

STATE OF NEW YORK  
TAX APPEALS TRIBUNAL

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In the Matter of the Petition :

of :

**JAMES R. SHOLLY AND KATHLEEN V. SHOLLY:**

for Redetermination of a Deficiency or for Refund of  
Personal Income Tax under Article 22 of the Tax Law  
for the Years 1978 through 1980. :

DECISION

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In the Matter of the Petition :

of :

**HAWK & DOVE RESTAURANT CORP.** :

for Redetermination of a Deficiency or for Refund of  
Corporation Franchise Tax under Article 9-A of the Tax  
Law for the Years 1978 through 1980. :

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Petitioners James R. Sholly and Kathleen V. Sholly, 836 Locust Avenue, Bohemia, New York 11716, filed an exception to the determination of the Administrative Law Judge issued on January 20, 1989 with respect to their petition for redetermination of a deficiency or for refund of personal income tax under Article 22 of the Tax Law for the years 1978 through 1980 (File No. 801151).

Petitioner Hawk & Dove Restaurant Corp., 1290 Smithtown Avenue, Bohemia, New York 11716, filed an exception to the determination of the Administrative Law Judge issued on January 20, 1989 with respect to its petition for redetermination of a deficiency or for refund of corporation franchise tax under Article 9-A of the Tax Law for the years 1978 through 1980 (File No. 801152).

Petitioners appeared by Kaplan and Kaplan, P.C. (Morris A. Kaplan, Esq., of counsel). The Division of Taxation appeared by William F. Collins, Esq. (Kevin A. Cahill, Esq., of counsel).

Petitioners filed a brief in support of their exception. The Division submitted a letter in lieu of a brief. Oral argument was not requested.

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

### ***ISSUES***

I. Whether the Administrative Law Judge correctly concluded that petitioners have the burden of proof with regard to the six-year statute of limitations.

II. Whether the Administrative Law Judge erred in rejecting some of the evidence submitted by petitioners in support of their claim of entitlement to certain cost of living adjustments.

### ***FINDINGS OF FACT***

We find the facts as determined by the Administrative Law Judge and such facts are stated below.

For the periods at issue herein, petitioner Hawk & Dove Restaurant Corp. ("Hawk & Dove") operated a bar and restaurant at 1290 Smithtown Avenue, Bohemia, New York. Petitioner James R. Sholly was the president of Hawk & Dove, and he and his brother, John Sholly, were the corporation's sole shareholders. John Sholly was not employed by Hawk & Dove nor did he receive income therefrom. (John Sholly was employed as a schoolteacher.) Petitioner James R. Sholly operated the bar and restaurant business with the assistance of various family members, including his wife, petitioner Kathleen V. Sholly.

The Division of Taxation conducted a multi-audit of petitioners for the following taxes and periods:

<u>Petitioner</u>	<u>Tax</u>	<u>Period</u>
Hawk & Dove Restaurant Corp.	Sales and use tax	9/1/77-8/31/80
Hawk & Dove Restaurant Corp.	Corporation franchise tax	1978, 1979, 1980
James R. & Kathleen V. Sholly	Personal income tax	1978, 1979, 1980

### ***THE SALES TAX AUDIT***

Finding of fact "3" is modified by changing its first paragraph to read as follows:

Gross sales per books were compared to gross sales per sales tax returns and Federal income tax returns and were found to be in substantial agreement. Overall markup per Federal income

tax returns was determined to be 75.26 percent. No register tapes were retained by the vendor and none, therefore, were made available for the audit. The vendor also did not generally retain guest checks. However, a few guest checks were provided to the auditor to substantiate petitioners' claim that liquor prices were lower during the first two years of the audit period. This claim resulted in an adjustment to the liquor markup discussed below.<sup>1</sup>

An analysis of purchases for the entire audit period was done by the auditor by means of an examination of check stubs. It was determined that \$56,272.04 represented food purchases, \$41,163.02 represented beer purchases and \$54,777.83 represented liquor and wine purchases.

In order to determine the markup percentage for food, Mr. Sholly was requested to and did maintain guest checks for a two-week period. These guest checks were analyzed, with the cost of the food previously determined with the assistance of Mr. Sholly. Petitioners' assertions with respect to size of portions, etc. were accepted by the auditor who determined the food markup to be 74 percent.

