

STATE OF NEW YORK

TAX APPEALS TRIBUNAL

In the Matter of the Petition :

of :

ERIC MOSKOWITZ :

DECISION
DTA NO. 816252

for Redetermination of a Deficiency or for Refund of :
New York State and New York City Income Taxes under :
Article 22 of the Tax Law and the New York City :
Administrative Code for the Years 1992, 1993 and 1994. :

Petitioner Eric Moskowitz, 2966 Cheryl Road, Merrick, New York 11566, filed an exception to the determination of the Administrative Law Judge issued on November 24, 1999. Petitioner appeared by Lawrence F. Ruggiero, Esq. The Division of Taxation appeared by Barbara G. Billet, Esq. (Kevin R. Law, Esq., of counsel).

Petitioner filed a brief in support of his exception. The Division of Taxation filed a brief in opposition. Oral argument was not requested.

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

ISSUES

I. Whether petitioner has showed by clear and convincing evidence that he is entitled to employee business expenses and expense deductions which had been an integral part of Subchapter S losses reported by petitioner for tax years 1992, 1993 and 1994.

II. Whether petitioner has established grounds for abatement of penalties in this matter.

FINDINGS OF FACT

We find the facts as determined by the Administrative Law Judge except for findings of fact “2,” “4,” “5,” “6,” “8,” “10” and “11” which have been modified. We have also made an additional finding of fact. The Administrative Law Judge’s findings of fact, the modified findings of fact and the additional finding of fact are set forth below.

The Division of Taxation (“Division”) audited Eric Moskowitz’s (“petitioner”) New York State personal income tax returns for 1992, 1993 and 1994. The audit of petitioner’s return originated as a result of information obtained from a withholding tax audit of Sheil Medical Laboratory (“Sheil”), formerly known as Physicians Medical Laboratory Incorporated,¹ petitioner’s employer. As an employee of Sheil, petitioner had claimed an exemption from New York State tax withholding. In attempting to determine whether petitioner was qualified for such exemption, the auditor reviewed petitioner’s personal income tax filings for the tax years in issue, and became aware of large Federal Schedule E, Subchapter S corporation losses. The scope of the audit was to verify miscellaneous employee business expense deductions claimed on petitioner’s returns, and verify flow-through losses from Sure Marketing, Inc. (“Sure”), petitioner’s wholly-owned Subchapter S corporation.

We modify finding of fact “2” of the Administrative Law Judge’s determination to read as follows:

Sure was incorporated in New York in 1990 and its New York State S Corporation Franchise Tax Return indicates that its principal business activity is sales. Prior to 1992, Sure was in the

¹ Although petitioner’s W-2 indicates that he was paid by Physicians Medical Laboratory Inc., throughout the hearing the parties employed the name “Sheil,” which succeeded the former corporation and is hereafter used to refer to both corporations.

business of procuring blood samples from doctors upon which Sheil would perform blood analysis. At some time early in 1992, Medicaid changed its rules with respect to whom Sheil could pay to perform such services, and Sheil was required to discontinue payments to Sure as a corporation. Thereafter, Sheil hired petitioner as an employee to bring blood samples to the laboratory. From that point on, the Division had difficulty determining the business purpose of Sure, if any. The Division believed that, in part, Sure was involved in transporting the blood samples. Additionally, there was some evidence of sales of surgical supplies by Sure to a company referred to as Sigma.²

A significant portion of the funds upon which Sure was operating appeared to the Division to have as its source shareholder loans made from petitioner to Sure. During the years in issue petitioner was between the ages of 27 and 29, and he was paid a salary of between \$700,000.00 and slightly over \$1,000,000.00 for his work for Sheil. It appears from the record that petitioner's salary provided a significant portion of the shareholder loans made to Sure.

We modify finding of fact "4" of the Administrative Law Judge's determination to read as follows:

Petitioner, filed a New York State Resident Income Tax Return, Form IT-201, for tax years 1992, 1993 and 1994. The components of petitioner's personal income tax returns as relevant to this matter are discussed below.

Petitioner's return for 1992, in pertinent part, shows reported wages in the amount of \$710,191.00, a Schedule E Loss from Sure in the amount of \$295,194.00, New York adjusted gross income in the amount of \$414,604.00 and miscellaneous deductions from Federal Schedule A in the amount of \$153,078.00.³ The following

²We modified finding of fact "2" of the Administrative Law Judge's determination to more accurately reflect the record.

