STATE OF NEW YORK

STATE TAX COMMISSION

In the Matter of the Petition

of

MICHAEL D'ANGELO (DECEASED)

for Redetermination of a Deficiency or for Refund of Personal Income and Unincorporated Business Taxes under Articles 22 and 23 of the Tax Law for the Years 1979, 1980 and 1981. :

DECISION

Petitioner, Michael D'Angelo (deceased), 254 Park Avenue, East White Plains, New York 10604, filed a petition for redetermination of a deficiency or for refund of personal income and unincorporated business taxes under Articles 22 and 23 of the Tax Law for the years 1979, 1980 and 1981 (File No. 46417).

A hearing was held before James Hoefer, Hearing Officer, at the offices of the State Tax Commission, Two World Trade Center, New York, New York, on September 12, 1985 at 1:15 P.M. Petitioner appeared by Raymond P. Liverzani, C.P.A. The Audit Division appeared by John P. Dugan, Esq. (Irwin A. Levy, Esq., of counsel).

ISSUE

Whether it was proper for the Audit Division to increase petitioner's reported net income for personal income and unincorporated business tax purposes based upon the results of a sales tax audit.

FINDINGS OF FACT

1. Petitioner, Michael D'Angelo (deceased), and his spouse, Grace D'Angelo, timely filed joint New York State income tax resident returns for the years 1979 and 1980. For the year 1981, Michael D'Angelo and Grace D'Angelo timely filed separate New York State income tax returns. The primary source of income

reported on all three returns in question was generated from the operation of a retail liquor store known as Lexington Liquor Store (hereinafter "the liquor store"). The net profit realized from the liquor store totalled $20,430.27 for 1979, $20,189.07 for 1980 and $30,094.45 for 1981. One-half of the liquor store's net profit for 1981 was reported on Michael D'Angelo's separate return, while the other half was reported by Grace D'Angelo on her separate return. In addition to his personal income tax returns, petitioner Michael D'Angelo filed unincorporated business tax returns for 1979 and 1980, reporting thereon the net profit generated from his operation of the liquor store. No unincorporated business tax return was required to be filed for the year 1981.

2. Prior to his death on May 10, 1981, Michael D'Angelo owned and operated the liquor store as a sole proprietor. After his death, Grace D'Angelo took over the operation of said liquor store and, like her husband, conducted business as a sole proprietor.

3. In the latter part of 1981, the Audit Division, through the sales tax audit section of its White Plains District Office, conducted a field audit of the liquor store to determine if the proper amount of sales tax was reported and remitted. The sales tax audit was conducted using a purchase markup analysis, however, the reason for the Audit Division's resort to external indices is unknown. The purchase markup analysis initially resulted in the assertion of additional taxable sales of $53,100.27 for the period September 1, 1978 through August 31, 1981. To determine additional taxable sales of $53,100.2 the Audit Division marked up wine purchases 53.014 percent, while liquor purchases were marked up 17.080 percent. The markup on wine was subsequently reduced to 47.817 percent, thus reducing additional taxable sales to $43,821.18. The sales tax audit resulted in additional sales tax due of $2,191.06 plus

interest and, because of the relatively small amount of tax due, Grace D'Angelo ultimately consented to the assessment. Mrs. D'Angelo was not informed at any point in the course of the sales tax audit that the results would or might be employed to determine personal income and unincorporated business tax deficiencie

4. After Grace D'Angelo consented to the results of the sales tax audit, said results were forwarded to the income tax audit section in the White Plains District Office. An income tax field audit was subsequently commenced and the income tax auditor assigned to the case performed a cash availability analysis to verify the accuracy of reported net income for the year 1980. Said cash availability analysis resulted in an understatement of net income for 1980 in the amount of $731.00. Since the sales tax audit findings produced a significantly higher adjustment than the cash availability analysis, the income tax auditor elected to utilize the sales tax adjustments as a basis for recomputing petitioner's personal income and unincorporated business tax liabilities.

5. In order to make the sales tax audit adjustments applicable for personal income and unincorporated business tax purposes, the income tax auditor made the following determinations:

(i) that the increase in gross sales of $43,821.18 determined pursuant *to* the sales tax purchase markup analysis resulted in additional net income for personal income and unincorporated business tax purposes of $43,821.18; and

(ii) that since the sales tax audit encompassed the period September 1, 1978 through August 31, 1981, the additional income of $43,821.18 was apportioned to the calendar years 1978[1], 1979, 1980 and 1981 in the sums of $4,229.53, $13,686.45, $15,621.65 and $10,283.55, respectively.

6. On December 15, 1982, the Audit Division issued three statements of audit changes to petitioner for the years 1979, 1980 and 1981. On two of the statements of audit changes, the Audit Division proposed to increase reported income for personal income and unincorporated business tax purposes by $14,486.45 for 1979 and by $16,456.01 for 1980. Said increases were computed as follows:

	1979	1980
Additional income per sales tax audit	$13,686.65	$15,621.65
Disallowed insurance expenses as personal	800.00	834.36
Net increases	$14,486.65	$16,456.01

On the third statement of audit changes, the Audit Division proposed, ~~inter alia~~, to increase Mr. D'Angelo's reported income for 1981 by $10,283.55 for additional income per the sales tax audit and also by $800.00 for disallowed insurance expenses. The Audit Division also asserted that "[S]ince Schedule C income (for 1981) is not a partnership the allocation between husband and wife is disallowed." The Audit Division recomputed Mr. and Mrs. D'Angelo's 1981 personal income tax liability on a joint return basis rather than on a separate return basis since recomputation in this manner produced a lower tax due.

