

STATE OF NEW YORK
TAX APPEALS TRIBUNAL

In the Matter of the Petition :
of :
WILLIAM METZGER :
for Redetermination of a Deficiency or for :
Refund of Personal Income Tax under Article 22 :
of the Tax Law for the Years 1984 and 1985. :

In the Matter of the Petition :
of :
THE CAR STORE :
for Revision of a Determination or for Refund :
of Sales and Use Taxes under Articles 28 and 29 :
of the Tax Law for the Period June 1, 1985 :
through November 30, 1985. :

DECISION
DTA Nos. 808033
and 808036

The Division of Taxation filed an exception to the determination of the Administrative Law Judge issued on January 9, 1992 with respect to the petitions of William Metzger, 103 Creekward Drive, West Seneca, New York 14224 for redetermination of a deficiency or for refund of personal income tax under Article 22 of the Tax Law for the years 1984 and 1985 and The Car Store, 103 Creekward Drive, West Seneca, New York 14224 for revision of a determination or for refund of sales and use taxes under Articles 28 and 29 of the Tax Law for the period June 1, 1985 through November 30, 1985. Petitioner William Metzger appeared pro se, and for petitioner The Car Store as its sole proprietor. The Division of Taxation appeared by William F. Collins, Esq. (Deborah J. Dwyer, Esq., of counsel).

Neither party filed a brief on exception. The Division of Taxation's request for oral argument was denied.

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 William Metzger for 1984 by utilizing a source and application of funds audit.

II. Whether the notice of determination issued against The Car Store was jurisdictionally defective and, therefore, invalid because it failed to contain a statement in bold-faced type that the tax assessment was estimated as required by Tax Law § 1138(a)(2).

FINDINGS OF FACT

We find the facts as determined by the Administrative Law Judge. These facts are set forth below.

Petitioner William Metzger, during the years 1984 and 1985, had varied business interests consisting of (1) the ownership and operation of a bar/restaurant known as the Honky Tonk Cabaret in West Seneca (Erie County); (2) two rental properties in 1984, one residential, 3428 Southwestern Boulevard, Orchard Park, New York, and the other commercial, 5200 Seneca Street, West Seneca, New York, and an additional rental property in 1985, 6800 Seneca Street, Elma, New York¹; and (3) a used car business.

The Division of Taxation issued a Statement of Personal Income Tax Audit Changes dated November 29, 1988 against petitioner William Metzger which asserted additional personal income tax due of \$10,465.52 for 1984 and \$4,099.17 for 1985. Penalties under Tax Law § 685(b) and interest were also asserted as due. The statement showed the following calculation of taxes due:

	<u>1984</u>	<u>1985</u>
Partnership income	\$30,942.50	
Unreported income	33,237.05	
Income from Car Store		\$41,806.87
Capital gain	<u>8,651.00</u>	<u> </u>

¹On the Federal Schedule E, Supplemental Income Schedule, included in petitioner's 1985 State tax return, petitioner reported rents received of \$9,600.00 on this property, which was reported as acquired in 1986. (Petitioner apparently meant 1985.) The property was described as a frame house, but it is not known whether the property was residential or commercial real estate.

Net adjustment	\$72,830.55	\$41,806.87
Taxable income previously stated	10,760.00	(1,940.19)
Net New York income	83,590.55	39,866.68
Taxable New York income	83,590.55	39,866.68
Tax on above	\$10,262.68	\$ 4,099.17
Minimum tax	<u>665.84</u>	<u>--</u>
Corrected tax due	10,928.52	4,099.17
Tax previously computed	<u>463.00</u>	<u>-0-</u>
	\$10,465.52	\$ 4,099.17

The Division of Taxation then issued a Notice of Deficiency dated February 3, 1989 against Mr. Metzger asserting additional income taxes due of \$14,564.69, plus penalty and interest, for the years 1984 and 1985 (\$10,465.52 for 1984 and \$4,099.17 for 1985 as per the statement of audit changes, supra).

