

STATE OF NEW YORK  
TAX APPEALS TRIBUNAL

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In the Matter of the Petition :  
of :  
**JOSEPH AND JOSEPHINE MACALUSO** :  
for Redetermination of a Deficiency or for :  
Refund of New York State and New York City :  
Personal Income Taxes under Article 22 of the :  
Tax Law and the New York City Administrative :  
Code for the Years 1983 through 1985. :

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DECISION  
DTA NOS. 810181  
AND 810182

In the Matter of the Petition :  
of :  
**SIPAM CORP.** :  
for Redetermination of a Deficiency or for :  
Refund of Corporation Franchise Tax under :  
Article 9-A of the Tax Law for the Fiscal Years :  
Ended September 30, 1983 through September 30, :  
1985. :

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Petitioners Joseph and Josephine Macaluso and Sipam Corp., 1091 Cuyama Road, Ojai, California 93023, filed an exception to the determination of the Administrative Law Judge issued on October 31, 1994. Petitioners appeared by Serpico & Ehrlich (John R. Serpico, Esq. and Jeffrey S. Ehrlich, Esq., of counsel). The Division of Taxation appeared by Steven U. Teitelbaum, Esq. (John E. Matthews, Esq., of counsel).

Petitioners filed a brief in support of their exception. The Division of Taxation filed a brief in opposition. Oral argument, at petitioners' request, was heard on March 20, 1997 in Troy, New York.

After reviewing the entire record in this matter, the Tax Appeals Tribunal renders the following decision. Commissioner Jenkins took no part in the consideration of this decision.

***ISSUES***

I. Whether the Division of Taxation's audit methodology was reasonably calculated to reflect the taxes due.

II. Whether there was a liquidation of Sipam Corp. under Internal Revenue Code § 337.

III. Whether the Division of Taxation properly determined that petitioners received constructive dividends during the period in issue attributable to disallowed corporate expenditures and loans made by Sipam Corp.

IV. Whether Josephine Macaluso qualifies for treatment as an innocent spouse for the years 1983 and 1984 and cannot be taxed for 1985 because she was not required to file a return for that year.

***FINDINGS OF FACT***

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

Petitioner Sipam Corp. ("Sipam"), a New York corporation incorporated in October 1976, owned and operated a motel known as the Conca D'Oro Motel<sup>1</sup> located at 2232 Forest Avenue, Staten Island, New York. During the period at issue, the Conca D'Oro Motel rented exclusively to welfare recipients. Sipam's certificate of incorporation indicates that its tax year was to end on December 31.

Sipam filed its Federal income tax return (Form 1120) for the year ended May 31, 1983. Sipam did not file Federal income tax returns for any subsequent periods. Unsigned copies of Sipam's unfiled Federal income tax returns for the years ended May 31, 1984 and May 31, 1985 were entered into the record herein.

Sipam did not file any New York corporation franchise tax reports for any part of the relevant period.

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<sup>1</sup>The motel is also referred to as the Conca D'Oro Hotel at various points in the record.

Petitioners Joseph and Josephine Macaluso, husband and wife, timely filed joint Federal and New York State personal income tax returns for the years 1983 and 1984. Petitioners did not file either Federal or State returns for 1985. On their 1983 and 1984 New York returns, petitioners reported adjusted gross income of \$129,736.00 and \$62,000.00, respectively.

Mr. Macaluso became president of Sipam in 1977, soon after the corporation's formation, and remained president at all times relevant herein. Mr. Macaluso was also a director of Sipam. According to a "Resolution" of the board of directors of Sipam, dated March 27, 1979, signed by Mr. Macaluso and a Mr. Roberto Mameli, Mr. Macaluso was given "the authority to make loans at his own discretion." Minutes of meetings of Sipam's board of directors dated March 22, 1981 and February 28, 1983 indicate that Mr. Macaluso was given complete discretion regarding an expansion of the Conca D'Oro Motel. Additionally, the minutes of a board meeting of April 7, 1984 indicate a board decision to allow Mr. Macaluso "complete and total control in all financial decisions that concern Sipam Corporation."

Regarding the stock ownership of Sipam, the record contains some conflicting evidence. Sipam's unfiled Federal income tax return for the year ended May 31, 1985 states that Mr. Macaluso owned 100% of Sipam's stock. In contrast, the minutes of a meeting of Sipam's board on July 20, 1977 indicate the issuance of 100 shares of Sipam stock to Mr. Macaluso and 100 shares to Princex Trading International ("Princex"), a Panama corporation. Other corporate records also indicate that Mr. Macaluso was issued 100 shares of stock on July 20, 1977 and indicate that Princex transferred 50 of its shares to Zurital Trading Corporation ("Zurital"). Additionally, the minutes of a Sipam board meeting held on January 8, 1985 with Mr. Macaluso present indicate the board's decision "that other stockholders be consulted about the decision whether or not to sell the motel." These minutes further state the board's decision "to contact Mr. Roberto Mameli and inform him of the proposal [to sell the motel] so that he can get the decision of the foreign stockholders . . . so that we may pursue this offer if it is acceptable." The minutes of the board meeting held on April 7, 1985 state that "[t]he letter from Mr. Mameli was read to the Board, giving Mr. Macaluso authority to further pursue the sale of the Conca

D'Oro Motel." The record also contains a resolution of Princex Trading International, Inc., dated March 20, 1979, which indicates that Princex owned 50% of the capital stock of Sipam and that Princex had transferred 50% of its shares to Zurital. The resolution also indicates that Princex remitted \$1,077,500.00 to Sipam during 1977 and 1978 "for the purchase of the land and the construction of the buildings."

