

STATE OF NEW YORK

TAX APPEALS TRIBUNAL

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In the Matter of the Petition :  
of :  
**STEVEN AND JAMIE BABEL** : DECISION  
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. :

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Petitioners, Steven and Jamie Babel, and the Division of Taxation each filed an exception to the determination of the Administrative Law Judge issued on November 29, 2012. Petitioners appeared by Ballon Stoll Bader & Nadler, P.C. (Norman R. Berkowitz, Esq., of counsel). The Division of Taxation appeared by Amanda Hiller, Esq. (Marvis A. Warren, Esq., of counsel).

The Division of Taxation filed a brief in support of its exception. Petitioners did not file a brief in support of their exception, but instead relied upon their brief submitted to the Administrative Law Judge. Petitioners filed a letter brief in lieu of a formal brief in opposition to the Division of Taxation's exception. The Division of Taxation did not file a brief in opposition to petitioners' exception, but relied upon a brief submitted to the Administrative Law Judge. The Division of Taxation filed a letter brief in lieu of a formal reply brief. Petitioners did not file a reply brief, but instead relied upon their brief submitted to the Administrative Law Judge. Oral argument was heard in New York, New York on September 18, 2013.

After reviewing the entire record in this matter, the Tax Appeals Tribunal renders the following decision.

## ***ISSUES***

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

II. Whether it is appropriate to consider a factual challenge regarding certified mailing of the Notice of Deficiency when the argument was raised after the record was closed.

## ***FINDINGS OF FACT***

We find the facts as determined by the Administrative Law Judge, except for findings of fact 7 through 10, and 12, which have been modified to more accurately reflect the record. The Administrative Law Judge's findings of fact and the modified findings of fact are set forth below.<sup>1</sup>

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).<sup>2</sup>

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

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<sup>1</sup> Pursuant to State Administrative Procedure Act § 306 (4), we take official notice of the records in two related matters, which are being issued with this decision, and involve the parties and facts of this case (*see e.g. Matter of Kolovinas*, Tax Appeals Tribunal, December 28, 1990). The records of the proceedings before the Division of Tax Appeals and Tax Appeals Tribunal, of which we take official notice, are *Matter of MediaBuss Systems* (Tax Appeals Tribunal, March 18, 2014 [DTA No. 824190]) and *Matter of MediaBuss Systems* (Tax Appeals Tribunal, March 18, 2014 [DTA No. 824207]).

<sup>2</sup> Petitioner, Jamie Babel, appears only because she filed on a joint basis with Steven Babel. As such, further references to "petitioner" in this decision refer to Mr. Babel.

referred for audit based on the draw account and labor charges appearing on sales invoices, because the Division believed that 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, and requested 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. As a result of the sales tax audit, the Division also assessed MediaBuss for additional corporation franchise tax due for the years at issue. In sum, the auditors calculated the corporation's adjusted entire net income by taking the additional sales per the sales tax audit, subtracting operations cost, and making certain adjustments for the amounts actually reported by MediaBuss on its corporate returns as well as Mr. Babel's personal draws.<sup>3</sup>

8. In examining the bank reconciliation statement for the MediaBuss operating account, which was provided during the sales tax audit, it was clear that many operating account disbursements were personal in nature. The Division's auditor, who was also the auditor in the corporation franchise tax audit, created a draw account profile from the information in the bank reconciliation. He believed that the selected items reflected expenditures paid by the corporation solely for the benefit of Mr. Babel.<sup>4</sup>

The items selected for the draw account cover a wide range of expenditures. These include, among other items, cash paid directly to Mr. Babel, as well as payments to Bloomingdale's, private schools, furniture companies, credit cards, art and antique stores, pool services, yacht yards, doctors, landscaping, summer camps, cable television services and telecom services. The draw account did not include all disbursements that may have been personal expenses (e.g., payments made to Jaguar, Land Rover, etc.).

The Division sought explanations of these items from petitioner, Mr. Babel, but received none in either the corporation franchise tax audit or in the instant personal income tax audit.

