notice of deficiency. Petitioner contends that the Division failed to prove that the notice was issued by certified or registered mail, as prescribed by Tax Law § 681(a). Since the raising of an issue of fact is not permissible after the record is closed, petitioner's request for relief on this basis is denied. The Tribunal has consistently held that the raising of new factual issues after the hearing would disadvantage the party who had the burden of establishing the disputed fact (***Matter of Chuckrow***, Tax Appeals Tribunal, July 1,1993; ***Matter of Sandrich***, ***Inc***., Tax Appeals Tribunal, April 15, 1993).

F. Petitioner contends that the six-year statute of limitations provided for in Tax Law § 683(d) should be disallowed because the Division did not carry its burden of demonstrating that he omitted in excess of 25% of his New York adjusted gross income stated in his return. As noted in the audit results set forth above, it has been determined that petitioner did, in fact, omit far more than 25% of his New York adjusted gross income stated in his return. Therefore, the Notice of Deficiency was timely issued for all years in issue.

G. The petition of Steven and Jamie Babel is granted to the extent set forth in Conclusion of Law C, and the Notice of Deficiency, dated October 20, 2008, as modified by the Conciliation Order, dated April 2, 2010, is sustained.

DATED: Albany, New York
November 29, 2012

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