The record also contains a document, the purpose of which is unexplained but pursuant to which Roberto Mameli, as president of Zurital, states that Zurital owns 25% of the shares of Sipam. This document is dated May 9, 1988.

Although the record contains little evidence of Sipam's day-to-day activities, the minutes of the board clearly indicate that Mr. Macaluso was in charge of Sipam's operations. Mr. Macaluso had no involvement in Sipam's clerical or bookkeeping activities. Such responsibilities were delegated to a Mr. Stephen Sano, an accountant, and Mr. Sano's mother, employed by Sipam in a clerical capacity. The record also indicates that Mr. Macaluso hired an individual to manage the property.

The expansion of the motel referred to in the minutes resulted in an increase in the number of rooms from 59 to 120 rooms. This expansion occurred in the early 1980's.

Sipam sold the Conca D'Oro Motel to an unrelated party on May 24, 1985. Under the terms of the sale, Sipam received \$600,000.00 for the sale of the business and \$4,100,000.00 for the sale of the real property. The purchase price for the real property was paid, in part, by a purchase money mortgage and note given to Sipam in the amount of \$3,975,000.00.

Pursuant to the terms of an Assignment of Mortgage dated December 3, 1985, Sipam assigned the \$3,975,000.00 purchase money mortgage to Mr. Macaluso for \$1,000.00.

The record also indicates that, by assignment dated December 20, 1985, Mr. Macaluso assigned the purchase money mortgage to Gateway State Bank in consideration of \$120,000.00. This assignment indicates that the mortgage had a principal value of \$3,906,164.00 as of December 1, 1985.

Also present in the record is an assignment dated March 12, 1986 whereby, in consideration of \$1,000.00, Mr. Macaluso assigned the same purchase money mortgage to Belleview Estates, Inc., a California corporation with an address of 1091 Cayama Road, Ojai, California. Stephen M. Sano executed the assignment on behalf of the assignee.

The record also contains an assignment dated August 26, 1986 whereby Belleview Estates, Inc. assigned the same purchase money mortgage back to Mr. Macaluso for \$1,000.00.

The record contains no explanation or other information regarding the assignments referred to in Findings of Fact "12", "13" and "14", nor does the record contain any information regarding any other assignments of the purchase money mortgage. Given the chronology of assignments as noted, it would seem that some additional information would be necessary to explain what happened between the December 20, 1985 assignment and the March 12, 1986 assignment.

The record herein contains copies of four loan agreements, each dated August 14, 1978, the terms of which indicate that Sipam borrowed as follows:

Lender	MJJ Investors Co. <sup>2</sup>	Zurital	Princex	Crailhurst Ltd.
Amount of Loan	\$500,000.00	\$450,000.00	\$450,000.00	\$400,000.00

By a letter dated January 26, 1986, Zurital, acting through Mr. Mameli, appears to have ratified the December 3, 1985 assignment of mortgage to Mr. Macaluso with the following conditions:

- "1. You personally [sic] assume and agree to pay, the existing obligations to the stockholders. By this, we mean, the outstanding loans made to Sipam Corporation in 1977, and any and all outstanding interest that is due and payable on said loans.
- "2. After the above mentioned obligations are met, any and all appropriate share of the profit from the sale of the Conce [sic] D'Oro Motel be paid to the stockholders of record."

The January 26, 1986 letter further states:

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2

It should be noted that Mr. Macaluso signed the loan agreement on behalf of MJJ Investors Co.

"If there is not going to be any further business, then Sipam Corporation will become a Dormant Corporation. If in your opinion, there will not be any further business for Sipam

Corporation, then we feel that you should investigate the feasibility [sic] and practicality of dissolving [sic] Sipam."

Mr. Macaluso made the following payments to Princex and Zurital:

<u>Date of Check</u>	<u>Payee</u>	<u>Amount</u>
12/17/86	Zurital	\$225,000.00
3/19/86	Zurital	100,000.00
3/19/86	Zurital	400,000.00
4/14/87	Princex	100,000.00
5/4/87	Princex	100,000.00
5/30/87	Princex	150,000.00
6/15/87	Zurital	100,000.00
7/7/87	Zurital	100,000.00
9/8/87	Zurital	150,000.00
12/15/87	Princex	100,000.00
3/25/88	Zurital	100,000.00
4/15/88	Zurital	86,500.00
date illegible	Princex	86,500.00

Mr. Macaluso testified that the payments listed above were made in consideration of the December 3, 1985 assignment of mortgage to him. Mr. Macaluso further testified that he paid Princex and Zurital through Mr. Mameli a total of \$1,900,000.00 in respect of the assignment and that no written agreement was ever drawn up in respect of this arrangement with Mr. Mameli.

Mr. Macaluso also paid Mr. Mameli \$30,000.00 by check dated November 24, 1987. Mr. Macaluso testified that this payment was intended for Mr. Mameli to pay Federal withholding taxes.

The minutes of Sipam's board meeting of April 7, 1985 state, in part:

"Discussion pursued concerning the future of Sipam Corp after the sale of the motel. Several alternative ideas were presented for the Boards opion [sic], such as purchasing another motel in another part of the city, land development, building of residential units or condominiums. These ideas were taken into consideration and will be pursued for further discussion at subsequent meetins [sic]."