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<sup>3</sup> This finding, formerly finding of fact 8 in the Administrative Law Judge's determination, has been modified to eliminate details that are not relevant to the instant personal income tax deficiency. Further discussion of the corporation franchise tax audit may be found in the companion case, *Matter of MediaBuss Systems* (Tax Appeals Tribunal, March 18, 2014 [DTA No. 824190]). By virtue of this modification, we deny the Division's exception to this finding of fact because its objection has been rendered moot.

<sup>4</sup> This finding was previously finding of fact 7 in the Administrative Law Judge's determination.

9. The following table lists the MediaBuss earnings and profits (E&P) figures that are relevant to the instant matter:

	2002	2003	2004	2005
Gross E&P <sup>5</sup>	\$1,365,035.00	\$1,233,082.00	\$1,087,575.00	\$893,425.00
<b>(Draw Amount)</b>	(\$220,182.00)	(\$322,842.00)	(\$370,404.00)	(\$754,182.00)
Gross E&P Less Draw	\$1,144,853.00	\$910,240.00	\$717,171.00	\$139,243.00
Retained E&P <sup>6</sup>	\$1,144,853.00	\$2,055,093.00	\$2,772,264.00	\$2,911,507.00

The first row lists the Gross E&P, which is the total revenue less total expenses prior to tax. The second row lists the amounts of Mr. Babel's personal draws from the MediaBuss operating accounts. The third row represents the difference between the Gross E&P and the draw amounts. The fourth row lists Retained E&P, which is the amount of E&P carried forward.

We have modified the Gross E&P amounts for the years 2004 and 2005 because the initial figures of \$754,321.00 and \$55,693.00, respectively, were erroneous. After reviewing the record in the related corporation franchise tax matter (*Matter of MediaBuss Systems*, March 18, 2014 [DTA No. 824190]), it became clear that the original E&P calculation for 2004 failed to account for disallowed deductions in the amount of \$333,254.00, which were included in the operating expenses. To correct this error, we have upwardly adjusted the 2004 Gross E&P by that amount. Similarly, the 2005 Gross E&P figure failed to include additional ordinary income, other income, and disallowed expenses. Accounting for these amounts resulted in an

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<sup>5</sup> The "Gross E&P" column is the "Gross Profit" column in the determination. By virtue of our modifications to the 2005 figure, we grant the Division's exception on this finding of fact.

<sup>6</sup> "Retained E&P" is synonymous with accumulated E&P.

upward adjustment of \$837,732.00 in Gross E&P for that year.<sup>7</sup>

10. During the audit, Mr. Babel did not provide the Division with any documentation that any part of the disallowed draw expenses was reported on petitioner's personal income tax returns. Petitioner provided no evidence of loans, debts, or any federal tax liabilities owed either by himself or MediaBuss. At the hearing, despite Mr. Babel being present, petitioner introduced no documentary evidence or testimony on the expenses included in the draw account.

11. MediaBuss incorrectly filed 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 originally calculated the constructive dividend by adding the draw account amounts plus labor charges from sales invoices to petitioner's reported income. However, at the conciliation conference, the conferee excluded the labor charges, leaving only the draw account amounts, detailed above. For each of the years at issue, the adjusted gross income (AGI), including the constructive dividend, indicated that petitioner omitted more than 25% of his reported income.

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.

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<sup>7</sup> By virtue of our modification to the 2005 Gross E&P figure, we granted the Division's exception to this finding of fact.

14. The Division issued to petitioner a Notice of Deficiency, 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 \$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 by ignoring the payment of his personal expenses by MediaBuss.

15. At the Bureau of Conciliation and Mediation Services conference, the conferee cancelled 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 cancelled 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 \$135,542.00, plus the penalties mentioned above and statutory interest.

