

STATE OF 'NEW YORK

STATE TAX COMMISSION

In the Matter of the Petition

of

LAWRENCE KRUG and CAROLE KRUG

DECISION

for Redetermination of a Deficiency or for
Refund of Personal Income Tax under Article 22 :
of the Tax Law for the Years 1979 through 1981.

Petitioners, Lawrence Krug and Carole Krug, 1 Winston Court, Dix Hills, New York 11746, 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 1979 through 1981 (File No. 43285).

A hearing was held before Allen Caplowaith, Hearing Officer, at the offices of the State Tax Commission, Two World Trade Center, New York, New York, on July 23, 1985 at 9:15 A.M., with additional information to be submitted by August 23, 1985. Petitioners appeared pro se. The Audit Division appeared by John P. Dugan, Esq. (Angelo A. Scopellito, Esq., of counsel).

ISSUES

I. Whether the Audit Division properly determined that funds withdrawn by petitioner Lawrence Krug from his professional corporation were taxable as salary.

II. Whether expenses incurred by petitioners during 1976 in connection with the rental of a condominium to petitioner Lawrence Krug's professional corporation were deductible as expenses incurred in the production of income.

III. Whether penalties imposed pursuant to sections 685(a)(1), 685(a)(2) and 685(b) of the Tax Law should be waived.

FINDINGS OF FACT

1. Petitioners, Lawrence Krug and Carole Krug, filed New York State income tax resident returns for the years 1979 through 1981. They filed joint returns for 1979 and 1981 and separately on one return for 1980.

2. On January 12, 1983, the Audit Division issued three notices of deficiency against petitioners asserting personal income tax due as follows:

<u>Petitioner</u>	<u>Years</u>	<u>Tax</u>	<u>Penalty</u>	<u>Interest</u>	<u>Total</u>
Lawrence Krug	1979 & 1981	\$3,921.83	\$ 226.30	\$1,059.87	\$5,208.00
Lawrence Krug	1980	\$4,219.48	\$1,392.42	\$ 949.38	\$6,561.28
Carole Krug	1980	\$ 52.46	\$ 17.31	\$ 11.80	\$ 81.57

Among the adjustments made on audit, petitioner¹ objected to two items: a disallowance of a deduction for a **loss** incurred from the rental of property and the inclusion in income of certain funds withdrawn from petitioner's professional corporation. **All** other adjustments, with the exception of penalties, were conceded by petitioners.

3. Petitioner **is a** certified public accountant and sole shareholder of a professional corporation, Lawrence M. Krug, P.C. ("the P.C."). Petitioner did not maintain a personal checking account; all of his expenses, both personal and business were paid out of the P.C. checking account. Any personal expenses paid out of the P.C. account were charged as a debit to the P.C. withdrawal account. If petitioner received income from outside the P.C. from municipal bonds or interest payments, he would occasionally deposit such funds in the P.C. checking account. These deposits would be posted as credits to the withdrawal account. Petitioner thought that he could maintain better control

1 Unless otherwise indicated, all references to petitioner are to him.

of his funds by combining his business and personal income and expenses **in** one account. The addition of the outside funds to the P.C. enabled the P.C. to be in a better cash flow position to carry on corporate activity and it also allowed petitioner to heavily fund his pension plan. Petitioner was building up a prepaid trust account to fund his pension plan since he had funded it for more than the allowable deduction for such **a** plan.

4. At the end of the fiscal year, when computing his salary for tax purposes, petitioner determined the gross fees of the P.C. less its expenses and reported this amount as his salary on his tax returns. **On** the P.C. books, petitioner debited salary expense by the amount so computed. He then offset his contributions to the P.C. through the withdrawal account against his withdrawals for the year. He then credited the withdrawal account by the amount **of** net withdrawals in order **to** have **a** zero balance at the end of the fiscal year. Petitioner then credited the loans payable to officers account by the difference between the computed salary expense and the net withdrawals.

5. On audit of the P.C. records, the Audit Division found that for the fiscal year ended July 31, 1979, petitioner debited the withdrawal account \$71,417.13 and credited the account \$31,363.13. Of the amount debited, the auditor determined that \$19,171.75 had been erroneously debited to the withdrawal account and that said amount should have been debited as a prepaid asset to the retirement trust account. Therefore, petitioner's actual withdrawals from the P.C. were computed to be \$52,245.38. The auditor determined the latter amount to be petitioner's correct salary for the year. Petitioner had reported salary of \$36,625.00 **on** his return; thus, he was considered to have \$15,620.38 in additional salary income. The auditor deemed the non-P.C. income which was deposited in the P.C. account to be either contributed to the P.C. or

the corporation which, in either case, could not be offset against petitioner's withdrawals in computing salary.

6. Petitioner purchased a condominium apartment in Florida in 1977 for \$32,000.00 intending to rent it to others year round except for ten days each year of personal use during Christmas vacation. Instead of renting it to others, he decided to rent it to the P.C. since the P.C. had several major clients in Florida which required petitioner to make four to six business trips per year to that state. Rather than staying in hotels, petitioner thought he could save the P.C. money by utilizing the condominium. Petitioner charged the P.C. \$400.00 per month rent. During 1979, the year in issue, the fair market rental value for a furnished apartment similar in size and location to petitioner's apartment **was** approximately \$500.00 per month on a year-round rental basis.