In 1984, Mr. Metzger reported on his State income tax return² total New York income of \$13,927.00 consisting of the following:

Interest income		\$ 310.00
Business loss		(2,196.00)
Capital gain	8,922.00	
Rents		3,634.00
Partnership income		<u>3,257.00</u>
Total		\$13,927.00

In 1985, Mr. Metzger reported on his State income tax return³ total New York income of \$1,409.81 consisting of the following:

Interest income		\$ 350.00
Business loss		(4,041.66)
Rents		<u>5,101.47</u>
Total		\$1,409.81

²Mr. Metzger obtained an extension until October 15, 1985 to file his 1984 tax return. According to the application for extension of time to file, Mr. Metzger was "waiting for a partnership K-1 distribution which is necessary to file an accurate and complete tax return."

³Attached to Mr. Metzger's 1985 tax return were two duplicate applications for an automatic extension of time, until August 15, 1986, to file. No other applications for extension of time are included in the exhibit. It appears that the 1985 return, which is dated December 1, 1986 and indated December 8, 1986, was filed late.

In both 1984 and 1985, Mr. Metzger reported losses from his operation of the Honky Tonk Cabaret of \$2,196.18 and \$186.26, respectively, on gross receipts of \$145,833.27 and \$29,338.89,⁴ respectively. Ronald P. Pastwich, the Division of Taxation's auditor, who spent 67½ hours on the audit at issue herein, testified that the "operations [of Honky Tonk Cabaret] were correctly reported" by Mr. Metzger on his income tax returns after the auditor reviewed financial documents pertaining to the cabaret. However, the auditor's review of Mr. Metzger's personal checking account raised questions. The auditor testified:

"[T]here was activity that was going through Mr. Metzger's personal checking account itself that we could not quite tie down exactly what the particular deposits applied [sic]⁵ to and what the particular checks being written to cash were made for."

In addition, financial records pertaining to Mr. Metzger's used car business, which in 1984 was a partnership known as Southwood Motors, were inadequate, and there were, according to the auditor, "various large amounts of checks being written to Mr. Metzger from his investment in [Southwood Motors]." Consequently, the auditor testified that in order "to get a better picture of Mr. Metzger's overall financial . . . interests, we decided we would do . . . a source and application of funds⁶ [audit]."

The auditor detailed the following sources of funds for the year 1984 and where the information was derived from:

⁴There is no explanation in the record for this dramatic decrease in receipts in 1985.

⁵The auditor probably meant to use the word "related."

⁶The auditor described a "source and application funds audit" as follows:

"an attempt to determine all the sources of funds that are available to a taxpayer, whether they be from a taxable or a nontaxable [source]. These sources of funds are compared to applications which are, basically, all the expenditures or dollars that go out of a taxpayer's household in a given period, a given year. The two of them are compared. If your applications exceed your sources, well, the general question arises is what funded that overapplication of funds" (Transcript, p. 63).

Draws from Southwood Motors - per partnership records	\$ 15,600.00
Business loss from Honky Tonk Cabaret - as reported on tax return	(2,196.00)
Depreciation on loss from Honky Tonk Cabaret - as reported on tax return	11,425.60
Proceeds from sale of land and building - as reported on tax return	70,000.00
Income from two rental properties - as reported on tax return	3,634.00
Depreciation expense on two rental properties - as reported on tax return	1,811.00
Payments to William Metzger from Southwood Motors - per detailed review of checking account of Southwood Motors	120,704.00
Less: (1) rental payments on 5200 Seneca Street, West Seneca which is included above in the line for income from two rental properties, and (2) draws from Southwood Motors shown above	(5,220.00) (15,600.00)
Balance in Permanent bank account #7010011081 at 1/19/84 - per bank statement	9,192.30
Balance in Norstar bank account #4645-006 at 1/16/84 - per bank statement	5,732.98
Interest income - as reported on return	<u>310.00</u>
Total Sources	\$215,393.88

The auditor detailed the following application of funds for the year 1984 and where the information was derived from:

Balance in Permanent bank account #7010011081 at 12/31/84 - per bank statement	\$ 44,949.44
Balance in Norstar bank account #4645-006 - per bank statement	5,940.63
Payments of Citibank line of credit - from bank statements	3,010.04
Checks written from Permanent bank account #7010011081 - per detailed schedule after review of cancelled checks	191,827.99
Assets purchased in 1984 - per review of depreciation schedules	<u>2,902.83</u>
Total Applications	\$248,630.93

The auditor determined an overapplication of funds for 1984 of \$33,237.05 (\$248,630.93 less \$215,393.88). It is observed that this calculation was a revision of an earlier one based upon additional data obtained by the auditor at two meetings during early August of 1988.