Petitioners Joseph and Josephine Macaluso were audited by the Internal Revenue Service ("IRS") for the years 1986, 1987 and 1988. The results of this audit were eventually resolved by agreement of the parties under the aegis of the United States Tax Court. Petitioners

entered into the record herein copies of the Tax Court "decisions" relative to the IRS audit. Said decisions merely recite the amount of the tax deficiencies, penalties and interest for the years at issue in the IRS audit.

Petitioners Joseph and Josephine Macaluso also entered into evidence herein their joint 1986 Federal income tax return. Said return listed \$450,000.00 in interest income from Conca D'Oro Motel, Inc. and also listed as a deduction \$450,000.00 in interest paid to Roberto Mameli and \$55,000.00 in interest paid to Gateway State Bank.

On audit, the Division of Taxation ("Division") determined Sipam's audited gross receipts for the period at issue by reference to a document entitled "Welfare Hotels Fact Sheet" which was prepared internally by the Division using information obtained from the New York City Department of Social Services. The "fact sheet" listed "estimated welfare receipts" of the Conca D'Oro Motel for the calendar years 1983, 1984 and 1985. The Division determined the estimated welfare receipt amounts to be Sipam's audited gross receipts for its fiscal years ended September 30, 1983 and September 30, 1984.<sup>3</sup> For the year ended September 30, 1985, the Division determined Sipam's gross receipts to be the difference between the 1985 estimated receipts per the fact sheet and the reported gross receipts of the corporation that purchased the motel in May 1985. As determined in the foregoing manner, the Division determined the following audited gross receipts for Sipam:

Fiscal Year Ended	9/30/83	9/30/84	9/30/85
Audited Gross Receipts	\$1,275,562.00	\$2,247,872.00	\$960,447.00

It is noted that petitioner did not take issue with the estimated welfare receipt figures as listed on the Welfare Hotels Fact Sheet. It is further noted that documentation submitted by petitioner in an effort to refute the Division's audit result indicated a total gross receipts figure for the period at issue which exceeded the Division's total figure by \$250,117.00.

In determining Sipam's allowable expenses for the fiscal year ended September 30, 1984, the Division used as its starting point the total cash expenses claimed on Sipam's unfiled

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<sup>3</sup>The Division's records indicated that Sipam's tax year ended September 30.

Form 1120 for the year ended May 31, 1984. Such total cash expenses amounted to \$1,804,395.00. The Division then disallowed certain claimed expenses. Specifically, the Division disallowed 80% of the following expenses:

<u>Expense</u>	<u>Amount Claimed Per Return</u>
Repairs	\$141,809.00
Taxes	120,377.00
Interest	275,956.00
Consultants/Legal/Accounting	230,484.00
Casual Labor	132,295.00
Miscellaneous Expenses	<u>67,321.00</u>
	\$968,242.00 x .80 = \$774,594.00 =
	Amount Disallowed

The Division also disallowed in full the following claimed expenses:

<u>Expense</u>	<u>Amount Disallowed</u>
Automobile	\$ 14,806.00
Travel & Entertainment	56,779.00
Outside Contractors	57,622.00
Electrician <sup>4</sup>	30,700.00
Closing Costs	11,521.00
Equipment	<u>27,308.00</u>
	\$198,736.00

The Division thus disallowed a total of \$973,330.00 of the cash expenses claimed on Sipam's unfiled Federal income tax return for the year ended May 31, 1984. The Division allowed as expenses the difference between the amount claimed and the amount disallowed, which amounted to \$831,065.00. The Division then added to that amount Sipam's claimed depreciation of \$96,199.00 to reach total allowed expenses of \$927,264.00.

Audited gross receipts less allowable expenses as determined on audit above resulted in audited taxable income for the fiscal year ended September 30, 1984 of \$1,320,608.00.

On its unfiled Federal return for the year ended May 31, 1984, Sipam claimed a total of \$1,099,052.00 in "Other Deductions". Attached to the return was a schedule listing the specific

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4

Sipam's return claimed \$35,015.00 in electrician expenses. The Division allowed \$4,315.00 of such claimed expenses.

components of such other deductions. Included in the list of "Other Deductions" is an entry for "Real Estate Taxes" in the amount of \$165,229.00, which was not disallowed on audit by the Division.

In determining Sipam's allowable expenses for the fiscal year ended September 30, 1985, the Division used as its starting point the total cash expenses claimed on Sipam's unfiled Form 1120 for the year ended May 31, 1985. Such expenses amounted to \$417,847.00.

The Division next disallowed certain expenses claimed on the return. Specifically, the Division disallowed 80% of the following claimed expenses:

<u>Expense</u>	<u>Amount Claimed Per Return</u>
Repairs	\$ 33,411.00
Taxes	70,935.00
Interest	43,605.00
Miscellaneous other than Auto	<u>77,162.00</u>
	\$225,113.00 x .80 = \$180,090.00 =
	Amount Disallowed

The Division also disallowed, in full, petitioner's claimed automobile expenses of \$5,269.00 for the year ended May 31, 1985.

The Division further disallowed \$25,376.00 in cash expenses based upon a comparison of Sipam's cash disbursements as indicated by records reviewed by the Division on audit and the cash expenses taken on Sipam's tax return. Specifically, records reviewed by the Division on audit revealed \$563,269.00 in total disbursements for the year ended May 31, 1985. Capital expenditures accounted for \$171,158.00 of these total disbursements, leaving \$392,471.00 available for cash expenses for the year. As noted, Sipam claimed \$417,847.00 in cash expenses on its return. The Division thus disallowed the amount of cash expenses claimed on the return which exceeded the amount available for such expenses as indicated by the disbursement records reviewed by the Division on audit.