***THE DETERMINATION OF THE ADMINISTRATIVE LAW JUDGE***

After noting the validity of multi-tax audits, the Administrative Law Judge reviewed the standards for personal income tax audits. He noted that unlike sales tax audits, the Division need not make a records request and may estimate personal income tax liability based on any information in its possession. The Administrative Law Judge noted that, in order to prevail, petitioner must introduce clear and convincing evidence that the Notice of Deficiency had no rational basis.

The Administrative Law Judge found that the Division established a rational basis for the audit and that proper audit methods were followed. In particular, the Administrative Law Judge noted that petitioner, Mr. Babel, was present at the hearing, but neither testified nor provided any

other information that would explain petitioner's personal use of the MediaBuss operating account, or otherwise rebut the assessed additional income. However, the Administrative Law Judge ordered the Division to recompute the deficiency for 2005, because the constructive dividend exceeded the MediaBuss gross E&P for that year.

The Administrative Law Judge declined to consider petitioner's challenge on the proper issuance of the subject Notice of Deficiency. As stated in the determination, Mr. Babel did not raise this factual argument until after the close of the record. In rejecting this argument, the Administrative Law Judge noted that it is improper to address evidentiary arguments that are initially raised after the record is closed because it shifts the burden to the opposing party without allowing it the opportunity to provide proof.

Given the foregoing, the Administrative Law Judge sustained the Notice of Deficiency, as modified by the Conciliation Order and adjusted for the year 2005.

#### ***ARGUMENTS ON EXCEPTION***

Petitioner takes exception to the entire determination. Mr. Babel contends that the Administrative Law Judge erred in rejecting the mailing argument because, in his view, this issue was raised in his petition by his broad statute of limitations challenge. Petitioner contends that the Division possessed adequate notice that it had to prove that the subject Notice of Deficiency was sent by certified mail. Accordingly, petitioner contends that the Administrative Law Judge's refusal to consider the certified mailing requirement constitutes reversible error, and, as the Division failed to meet its burden, the subject Notice should be cancelled.

Petitioner submits that MediaBuss lacked sufficient current or retained E&P to pay the dividends. Therefore, Mr. Babel appears to be arguing that the corporation's payments of his personal expenditures could not be constructive dividends, but were nontaxable returns of



capital. Petitioner also argues that some amounts constituted loan repayments to certain individuals. Mr. Babel also takes exception to the determination that the auditor was credible. On these alternative grounds, petitioner requests that the Notice of Deficiency be cancelled because there was no rational basis for its issuance.

Finally, petitioner argues that the Division did not adjust the constructive dividends to account for income already reported on petitioner's personal income tax returns.

The Division takes exception to the extent that the Administrative Law Judge limited the constructive dividend in 2005. It argues that the gross E&P for that year should be adjusted to account for disallowed expenses, specifically, Mr. Babel's personal draws. Once such amounts are included, the Division argues that the adjusted E&P net profit for 2005 supports the payment of the constructive dividend. Apart from this modification and certain other objections to the findings of fact, the Division agrees with the determination, and contends that the rationale of the determination adequately and properly addresses the arguments raised on exception.

### ***OPINION***

This matter involves additions to petitioner's personal income tax return in the amounts of personal payments made on his behalf by MediaBuss, Mr. Babel's wholly owned corporation. The Division determined these amounts to be constructive dividends to Mr. Babel.

New York State has accepted the use of constructive dividends to properly determine personal income derived from closely-held corporations (*Matter of Macaluso v New York State Dept of Taxation and Fin.*, 259 AD2d 795 [1999]; *Matter of Petito*, Tax Appeals Tribunal October 17, 1991). This concept originates from federal income tax jurisprudence, which provides as follows:

“A finding that a shareholder received a constructive dividend from a corporation is only appropriate where ‘corporate assets are diverted to or for the benefit of a shareholder’, CTM Constr., Inc. v. Commissioner, 56 T.C.M. (CCH) at 974, ‘in order to distribute available earnings and profits without expectation of repayment’, Truesdell v. Commissioner, 89 T.C. at 1295; see also Palmer v. Commissioner, 302 U.S. at 69” (*Welle v Commissioner*, 140 TC No. 19 [2013]).

