STATE OF NEW YORK

TAX APPEALS TRIBUNAL

In the Matter of the Petition	:	
of	:	
MEDIABUSS SYSTEMS, INC.	:	DECISION DTA NO. 824190
for Redetermination of a Deficiency or for Refund of Corporation Franchise Tax under Article 9-A of the Tax Law for the Years 2001 through 2008.	:	

Petitioner, MediaBuss Systems, Inc., filed an exception to the determination of the Administrative Law Judge issued on November 29, 2012. Petitioner 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 parties did not file briefs on exception, but instead resubmitted and relied upon their respective briefs filed with the Administrative Law Judge. Oral argument was heard on September 18, 2013 in New York, New York.

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

ISSUES

I. Whether the Division of Taxation properly calculated additional corporation franchise tax due from petitioner for the audit period.

II. Whether the Division of Taxation has established that the imposition of fraud penalty under Tax Law § 1085 (f) and (g) was warranted or, in the alternative, whether negligence penalty under Tax Law § 1085 (b) should be imposed.

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

IV. Whether the Administrative Law Judge properly declined to consider petitioner's challenge to the validity of the subject Notice of Deficiency based on the lack of proof of certified mailing because this factual issue was raised after the close of the record.

FINDINGS OF FACT[1]

We find the facts as determined by the Administrative Law Judge with respect to findings of fact numbered 1 through 5, 15 through 18, and 20 through 22. We have modified the Administrative Law Judge's findings of fact numbered 6 through 14 and 19 to more accurately reflect the record. The Administrative Law Judge's findings of fact and the modified findings of fact are set forth below.

1. Petitioner, MediaBuss Systems, Inc., a New York corporation, was a systems integrator specializing in the installation of residential technologies, including home theaters, during the years 2001 through 2008 (audit period). At all relevant times, Steven Babel was the president and sole shareholder of petitioner.

2. The Division of Taxation (Division) began a corporation franchise tax audit of petitioner on or about June 21, 2007 with a written request for books and records for the period January 25, 2001 through December 31, 2005. The letter informed petitioner that if preliminary audit findings indicated a material effect on any other tax, it could result in a multi-tax audit.

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[1] Pursuant to State Administrative Procedure Act § 306 (4), we take official notice of the records in two related matters, that are being issued with this decision, and that involve the parties and facts of this case (***see 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 Babel*** (Tax Appeals Tribunal, March 18, 2014 [DTA No. 823681]) and ***Matter of MediaBuss Systems*** (Tax Appeals Tribunal, March 18, 2014 [DTA No. 824207]).

The request sought the following: copies of federal unemployment reports; a written description of business activities within and without New York State; general ledger; purchase, disbursements and sales or receipts journals; payroll ledger; accountant's workpapers reconciling books to tax returns; an organizational chart identifying all related entities and any management agreements between petitioner and its affiliated companies; and common officers or employees of the related companies. In addition, the Division requested consolidated Form 1120-S and New York corporation franchise tax returns; MTA surcharge returns; quarterly combined withholding, wage reporting and unemployment insurance returns; financial statements, and detailed information on executive compensation.

3. On or about March 25, 2010, the Division sent to petitioner's representative, Norman Berkowitz, Esq., another written request for information and documentation, this time for the extended audit period January 25, 2001 through December 31, 2008, which sought copies of all forms 1099 issued by petitioner; details of independent contractor compensation; details of intercompany transactions between petitioner and any affiliates; copies of any loan agreements between petitioner and Mr. Babel; corporate tax returns that may have been filed in Connecticut; copies of any audits performed by a state or the Internal Revenue Service; detailed explanation and documentation of "other deductions," salary and wages and cost of goods sold shown on federal returns; and proof that petitioner had gone out of business, including the date and details of a transfer, if any. The request also included a copy of the first request, dated June 21, 2007.

4. The March 25, 2010 letter also included a copy of a previous written request, dated January 29, 2010, which requested detailed information regarding charges labeled "other business deductions," including the amount for Mr. Babel's draw account. The January 29, 2010

letter also sought the business purpose of the expense purchases, supporting documentation, project affiliation and any invoices associated with the expenses.

5. Additional requests for records were made at meetings with petitioner's representative on November 27, 2007, February 22, 2008, April 25, 2008, June 9, 2008 and September 10, 2008.

6. In response to all of the requests for information and documentation, the Division received petitioner's Form 1120-S (U.S. Income Tax Return for an S Corporation) for 2004 and 2005 on or about December 6, 2007 and a bank transcript on or about February 29, 2008. Petitioner submitted no other information or documentation to the corporation franchise tax auditors, and did not submit any documentary or testimonial evidence in support of its petition at hearing, other than a letter from the Director of Tax Audits, Nonie Manion, to Mr. Berkowitz, dated March 16, 2010. The letter explained that the corporation franchise tax audit was the result of a sales tax audit of petitioner and the resulting tax found due therein. Ms. Manion noted that several corporate returns were not filed, deductions were being investigated, and the Division was awaiting additional information from Mr. Berkowitz. The letter also indicated that a Notice of Deficiency, notice number L-033395094-3, had been issued in error and was being canceled. In fact, a Consolidated Statement of Tax Liabilities, dated May 14, 2010, indicated that the assessment had been canceled, reflected in a $0.00 tax due for the period ended December 31, 2008.