7. In 1979, petitioner's total rent from the apartment was \$4,800.00 less depreciation of \$1,454.00 and other expenses of \$4,903.23 for a resulting loss of \$1,557.23. The rental income and expenses were reported on petitioner's Federal and State returns. In 1980, petitioner had net income of \$193.31 from the apartment and, in 1981, the net income was \$13.45. On audit, the Audit Division disallowed the loss for 1979 stating that: "**A loss** due to the rental of property at below fair market value cannot be allowed if the transaction is directly or indirectly between related taxpayers."

8. The Internal Revenue Service audited petitioners' 1979 Federal income tax return specifically with respect to rental income and expenses and four other items not at issue herein. On July 31, 1981, the Service notified petitioners that no change in the tax reported was required as a result of the examination.

9. The Audit Division asserted a negligence penalty under section 685(b) of the Tax Law for 1979 by reason of the fact that petitioner was an accountant and the auditor thought he had negligently prepared the 1979 return. For tax years 1980 and 1981, petitioners did not file their returns until after completion of the audit in September, 1982. For 1980, they had received an extension of time to file until September 15, 1981 and, for 1981, they had received an extension of time to file until August 15, 1982. The Audit Division asserted penalties for 1980 and 1981 for failure to file a return and failure to pay the tax under sections 685(a)(1) and 685(a)(2) of the Tax Law. Petitioner requested that the penalties be waived due to extenuating circumstances during the years in issue, including the untimely death of his mother which resulted in some difficult emotional problems for him. He also asserted that he was involved in extensive litigation involving his business which took him away from his work for a lengthy period of time. Petitioner, however, did not give any details regarding these events such as dates and the length of time over which they occurred.

CONCLUSIONS OF LAW

A. That the New York adjusted gross income of a resident individual is his Federal adjusted gross income for the taxable year with certain modifications. Tax Law §612(a). Federal adjusted gross income means gross income minus certain deductions. I.R.C. §62. Gross income means all income from whatever source derived except for those items specifically excluded. I.R.C. 561.

B. That all income which petitioner received from the P.C. was properly includible as income to petitioner. Funds which petitioner deposited in the P.C. account from outside the corporation became corporate funds and could not be used to offset funds withdrawn from the corporation for personal use. The funds deposited in the P.C. account were either contributed to the corporation or

the corporation or loans to the corporation which, in either case, were used by the corporation for corporate purposes, whether to put the P.C. in a better cash flow position or to fund the pension plan. The P.C. was a separate entity from petitioner and by commingling his personal and business income and expenses he was attempting to blur the distinction between the two entities. Petitioner treated the P.C. as if it were a sole proprietorship; this was improper and the \$52,245.38 received from the P.C. during 1979 was includible in income for tax purposes.

C. That section 183 of the Internal Revenue Code provides generally that no deduction attributable to an activity not engaged in for profit shall be allowed except as otherwise provided. An activity not engaged in for profit is an activity other than one with respect to which deductions are allowable under sections 162 or 212 of the Internal Revenue Code. Such deductions include deductible business expenses for property either used in a trade or business or held for the production of income. Thus, the operating expenses and depreciation relating to renting the apartment to the P.C. would be deductible if the property were held for the production of income.

D. That "[t]he key requirement under both section 162 and section 212 is that the taxpayer must have engaged in the activity with an actual and honest objective of making a profit (citations omitted). The taxpayer's profit objective must be bona fide, although it need not be reasonable, and greater weight is assigned to objective facts rather than the taxpayer's stated intent." Scull v. Commissioner, 45 T.C.M. 545. Based on the evidence presented, petitioner has not met his burden of proving the requisite profit objective. First, petitioner rented the apartment to a related party, the P.C., which consisted entirely of himself. Second, he rented the apartment to the P.C. for a nominal amount.

knowing this would result in a loss or at most a negligible profit. Third, he continued to use **the** apartment for his vacations. Overall, the rental plan with the P.C. appears to have been a convenient means of obtaining a deduction for the apartment rather than as a bona fide attempt to make a profit from its ownership. The auditor therefore properly disallowed the loss for 1979.

E. That section 685(b) of the Tax Law provides for a penalty if any part of a deficiency is due to negligence or intentional disregard of the Tax Law. Despite the fact that petitioner is an accountant, the deficiency was comprised primarily of items which had an arguable basis in fact and law and there was no intention to disregard the law. Therefore, the penalty imposed under section 685(b) is cancelled

F. That sections 685(a)(1) and 685(a)(2) of the Tax Law provide for penalties for failure to file a tax return and failure to pay the tax shown on the return, respectively, unless it is shown that such failure is due to reasonable cause and not due to willful neglect. Reasonable cause may include death or serious illness of the taxpayer, a member of his family or his employer or unavoidable absence of the taxpayer or employer from his usual place of business. 20 NYCRR 102.8(b)(1) and (2). Petitioner, however, has failed to show when any of the hardships occurred and how they affected his ability to file tax returns when they did not affect his ability to file for extensions of time. There was, therefore, no reasonable cause for failure to file the returns and pay the tax.

G. That the petition of Lawrence Krug and Carole Krug is granted to the extent indicated in Conclusion of Law "E"; that the Audit Division is directed


to modify the notices of deficiency issued January 12, 1983 accordingly; and that, except as so granted, the petition is in all other respects denied.

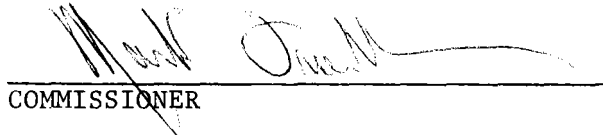
DATED: Albany, New York

STATE TAX COMMISSION

JAN 24 1986


PRESIDENT


COMMISSIONER


COMMISSIONER