An analysis of liquor and wine purchases for the period November 6, 1980 to December 4, 1980 was made. Using the selling prices charged at that time, the liquor and wine markup was found to be 423.18 percent. Petitioners were given a 15 percent allowance for spillage. Petitioners claimed that for certain hours during the week, liquor prices were reduced by one-half and/or two-thirds. This was accepted by the auditor who found that for 34 percent of the week, drinks were reduced by 50 percent. As a result, the markup on liquor was reduced from 423.18 percent to 334.40 percent.

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<sup>1</sup>The first paragraph of finding of fact "3" of the Administrative Law Judge's determination read as follows:

Gross sales per books were compared to gross sales per sales tax returns and Federal income tax returns and were found to be in substantial agreement. Overall markup per Federal income tax returns was determined to be 75.26 percent. No register tapes or guest checks were retained by the vendor and none, therefore, were made available for the audit.

We modified the fact because the record and subsequent facts revealed that a few guest checks had been retained by the vendor.

Beer purchases were analyzed for the period November 3, 1980 through December 9, 1980 disclosing a beer markup of 372.5 percent. Based upon discussions with petitioners, which disclosed that for 27 percent of the week beer prices were reduced by 50 percent, an overall adjustment of 13.4 percent was allowed which reduced the markup on beer from 372.5 percent to 309.18 percent.

Total taxable sales were, therefore, calculated as follows:

(a) Liquor and wine purchases of \$54,777.83 were marked up by 334.40 percent, resulting in audited liquor and wine sales of \$237,954.89.

(b) Beer purchases of \$41,163.02 were marked up by 309.18 percent, resulting in audited beer sales of \$168,430.84.

(c) Food purchases of \$51,631.04 (after allowance of \$4,641.00 for employees' meals) were marked up by 74 percent, resulting in audited food sales of \$89,838.01.

(d) Total taxable sales were, therefore, determined to be \$496,223.74. After credit was given for taxable sales reported (\$264,654.00), additional taxable sales were found to be \$231,569.74 with additional tax due thereon in the amount of \$16,209.88 for the audit period.

At a pre-assessment conference, certain additional adjustments were made with respect to beer and liquor sales. Beer sales were reduced from \$168,430.84 to \$164,524.88 due to the auditor's acceptance of petitioners' contentions that Hawk & Dove sold half kegs of beer at discounted prices as a sales promotion for a local softball league.

With regard to liquor sales, the auditor accepted petitioners' statement (supported with guest checks) that liquor prices were lower during the first two years of the audit period. As a result thereof, the markup on liquor was reduced from 334.4 percent to 293.11 percent, thereby reducing audited liquor sales from \$237,954.89 to \$215,337.12.

Due to these adjustments, audited taxable sales were recomputed to be \$469,700.01. After credit for reported taxable sales of \$264,654.00, additional taxable sales were determined to

be \$205,046.01 with additional tax due thereon in the amount of \$14,353.22. Petitioners agreed to the revised assessment.<sup>2</sup>

### ***THE CORPORATION FRANCHISE TAX AUDIT***

The additional sales determined to have been made by Hawk & Dove were applied as additional gross sales for corporation franchise tax purposes, after conversion into proper franchise tax reporting periods (Hawk & Dove was a calendar year taxpayer). Therefore, on May 31, 1983, the Division of Taxation issued to Hawk & Dove a Statement of Franchise Tax Audit Changes which asserted additional corporation franchise tax due as follows:

	<u>1978</u>	<u>1979</u>	<u>1980</u>
Additional unreported sales	\$73,125.00	\$71,622.00	\$41,628.00
Taxable income as reported	(3,351.00)	(7,271.00)	(3,064.00)
Corrected taxable income	69,774.00	64,351.00	38,564.00
Franchise tax	6,977.40	6,435.10	3,856.40
Tax previously paid	250.00	250.00	250.00
Tax due	6,727.40	6,185.10	3,606.40
Penalties (§ 1085)	1,681.85	309.26	360.64
Interest	<u>3,418.81</u>	<u>2,617.47</u>	<u>1,219.64</u>
Total due	\$11,828.06	\$ 9,111.83	\$ 5,186.68