7. Petitioner did not file federal or New York corporation franchise tax returns for the years 2001, 2003, 2006 and 2007. For the years 2002, 2004 and 2005, it filed both federal and New York State returns as a subchapter S corporation, although it had not applied for or been deemed a New York S corporation pursuant to Tax Law § 660. The New York returns were filed

with the fixed dollar minimum tax of $100. Petitioner also filed a request for a six-month extension to file its 2006 New York S Corporation Franchise Tax return, dated March 7, 2007, but never filed said return. Petitioner's 2002 federal and New York returns reported zeros for gross receipts, gross profit and ordinary income.

8. In fact, before it received petitioner's New York S corporation Franchise Tax Return for 2002 on or about December 30, 2003, the Division had instructed petitioner to file a CT-3, Corporation Franchise Tax Return, under article 9-A of the Tax Law, by Notice of Failure to File Corporation Tax Return, dated December 1, 2003. The notice also specifically noted that petitioner might be liable for filing a Metropolitan Business Tax return (Form CT-3M). In addition, the Division informed petitioner of its failure to file the election to be treated as a New York S corporation by notices dated September 7, 2006, April 11, 2007, and April 22, 2009. The record of the companion income tax case (***Matter of Babel***) reveals that such notices were addressed to petitioner at Mr. Babel's home address. Also, a letter was sent to Mr. Berkowitz, dated March 25, 2008, in which it was reiterated that petitioner had filed as an S corporation without authorization and was considered a C corporation, for which a new power of attorney was required. Petitioner never submitted a form CT-6, election by a federal S corporation to be treated as a New York S corporation.

9. The instant audit began after the corporation franchise field audit bureau received a referral from the sales tax audit bureau concerning the discovery of additional sales by petitioner that may not have been included in petitioner's corporation franchise tax returns. Apart from Forms 1120-S for the years 2004 and 2005 and the bank reconciliation detail for the period ending December 31, 2005, petitioner did not submit the books and records requested by the Division. Accordingly, the Division used records collected by the sales tax auditors and gross

sales as calculated by the sales tax auditors in its audit of petitioner. The franchise tax auditor also used the ratios calculated in the sales tax audit with respect to recurring expenses to determine cost of operations.

10. In light of petitioner's failure to produce almost all records requested, the Division utilized numerous records from the sales tax audit in performing the corporation franchise audit, including check book stubs; the 2005 profit and loss statement; an operating account transcript, which differed somewhat from the bank reconciliation produced by petitioner to the franchise tax auditor; New York State corporation franchise tax returns for an S corporation for 2002, 2004 and 2005; and petitioner's 2004 and 2005 federal income tax returns (Forms 1120-S).

11. The auditor calculated petitioner's entire net income by adjusting the gross sales as determined on the sales tax audit (referred to as "net sales" by the sales tax auditors) by information available to it, including expense information reported on the filed tax returns. Specifically, the auditor sought to adjust gross sales by subtracting the cost of operations from gross sales to reach gross profit. For 2004 and 2005, where a filed federal 1120-S was available, the auditor subtracted the cost of operations (i.e., total deductions plus cost of goods sold) as reported on the returns to arrive at gross profit for those years. For the years 2001, 2002, 2003 and 2006, the auditor sought to account for the cost of operations by estimating such costs to be 43.7 percent of gross sales for each year. This percentage was taken from the sales tax audit and equals the sum of petitioner's 2004 and 2005 recurring taxable expense purchases[2] as a

[2] Recurring taxable expense purchases for the years 2004 and 2005 as determined on the sales tax audit are a portion of the expenses accounted for as "other deductions" on the 1120-S forms. Specifically, the Division used the detail statements attached to the returns and included as recurring taxable purchases those categories of expenses deemed to be subject to sales tax and excluded those categories deemed nontaxable (e.g. accounting, insurance) or with respect to which tax was paid (e.g. fuel and a portion of office expense). Included as a taxable recurring purchase was a category on the detail statement called "other business deductions." Petitioner claimed $824,665 in such "other business deductions" for 2005 and $31,889 in such "other business deductions" for 2004.

percentage of 2004 and 2005 gross sales (39.8845%) and petitioner's 2004 and 2005 utilities purchases as a percentage of 2004 and 2005 recurring taxable purchases (3.8104%).[3] The sales tax auditor took such purchase amounts directly from the federal returns. The foregoing calculations resulted in audited gross profit, and in turn yielded unreported additional income for each year. The following chart sets forth the income determined for corporation franchise tax as so calculated:

Year	Gross sales	Cost of Ops	Cost of Ops	Gross Profit	Ordinary Income	Ordinary Income per return	Unreported Addt'l Income
2001	$1,491,744	43.7%	$651,818	$839,926	$839,926	not filed	$839,926
2002	$2,424,358	43.7%	$1,059,323	$1,365,035	$1,365,035	CT-3S $0	$1,365,035
2003	$2,190,005	43.7%	$956,923	$1,233,082	$1,233,082	not filed	$1,233,082
2004	$1,440,670	1120-S	$686,349	$754,321	$754,321	$71,010 CT-3S	$683,311
2005	$1,980,064	1120-S	$1,924,371	$55,693	$55,693	CT-3S $139,343	($83,650)
2006	$786,626	43.7%	$343,716	$442,910	$442,910	not filed	$442,910
2007	$1,743,120	43.7%	$761,656	$981,464	$981,464	not filed	$981,464
2008	$1,743,120	43.7%	$761,656	$981,464	$981,464	CT-3S $0	$981,464
Total	$13,799,707		$7,145,812	$6,653,895	$6,653,895	$210,353	$6,443,542

12. In examining the bank reconciliation statements and operating account detail produced in the sales tax audit, it was apparent that many expenses were personal in nature. The auditor

[3] Recurring taxable purchases as determined on the sales tax audit included utilities purchases. It would thus appear illogical to add utilities purchases to recurring taxable purchases. It is also mathematically incorrect to simply add these raw percentages, as each is a percentage of a different number.

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 Bloomingdale's, private schools, colleges, ATM withdrawals, Olympia pool service, Lord and Taylor, Capital One, Discover card and T & R Jewelers. Additionally, the detail of the operating account indicates a payment or transfer of $375,000 to Mr. Babel on January 18, 2005. Although the Division sought explanations of the payments from petitioner, it received none. As a result, the auditor disallowed these expenses as personal in nature and not business related. The expenses so disallowed were deemed to be constructive dividends from petitioner to Mr. Babel and the disallowed deductions were added back to income for each year of the audit. The draw amounts added back to income for the years 2001 through 2006 are as follows:

2001	2002	2003	2004[4]	2005	2006
$149,636	$220,182	$322,842	$333,254	$754,182	$338,515

13. To ensure that this treatment of disallowed personal expenses was correct, the Division analyzed the information it had on hand for the year 2005, including the form 1120-S, a profit and loss statement and the prepared schedule of Mr. Babel's draw account. The result was that the Division found that petitioner had deducted the draw expenses identified for 2005 in the amount of $754,182 in determining its income, demonstrated by a deduction of $824,665, identified simply as "other business deductions" in the detail statement attached to the return. This $824,665 was included in the $1,244,589 of "other deductions" claimed on petitioner's 2005 form 1120-S.

[4] The draw amount as indicated by the operating account analysis totaled $370,404. The auditor, however, limited the draw add-back to the amount claimed as "other deductions" on petitioner's 2004 1120-S.

14. The Division derived the business allocation percentage from its own observations on audit and relied on figures calculated by the sales tax auditors. Since records were not provided by petitioner, and since it was a New York corporation with a New York address, the Division determined that it was logical to assume that all property was New York property and the allocation percentage was 100% for all years. The same assumption was made for the wage allocation because a New York corporation's employees were presumed to be in New York in the absence of any proof to the contrary. Although petitioner asserted that it had no employees, its returns for 2004 and 2005 claimed deductions of $327,213 and $266,398, respectively, for salaries and wages. The double-weighted receipts factor was determined by a ratio of out-of-state sales to sales everywhere. The values used to determine New York and everywhere receipts were taken from sales as determined on the sales tax audit and gross sales listed on the forms 1120-S; gross sales allocated to tangible personal property; gross sales allocated to services; and other business receipts. A discreet business allocation percentage (BAP) was calculated for each year and is reflected in the table below in finding of fact 15.

15. The Division added the unreported additional income it calculated for each year to entire net income reported by petitioner on the returns it filed, 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:

Year	Income Reported	Adjusted ENI	BAP %	ENI Base	Tax Rate %	ENI Base Tax
2001	0	$1,054,562	52.9170	$558,043	8	$44,643
2002	0	$1,597,633	65.0672	$1,039,535	7.5	$77,965
2003	0	$1,605,156	77.0250	$1,236,372	7.5	$92,728
2004	$71,010	$1,380,908	68.9439	$952,052	7.5	$71,404
2005	$139,343	$893,425	76.6780	$685,060	7.5	$51,380
2006	0	$781,425	77.9594	$609,194	7.5	$45,690
2007	0	$981,464	51.3879	$504,353	7.1	$35,809
2008	0	$981,464	51.3879	$504,353	7.1	$35,809

16. Since petitioner's sole place of business was within a metropolitan commuter transportation district (MCTD) district and it was determined that additional franchise tax was due, petitioner was subject to the temporary metropolitan transportation business tax surcharge pursuant to Tax Law § 209-B. The Division computed the surcharge by applying the rate, 17%, to the net New York State franchise tax for each of the years in issue. The resulting metropolitan transportation business tax (MTBT) surcharge asserted by the Division for each year was:

2001	$8,538
2002	$15,905
2003	$18,916
2004	$14,566
2005	$10,481
2006	$9,321
2007	$7,717
2008	$7,717

17. Petitioner paid the $100 fixed dollar minimum tax for the years it filed returns and was given credit for said payments. However, petitioner never paid the MTBT surcharge.