³ A list attached to the 1992 tax return reflects "Employee Expenses" in the amount of \$161,369.51. Although the Administrative Law Judge noted that no explanation was provided as to why this amount differs from the Federal Schedule A deductions of \$153,078.00, it appears that the 2% floor adjustment imposed by the
(continued...)

table shows a list of expenses, entitled “Employee Expenses” as attached to the 1992 return and deducted as itemized deductions, in addition to those expenses which the Division disallowed on audit, and the explanation for such disallowance:

TABLE A

Expense Category	Schedule A Deduction	Disallowed on Audit	Explanation of Disallowance
Commissions	\$ 3,498.88		
Salaries	83,306.00	50,000.00	Salary to Mr. Lazar.
Accounting	825.00		
Automobile Expense	34,121.38		
Bank Charges	199.26		
Dues & Subscriptions	524.48		
Employee Benefits	3,560.75	3,560.00	No employees.
Insurance	3,688.90	3,179.00	4 cars, allowed one.
Legal	2,500.00		
Miscellaneous Expense	1,449.47		
Office Expense	174.53		
Office Supplies	10,252.36	10,252.00	Not verified.
Postage	49.00		
Repairs	1,719.18		
Supplies	3,120.77		
Taxes Payroll	518.00		
Telephone	3,989.09	2,992.00	Paid other peoples' bills.
Travel	5,267.60	2,634.00	Allowed 50%.

³(...continued)
Internal Revenue Code (“IRC”) factored into such reduction.

Utilities	2,604.86	2,604.00	Other peoples' charges.
Total	\$ 161,369.51	\$ 75,221.00	
Cost of Goods Sold (allowed on Schedule A; disallowed on 1120S) ⁴		(19,912.00)	
Net Deduction Disallowed		\$ 55,309.00	

A W-2 attached to the 1992 return shows wages paid to petitioner, at 3086 Driftwood Lane, Bellmore, New York, from Physicians Medical Laboratory (Employer ID Number 11-2618040), 608 Sheepshead Bay Road, Brooklyn, New York. Wages were reported as paid to petitioner in the amount of \$710,191.00, with Federal Taxes withheld in the amount of \$105,497.00. Although Social Security and Medicare taxes were withheld, no tax was withheld for New York State.

Petitioner's 1993 return reports wages paid by the same employer noted above in the amount of \$923,000.00, a Schedule E, Subchapter S loss generated by Sure in the amount of \$442,974.00, New York adjusted gross income of \$479,963.00 and miscellaneous deductions from Federal Schedule A in the amount of \$126,391.00. The W-2 attached to petitioner's return indicates that Federal income tax in the amount of \$125,999.40 was withheld for 1993. Social Security and Medicare taxes were also withheld. However, there was no New York State withholding. Table B below sets forth the employee expenses deducted on petitioner's 1993 tax return, and the amounts disallowed by the Division.

⁴ The Division allowed \$19,912.00 of expenses for phlebotomy as an employee business expense on the basis that such expenses were connected to and incurred by petitioner with regard to his employment with Sheil. The expenses had been deducted as cost of goods sold on Sure's corporate tax returns (Form 1120S and CT-4S), but disallowed by the Division.

TABLE B

Expense Category	Schedule A Deduction	Disallowed on Audit	Explanation of Disallowance
Consulting Fees	\$ 100,000.00	\$ 100,000.00	Salary to Mr. Lazar.
Other Outside Services	29,315.00	0	
Local Travel	5,928.00	2,964.00	
Supplies	747.00		
Total	\$ 135,990.00	\$102,964.00	
Cost of goods sold: (allowed in Sch A from 1120S Direct Labor)		(10,612.00)	
Net Disallowed amount		\$92,352.00	

Petitioner's 1994 return reports wages paid by Physicians Medical Laboratory, Inc. in the amount of \$1,051,419.00, a Schedule E, Subchapter S loss from Sure in the amount of \$561,167.00, New York adjusted gross income in the amount of \$491,653.00 and miscellaneous deductions from Federal Schedule A in the amount of \$133,281.00. The attached W-2 shows Federal income taxes (\$125,709.40), Social Security and Medicare taxes withheld; however, no New York State withholding is shown.⁵

We modify finding of fact "5" of the Administrative Law Judge's determination to read as follows:

The Division's auditor was unable to determine the kind of business Sure was conducting after petitioner became an employee of Sheil in early 1992. In an attempt to substantiate Sure's expenses in general for the three tax years, the auditor found the following:

a) Sure paid Herbert Lazar, petitioner's uncle, a consulting fee in the amount of \$450.00 per hour for consulting services which the Division categorized as "vaguely defined" and not

⁵We modified finding of fact "4" of the Administrative Law Judge's determination by deleting extraneous matters.