In the instant matter, Mr. Babel is the sole shareholder of MediaBuss. The Division contends that unexplained cash distributions to Mr. Babel and payments of his personal expenses from the MediaBuss operating account constitute constructive dividends because these amounts were distributed for his personal benefit. As such, the Division asserts that these receipts constitute additional income upon which Mr. Babel must pay income tax.

In challenging personal income tax deficiencies, the taxpayer bears the burden of introducing clear and convincing evidence establishing that the assessment was erroneous (Tax Law § 689 [e]; *Matter of Grace v New York State Tax Commn.*, 37 NY2d 193, 195-196 [1975]). It may meet this burden by proving that the audit methodology was irrational (*see e.g. Matter of Donahue v Chu*, 104 AD2d 523 [1984]). In constructive dividend cases, a taxpayer could meet this evidentiary burden many ways, including establishing that the audit lacked a rational basis (*see e.g. Matter of 33 Virginia Place*, Tax Appeals Tribunal, December 23, 2009), or that the distributions constituted nontaxable returns of capital (*Truesdell v Commissioner*, 89 T.C. 1280, 1296 [1987]; *see also Ireland v US*, 621 F2d 731 1980]).

The tax treatment of the constructive dividends, such as those at issue, depends upon the corporation’s ability to pay those amounts. Business Corporation Law § 510 (b) provides that dividends may only be paid out of surplus, which, in the federal lexicon, is analogous to E&P.

Relevant federal jurisprudence provides the following:

“Because dividends can only be distributed to the extent of a corporation’s earnings and profits under IRC § 316, a court can only find a constructive

dividend to be taxable as ordinary income to the extent of the corporation's earnings and profits. 'Otherwise, a distribution to a stockholder is merely a recovery from his basis in his shares to the extent that he has such a basis; to the extent that the payments exceed the basis, the payments amount to a gain.' See [Estate of DeNiro v Commissioner, 746 F2d 327, 331 (1984)]. §§ 316 (a), 301 (c)" (*Hagaman v Commissioner*, 958 F2d 684, 694 [1992]).

Constructive dividends may be made out of accumulated or current year E&P (26 USC § 316 [a]; see *Rodriguez v Commissioner*, 137 TC 174 [2011], *affd* 722 F3d 306 [2013]), and the distribution need not be declared (see *Boulware v U.S.*, 552 US 421 [2008] *cert denied* 558 US 1048 [2009]). In the instant matter, insofar as Mr. Babel argues that the draw account constitutes nontaxable returns of capital, he bears the burden of proving his basis in the corporation (*Truesdell v Commissioner*, 89 TC 1280 [1987]; *Laciny v Commissioner*, TC Memo 2013-107). Bearing these principles in mind, we turn to the facts of the instant matter.

We find that MediaBuss had sufficient E&P to distribute the constructive dividends for the years at issue. As indicated in finding of fact 9 above, the corporation had sufficient current year E&P, as well as retained E&P, to pay the draw. Additionally, we remain unpersuaded by the argument that the asserted New York State and alleged federal tax liability should reduce the MediaBuss E&P. Petitioner did not advance any legal support that these contested, unpaid tax deficiencies should impact E&P.<sup>8</sup> Additionally, the record lacks evidence substantiating the existence of federal tax liabilities for the period at issue. In sum, petitioner's bare assertion falls

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<sup>8</sup> It appears that accrual basis taxpayers may deduct unpaid, *uncontested* state tax liabilities accrued during that tax year (*Dixie Pine Products Co. v US*, 320 US 516 [1944]). However, contested unpaid liabilities may not be deducted because they have not yet accrued (*id.*; see e.g. *Gillis v US*, 402 F2d 501, 506 [1968] [providing three conditions for the accrual of an item]). These principles apply to accrual basis taxpayers. As relevant herein, MediaBuss was a cash basis taxpayer that contested the amounts assessed for the periods at issue (see *Matter of MediaBuss Systems*, Tax Appeals Tribunal, March 18, 2014 [DTA No. 824207] [contesting assessed sales tax]; *Matter of MediaBuss Systems*, Tax Appeals Tribunal, March 18, 2014 [DTA No. 824190] [contesting assessed corporation franchise tax]; see footnote 1).

far short of a cogent, convincing argument that would merit modifying the E&P calculations.<sup>9</sup> As such, we conclude that MediaBuss had sufficient funds to distribute the constructive dividends paid to Mr. Babel.