The auditor also calculated a capital gain in 1984 from Mr. Metzger's sale of his partnership interest in Southwood Motors as follows:

Amounts received as repayments from Southwood Motors - per check register of Southwood Motors and analysis of checks to Mr. Metzger	\$20,215.00
Amount of inventory received from Southwood Motors ⁷	<u>63,537.00</u>
Total \$83,752.00	
Less: Mr. Metzger's interest per partnership return	<u>62,125.00</u>
Gain	\$21,627.00
Less: Capital gain deduction	<u>12,976.00</u>
Capital Gain	\$ 8,651.00

For 1984, in addition to the auditor's determination of unreported income of \$33,237.05 and of an unreported capital gain of \$8,651.00, the auditor determined additional partnership income of \$30,942.50 after a separate and distinct audit of Southwood Motors for 1984. The auditor testified:

"What we did is we examined the various books and records such as the cash disbursements journal, the cash receipts journal, the bank statements that were supplied to us by Southwood Motors itself."

The auditor disallowed as partnership business expense deductions the following checks written to Mr. Metzger:

<u>Check Number</u>	<u>Amount</u>	<u>Reason for Disallowance</u>
4403	\$ 2,046	No substantiation
4481	4,700	No substantiation
4485	1,980	No substantiation
4551	5,000	Loan repayment
4642	5,000	Loan repayment
4673	1,150	No substantiation
4689	5,000	Loan repayment
4722	3,800	Boat - not a business expense
4736	4,215	Loan repayment
4951	1,200	No substantiation
4966	3,987	No substantiation
5027	7,207	Appears to be deducted twice
5055	<u>1,000</u>	Loan repayment
	\$46,285	

⁷According to a detailed schedule prepared by the auditor, Mr. Metzger received 30 cars from Southwood Motors. (Mr. Metzger subsequently transferred such cars to The Car Store.) The auditor averaged the high wholesale and low wholesale values for such cars, which he took from National Car Dealers' Association ("NADA") trade books, in calculating the value of the inventory of cars received by Mr. Metzger from Southwood Motors shown above.

In addition, the auditor disallowed as partnership business expense deductions the total amount of draws paid to Mr. Metzger during 1984 of \$15,600.00 (52 weeks x \$300.00). As a result, partnership income was increased by \$61,885.00 (\$46,285.00 + \$15,600.00). Since Mr. Metzger and Edward Gorczyca were 50% partners in Southwood Motors, one-half of the increase in partnership income, or \$30,942.50, was allocated to Mr. Metzger.

For 1985, the auditor determined that The Car Store had an understatement of gross receipts of \$163,672.73 by analyzing its checking account which was opened in the early part of April 1985. From the opening date to the end of 1985, the auditor found \$252,458.57 of deposits. He then subtracted "items which would have been reflected somewhere else in a tax return...some rents and some lease dollars that were received by Mr. Metzger" in the amount of \$28,800.00 to calculate so-called "net deposits" from The Car Store's operations of \$223,658.57. To calculate The Car Store's "total receipts", the auditor also calculated expenditures made in cash of \$21,040.36 as follows:

Purchases from Schedule "C" of Mr. Metzger's 1985 tax return	\$211,295.02
Business expenses (less depreciation) from the Schedule "C"	38,856.58
Checks written per bank statement less amount of checks expensed on the Schedule "C" ⁸	<u>18,274.91</u>
Total	\$268,426.51
Less: checks written	<u>(247,386.15)</u>
Cash expenditures	\$ 21,040.36

"Total receipts" of \$244,698.93 were then calculated by adding the "net deposit" from The Car Store's operations of \$223,658.57 and cash expenditures of \$21,040.36. The understatement of gross receipts of \$163,672.73 was computed by subtracting total receipts as reported on the Schedule "C" of \$81,026.20 from "total receipts" of \$244,698.93.