substantiated by an employment contract or other type of agreement. The auditor noted in his report that Mr. Lazar received “1099 income” from Sure in the amount of \$240,000.00 in 1992,⁶ \$300,000.00 in 1993 and \$334,000.00 for 1994. Although Mr. Lazar was not an employee of Sure, the general ledger showed that Sure was paying his health insurance premiums. The Division discovered that Mr. Lazar had not filed returns for the years in question, and when the issue was raised, the Division was informed that he had not filed because he had a net operating loss carryforward, and owed no tax. Based on this information, the Division questioned further whether the payments to Mr. Lazar by petitioner were simply an attempt to shift income and not arms-length transactions.

b) Rent expense deducted by Sure was disallowed when no leases were provided. Further, the auditor’s visits to claimed rented locations for Sure could not be independently verified, since the premises were no longer rented. Mr. Lazar claimed that an address at 166 E. 88th Street, New York City was rented by Sure as an office. The auditor visited that address and was informed by Dr. Pullano’s receptionist that neither petitioner nor Sure had an office in that location, but that a Dr. Pullano, the owner of the building, maintained his office at that address. The receptionist stated that Dr. Pullano had no connection with Sure, but did have dealings with Sheil through petitioner. The receptionist stated that Dr. Pullano sent his blood samples to various labs and Sheil Medical Lab was just one of them (Exhibit “F,” Tr., p. 47).

The Brooklyn address discussed during the audit was a planned site for a diagnostic center according to Mr. Lazar. However, the auditor found the address to be a large apartment complex in a less than desirable neighborhood with no apparent public access for business purposes.

c) Substantiation was requested for all of Sure’s deductions. However, source documents substantiating Sure’s deductions were never provided.

d) The auditor asked petitioner’s former representative, Menachem David, CPA, for a schedule showing what was being

⁶ The Administrative Law Judge noted that although the Summary of Audit indicates this year to be 1993, it is believed to refer to 1992.

purchased by Sure and what was being sold. It too was never provided (Tr., p. 112).

e) Mr David produced Sure's General Ledger ("G/L"). However, the auditor was unable to tie in the amounts listed on the G/L to other documents submitted. The records generally were not found to be in auditable form. Those source documents that were received by the auditors were for personal expenses of petitioner and his family, such as meals for petitioner's parents and uncle, landscaping his parents' lawn and medical bills.

f) After February 1992, other than petitioner's loans to Sure, the only source of receipts identified by the Division for Sure was from Sigma in the amount of \$25,500.00 for sales of medical paper goods. However, the Division's examination of purchases did not show purchases of similar goods. Sure had no beginning or ending inventory of goods and no accounts payable. The auditor found that after he became an employee of Sheil, petitioner gave his entire salary to Sure in the form of a loan. Personal expenses paid by the corporation on petitioner's behalf reduced the loan amounts, as well as cash withdrawal by petitioner from the corporate account (Exhibit "F").

g) Although Sure had no employees, it took large deductions for employee expenses (Tr., p. 98; Exhibit "F"). Petitioner was not an employee of Sure. The general ledger submitted to the Administrative Law Judge after the hearing shows that wages were also paid to petitioner's mother, although she was not an employee.⁷

We modify finding of fact "6" of the Administrative Law Judge's determination to read as follows:

The Division's auditor determined that there was no economic substance to Sure and that it was merely being used by petitioner to deduct his personal expenses under the guise of being a legitimate business. It was on this basis that the Division disallowed all claimed expenses of Sure at the corporate level and the resulting Subchapter S losses for each tax year. Some of

⁷We modified finding of fact "5" of the Administrative Law Judge's determination to more completely set forth the facts.

petitioner's expenses, however, were allowed as unreimbursed employee business expenses, deductible on petitioner's personal tax returns as an employee of Sheil. Some of these were verified expenses and others were expenses that the auditor determined would have been reasonable to incur even in the absence of substantiating documentation.⁸

The Division issued a Notice of Deficiency dated March 25, 1996 asserting additional tax due for tax years 1992, 1993 and 1994 in the amount of \$140,848.42 plus penalty and interest, for a total of \$193,582.96. The tax assessed for each individual year was \$37,673.72 for 1992, \$48,257.23 for 1993 and \$54,917.47 for 1994.