In total, the Division disallowed \$210,735.00 of the cash expenses claimed on Sipam's unfiled Federal income tax return for the year ended May 31, 1985. The Division allowed as expenses the difference between the amount claimed and the amount disallowed, which

amounted to \$207,112.00. The Division then added to that amount Sipam's claimed depreciation of \$96,199.00 to reach total allowed expenses of \$303,311.00.

Audited gross receipts less allowable expenses as determined on audit resulted in audited taxable income for Sipam for the fiscal year ended September 30, 1985 of \$657,136.00.

Sipam did not provide disbursement records to the Division on audit for the fiscal year ended September 30, 1983. Accordingly, the Division disallowed a percentage of the cash expenses claimed on Sipam's filed Federal income tax return for the year ended May 31, 1983. Specifically, the Division disallowed 52.18% of such cash expenses. This particular percentage was used because it represented the average of the percentages of disallowance of cash expenses for the two subsequent years at issue.<sup>5</sup>

Applying the percentage of disallowance to the cash expenses claimed on the return resulted in total cash expenses disallowed of \$316,871.00 and total cash expenses allowed of \$290,394.00. Following an addback of the \$87,621.00 in depreciation claimed, the Division determined total expenses allowed of \$378,015.00.

Audited gross receipts less allowed expenses resulted in audited taxable income to Sipam for the fiscal year ended September 30, 1983 of \$897,547.00.

The Division also determined that Sipam had additional unreported income for the fiscal year ended September 30, 1985 resulting from the sale of the Conca D'Oro Motel in May 1985.<sup>6</sup> This additional income had two components. First, the Division determined \$600,000.00 in additional ordinary income to Sipam based upon the sale of the Conca D'Oro Motel business. Second, the Division determined \$2,167,464.00 in capital gain income resulting from Sipam's sale of the real property. The capital gain was calculated as follows:

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<sup>5</sup>Percentage of disallowance as used herein equals the ratio of total cash expenses disallowed to total cash expenses per returns. For the fiscal years ended September 30, 1984 and September 30, 1985, this ratio equaled 53.94% and 50.43%, respectively.

<sup>6</sup>Although petitioner took issue with the Division's determination of tax due arising from the sale of the motel, the Division's calculation of gain in respect of the sale is not in dispute.

Gross consideration	\$4,100,000.00
Basis	(1,847,536.00)
Brokerage Fees	(30,000.00)
Other Expenses	<u>(55,000.00)</u>
Gain	\$2,167,464.00

The Division introduced into the record a copy of an automobile retail installment contract dated September 20, 1982 which indicated the purchase of an automobile by Sipam. The contract contained a heading "Use For Which Purchased" and listed thereunder an "X" in a box labeled "Personal". The record contains no other evidence regarding Sipam's use of this or any other car.

In order to establish the amount of water, sewer and real estate taxes paid by Sipam during the period at issue, Sipam introduced into the record photocopies of documents maintained by the City of New York listing various water, sewer and real estate tax charges to Sipam's premises. The headings of the various columns of these documents (referred to by Sipam as "History of Payments") are, for the most part, either abbreviations or are illegible (or both). To explain these documents, Sipam introduced an affidavit by Anthony P. Barone, an attorney and vice-president and counsel of Regency Abstract, Inc. Mr. Barone's affidavit offered an explanation of the various column headings contained on these documents. Mr. Barone's affidavit did not offer an explanation for the final two column headings on the right side of the documents, both of which were sub-headings under the heading "Liquidation". The History of Payments documents and the affidavits together appear to indicate that Sipam paid \$207,260.00 in real estate taxes and \$13,782.00 in water and sewer charges on the subject property during the period at issue.

Mr. Macaluso testified that Sipam was in arrears on its real estate taxes at the time of the sale of the motel in 1985 and that Sipam paid about \$120,000.00 in back real estate taxes at that time. Upon review of the "History of Payments" documents submitted by petitioners, there appears to be no indication of any activity on or about May 25, 1985.

During the course of its audit of Sipam, the Division determined that petitioner Joseph Macaluso was a principal stockholder of Sipam and that he had directly or constructively

received substantial income from the corporation. Accordingly, the Division attributed to Mr. Macaluso the additional corporate income resulting from the Sipam audit. Specifically, the Division determined that the full amount of the additional unreported income of Sipam resulting from the Division's audit of the corporation's gross receipts and disallowance of certain claimed expenses constituted a constructive dividend to Mr. Macaluso in amounts as follows:

<u>1983</u>	<u>1984</u>	<u>1985</u>
\$897,547.00	\$1,320,608.00	\$657,136.00

The Division also determined that the full amount of the contract price from Sipam's sale of the Conca D'Oro Motel business (i.e., \$600,000.00) constituted a constructive dividend to Mr. Macaluso for the year 1985.

With respect to Sipam's 1985 sale of real property, the Division attributed income to Mr. Macaluso as follows:

Total Capital Gain on Sale	\$2,167,464.00
Less: Depreciation	<u>(653,642.00)</u>
Remaining Capital Gain	\$1,513,822.00

The Division then determined 40% of the remaining capital gain, or \$605,529.00, to be a capital gain to Mr. Macaluso and 60%, or \$908,293.00, to be an item of tax preference for Mr. Macaluso, subject to minimum income tax.

Also with respect to the sale of the real property, the Division determined \$653,642.00 to be additional ordinary income to Mr. Macaluso for 1985 as depreciation recapture.