Reviewing the determination, the Administrative Law Judge committed computational errors in calculating E&P for the purposes of the constructive dividend. As indicated in finding of fact 9, we modified the Gross E&P figures for 2004 and 2005 because the original figures failed to account for certain items, including disallowed deductions. These amounts distorted the Gross E&P of MediaBuss because they inflated the corporation's operating costs for those years. As such, we adjusted these figures to account for those amounts. The Administrative Law Judge also erroneously limited the constructive dividend to current year E&P. As provided under the IRC, dividends may also be made out of retained E&P (26 USC § 316 [a] [1]; *see e.g. Mazzocchi US Co., Inc. v Commissioner*, 14 F3d 923 [1994]). Accordingly, the Administrative Law should have accounted for the foregoing in the E&P calculation.

Petitioner failed to introduce evidence supporting his arguments for further modifications to the Notice of Deficiency. Mr. Babel did not introduce proof that any amounts listed in the operating account constituted loan repayments. Petitioner failed to prove that the draw account amounts had been the same items reported on his personal income tax returns.<sup>10</sup> As Mr. Babel

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<sup>9</sup> In passing, we note petitioner's failure to avail himself of opportunities to present evidence in his favor, such as financial documentation, bears a striking similarity to other constructive dividend cases (*see e.g. Matter of Drebin v Tax Appeals Trib. of State of N.Y.*, 249 AD2d 716 [1998]; *Matter of Macaluso v New York State Dept of Taxation and Fin.*).

<sup>10</sup> This particular issue was not addressed by the Administrative Law Judge. While we generally accept that the benefits provided by our two-stage process require the benefit of the Administrative Law Judge's analysis on each issue presented by the parties, as petitioner in this matter submitted no evidence in support of his claim, there would be nothing to be gained by remanding the matter for the Administrative Law Judge's analysis on this particular issue (*c.f. Matter of Barker*, Tax Appeals Tribunal, September 24, 2009 [where evidence was in the record upon which the Administrative Law Judge could base an analysis]).

neither testified at the hearing, nor introduced documentary evidence to substantiate this claim, petitioner failed to provide any basis for modifying the asserted deficiency. Due to the lack of clear and convincing evidence, we conclude that petitioner failed to establish grounds for modifying the Notice of Deficiency.

In our review, the determination properly addressed petitioner's argument on certified mailing. Contrary to petitioner's allegations, this point was not presented in the petition, and did not appear until petitioner's post-hearing brief. Therefore, the Administrative Law Judge properly determined that it was procedurally inappropriate to consider this argument because it raises a factual issue after the close of the record.

Accordingly, it is ORDERED, ADJUDGED and DECREED that:

1. The exception of Steven and Jamie Babel is denied;
2. The exception of the Division of Taxation is denied to the extent that its objection to finding of fact 8 was rejected, but it is otherwise granted;
3. The determination of the Administrative Law Judge is reversed to the extent that the deficiency for the year 2005 is sustained, but it is otherwise affirmed as modified;
4. The petition of Steven and Jamie Babel is denied; and
5. The Notice of Deficiency, dated October 20, 2008, as modified by the Conciliation Order, dated April 2, 2010, is sustained.

DATED: Albany, New York  
March 18, 2014

/s/ Roberta Moseley Nero  
Roberta Moseley Nero  
President

/s/ Charles H. Nesbitt  
Charles H. Nesbitt  
Commissioner

/s/ James H. Tully, Jr.  
James H. Tully, Jr.  
Commissioner