18. The Division requested from petitioner consents extending the period of limitations on assessment many times during the course of the audit. The auditor's log recites numerous exchanges of consents regarding the tax years 2004 and 2005 with the taxpayer's representative. These were the only two years petitioner filed returns, thus requiring consents to keep the period open for assessment by the Division. Although petitioner did file a return for 2002, the Division did not seek a consent because the period for assessment had expired prior to audit.

19. Despite references to many consents in the auditor's log, the Division submitted into evidence only one consent extending the period for assessment of the years 2004 and 2005. Executed by petitioner's representative on March 3, 2010 and the Division on March 9, 2010, it permitted a determination of additional tax or assessment at any time on or before June 15, 2010. Petitioner's New York S corporation franchise tax returns (forms CT-3-S) for the years 2004 and 2005 were received by the Division on June 3, 2005 and August 9, 2006, respectively.

20. The Division determined that imposition of fraud penalty was warranted in this matter after a meeting among the auditor, his team leader and the group's section head on March 27, 2008. The reasons cited by the Division included the substantial and purposeful underreporting of tax as discovered on audit, due to overstating expenses and understating receipts. The payment of personal expenses of Mr. Babel, which were then deducted as business expenses by the corporation, was seen as a clear tax avoidance scheme by the Division. In addition, petitioner failed to file any returns for the years 2001, 2003, 2006, 2007 and 2008, and those it did file were improperly filed as S corporation returns, avoiding the corporation franchise tax and the MTBT surcharge. Petitioner failed to file the proper returns even after being notified to do so on many

occasions, including one written notification prior to filing its 2002 return. Petitioner also failed to cooperate on audit by producing books and records, producing only two forms 1120-S for the years 2004 and 2005 and a bank reconciliation schedule.

21. The Division issued a Notice of Deficiency to petitioner, dated June 7, 2010, for the years 2001 through 2008, which asserted additional corporation franchise tax due in the sum of $548,164.00, penalties of $451,757.20 and interest of $323,376.48 for a total amount due of $1,323,297.68.

22. At the Bureau of Conciliation and Mediation Services conference, the conferee canceled the tax, penalties and interest for the years 2007 and 2008, consistent with the cancellation of these periods in the sales tax audit. Therefore, the years remaining in issue are 2001 through 2006. The tax remaining due was recomputed to be $461,137.00, plus penalty of $406,223.00 and interest of $327,327.00.

THE DETERMINATION OF THE ADMINISTRATIVE LAW JUDGE

After noting the validity of multi-tax audits, the Administrative Law Judge reviewed the standards for corporation franchise tax audits. He noted that unlike audits of sales taxes, in the case of the corporation franchise tax, the Division may estimate liability based on any information in its possession without first making a request for records. The Administrative Law Judge noted that, in order to prevail, petitioner must show error in the audit method or the audit result.

The Administrative Law Judge found that the audit method and the resulting deficiency herein had a rational basis and that petitioner did not meet its burden to show error.

The Administrative Law Judge also determined that fraud penalty was appropriate on the following grounds: (a) petitioner's substantial underreporting of tax and failure to report any

income in the years it failed to file returns; (b) petitioner's consistent payment of Mr. Babel's personal expenses and consistent deduction thereof; (c) petitioner's failure to file any tax returns for the years 2001, 2003, 2006, 2007 and 2008; (d) petitioner's failure to file a 9-A corporation tax return for 2002, despite notice of such failure; (e) petitioner's failure to file form CT-6 to elect S corporation status (and thereby properly file as an S corporation), despite receiving notice from the Division of the need to do so; (f) petitioner's failure to produce books and records on audit (beyond the few that were produced) and generally concealing the true income and business operations; and (g) petitioner's failure to provide any information on the personal expenses of Mr. Babel that were paid by petitioner, even when confronted with evidence of such expenditures.

The Administrative Law Judge found that, given the fraud penalty, there was no time limitation on the subject assessment. He also found that, had fraud not been established, the years 2002, 2004 and 2005 would have been time-barred. The Administrative Law Judge found that the consent to extend the limitations period for the years 2004 and 2005 was executed beyond the period for assessment for those years.

The Administrative Law Judge also declined to consider petitioner's challenge to the validity of the subject Notice of Deficiency based on the lack of proof of certified mailing because petitioner elected to raise this factual issue after the close of the record.