Accordingly, on March 2, 1984, three notices of deficiency were issued to Hawk & Dove as follows:

<u>Period Ended</u>	<u>Tax</u>	<u>Interest</u>	<u>Additional Charge</u>	<u>Total Due</u>
12/31/78	\$6,727.40	\$4,193.47	\$1,681.85	\$12,602.72
12/31/79	6,185.10	3,297.10	309.26	9,791.46
12/31/80	3,606.40	1,596.91	360.64	5,563.95

Petitioners were unable to substantiate any additional costs, expenses or other deductions which would reduce the taxable income of Hawk & Dove for the years at issue.

### ***THE INCOME TAX AUDIT***

Petitioners James R. Sholly and Kathleen V. Sholly filed joint New York State resident income tax returns for each of the years at issue herein. Initially, the additional gross sales determined from the sales tax audit of Hawk & Dove were attributed to these petitioners as constructive dividends which increased their personal income tax liability accordingly. On

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<sup>2</sup>It is not clear from the record herein whether or not the sales tax assessment was paid by petitioners.

May 31, 1983, a Statement of Personal Income Tax Audit Changes was issued to James and Kathleen Sholly asserting a deficiency of personal income tax for 1978, 1979 and 1980 in the amount of \$22,980.97, plus penalty and interest. Subsequently, a conference was held wherein it was decided that an audit based upon a cash availability analysis would be conducted. Federal returns, bank accounts, checks and certain other financial data such as mortgage statements, were made available and were examined by the auditor. The following is a summary of the cash availability analysis:

<u>Cash In</u>	<u>1978</u>	<u>1979</u>	<u>1980</u>
Salary (net)	\$ 5,800	\$ 7,160	\$ 7,580
Federal tax refund	1,000	1,432	1,802
State tax refund	<u>200</u>	<u>298</u>	<u>425</u>
Total	\$ 7,000	\$ 8,890	\$ 9,807
<u>Cash Out</u>			
Deposits (checking account)	\$ 7,894	\$11,740	\$ 7,479
Cash living	<u>16,865</u>	<u>19,280</u>	<u>19,375</u>
Total	\$24,759	\$31,020	\$26,854
Cash shortage	\$17,759	\$22,130	\$17,047

The annual cash living expenses as set forth above were calculated based upon the auditor's experience in estimating the personal and family expenses of a family of five residing in a similar location to that of petitioners. The following is a summary of said estimate:

	<u>1978</u>	<u>1979</u>	<u>1980</u>
Food	\$ 3,500	\$ 3,750	\$ 4,000
Mortgage	5,365	5,350	4,983
Utilities	2,000	2,200	2,400
Auto	2,000	2,000	2,000
Personal items	1,000	1,200	1,400
Out-of-pocket	1,000	1,200	1,400
Clothes	1,000	1,200	1,400
Travel	1,000	1,500	1,500
Medical insurance		<u>880</u>	<u>292</u>
Total	\$16,865	\$19,280	\$19,375

Pursuant to the cash availability analysis, a revised Statement of Personal Income Tax Audit Changes was issued to petitioners James Sholly and Kathleen Sholly on January 10, 1984 which contained the following explanation:

	<u>1978</u>	<u>1979</u>	<u>1980</u>	<u>TOTAL</u>
"Based on field audit, it was determined that you had a constructive dividend from Hawk and Dove Restaurant Corp.	17,759.00	22,130.00	17,047.00	
Net Adjustment	17,759.00	22,130.00	17,047.00	
Taxable Income Previously Stated	<u>2,650.00</u>	<u>1,222.00</u>	<u>1,801.00</u>	
Corrected Taxable Income	20,409.00	23,352.00	18,848.00	
Tax on Corrected Taxable Income	1,449.08	1,829.28	1,263.28	
Corrected Tax Due	1,449.08	1,829.28	1,263.28	
Tax Previously Computed	<u>34.50</u>	0	<u>9.00</u>	
Total Additional Tax Due	1,414.58	1,829.28	1,254.28	4,498.14
Penalties: 685(b)	70.73	91.46	63.16	225.35
Interest	724.08	<u>774.81</u>	<u>420.51</u>	<u>1,919.40</u>
Total	2,209.39	2,695.55	1,737.50	6,642.89"

While the aforesaid explanation stated that the adjustments were constructive dividends, said adjustments were, in fact, the result of the cash availability analysis performed. The Division of Taxation categorized the adjustments as constructive dividends based upon its determination that all of petitioners' income was derived from Hawk & Dove.