Based upon the gross receipts per audit of \$244,698.93, the auditor recomputed Mr. Metzger's profit from The Car Store as follows:

⁸The auditor assumed that the difference between these two amounts was non-business expenses. Apparently, if they were business expenses, they would have been deducted or "expensed" on the Schedule "C."

Gross receipts - per audit		\$244,698.93
<u>Cost of Goods Sold:</u>		
Beginning inventory - per audit	\$63,537.00 ⁹	
Autos purchased - per audit	68,093.38	
Parts purchased - per audit	52,696.00	
Ending inventory - per audit	<u>(30,732.50)¹⁰</u>	
Cost of Goods Sold		<u>153,593.88</u>
Gross profit		\$ 91,105.05
<u>Deductions</u> (as reported on Schedule "C")		
Advertising	\$ 486.99	
Depreciation	3,200.00	
Due	35.00	
Insurance	3,431.91	
Mortgage interest	6,609.83	
Office expense	194.41	
Repairs	3,016.81	
Repairs	19,660.77	
Utilities	3,103.39	
Wages	2,729.55	
Licenses	407.00	
Subcontract	3,440.00	
Miscellaneous expenses	<u>227.92</u>	
Total deductions		\$ 36,943.58
Net profit per audit (\$91,105.05 less \$36,943.58)		\$ 54,161.47
Net loss as reported		<u>(3,855.40)</u>
Amount of adjustment		\$ 58,016.87

Subsequently, the auditor reduced the adjustment based upon two checks, one for \$11,910.00 and the other for \$4,300.00, written by Southwood Motors that were allowed as expenses of The Car Store. Therefore, income from The Car Store was revised downwards to \$41,806.87 (\$58,016.87 less the two checks, \$11,910.00 and \$4,300.00). As noted above, this income from The Car Store of \$41,806.87 resulted in tax due of \$4,099.17.

⁹As noted above, Mr. Metzger received 30 cars from Southwood Motors which he subsequently transferred to The Car Store. The auditor valued the 30 cars by utilizing NADA trade book wholesale values. The total valuation of \$63,537.00 noted supra was also used as the value for the beginning inventory of The Car Store.

¹⁰The ending inventory was also estimated by utilizing wholesale values in NADA trade books. According to the auditor, invoices showing how much The Car Store paid for the cars included in the ending inventory were never provided so that a reasonable estimate of their value was made by using the trade books.

The auditor also calculated additional sales tax based upon the understatement of gross receipts by The Car Store of \$163,672.73, as computed above. According to the auditor:

"We recomputed sales tax basically because of the fact that since the income...came from a taxable source as far as sales tax itself was concerned."

The additional receipts of \$163,672.73 were evenly distributed over each of the six months included in the quarters ending August 31, 1985 and November 30, 1985 because The Car Store's book of registry did not reflect the purchase of any cars until June 1985. Therefore, additional monthly receipts of \$27,278.79 were calculated (\$163,672.73 divided by 6). Sales tax due for each of the quarters at issue was calculated as follows:

Quarter Ending August 31, 1985

Gross sales - as reported	\$ 31,678.00
Additional sales - \$27,278.79 x 3	<u>81,836.37</u>
Total sales (taxable) - per audit	113,514.37
Taxable sales - as reported	<u>31,678.00</u>
Additional taxable sales	81,836.37
Rate	<u>8%</u>
Sales tax due	\$ 6,546.91

Quarter Ending November 30, 1985

Gross sales - as reported	\$ 24,810.00
Additional sales	<u>81,836.37</u>
Total sales (taxable) - per audit	106,646.37
Taxable sales - as reported	<u>21,310.00</u>
Additional taxable sales	85,336.37
Rate	<u>8%</u>
Sales tax due	\$ 6,826.91

The Division of Taxation issued a Statement of Proposed Audit Adjustment dated August 12, 1988 asserting total sales tax due of \$13,373.82, plus penalty and interest, for the period June 1, 1985 through November 30, 1985. The statement noted it was based on an "audit of records". A Notice of Determination and Demand for Payment of Sales and Use Taxes Due, also dated August 12, 1988, was issued assessing sales taxes due of \$13,373.82, plus penalty and interest. On the face of the notice under the subheading "Explanation" was an unchecked box next to the following statements printed in bold type:

"THE TAX ASSESSED ABOVE HAS BEEN ESTIMATED IN ACCORDANCE WITH THE PROVISIONS OF SECTION 1138(a)(1) OF THE TAX LAW.