The Division also determined that Mr. Macaluso received constructive dividends from Sipam in the amount of certain payments purportedly made by Sipam during 1984 and 1985 which were characterized as loans on Sipam's disbursement records. The Division's review of Sipam's records revealed that such loans totalled \$503,502.00 in 1984 and \$48,603.00 in 1985.

The Division took issue with the existence and validity of the purported loans because the Division believed that the parties which purportedly received the loan proceeds could be related to Sipam. Additionally, there were no loan documents or records of repayment and Sipam offered no explanation for the loans. Further, the parties purportedly receiving the loans

did not file tax returns. The Division thus characterized the purported loans as retained earnings.

Sipam's disbursement records indicate approximately 120 separate "loan disbursements" during 1984 and 1985. The amounts of such disbursements ranged from \$50.00 to \$28,000.00. Some disbursements were made in round number amounts, others were not. One entity, Staten Island Realty Holding Corp., appears as the recipient of the majority of these disbursements. Other entities listed as receiving these loans are: US Mining International Ltd.; Ceramicus Manufacturing, Ltd.; Ramfis Realty, Inc.; and an entity listed in the auditor's workpapers as MVJ.

Mr. Macaluso described the purported loan to US Mining International as an investment. Mr. Macaluso further testified that Mr. Mameli had suggested making the purported loan to US Mining International.

Following the field audit, the Division issued to Sipam six notices of deficiency under Article 9-A of the Tax Law, each dated January 31, 1990. Said notices asserted tax due as follows:

<u>Period Ended</u>	<u>Tax</u>	<u>Amount</u>
9/30/83	Corporation Franchise	\$ 89,754.70
9/30/83	MTB <sup>7</sup> Tax	16,155.85
9/30/84	Corporation Franchise	132,060.80
9/30/84	MTB Tax	22,450.33
9/30/85	Corporation Franchise	342,460.00
9/30/85	MTB Tax	<u>58,218.20</u>
Total Tax Due		\$661,099.88

The Sipam notices also asserted penalties and interest. Statements of franchise tax audit changes contained in the Division's audit report indicated that penalties were asserted pursuant to Tax Law § 1085(a)(1) and (b)(1).

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7

"MTB" refers to Metropolitan Transportation Business Tax Surcharge imposed under Tax Law § 209-B.

Also following the field audit, on December 15, 1989, the Division issued to petitioners Joseph and Josephine Macaluso a Notice of Deficiency which asserted additional New York State and New York City personal income taxes due as follows:

<u>Year</u>	<u>Tax</u>	<u>Amount</u>
1983	NYS	\$ 125,139.59
1983	NYC	42,439.00
1984	NYS	253,768.01
1984	NYC	82,334.38
1985	NYS	383,837.48
1985	NYC	<u>127,460.16</u>
	Total Tax Due	\$1,014,978.62

The income tax notice also asserted penalties and interest. The Division's audit report indicated that penalties were asserted pursuant to Tax Law § 685(b)(1) for each of the years at issue. With respect to 1985, the audit report indicated additional penalties asserted pursuant to Tax Law § 685(a)(1), (b)(2) and (p).

On August 21, 1985, Sipam executed a contract of sale pursuant to which it agreed to sell to Anthony and Josephine Cupo certain real property adjacent to the Conca D'Oro Motel. The purchase price for the property was \$385,000.00, subject to an existing mortgage of \$221,167.55. Simultaneous with the contract of sale, the parties also executed a lease of the same property with Sipam as landlord and Anthony and Josephine Cupo as tenant. The lease had a term of 20 years with the tenant agreeing to pay \$10.00 in rent, the balance due on a mortgage, and all taxes. The lease further provided that it would terminate when the landlord "is ready to convey good and marketable title" to the tenant at any time during the lease term pursuant to the August 21, 1985 contract of sale.

The contract of sale between Sipam and the Cupos was not consummated and title to the property did not pass from Sipam to the Cupos. The lease did take effect and the Cupos took possession of the property as tenants under the terms of the lease.

On August 22, 1989, Sipam, by Joseph Macaluso, president, executed a deed pursuant to which title to the Cupo property passed to Joseph Macaluso.

On December 6, 1989, Sipam filed New York State franchise tax reports under Article 9-A (Forms CT-4 and CT-3M/4M) for the fiscal years ended September 30, 1981 through September 30, 1983 and September 30, 1985 through September 30, 1988. Said reports were signed by Joseph Sano, vice president. None of these reports contained any notation indicating that these were "final" reports or returns.

At hearing, in response to a question regarding whether Mrs. Macaluso was authorized to take money from Sipam, Mr. Macaluso stated: "Mrs. Macaluso never knew . . . my wife never knows what I do" (tr., p. 147).

At hearing, the Division asserted an additional deficiency against petitioners Joseph and Josephine Macaluso. Specifically, the Division took the position that the individual petitioners had additional taxable income of \$3,974,000.00 based on the terms of the assignment of mortgage from Sipam to Joseph Macaluso, dated December 3, 1985 (see, Finding of Fact "11"). In making this assertion of an additional deficiency, the Division's representative stated that, under the statutory notices, the Division had "only assessed petitioners one-half of the dividend he received of \$4 million" (tr., p. 13). This statement mischaracterizes the theory upon which the Division assessed tax against the Macalusos in respect of the sale of the Conca D'Oro Motel. Under the Notice of Deficiency, the Division deemed a constructive dividend to Mr. Macaluso based on the full amount of Sipam's gain on the sale of the motel (see, Findings of Fact "46" through "48"). The theory of liability for the additional deficiency advanced at hearing is that Mr. Macaluso received a mortgage worth \$3,975,000.00 in consideration of only \$1,000.00.