On March 26, 1984, a Notice of Deficiency was issued to James R. Sholly and Kathleen V. Sholly which asserted a personal income tax deficiency of \$4,498.14, plus penalty and interest, for a total amount due of \$6,768.18 for the years 1978 through 1980.

The only source of income set forth on petitioners' income tax returns for the years at issue was the salary received by James R. Sholly from Hawk & Dove. While Kathleen V. Sholly was present at the place of business during much of the sales tax audit, she received no wage and tax statement (Form W-2) from Hawk & Dove. She stated that, along with certain other family members, she was at the premises only to help out her husband.

As indicated above, John Sholly, brother of petitioner James R. Sholly, was a shareholder of Hawk & Dove, but he neither worked there nor did he receive income from the business. During the years at issue, John Sholly lived in and owned a 50 percent interest in the home wherein petitioners and their children resided. John Sholly paid a minimum of 50 percent of all

housing expenses (mortgage and utilities) for each of the years at issue. In addition, he contributed approximately \$75.00 per week toward food and other living costs.

### ***OPINION***

In the determination below, the Administrative Law Judge determined that the Division properly used the results of the sales tax audit to adjust the corporate franchise tax liability for petitioners for the years at issue. It was further held that petitioners bore the burden of proving both that they had not omitted more than 25 percent of adjusted gross income on their filed returns and that the six-year statute of limitations set forth in Tax Law §§ 683(d)(1) and 1083(d) did not apply. Because petitioners failed to sustain that burden, the six-year statute of limitations was found to be applicable and accordingly, the Administrative Law Judge held that the notices of deficiencies pertaining to personal income tax and corporation franchise tax for the years 1978 and 1979 were timely issued. As to petitioners' claim of entitlement to certain cost of living expense adjustments, the Administrative Law Judge found the evidence sufficient to substantiate the claim that petitioner James Sholly's brother had contributed to certain housing and living expenses. The claim that certain other family members also contributed money to defray those expenses, however, was found to be without sufficient substantiation or supporting testimony. The Administrative Law Judge also held that petitioners had failed to prove that petitioner Kathleen Sholly qualified as an "innocent spouse" pursuant to Tax Law § 651(b) or that certain funds were embezzled from the restaurant. Lastly, the Administrative Law Judge sustained in full the penalties imposed upon the deficiencies of personal income tax and corporate franchise tax.

On exception, petitioners contend that the Division rather than petitioners bears the burden of proving the facts necessary to show that the six-year statute of limitations applies, and that in this matter, the Division has failed to sustain that burden. Further, petitioners assert that the Administrative Law Judge improperly distinguished Federal case law which places the burden of proof on the Commissioner of Internal Revenue in analogous situations. Petitioners also maintain that the Administrative Law Judge erred in rejecting some of the evidence submitted by petitioners in support of their claim of entitlement to certain cost of living adjustments.



In response, the Division contends that the Administrative Law Judge properly ruled that the burden of proof rests with petitioners with regard to the applicability of the six-year statute of limitations. The Division also argues that the audit method employed herein was proper.

We affirm the determination of the Administrative Law Judge.

Tax Law § 683(d)(1) provides that where an individual omits from adjusted gross income an amount in excess of 25 percent of the amount stated on the filed return, personal income tax may be assessed within six years after the return was filed. Similarly, Tax Law § 1083(d) imposes a six-year statute of limitations with respect to the corporate franchise tax where the taxpayer has omitted from gross income an amount in excess of 25 percent of the amount stated on the franchise tax report.