Accordingly, the Administrative Law Judge sustained the Notice of Deficiency, as modified by the Conciliation Order.

ARGUMENTS ON EXCEPTION

Both parties relied on the arguments made in their briefs submitted to the Administrative Law Judge. Petitioner also made certain further contentions in its Notice of Exception.

Petitioner contends that the Notice of Deficiency was not issued within the relevant period of limitations and that the Division provided no proof that the Notice was mailed by registered or certified mail. Consequently, petitioner asserts that the Notice is void. Petitioner asserts that the factual issue regarding proof of mailing was raised through its general statute of limitations claim that was first raised in its petition.

Petitioner argues that the Division's reliance on the sales tax audit for its determination of entire net income was improper because the sales tax audit was inaccurate and its estimates were erroneous. Petitioner also contends that the sales tax audit's recurring expense percentage was not utilized in the franchise tax audit. Petitioner asserts that the computation of entire net income was distorted because the Division improperly failed to utilized certain recurring expenses, such as accounting fees, rent and commissions, that were excluded from the computation of recurring taxable expenses in the sales tax audit. As a consequence of such errors, petitioner contends that the audit lacked a rational basis.

Petitioner denies that it deducted any of the draw account expenditures. Petitioner further denies any correlation between the draw expenses and the other deductions on its federal return, noting that the difference between the draw expenditures and the other deductions for 2005 is about $70,000.

Petitioner maintains that the calculation of the business allocation percentage was flawed because it used 100% New York allocation for wages even though, according to petitioner, there was no payroll and most sales were out of state.

Petitioner argues that the testimony of all Division witnesses at hearing was not credible because of long, vague answers, lack of recall, and an inability to express the consequences of a distribution to a shareholder in an S corporation.

Additionally, petitioner asserts that all notices regarding its failure to file an election to be treated as a New York S corporation were not sent to its corporate address.

Petitioner contends that the Division has not demonstrated fraud in this matter even though it has the duty to do so by clear and convincing evidence. Petitioner maintains that, based upon the facts in evidence, the Division has failed to meet its burden.

Accordingly, petitioner requests that the Administrative Law Judge's determination be reversed and the subject Notice of Deficiency cancelled.

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 that it was petitioner's burden to show that the determination was erroneous.

The Division makes several arguments with respect to the timely issuance of the Notice of Deficiency. First, the Division argues that the Notice was timely with respect to all periods at issue because the Division has established fraud. If the fraud penalty is not sustained, the Division argues that the Notice was timely for the years 2004 and 2005 because it was issued within the period provided in the consent extending the period of limitations. The Division concedes that the Notice would be time-barred with respect to the 2002 tax year if the fraud penalty is not sustained. For all other years, the Division contends that the Notice is timely because no returns were filed.

The Division contends that the Administrative Law Judge properly disregarded petitioner's argument that no proof of certified mailing was presented to establish proper mailing

of the Notice. The Division asserts that this was a factual issue that had not been raised at any time prior to submission of briefs, thus precluding it from submitting any proof on the matter.

The Division contends that it has sustained its burden of proving fraud, or, in the alternative, negligence penalty. It asserts that the record identifies a pattern of conduct that confirms petitioner's intent to evade tax. The Division specifically notes that petitioner's substantial understatement of tax; deduction of personal expenses; filing as an S corporation when it had never applied for S corporation status; and its failure to provide any meaningful books and records during audit constitute the proof necessary to prove fraud, or, at a minimum, negligence penalties.

The Division thus requests that the Administrative Law Judge's determination be affirmed.

OPINION

Tax Law § 209 (1) imposes franchise tax on the basis of entire net income or other basis as may be applicable, for the privilege of a corporation's exercising its corporate franchise, or of doing business or of employing capital or leasing property in New York. Tax Law § 209-B imposes a surcharge on said privilege when an office is maintained in a metropolitan commuter transportation district.

As relevant herein, Tax Law § 208 (9) defines "entire net income" as "total net income from all sources, which shall be presumably the same as the entire taxable income . . . which the taxpayer is required to report to the United States treasury department . . . except as hereinafter provided."

Pursuant to Tax Law § 1081 (a), "[i]f a taxpayer fails to file a return required under . . . Article 9-A . . . , [the Division] is authorized to estimate the taxpayer's New York tax liability

from any information in its possession." Here, petitioner failed to file any returns under Article 9-A for the years 2001, 2003 and 2006. Petitioner also failed to file the "return required" under Article 9-A for the years 2002, 2004 and 2005. As noted in the record, petitioner improperly filed returns as an S corporation for those years, having failed to make an S corporation election as required (***see*** Tax Law § 660). Additionally, although required to do so, petitioner failed to file any MTA Surcharge Returns for the years at issue. The Division was thus statutorily authorized to estimate petitioner's tax liability under Article 9-A for all of the years at issue.