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

The Administrative Law Judge found that the Division's reconstruction of Sipam's income and expenses through records of the New York City Department of Social Services and subsequent determination of its taxable income was proper, without previously determining the adequacy of Sipam's books and records where Sipam did not file a return as required under Article 9-A of the Tax Law (Tax Law § 1081[a]; *Matter of Lee*, Tax Appeals Tribunal, October 11, 1990).

Petitioners disputed the disallowance of certain expenses but did not carry their burden of proving that they were entitled to said expenses (*citing, Matter of Fazal Ahmad, P.C.*, Tax Appeals Tribunal, August 8, 1991), based upon their failure to produce any source documentation. The Administrative Law Judge noted that petitioners were allowed a substantial portion of the real estate taxes paid by Sipam during the period in issue.

Petitioners objected to the Division's use of a calendar year instead of Sipam's fiscal year, but this was rejected by the Administrative Law Judge because petitioners failed to make available or maintain records to allow for such an adjustment. For these reasons, the Administrative Law Judge found the audit methodology reasonable.

Concerning the issue of the gain charged to Sipam on the sale of the Conca D'Oro Motel, the Administrative Law Judge rejected petitioners' argument that no gain was recognized by Sipam because it was liquidated pursuant to Internal Revenue Code § 337 within 12 months of the date of the motel's sale, finding that Sipam did not dispose of all of the assets of the corporation within 12 months, but rather, retained land adjacent to the motel for almost four years after it claims to have liquidated.

The Administrative Law Judge approved the Division's use of the Sipam audit results in the audit of the Macaluso's and, given the Macaluso's failure to explain the disposition of the unreported corporate income, it was proper to deem the excess income as constructive dividends in proportion to their interest in the corporation. In addition, the Administrative Law Judge found that petitioners failed to meet the burden of proof that Sipam made the disallowed expenditures and offered no explanation of the disposition of the disallowed expenditures. Since there was a failure of proof on the issue of loans made by Sipam, they were also determined by the Administrative Law Judge to be constructive dividends.

Petitioners argued to the Administrative Law Judge that the Division did not establish a constructive dividend because it did not show that the distribution to Mr. Macaluso occurred or that the disallowance of an expenditure was proper and was expended for the benefit of Mr. Macaluso. The Administrative Law Judge rejected this argument on the basis that

petitioners bore the burden of proof as to the disposition of the unreported income found on audit and offered no satisfactory explanation.

The Administrative Law Judge, noting Mr. Macaluso's 50% interest in Sipam, reduced the constructive dividends attributed to him by half, thereby reflecting his proportionate interest in the corporation.

The Division asserted an additional deficiency against Mr. Macaluso at hearing on the assignment of the mortgage from Sipam to him on which the Administrative Law Judge found the Division had the burden of proof. The Administrative Law Judge found that the Division failed to meet the burden by proving that Mr. Macaluso actually received the mortgage from Sipam for \$1,000.00. Further, the Division had already deemed the gain on the sale of the motel measured by the value of the purchase money mortgage as a constructive dividend. The Administrative Law Judge reasoned that allowing the increased deficiency based on the receipt of the mortgage would be to allow the taxation of the same gain twice (Determination, conclusion of law "M").

The Administrative Law Judge found the statute of limitations applicable to 1983 and 1984 to be six years due to petitioners' failure to report an amount greater than 25% of the amount of New York adjusted gross income as stated on the return.

Josephine Macaluso claimed that she was not required to file a return for the year 1985 because she did not have the requisite amount of income. The Administrative Law Judge found that she offered no evidence of this and neither Mr. nor Mrs. Macaluso filed a Federal return for 1985. Tax Law § 651(b)(2) requires that a joint return be filed in such cases. The Administrative Law Judge found that petitioners should have filed a joint return.

Finally, petitioner Josephine Macaluso claimed that she should have been afforded innocent spouse status for the years 1983 and 1984. However, the Administrative Law Judge, noting the requirements of Tax Law former § 651(b)(5)(i) (where a joint return is filed, that the spouse did not have knowledge of the omission of income and that the spouse benefitted significantly and directly or indirectly from the excess income from the items of income

omitted), held that Mrs. Macaluso had not established entitlement to the benefit of innocent spouse status. He noted that Mrs. Macaluso did not testify and, therefore, there was no credible evidence of her knowledge of the omitted income. In addition, no evidence was introduced to show that it would be inequitable to hold Mrs. Macaluso liable for the tax due or that she did not benefit from the omitted income. Although the law regarding innocent spouse status changed in 1985, the requirement that the spouse not know of the understatement of income was unchanged, and Mrs. Macaluso still failed to meet the burden of proof on this issue.

Except for the modifications made with regard to Mr. and Mrs. Macaluso, the petitions of Sipam and the Macaluses were denied and the assessments sustained as modified.

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

Petitioners argued strenuously in their exception that the audit method chosen by the Division was not reasonably calculated to reflect the taxes due because the disallowance of the expenses was irrational and, therefore, the entire audit was flawed. Petitioners reasoned that if there was no reason for disallowing the expenses, it was arbitrary to disallow some and allow others. It would then follow that the audit methodology was not reasonably calculated to accurately reflect the taxes due. This argument was not raised again in petitioners' brief.