IF THE BOX ABOVE IS CHECKED SEE ADDITIONAL INFORMATION ON BACK OF THIS NOTICE. IF THE BOX ABOVE IS NOT CHECKED, THE TAX HAS NOT BEEN ESTIMATED."

Underneath the bold type in regular typed format was the following statement:

"The following taxes have been determined to be due in accordance with Section 1138 of the Tax Law, and are based on an audit of your records."

Mr. Metzger, who appeared pro se with regard to his income tax assessment and on behalf of his sole partnership, The Car Store, with regard to the sales tax assessment, presented very little evidence in opposition to the assessments.¹¹ Only two documents were introduced into evidence. Petitioners' Exhibit "1" is a certified copy of a "Certificate of Conducting Business under an Assumed Name" which was filed by Mr. Metzger with the Erie County Clerk on April 1, 1985. Mr. Metzger certified that he was "conducting or transacting business under the name or designation of The Car Store at 5200 Seneca, West Seneca, County of Erie."

Petitioners' Exhibit "2" is an affidavit dated October 29, 1986 of Edward Gorczya, who was Mr. Metzger's partner in Southwood Motors. The affidavit stated as follows:

"In 1983 William Metzger opened up a new business known as the Honky Tonk Carbet [sic] and could not run both businesses. At that time I took over the used car lot business. Then gave Mr. Metzger \$300 a week for the inventory that was left on the car lot at that time."

Mr. Metzger testified that he started a used car business in 1957, then also known as The Car Store. The evolution of The Car Store into Southwood Motors and back to The Car Store was described in an indistinct way, difficult to decipher:

¹¹It is further noted that, in the course of the audit, commenced in December 1986 and completed approximately two years later, petitioners were provided with several opportunities to document other nontaxable sources of income. They failed to do so, other than the allowance of two Southwood Motors checks as business expenses of The Car Store as noted above.

"ADMINISTRATIVE LAW JUDGE: You started Southwood Motors in 1957?

MR. METZGER: Well, it used to be The Car Store, and then I changed it to Southwood Motors. When they took it over, it went from The Car Store to Southwood Motors, but I left the inventory there because you can't run a business with no money, with no inventory.

ADMINISTRATIVE LAW JUDGE: When Eddie Gorczya took it over?

MR. METZGER: The inventory was always mine. I just left it there. And I worked with these guys for years. There was never any problems, you know, money wise or arguing or nothing.

ADMINISTRATIVE LAW JUDGE: And you never received inventory back from --

MR. METZGER: In the end, I did. When I went from Southwood Motors to The Car Store, then I took my inventory back, I just transferred it And prior to that, it was money. When he would sell a car, then he would give me the money for the car, and I would let him keep the sales tax because he was liable for it¹² . . . and I gave him half of the profit. We made 600, I took 3, he got 3. I was always fair with the guys."

As noted above, Mr. Metzger received payments from Southwood Motors of \$120,704.00.

Mr. Metzger testified that he used some unspecified portion of such payments to purchase cars up in Canada:

"And when you go to Canada, you have to buy with cash; they won't accept a check Now, you know, 10,000, 8,000, buy cars, bring them back, take the money, go back next week, buy a few more, you know, and I used to be able to make a few bucks doing that. That's where all the cash came from."

Mr. Metzger testified that he showed a "pile of receipts...from the Toronto Auto Auction" to the auditor. None, however, were introduced at the hearing.