An estimated audit of a taxpayer's income, whether under personal income tax or corporation franchise tax, requires only a rational basis to be sustained on review (***see e.g***. ***Matter of Estate of Gucci***, Tax Appeals Tribunal, July 10, 1997, citing ***Matter of Atlantic & Hudson***, Tax Appeals Tribunal, January 30, 1992). The taxpayer bears the burden of proving error in the audit method or audit result (***see Matter of Giuliano v Chu***, 135 AD2d 893 [3rd Dept. 1987]; Tax Law § 1089 [e]).

The audited estimate of petitioner's entire net income (ENI) involved three components, the first of which was the use of gross sales as determined on the sales tax audit as gross receipts on the franchise tax audit. As noted in the companion sales tax matter (***Matter of MediaBuss Systems*** [DTA No. 824207]), such gross sales were derived from petitioner's own invoices, bank statements and federal income tax returns. We found the Division's estimate of gross sales to be reasonable in the sales tax matter and do so herein. We note that petitioner offered no evidence in the present matter to refute the Division's estimate of gross sales.

The second component of the Division's ENI estimate is the adjustment for petitioner's cost of operations. For the years 2004 and 2005, the Division used such costs as reported on petitioner's federal income tax returns and petitioner does not contest the cost of operations

adjustment for those years. For the years 2001, 2002, 2003 and 2006, the Division made the cost of operations adjustment by estimating such costs to be 43.7% of gross sales for each year. This percentage was taken from the sales tax audit and equals the sum of petitioner's 2004 and 2005 recurring taxable expense purchases as a percentage of 2004 and 2005 gross sales (39.8845%) and petitioner's 2004 and 2005 utilities purchases as a percentage of 2004 and 2005 recurring taxable purchases (3.8104%). Petitioner contends that the Division did not use the recurring purchases percentage utilized on the sales tax audit. This contention is without merit. While there may have been errors in its computation, the cost of operations adjustment percentage consisted almost entirely of the recurring taxable purchases percentage as determined on the sales tax audit and the minor errors in its computation benefitted petitioner.[5]

Petitioner notes, correctly, that the recurring taxable expenses as determined on the sales tax audit, which were used in the corporation tax audit to estimate petitioner's cost of operations, do not include certain recurring expenses, such as those considered nontaxable (e.g., rent, insurance) or those with respect to which sales tax was paid (e.g., fuel, a portion of office expense). Petitioner has failed to show, however, that the exclusion of such items from the cost of operations estimate was in error. In the absence of documentation substantiating petitioner's actual cost of operations, it was certainly rational to use the recurring taxable purchases percentage from the sales tax audit to estimate petitioner's cost of operations. It was incumbent upon petitioner to prove that this estimate was erroneous. Petitioner did not offer any evidence or point to any evidence in the record establishing any part of its actual cost of operations for the years 2001, 2002, 2003 or 2006. Accordingly, this portion of the audit must be sustained (***see***

[5] We have noted the errors in the cost of operations adjustment percentage (***see*** footnote 3). The benefit to petitioner is that the errors increased the cost of operations adjustment percentage slightly, thereby decreasing ENI.

Matter of Leogrande v Tax Appeals Trib., 187 AD2d 768 [3rd Dept. 1992], ***lv denied*** 81 NY2d 704 [1993]).

The third component in the Division's computation of ENI was the adding back of the yearly draw account totals. The Division's rationale for adding these totals to ENI was that the expenses listed in the draw account were the personal expenses of Mr. Babel and that such personal expenses were improperly deducted by petitioner as business expenses. With respect to the propriety of this component of the audit, we note first that petitioner offered no evidence to show that the computation of the draw account totals was in any way inaccurate or that the amounts listed in the auditor's draw account were, in any part, business, and not personal, expenses.

For the 2005 tax year, where the federal return claimed $824,665 in "other business deductions" within $1,244,589 of "other deductions," it was clearly reasonable for the Division to conclude that the $754,182 in draws for that year were deducted as part of the otherwise unidentified "other business deductions." The add-back thus effectively disallowed a portion of the claimed "other business deductions." For the 2004 tax year, the federal return claimed $333,254 in "other deductions" and the draw amount was $370,404. The Division limited the add-back to the amount of "other deductions" claimed on the return. Given the evidence of petitioner's payment of Mr. Babel's personal expenses throughout the audit period and the circumstantial evidence that such personal expenses were deducted on the 2005 return, it was rational for the Division to add-back the draw amount and thereby disallow the claimed "other deductions" on audit. The add-back part of the audit for 2004 and 2005 thus resulted in a disallowance of a portion of petitioner's claimed deductions. Petitioner produced no evidence to

show that such disallowance for either 2004 or 2005 was in any way erroneous, and therefore failed to sustain its burden of proof on this issue.