7. Based on the aforementioned three (3) statements of audit changes, the Audit Division, on April 11, 1983, issued two (2) notices of deficiency to

1 The calendar year 1978 is not at issue in this proceeding as the general three year statute of limitations had expired before completion of the income tax audit.

Michael D'Angelo (deceased)[2]. One Notice of Deficiency was for the years 1979, 1980 and 1981 and asserted additional personal income tax due of $6,624.62[3], plus penalty[4] of $132.48 and interest of $1,509.64, for a total allegedly due of $8,266.74. The second Notice of Deficiency was for the years 1979 and 1980 and asserted additional unincorporated business tax due of $1,266.39, plus interest of $320.82, for a total allegedly due of $1,587.21.

8. It is petitioner's position that the sales tax audit findings were erroneous for a number of reasons. First, it has been established that there was an increase in inventory of $10,694.17 from January 1, 1979 to December 31, 1981 and that said inventory increase was not considered in the sales tax audit. Petitioner further argued that the use of the test period September, October and November of 1979 to determine the percentage of liquor purchases to total purchases and the percentage of wine purchases to total purchases and the

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2 Although joint personal income tax returns were filed for 1979 and 1980 and the D'Angelos' 1981 personal income tax liability was recomputed on a joint return basis, the record does not disclose why the notice of deficiency asserting personal income tax due was issued solely to Michael D'Angelo (deceased).

3 The tax due of $6,624.62 was computed giving Mr. D'Angelo credit for an overpayment of $748.74 due Mrs. D'Angelo for the year 1981. The $748.74 overpayment due Mrs. D'Angelo was caused by the Audit Division's recomputation of the D'Angelos' 1981 personal income tax liability on a joint return basis. (See Finding of Fact "6", supra.)

4 It is unclear exactly what penalty was being asserted due. Moreover, no penalty was asserted due in any of the three (3) underlying statements of audit changes and the narrative portion of the field audit report indicated that "No penalties were asserted." Furthermore, the returns in question were all timely filed and petitioner also made payments into an estimated tax account for each year at issue in amounts sufficient to avoid the Tax Law §685(c) penalty. Finally, there has been no assertion

use of the month of October, 1981 to determine markup percentages was inappropriate since these months were too close to the holiday season and therefore produced a distorted result. Finally, petitioner's certified public accountant performed his own markup test for wine and liquor and concluded that wine was marked up approximately 43 percent and that the liquor markup was approximately 15 percent.

9. Petitioner agrees to the adjustment which disallowed certain insurance expenses as personal. The disallowed insurance expenses totalled $800.00 for 1979, $834.36 for 1980 and $800.00 for 1981.

CONCLUSIONS OF LAW

A. That it is proper to use a purchase markup analysis to reconstruct a taxpayer's net income for income tax purposes (Matter of William T. Kelly, State Tax Comm., December 31, 1984). However, in the instant matter, petitioner has presented sufficient evidence which would tend to show that there were errors in the sales tax audit (e.g. failure to consider an inventory increase; the existence of lower markup percentages on wine and liquor; and the use of test periods too close to the holiday season).[5] Moreover, the cash availability analysis for 1980 (an audit methodology designed to determine a taxpayer's net income, as opposed to the purchase markup analysis which determines gross sales) disclosed only a negligible understatement of income. Under these circumstances, it cannot be held that the sales tax audit results constituted a proper basis to determine petitioner's income and unincorporated business tax liability.

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5 It must be noted that Grace D'Angelo has previously consented to the sales

Accordingly, the proposed increases to petitioner's income which were based on said sales tax audit results must be deleted from the two notices of deficiency dated April 11, 1983.

B. That pursuant to Finding of Fact "2", supra, Michael D'Angelo owned and operated the liquor store until his death on May 10, 1981, and that Grace D'Angelo owned and operated said liquor store after this date. Accordingly, both Michael D'Angelo and Grace D'Angelo reported the proper amount of the liquor store's net profit on their separate 1981 returns and the Audit Division incorrectly recomputed Mr. and Mrs. D'Angelo's 1981 liability on a joint return basis.

C. That it cannot be determined from the record why a penalty of $132.48 was asserted due in one of the notices of deficiency or even what penalty was being assessed. Furthermore, the evidence presented supports that the income tax auditor did not recommend the assertion of any penalties and there appears to be no basis for the assertion of any penalties against petitioner (see footnote "4", supra). Accordingly, the penalty in the amount of $132.48 is cancelled.

D. That pursuant to Finding of Fact "9", supra, the Audit Division properly disallowed insurance expenses of $800.00 for 1979, $834.36 for 1980 and $800.00 for 1981.

E. That the petition of Michael D'Angelo (deceased) is granted to the extent indicated in Conclusions of Law "A", "B" and "C", supra; that the Audit Division is directed to recompute the notices of deficiency dated April 11, 1983

consistent with **the conclusions rendered herein; and that, except as so granted the petition is** in **all other respects denied.**

DATED: **Albany, New York**

[illegible] 1986

STATE TAX COMMISSION

PRESIDENT

COMMISSIONER

COMMISSIONER