Mr. Metzger candidly admitted that "everything got to be such a mess", but he "didn't know it". The culprit was his bookkeeper:

¹²However, the sales tax assessed was not for the period that Southwood Motors conducted the used car business. Mr. Metzger's contention that the sales tax liability "belonged to Southwood Motors" was irrelevant.

"My bookkeeper moved to Florida, and when he moved to Florida, he gave his business to his associates and they didn't do nothing. It was only just a young guy out of college or whatever, and here I am sending him a check every month to do the bookwork and he never done it."

OPINION

In the determination below, the Administrative Law Judge held that: 1) it was reasonable for the Division of Taxation (hereinafter the "Division") to treat the excess of the application of funds over sources calculated during a source and application of funds audit as additional income for the year 1984; 2) because the \$30,942.50 increase in petitioner's share of partnership income, determined by an audit of the expenditures of Southwood Motors, was subsumed by the source and application of funds audit, it was not reasonable to increase Mr. Metzger's (hereinafter "Metzger") taxable income by this amount; 3) a rational basis existed for the notice of deficiency issued to Metzger for 1985 income taxes and that he failed to meet his burden of proving that the assessment was incorrect; and 4) the notice of determination issued to The Car Store was jurisdictionally defective for failure to indicate on the notice that the tax had been estimated in accordance with Tax Law § 1138(a)(2), and cancelled the assessment.

On exception, the Division contends that it was an error for the Administrative Law Judge to treat the additional partnership income determined by the audit of Southwood Motors as having been subsumed by the source and application of funds audit. Specifically, the Division contends that while ordinary partnership income is required to be reported as taxable income by the partners in the year it is realized, there is no requirement that such income actually be distributed to the partners. Therefore, it argues, partnership income, which is separate and distinct, cannot be and was not used as a source of funds, and the partnership audit must be considered separately from the source and application of funds audit. The Division also contends that the Administrative Law Judge erroneously placed the burden of establishing a rational basis for the notice of determination on the Division. Finally, the Division argues that its failure to

indicate on the notice of deficiency that sales tax had been estimated in accordance with Tax Law § 1138(a)(2) does not render the notice void due to a jurisdictional defect.

Petitioner did not respond to the Division's exception.

We reverse the determination of the Administrative Law Judge.

In order to understand the basis for our decision, it is important to recognize the fundamental differences between the audit techniques employed by the Division on Metzger and Southwood Motors, respectively, for the year 1984. The audit performed on Southwood Motors included an examination of the partnership's books and records, comparing this information to the entries made on the partnership return. One purpose of this type of audit is to determine, for instance, whether deductions claimed by the partnership had both a legal basis and were adequately substantiated.

By contrast, the audit technique applied to Metzger's personal records is termed a "source and application of funds" audit. This type of audit is concerned only with the flow of cash to and from a taxpayer during the period at issue. More specifically, this method compares all sources of money received by a taxpayer during a given year with the amount of money expended or "applied."¹³ If the amount applied exceeds the amount received, it is assumed that the difference represents additional, unreported income, although the source of this income has not been identified (see, Jacobson v. State Tax Commn., 129 AD2d 880, 514 NYS2d 145). The use of this method has been held to be "appropriate when a taxpayer's records are inadequate for the determination of his income" (Jacobson v. State Tax Commn., supra, 514 NYS2d 145, 147). The auditor in this matter testified that this audit method was used because of the significant number of checks received by Metzger from Southwood Motors, which were not explained by Metzger (see, Finding of Fact "5"). Because these unexplained receipts rendered Metzger's records

¹³The Administrative Law Judge treated a source and application of funds audit and a cash availability audit as synonymous terms (Determination, p. 15). However, there exists a significant difference between the two methods. Unlike a source and application of funds, a cash availability audit is limited to a comparison of a taxpayer's reported income with his or her expenditures for the same period, with the amount of excess expenditures treated as additional income to the taxpayer (see, Matter of Giuliano v. Chu, 135 AD2d 893, 521 NYS2d 883).

inadequate to determine Metzger's income, we see no error in the auditor's resort to a source and application of funds audit in this instance.