For the years 2001, 2003 and 2006, petitioner did not file returns. Petitioner's 2002 return reported zeros for gross receipts, gross profit and ordinary income and claimed no business deductions. For these four years, the Division's rationale for adding back draw amounts to income did not apply; for, logically, one cannot disallow a deduction that has not been taken.[6] While the draw account information in the record supports a finding that petitioner paid Mr. Babel's personal expenses during these years, it is the improper deduction of such expenses that improperly decreases ENI and thereby gives rise to corporation franchise tax liability. The Division offered no other theory as to how petitioner's payment of Mr. Babel's personal expenses could result in an increase to petitioner's ENI. The draw add-back component of the audit is thus irrational on its face with respect to the years 2001, 2002, 2003 and 2006 (***see Matter of Atlantic & Hudson Limited Partnership***, Tax Appeals Tribunal, January 30, 1992). The Division is directed, therefore, to recompute petitioner's liability for the years 2001, 2002, 2003 and 2006 by subtracting from entire net income as determined on audit, the draw amounts associated with these years of $146,636, $220,182, $322,842 and $338,515, respectively.

The Division's estimate of petitioner's business allocation percentage is sustained, as petitioner offered no evidence to show that this component of the audit was in error. We further note that, contrary to petitioner's claim that it had no payroll, petitioner's 2004 and 2005 tax returns both claim deductions for wages and salaries.

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[6] We observe that by limiting the add-back amount for 2004 to the amount claimed as "other deductions" on the return, the Division implicitly concedes that the draw add-back part of the audit is, ultimately, a disallowance of improper deductions and further implicitly concedes the converse of its premise, i.e., that without a deduction, there can be no disallowance.

The subject Notice of Deficiency asserts fraud penalty pursuant to Tax Law § 1085 (f). Such penalty is properly imposed where "any part of a deficiency is due to fraud." The Notice also asserts the additional fraud penalty under Tax Law § 1085 (g), applicable where a taxpayer fraudulently fails to pay tax or to file a return. The Division bears the burden of proof with respect to fraud (Tax Law § 1089 [e] [1]). We have explained the standard for the imposition of the fraud penalty as follows:

> "For the Division to establish fraud by a taxpayer, it must produce 'clear, definite and unmistakable evidence of every element of fraud, including willful, knowledgeable and intentional wrongful acts or omissions constituting false representation, resulting in deliberate nonpayment or underpayment of taxes due and owing' (***Matter of Sener***, Tax Appeals Tribunal, May 5, 1988; ***see also***, ***Schaffer v. Commissioner***, 779 F2d 849 [2nd Cir. 1985]; ***Matter of Cousins Serv. Sta.***, Tax Appeals Tribunal, August 11, 1988).
>
> The Division need not establish fraud by direct evidence, but can establish it by circumstantial evidence by surveying the taxpayer's entire course of conduct in the context of the events in question and drawing reasonable inferences therefrom (***Plunkett v. Commissioner***, 465 F2d 299 [7th Cir. 1972]; ***Biggs v. Commissioner***, 440 F2d 1 [6th Cir. 1971]; ***Matter of Cinelli***, Tax Appeals Tribunal, September 14, 1989, citing ***Korecky v. Commissioner***, 781 F2d 1566 [11th Cir. 1986])" (***Matter of Ellett***, Tax Appeals Tribunal, December 18, 2003).

As the Administrative Law Judge noted, the consistent and substantial understatement of income is a factor that may indicate fraud (***Merritt v. Commissioner***, 301 F2d 484 [5th Cir. 1962]). In order to constitute evidence of fraud, however, such underreporting must be affirmatively proven by the Division (***see Matter of Cousins Serv. Sta.***, Tax Appeals Tribunal, August 11, 1988). In the present matter, the audit adjustments made herein notwithstanding, the understatement of income for the years 2001 through 2003 and 2006 has been affirmatively established. By its failure to file any returns for the years 2001, 2003 and 2006 and by the filing of a return reporting zero sales or income in 2002, petitioner failed to report any income for those years. In stark contrast, petitioner's invoices indicate sales totaling approximately $6.5 million

during the same period.[7] Even allowing for a more generous cost of operations adjustment than that allowed on the audit, it is clear that petitioner failed to report a substantial amount of income during these four years.

The Division has also established that petitioner substantially understated its income for the years 2004 and 2005, the years for which petitioner filed returns. The 2004 return's report of $757,359.00 in gross sales is contradicted by petitioner's invoices that showed $1,440,669.67 in sales for that year.[8] For 2005, the underreporting results from petitioner's improper deduction of Mr. Babel's personal expenses, a fact affirmatively established by the reasonable inference drawn from the fact of $754,182 in such expenses paid by petitioner as indicated by the draw account and the fact of an otherwise unexplained $824,665 in "other business deductions" on the 2005 federal return. The record thus shows "highly persuasive evidence of fraudulent intent" by petitioner's "consistent failure to report substantial amounts of income over a number of years . . ." (***see Lain v Commissioner***, TC Memo 2012-99).