We modify finding of fact "8" of the Administrative Law Judge's determination to read as follows:

Petitioner filed a Request for Conciliation Conference dated May 13, 1996.⁹

A conciliation conference was conducted on June 20, 1997, and the statutory notices were recomputed to reflect a total tax deficiency in the amount of \$138,880.11, plus penalty and interest at the applicable rate, by a Conciliation Order issued on November 21, 1997. Attached to the Conciliation Order were revised statements of personal income tax audit changes for 1992, 1993 and 1994 issued by the Division. The component adjustments and calculations for each of the years follow:

1992 Deficiency

Petitioner reported \$414,604.00 as his New York Adjusted Gross Income ("NY AGI"). To this amount, the Division added \$390,630.00 (comprised of the disallowed Federal Schedule E

⁸We modified finding of fact "6" of the Administrative Law Judge's determination to clarify that the employee business expenses that were allowed petitioner were as an employee of Sheil, not Sure.

⁹We modified the first paragraph of finding of fact "8" of the Administrative Law Judge's determination by deleting extraneous arguments made at the Bureau of Conciliation and Mediation Services conference.

loss in the amount of \$295,194.00, plus the reported amount of gross receipts earned by Sure of \$95,436.00), to arrive at corrected NY AGI of \$805,234.00.

Petitioner claimed employment and miscellaneous expenses in the amount of \$161,370.00, prior to the 2% floor adjustment of Internal Revenue Code § 67(a), of which the Division disallowed \$75,221.00 (*see*, Table A). However, since the Division allowed expenses in the amount of \$19,912.00 from Sure as an employee business expense on petitioner's personal income tax return, the net disallowance resulted in \$55,309.00. The disallowance of \$55,309.00 was subtracted from the original claimed amount (\$161,370.00) to result in \$106,061.00. The amount was then limited by the 2% floor on the recomputed NY AGI of \$805,234.00 (or \$16,105.00), to arrive at \$89,956.00. Subtracting \$89,956.00 from the total reported employment and miscellaneous expenses on Federal Schedule A (\$153,078.00) resulted in disallowed expenses of \$63,122.00. This amount was subtracted from the itemized deductions originally reported of \$149,969.00 to arrive at \$86,847.00. This amount was adjusted pursuant to Tax Law § 615(f), leaving \$43,423.50 as the corrected itemized deduction. The corrected deduction was subtracted from NY AGI of \$805,234.00 to arrive at taxable income of \$761,810.50. Additional tax of \$37,797.44, plus penalties pursuant to Tax Law § 685(b) and (p), were computed.

1993 Deficiency

Petitioner reported \$479,963.00 as his NY AGI. To this amount, the Division added \$518,042.00 (comprised of the disallowed Federal Schedule E loss in the amount of \$442,974.00, plus the reported amount of gross receipts earned by Sure of \$75,068.00), to arrive at corrected NY AGI of \$998,005.00.

Petitioner claimed employment and miscellaneous expenses in the amount of \$135,990.00,

prior to the 2% floor adjustment of Internal Revenue Code § 67(a), of which the Division disallowed \$102,964.00 (*see*, Table B). However, since the Division allowed expenses in the amount of \$10,612.00 from Sure as an employee business expense on petitioner's personal income tax return, the net disallowance resulted in \$92,352.00. The disallowance of \$92,352.00 was subtracted from the original claimed amount (\$135,990.00) to result in \$43,638.00. The amount was then limited by the 2% floor on the recomputed NY AGI of \$998,005.00 (\$16,105.00), to arrive at \$23,678.00. Subtracting \$23,678.00 from the total reported employment and miscellaneous expenses on Federal Schedule A (\$126,391.00) resulted in disallowed expenses of \$102,713.00. This amount was subtracted from the itemized deductions originally reported of \$142,309.00 to arrive at \$39,956.00. This amount was adjusted pursuant to Tax Law § 615(f), leaving \$19,798.00 as the corrected itemized deduction. The corrected deduction was subtracted from NY AGI of \$998,005.00 to arrive at taxable income of \$978,207.00. Additional tax of \$47,358.30, plus penalties pursuant to Tax Law § 685(b) and (p), were computed.

1994 Deficiency

Petitioner reported \$491,978.00 as his NY AGI. To this amount, the Division added \$650,226.00 (comprised of the disallowed Federal Schedule E loss in the amount of \$561,167.00, plus the reported amount of gross receipts earned by Sure of \$89,059.00), to arrive at corrected NY AGI of \$1,142,204.00.