We emphasize two aspects of a source and application of funds audit which are critical to our decision. First, in determining the total sources of funds under this method, all sources received by a taxpayer are included, regardless of whether they are taxable or nontaxable.¹⁴ Second, when a payment received by a taxpayer is included in this "source" amount, its effect is to decrease the amount by which applications exceed sources and, thus, reduces what we will refer to as "unidentified income." From these two points, it follows that all sources received and accounted for during the audit period are included within this source of funds component and are, therefore, excluded from unidentified income.

In 1984, several payments from Southwood Motors to Metzger totaling \$61,885.00 were found to have been improperly taken as deductions by Southwood Motors. Because Metzger, a partner in Southwood Motors, received one-half of partnership profits, this adjustment resulted in Metzger being assessed for one-half of this amount, or \$30,942.50. These disallowed deductions were in regard to 1984 payments from Southwood Motors to Metzger, and were included in Metzger's sources of funds (see, Exhibit "M"; Findings of Fact "6" and "8"). Because of the inclusion of these payments as sources of funds, it follows that the increase in partnership income caused by the disallowance of the deductions was not contained in the \$33,237.05 unidentified income figure determined by the source and application of funds audit. Accordingly, we hold that the Division properly treated this "paper" adjustment to the income of Southwood Motors as having no bearing on, and no existence separate and apart from, income determined by the source and application of funds audit -- an audit method which employs a pure cash-flow analysis.

¹⁴For example, if a partnership recognizes income in year one, this income is reported on the partners' individual returns in year one (based on each partner's proportionate share of income), regardless of whether the income was actually distributed to the partners (26 USC § 701; 26 CFR 1.701-1). Thus, it is the partnership's recognition of income, not the actual receipt by a partner, which is the taxable event to the partner. This raises the clear possibility that a partner will receive a "nontaxable" or, more accurately, a previously taxed partnership draw. This type of receipt would, nevertheless, be included in a taxpayer's source of funds.

In cancelling the partnership income amount of \$30,942.50, the Administrative Law Judge found that the unidentified source of funds (\$33,237.05) was "more than likely" derived from Southwood Motors (Determination, p. 16). However, even if we assume that this is true, Metzger is not entitled to an exclusion of the \$30,942.50. This upward adjustment to Metzger's income resulting from the audit of Southwood Motors was not due to the existence of an additional, unreported receipt of cash by Metzger (either directly or constructively through his partnership). Rather, this was caused by a disallowance of business expense deductions taken by the partnership which either lacked a legal basis or were not adequately substantiated (see, Finding of Fact "8"). The consequent increase to partnership income did not provide the partnership with additional cash which could be distributed to Metzger as unidentified income -- a fact necessary to conclude that the \$30,942.50 increase to partnership income was included in the \$33,237.05 amount. Because there is no risk of taxing the same income twice, the Administrative Law Judge's reliance on Matter of Petito (Tax Appeals Tribunal, October 17, 1991) as support for excluding the \$30,942.50 amount from Metzger's income is misplaced.

We will now address the issue of whether the notice of determination issued to The Car Store contains a jurisdictional defect which would require the assessment to be cancelled. Tax Law § 1138(a)(2) provides:

"[w]henver such tax is estimated as provided for in this section, such notice shall contain a statement in bold face type conspicuously placed on such notice advising the taxpayer: that the amount of the tax was estimated; that the tax may be challenged through a hearing process; and that the petition for such challenge must be filed with the tax commission within ninety days."

The Division does not dispute that the tax was estimated. Rather, the Division contends that: 1) because the Administrative Law Judge, acting on his own initiative, erroneously placed the burden on the Division to establish that the notice had a rational basis, and The Car Store failed to raise this issue at hearing, the jurisdictional issue is not properly before the Tribunal; and 2) in the alternative, because The Car Store was not prejudiced by the form of the notice, no

jurisdictional defect exists. In addressing the Division's first contention, we look to 20 NYCRR 3000.5(b)(5), which states that:

"[t]he tribunal or the supervising administrative law judge on his own motion may upon notice to the parties, issue a decision or determination dismissing the petition on the ground that:

"(i) the tribunal lacks jurisdiction of the subject matter of the petition"