Petitioners also contend that they did not receive constructive dividends. Petitioners argue that disallowed corporate expenditures do not constitute constructive dividends to shareholders and that loans made by a corporation cannot be considered constructive dividends to shareholders unless it is found that the loans were made directly to the shareholder or an entity controlled by the shareholder.

Petitioners also argue that Mrs. Macaluso should not have been assessed for 1983 or 1984 due to her status as an innocent spouse and she was not required to file a return for 1985.

Finally, petitioners contend that Sipam properly liquidated pursuant to Internal Revenue Code § 337, stating that the parcel of property in issue was transferred in substance in 1985, although not in form, citing *Commissioner of Internal Revenue v. Court Holding Co.* (324 US

331, 89 L Ed 981) for the proposition that courts have consistently held that in tax transactions the substance of a transaction prevails over the form.

The Division addressed itself to the three issues raised in petitioners' brief. The Division relies upon the case of *Matter of Petito* (Tax Appeals Tribunal, October 17, 1991) in support of the constructive dividends it assessed to petitioners. In addition, the Division notes the lack of evidence submitted by petitioners and their ultimate failure to meet their burden of proof.

On the issue of whether Mrs. Macaluso was properly denied innocent spouse status, the Division essentially restates the Administrative Law Judge's rationale and urges that petitioners have not met the burden of proof established in cases like *Matter of Miller* (Tax Appeals Tribunal, February 22, 1991). With regard to 1985, the Division notes the duty of Mrs. Macaluso to file a return under Tax Law § 611(b)(2).

Finally, the Division contends that Sipam did not liquidate pursuant to Internal Revenue Code § 337, arguing that to accept petitioners' argument would be to allow a taxpayer's scheme to supersede legislation in the determination of the time and manner of taxation (*citing Higgins v. Smith*, 308 US 473, 84 L Ed 406). Instead, the Division cites *Sverdlow v. Bates* (283 App Div 487, 129 NYS2d 88) in support of its argument that it is the taxing authority, not the taxpayer, which may utilize the substance over form doctrine and that petitioners herein are bound by the unfortunate form of their transaction.

### **OPINION**

We affirm the determination of the Administrative Law Judge.

Petitioners raised four issues on appeal, the first of which was that the Division's audit methodology lacked a rational basis. Petitioners' attack was scattered in that it recognized that there was a distinction between corporate and sales tax audit requirements, but still believed the sales tax case law applied. They are in error.

Tax Law former § 1081(a) provided that where a taxpayer, like Sipam, failed to file a return as required, the Division was authorized to estimate its tax liability from any information in its possession. Despite petitioners' arguments to the contrary, the provisions of Tax Law §

1138 and the case law attendant thereto are not applicable to the instant situation. Further, petitioners' argument that the disallowance of the corporate expenses was irrational is also without merit. The burden of proof is upon petitioners to establish an entitlement to the expenses claimed, not upon the Division to establish why it disallowed them (Tax Law § 1089[e]; **Matter of Fazal Ahmad, P.C., supra**). The absence of supporting records will "'bear heavily' against the taxpayer 'whose inexactitude is of his own making'" (*see, Olken v. Commissioner*, T.C. Memo 1981-176, 41 TCM 1255, 1257, *quoting Cohan v. Commissioner*, 39 F2d 540, 544). In the instant matter, petitioners did not provide adequate books and records to the Division in the form of source documentation. Since they could not establish a right to the expense deductions, the Division properly disallowed them.

Petitioners also raised a related argument concerning the Division's use of both the fiscal year ended September 30 and a calendar year. As discussed by the Administrative Law Judge, this was solely due to the failure by petitioners to provide records which would have established which period was utilized by Sipam. In the absence of such records, the Division was justified in resorting to the term best suited to determine Sipam's income.

Finally, it is noted that in petitioners' exception they state that the Division chose to arbitrarily disregard the books and records of Sipam in favor of income determined from records of the Department of Social Services. However, the "books and records" referred to by petitioners were "as compiled [sic] from Sipam's books and records by Mr. Carey . . ." not source documentation, which never appears in the record and, thus, justifies the resort to other sources of information in the possession of the Division (Tax Law former § 1081[a]). For all of these reasons and those more fully discussed by the Administrative Law Judge, we determine that the audit methodology was rational and reasonably calculated to determine the correct tax owed, and that the disallowance of expense deductions, the use of specific audit years and information provided by the Department of Social Services were valid and proper.

The Division converted the disallowed expense deductions and certain loans of Sipam into constructive dividends. Petitioners argue that the expense deductions cannot be so

construed without a showing that there was an economic benefit received by the shareholder (*citing Palo Alto Town & Country Village v. Commissioner*, 565 F2d 1388, 78-1 USTC ¶ 9200). Petitioners argue that the Administrative Law Judge's reliance on the Tribunal case of *Matter of Petito (supra)* is misplaced because in *Petito* the constructive dividends were based upon unreported income and not disallowed expenses. However, as quoted by petitioners in their brief (page 3), we held in *Petito* that "absent an explanation as to the disposition of the additional corporate income, [petitioner was] deemed to have received same in proportion to his interest in the corporation." Further, petitioners cite *Matter of Pugkhem* (Tax Appeals Tribunal, January 23, 1992) in which we held that to the extent that the petitioner was unable to substantiate business expenses of a doctor's professional corporation, such expenses were personal in nature and properly assessed to the petitioner as constructive dividends. However, contrary to petitioners' position, it is not fatal that the Division failed to demonstrate that Sipam's disallowed expenses were personal in nature. As stated above, it was petitioners' burden to substantiate the expenses claimed. In failing to do so, the excess income was attributed to the corporation and then deemed received by the shareholders. This is consistent with our holding in *Petito* and we agree with the Administrative Law Judge's conclusion that petitioners' failure to substantiate the corporate expenses or otherwise challenge the disposition of the excess income of Sipam justifies the treatment of such income to the shareholders as constructive dividends.