Petitioners' primary contention is that the burden is on the Division to prove that the six-year limitations period, rather than the general three-year period (see, Tax Law §§ 683[a], 1083[a]), is applicable to the personal income tax and corporate franchise tax returns filed for the periods at issue here and that the Division failed to sustain that burden in this matter. In support of their argument, petitioners direct our attention to the line of Federal cases which place the burden of proof on the Commissioner of Internal Revenue Service to establish the applicability of the six-year statute of limitations (see, Kavoosi v. Commr., T.C. Memo 1986-190; Reis v. Commr., 1 T.C. 9, 12-13, affd 142 F2d 900). Because under federal law the six-year statute of limitations is viewed as an exception to the general three-year limitations period, the burden is placed upon the Internal Revenue Service to demonstrate entitlement to the longer limitations period upon which it relies (Metas v. Commr., T.C. Memo 1982-36; Reis v. Commr., supra, at 12). In order to discharge that burden, the Internal Revenue Service must prove, by a preponderance of the evidence, that there has been an omission from gross income of more than 25 percent of the amount stated in the return and that the omitted amount was properly includable in gross income (Gmelin v. Commr., T.C. Memo 1988-338; see, Metas v. Commr., supra; Burbage v. Commr., 82 T.C. 546, 553). Petitioners contend that as in Federal matters, it would

be appropriate here to shift the burden of proof to the Division in matters relating to the applicability of the six-year statute of limitations.

We are not persuaded by petitioners' contention. Tax Law § 689(e) and § 1084(e) expressly place the burden of proof on the petitioner, subject to certain exceptions inapplicable here (see also, 20 NYCRR 3000.10[d][4]). In view of that express statutory directive, we have recently held that the Federal case law placing the burden of proof on the Internal Revenue Service is not controlling and that the taxpayer bears the burden of showing that the six-year limitations period does not apply (see, Matter of Ted M. Bach, Tax Appeals Tribunal, January 20, 1989). While we have recognized that where fundamental considerations of fairness and due process are implicated it is appropriate to shift the burden of proof to the Division (see, Matter of Ilter Sener, Tax Appeals Tribunal, May 5, 1988 [placing the burden of proof on the Division where the late-payment penalty is asserted for the first time by the Division in its answer as an alternative to the fraud penalty]), we perceive no such concerns present here. Petitioner has not asserted any violation of the principles of fairness or due process and we fail to discern any such violations of sufficient magnitude to warrant shifting the burden to the Division in this matter. Accordingly, we hold that the burden is upon petitioners to demonstrate that they have not omitted more than 25 percent of their gross income and that the six-year statute of limitations is not applicable. Because petitioners have failed to sustain their burden with regard to the corporate franchise tax and personal income tax returns filed, we find the six-year statute of limitations applicable and that the notices of deficiency issued on March 2, 1984 for the years 1978, 1979 and 1980 and on March 26, 1984 for the years 1978 through 1980 are timely.

We now turn to the remaining issue raised by petitioners that the Administrative Law Judge erred in rejecting some of the evidence submitted by petitioners in support of their claim of entitlement to certain cost of living adjustments. The burden of proof rests with the taxpayer to establish that excess cash availability was due to nontaxable gifts from the taxpayer's relatives (see, Matter of Gun Hill Plumbing Supply Co., v. Chu, 145 AD2d 769, 535 NYS2d 497, 499). In attempting to discharge that burden, petitioners submitted three affidavits from family members

and cancelled checks from petitioner Kathleen Sholly's sister to show an additional source of available funds to reduce or eliminate the unexplained cash availability found during the audit. We agree with the Administrative Law Judge that the evidence is insufficient to sustain that burden. The record shows that the affidavits were unsupported by testimony at the hearing or by further substantiation or verification as to the specific purpose of the cash advances or gifts. Further, we find that the cancelled checks are not sufficient on their face to establish that the money was used by petitioners for the express purpose to defray cost of living expenses. Consequently, we find that the Administrative Law Judge properly rejected petitioners' claim of entitlement to adjustments based upon that evidence.

Petitioners, in reliance on the Supreme Court decision in Holland v. United States (348 US 121) and the line of cases generated in its wake, argue that the Division has an affirmative duty to investigate the "leads" offered by petitioners to explain the excess cash availability found during the audit. We reject this view as it would, in essence, necessitate an impermissible shift in the burden of proof to the Division in this instance.