Since the Division raised this issue at hearing, there is no question of notice to the parties. Therefore, based on the above regulation, it is clear that the Administrative Law Judge had the authority to raise this jurisdictional issue on his own initiative (see, Matter of A & J Parking Corp., Tax Appeals Tribunal, April 9, 1992).¹⁵

We recently addressed the consequences of the Division's failure to "check the box" on the notice of determination, indicating that the sales tax assessed had been estimated, in Matter of A & J Parking Corp. (*supra*). There, we held that the Division's failure to check the box on the notice did not in itself constitute a jurisdictional defect causing the assessment to be cancelled. Because the purpose for the requirement was to insure that taxpayers were informed of the nature of the assessments against them in order to allow them to respond by means of a protest procedure, the taxpayer must show that he was prejudiced by this omission (Matter of A & J Parking Corp., *supra*).

In this case, The Car Store timely filed a petition to the sales tax assessment. At hearing, the Division's auditor explained the method used in arriving at the assessed amounts (Tr., pp. 85-95, 106-110). In addition, Metzger, The Car Store's representative, declined an offer at the close

¹⁵While this jurisdictional issue is properly before us, we agree with the Division that the Administrative Law Judge erred to the extent that his statements at the hearing suggest that the Division had an affirmative burden to establish a rational basis for the assessment on the Division (Tr., p 5). A presumption of correctness attaches to an assessment issued by the Division which, in itself, provides the rational basis, so long as no evidence is introduced challenging the assessment (Matter of Leogrande v. Tax Appeals Tribunal, ___ AD2d ___ [1992], 589 NYS2d 383; see, Matter of Tavolacci v. State Tax Commn., 77 AD2d 759, 431 NYS2d 174). Our cases establish that the Division has the obligation, in response to the petitioner's inquiry at the hearing, to describe the audit methodology used and that the method as described must be rational (see, Matter of Atlantic and Hudson Ltd. Partnership, Tax Appeals Tribunal, January 30, 1992).

of the hearing to submit additional evidence as well as a post-hearing brief (Tr., pp. 141-143). Based on this, we conclude that The Car Store was aware of the estimated nature of the tax, was not misled or prejudiced, and enjoyed every privilege that a formally correct notice would have given him (Matter of A & J Parking Corp., supra). Thus, we hold that the notice of determination issued to The Car Store was not jurisdictionally defective.

Accordingly, it is ORDERED, ADJUDGED and DECREED that:

1. The exception of the Division of Taxation is granted to the extent that the notice of deficiency is modified to reinstate the amount assessed pertaining to income derived from Southwood Motors, and the notice of determination is reinstated;
2. The determination of the Administrative Law Judge is reversed to the extent indicated in paragraph "1" above, but is otherwise affirmed;
3. The petition of The Car Store is denied;
4. The petition of William Metzger is denied;
5. The notice of deficiency dated February 3, 1989 is sustained; and
6. The notice of determination dated August 12, 1988 is sustained.

DATED: Troy, New York
February 11, 1993

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

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

Dissenting Opinion in the Matter of the Petition of
WILLIAM METZGER and THE CAR STORE

Francis R. Koenig (dissenting):

I concur with the result reached by the majority with respect to the notice of deficiency issued to petitioner William Metzger; however, I respectfully dissent from the result reached by the majority with respect to the notice of determination issued to petitioner The Car Store.

For the reasons stated in my dissenting opinion in Matter of Cheakdkaipejchara, Tax Appeals Tribunal, April 23, 1992, and my concurring opinions in the Matter of A & J Parking Corp., Tax Appeals Tribunal, April 9, 1992 and Matter of Negat, Inc., Tax Appeals Tribunal, April 9, 1992, I dissent from the majority's holding that the Division's failure to comply with section 1138(a)(2) of the Tax Law does not render the notice of determination invalid.

For the reasons stated in the above cited decisions, I conclude that the failure to comply with section 1138(a)(2) of the Tax Law rendered the notice of determination invalid and that the assessment issued to The Car Store should be cancelled on this basis.

DATED: Troy, New York
February 11, 1993

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