An extended pattern of failing to file tax returns may also be persuasive circumstantial evidence of fraud (***see Marsellus v Commissioner***, 544 F2d 883 [5th Cir. 1977], ***aff'g*** TC Memo 1975-368). Here, petitioner failed to file any corporate returns for the years 2001, 2003 and 2006. Petitioner also failed to file the required returns for all of the years at issue, including any MTA surcharge returns. As noted, petitioner was a C corporation and should have filed accordingly. Petitioner was notified by the Division of its failure to file as a C corporation and of

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[7] This $6.5 million amount is gleaned from workpapers created for the sales tax audit and submitted in evidence herein as part of the corporation franchise tax audit workpapers. Such workpapers indicate sales according to petitioner's invoices of $1,491,743.51, $2,424,357.98, $1,794,338.16 and $786,626.33 for the years 2001through 2003 and 2006, respectively.

[8] The source of this $1,440,669.67 amount is also from workpapers created for the sales tax audit and submitted in evidence herein as part of the corporation franchise tax audit workpapers.

the need to make an S corporation election as a necessary prerequisite to filing as an S corporation, but took no corrective action. With respect to such notifications, we observe that petitioner's complaint that they were not sent to the corporate address is insignificant because the notifications were mailed to the home address of Mr. Babel, petitioner's sole shareholder and the person required under the relevant statute to make the S corporation election (***see*** Tax Law § 660). Given the fact of its filing as an S corporation for some years and the notifications from the Division, we find that petitioner was aware of its obligation to file returns under Article 9-A. Accordingly, its failure to properly file, or to file at all with respect to 2001, 2003 and 2006, cannot be deemed to result from ignorance or mistake, but is properly considered to be indicative of fraudulent intent (***see Matter of AAA Sign Co.***, Tax Appeals Tribunal, June 22, 1989).

Petitioner's failure to maintain adequate records is another "badge" of fraud present in the record (***see Niedringhaus v Commissioner***, 99 TC 202 [1992]). In the corporation franchise tax audit, petitioner produced only some tax returns and a bank reconciliation statement in response to the Division's requests, and the facts in the sales tax matter reveal the inadequacies of petitioner's recordkeeping in detail. Specifically, petitioner had no internal controls over its sales invoices and maintained no general ledger, cash receipts journal or other summary schedules (***see Matter of MediaBuss Systems*** [DTA No. 824207]). Additionally, petitioner's failure to cooperate with the Division by its failure to provide any explanation of the draw account payments is also an indicia of fraud (***see Lain v Commissioner***). Despite the Division's requests, petitioner provided no explanation of its payments of Mr. Babel's personal expenses. Such failure is particularly significant, given the strong evidence that petitioner improperly deducted $754,182 of Mr. Babel's personal expenses on its 2005 return.

Considering all of the facts and circumstances in the present matter, in particular the various indicia of fraud discussed above, we find that the Division has shown by clear and convincing evidence that at least some part of the deficiencies for each of the years at issue is due to fraud. Accordingly, the penalties imposed under Tax Law § 1085 (f) and (g) are sustained.

Having sustained the Administrative Law Judge's determination with respect to fraud, we also sustain his conclusion with respect to the statute of limitations. Pursuant to Tax Law § 1083 (c) (1) (B), tax may be assessed at any time where there is a finding of fraud. The assessments for the years 2002, 2004 and 2005, i.e., the years for which returns were filed, were therefore not time-barred. Additionally, we note that there is no time limitation with respect to the years 2001, 2003 and 2006 because no returns were filed for those years (Tax Law § 1083 [c] [1] [A]).

Finally, we note that the Administrative Law Judge properly addressed petitioner's argument on the certified mailing of the subject Notice of Deficiency. Contrary to petitioner's assertion, this point was not presented in the petition, and did not appear until petitioner's post-hearing brief. We reject petitioner's contention that by generally raising the statute of limitations issue in its petition, it thereby raised an issue as to the proper mailing and validity of the statutory notice. Accordingly, 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 (***see Matter of Howard Enterprises***, Tax Appeals Tribunal, August 4, 1994).

Accordingly, it is ORDERED, ADJUDGED and DECREED that:

1. The exception of MediaBuss Systems, Inc., is granted to the extent provided below, but is otherwise denied:

(a) For the years 2001, 2002, 2003 and 2006, the Division is ordered to recompute petitioner's liability by reducing the entire net income for each of those years by the respective draw amounts of $146,636.00, $220,182.00, $322,842.00, and $338,515.00;

2. The determination of the Administrative Law Judge is modified to the extent indicated in paragraph 1 above, but is otherwise affirmed;

3. The petition of MediaBuss Systems, Inc., is granted to the extent indicated in paragraph 1 above, but is otherwise denied; and

4. The Notice of Deficiency, dated June 7, 2010, as modified by the Conciliation Order, dated January 28, 2011, and as further modified as indicated in paragraph 1 above, 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