Finally, petitioners argue that the Division erred in applying the "Cohan" rule in light of the testimony of the auditor and Mr. Macaluso "that the disallowed expenses were in the nature of Real Estate taxes, construction costs, etc., and were actually expended to third parties other than shareholders" (Petitioners' brief, p. 4). However, unlike the *Cohan* case, the expenses herein were not established and not deemed allowable. Petitioners herein were allowed considerable expenses as reported by Sipam, but specifically disallowed others. In *Cohan*, all travel expenses were disallowed even though it was found as a fact that moneys were spent on allowable expenses. The *Cohan* court ruled that absolute certainty is not necessary, that some

amount should be allowed and that the Board's approximation may "[bear] heavily if it chooses upon the taxpayer whose inexactitude is of his own making" (*Cohan v. Commissioner, supra*, at 543-544). Given the allowances made by the Division and petitioners' failure to substantiate the other expenses, the outcome is consistent with *Cohan*.

With regard to the issue of Sipam's loans which were deemed additional retained earnings, petitioners have raised no new arguments on appeal. It remains that there were no loan documents in the record, no record of repayment and no explanation of the loans. Although Mr. Macaluso testified that another shareholder requested that the loans be made to US Mining International Ltd. as an investment, the lack of any other documentation of the loan supports the Division's disallowance. Give the failure of petitioners' proof, we agree with the conclusion of the Administrative Law Judge which sustained the Division's disallowance of the loans.

Petitioners argue that Josephine Macaluso was an innocent spouse for the tax years 1983 and 1984 and was not required to file a return for the year 1985. After reviewing the arguments presented to us on exception regarding this issue, we find no basis for modifying the Administrative Law Judge's determination in any respect. The Administrative Law Judge adequately and correctly addressed all of the arguments petitioners raised on exception to this Tribunal.

Finally, petitioners argue that Sipam properly liquidated pursuant to section 337 of the Internal Revenue Code, although admitting that Sipam did not transfer title to the parcel of real property adjoining the motel property until 1989, years after entering into the contract of sale on May 24, 1985. The Administrative Law Judge found that a plan of liquidation existed but Sipam failed to distribute all of its assets within 12 months of the date of said plan. Sipam leased the property to the prospective purchasers until the ultimate sale in 1989, retaining title, landlord rights and equity in the property. Petitioners argue in their brief that outstanding liens and judgments against the property in excess of the selling price rendered the property a liability and not an asset. Petitioners reason that the ultimate physical transfer of the property was of no

import and that the liquidation actually (in substance as opposed to form) occurred on the contract date in May of 1985, thus qualifying it for Internal Revenue Code § 337 treatment.

Petitioners argue that the incidence of taxation depends on the substance of the transaction not only the transfer of legal title (*citing Commissioner of Internal Revenue v. Court Holding Co., supra*). This argument is problematic. First, the record does not support petitioners' allegations regarding the outstanding liens and judgments against the property which allegedly exceeded the selling price and "technically" rendered this asset a liability. Second, while petitioners' reliance on the *Court Holding* case is deemed misplaced, the Division's citation to *Sverdlow v. Bates (supra)* is on point. In *Sverdlow*, the Court held:

"[t]he difficulty with this argument is that much of the law of taxation, as of real property, depends upon form.

\* \* \*

"If a transaction comes within the form which the statute has made taxable, it is no answer to say that it is indistinguishable in substance from a transaction in a different form which could have accomplished the same result in a non-taxable manner. . . . The choice of form did not rest with the tax authorities but with the taxpayer. If he unfortunately chose a form which was taxable instead of an equally available form which was non-taxable, he must bear the consequences" (*Sverdlow v. Bates, supra*, 129 NYS2d, at 91-92.)

In the instant case, petitioners urge us to accept what they characterize as the true substance of the sale of the real property rather than the actual form of the transaction as set forth in the facts. As stated by the Court in *Sverdlow*, petitioners chose the form of the transaction and must bear the consequences.

The evidence does not support petitioners' position on the section 337 liquidation or that Sipam's corporate existence was terminated. The sale of the real property to the Cupos did not occur until 1989 and, therefore, Sipam did not distribute all of its assets within 12 months of the adoption of its plan of liquidation. Therefore, Sipam is not eligible for the nonrecognition of loss and gain from the sale or exchange of property within the 12 month period.

Accordingly, it is ORDERED, ADJUDGED and DECREED that:

1. The exception of Joseph and Josephine Macaluso and Sipam Corp. is denied;

2. The determination of the Administrative Law Judge is affirmed;

3. The petition of Joseph and Josephine Macaluso is granted to the extent indicated in conclusion of law "L" of the Administrative Law Judge's determination, but the petition is in all other respects denied, and the Division of Taxation is directed to modify its Notice of Deficiency, dated December 15, 1989, in accordance with said conclusion of law "L," and as modified, the Notice is sustained; and

4. The petition of Sipam Corp. is denied and the notices of deficiency, dated January 31, 1990, are sustained.

DATED: Troy, New York  
September 22, 1997

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Donald C. DeWitt  
President

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Joseph W. Pinto, Jr.  
Commissioner