In Holland v. United States (*supra*), a case involving criminal prosecution for tax evasion where the taxpayer raised the defense that a cash hoard existed to counter the Government's showing of unexplained increases in the taxpayer's net worth over a period of years, the Supreme Court opined that where the Government rests its case exclusively upon "the approximations and circumstantial inferences of a net worth computation, the cogency of its proof depends upon its effective negation of reasonable explanations by the taxpayer inconsistent with guilt", thus imposing an affirmative duty on the Government to investigate the validity of the relevant leads furnished by the taxpayer (*id.*, at 135). The duty to investigate articulated by the Supreme Court in Holland did not require a shifting of the burden of proof because as a criminal prosecution, the burden rested with the Government to prove beyond a reasonable doubt the elements of the crime charged (*id.*, at 130, 137). Consequently, the Government's failure to investigate leads furnished by the taxpayer in order to disprove the taxpayer's allegations raised issues of fundamental fairness and directly implicated the sufficiency of the Government's case against the taxpayer (*id.*, at 135).

The rule articulated in the Holland case has been extended to fraud prosecutions where, because the burden is on the Government to establish fraud by clear and convincing evidence, it has been held that the Government must investigate leads supplied by the taxpayer that are reasonably susceptible of being checked for accuracy in order to disprove the taxpayer's allegations (see, King v. Commr., T.C. Memo 1978-351; Powers v. Commr., T.C. Memo 1962-5). However, unlike the situation in cases such as criminal or fraud prosecutions where the burden of proof rests with the Government, here the burden lies with petitioners to introduce evidence sufficient to document and explain the excess cash availability found during the audit (see, Matter of Gun Hill Plumbing Supply Co. v. Chu, *supra*; Matter of Jacobson v. State Tax Commn., 129 AD2d 880, 514 NYS2d 145). Consequently, we decline to extend the rule articulated in the line of cases beginning with the Holland decision to the instant matter because here, the onus is on the taxpayer, not the Division, to present sufficiently credible evidence establishing the origin of the excess cash found during the audit. In our view, petitioners' argument that we impose upon the Division an affirmative duty to investigate the "leads" offered by petitioners would, in effect, simply permit petitioners to avoid the consequences of having failed in the first instance to satisfy their burden of proof. Further, petitioners' reliance on the decision in Pate v. Commr. (T.C. Memo 1957-59) for the proposition that the Government's affirmative duty to investigate formulated in the Holland decision is equally applicable to civil cases is misplaced. The Pate case, which involved the use of the net worth method of reconstructing the taxpayer's income over a period of seven years, cites with approval the discussion in the Holland case which cautions that the use of the net worth method requires the exercise of "great care and restraint" (see, Holland v. United States, *supra*, at 132; Pate v. Commr., *supra*). The Pate decision merely stands for the proposition that such caution is equally appropriate in civil, as well as criminal cases, where the net worth method is at issue (Pate v. Commr., *supra*). Contrary to petitioners' contention, the discussion in Pate does not include any reference to the Government's duty to investigate leads supplied by the taxpayer or extend that rule generally to all civil cases before the tax court.

Accordingly, we find no merit to petitioners' contention that the Division has an affirmative duty to investigate leads offered by petitioners to explain nontaxable sources of income.

Accordingly, it is ORDERED, ADJUDGED and DECREED that:

1. The exception of petitioners, James R. Sholly and Kathleen V. Sholly, is in all respects denied;
2. The determination of the Administrative Law Judge is affirmed;
3. The petition of James R. Sholly and Kathleen V. Sholly is granted to the extent indicated in conclusions of law "D" and "I" of the Administrative Law Judge's determination and denied in all other respects;
4. The Division of Taxation shall modify, as directed in paragraph "3" above, the Notice of Deficiency issued March 26, 1984 to petitioners James R. Sholly and Kathleen V. Sholly but such notice is in all other respects sustained;
5. The petition of Hawk & Dove Restaurant Corp. is denied; and
6. The notices of deficiency issued March 2, 1984 to Hawk & Dove Restaurant Corp. are sustained in their entirety.

DATED: Troy, New York  
January 11, 1990

/s/John P. Dugan  
John P. Dugan  
President

/s/Francis R. Koenig  
Francis R. Koenig  
Commissioner

/s/Maria T. Jones  
Maria T. Jones  
Commissioner