Petitioner claimed employment and miscellaneous expenses in the amount of \$85,765.00, prior to the 2% floor adjustment of Internal Revenue Code § 67(a), of which the Division disallowed \$50,500.00 (which is represented entirely by the disallowance of the amount claimed

for professional supplies). The disallowance of \$50,500.00 was subtracted from the original claimed amount (\$85,765.00) to result in \$35,265.00. The amount was then limited by the 2% floor on the recomputed NY AGI of \$1,142,204.00, to arrive at \$22,844.00. Subtracting \$22,844.00 from the total reported employment and miscellaneous expenses on Federal Schedule A (\$85,765.00) resulted in disallowed expenses of \$63,511.00. This amount was subtracted from the itemized deductions originally reported of \$133,281.00 to arrive at \$69,770.00. This amount was adjusted pursuant to Tax Law § 615(f), leaving \$34,885.00 as the corrected itemized deduction. The corrected deduction was subtracted from NY AGI of \$1,142,204.00 to arrive a taxable income of \$1,107,319.00. Additional tax of \$53,724.37, plus penalties pursuant to Tax Law § 685(b) and (p), were computed.

A timely petition was filed on December 19, 1997 with the Division of Tax Appeals, challenging the disallowed deductions.

We modify finding of fact “10” of the Administrative Law Judge’s determination to read as follows:

Petitioner did not testify in this proceeding nor did he offer any documentary evidence at hearing. The only witness who testified for petitioner was Mr. Lazar, petitioner’s uncle. When questioned about his contribution to Sure, Mr. Lazar stated that he was a consultant, “gave advice,” “assisted petitioner in getting ahead in the business world” and “introduced him to all the people that he knew to assist him in the successful operation of his venture.” When asked to define the venture, Mr. Lazar indicated that it “originally started with the laboratory business.” He was attempting “to assist him [petitioner], to show him when he was working with the laboratory business, there are many allied ventures that he could be involved in, Helm MRI, which is radiology, and the MRI, when the doctors order for it.” He believed that he was “enlightening him [petitioner] to the entire medical supply operation business . . . and . . . also enlightening

him to the future with nursing homes, assisted living centers, adult homes” (Tr. pp.135-136). Despite repeated urging by the Administrative Law Judge for Mr. Lazar to explain specifically the nature of Sure’s business, his answers were consistently vague and nonresponsive.

Mr. Lazar was similarly vague at hearing when it came to explaining what, exactly, he did for Sure and petitioner. During the audit Mr. Lazar submitted an affidavit which set forth in more detail than his testimony, his educational and business background. After graduating from New York University School of Business Administration in 1954, Mr. Lazar spent time as an insurance broker, a real estate broker, a business broker, the owner of a jewelry business, and owner-operator of a vision center. He was responsible for the formation of a medical plaza and suite of medical offices, a pharmacy, an ambulette service, and a surgical supply and rental corporation. Mr. Lazar testified that during 1989-1990 he became a consultant to petitioner to assist him with Sure. Subsequently he assisted petitioner with Helm Imaging Corp., described as a subsidiary of Sure, to create an MRI and Radiology Center on Avenue Z and East 12th Street, Brooklyn, New York. Although Mr. Lazar was paid \$450.00 per hour by Sure and petitioner, Mr. Lazar testified he did not submit time sheets showing the number of hours he worked, but rather wrote down the time on a “little memo page” which he kept (Tr., p. 147). Mr. Lazar testified that he did not tell petitioner what he did to earn the amounts he was paid, because “the work I did spoke for itself” (Tr., p. 147).¹⁰

We modify finding of fact “11” of the Administrative Law Judge’s determination to read as follows:

As noted earlier, petitioner offered no books, records or source documents at hearing. However, petitioner’s representative was granted an opportunity to submit petitioner’s books and records for review post-hearing. Included in the evidence submitted to the Administrative Law Judge post-hearing were general ledgers for the periods ending 5/31/92, 6/30/92, 8/31/92, 11/30/92, 12/31/92, 4/30/93, 8/31/93, and 11/30/93. In each case

¹⁰We modified finding of fact “10” of the Administrative Law Judge’s determination to delete matter not germane to Sure.

with the exception of the G/L for the periods ended 6/30/92 and 12/31/92, attached to the G/L were general journal entries for the three months preceding and ending with the period defined by the G/L. In the other two cases, the general journal entries were only for the month defined by the G/L period.

Petitioner submitted checking account bank statements from EAB in the name of Sure, 3086 Driftwood Lane, Bellmore, New York, for the 12 months of each tax year: 1992, 1993, and 1994. A complete set of canceled checks for the subject period was not submitted. There is no way of determining the business purpose of the individual checks and checking account stubs were not provided.

Petitioner submitted two leases between M. Gardose-Pullano as landlord, and Sure for the periods March 1, 1992 to December 31, 1992 and January 1, 1993 to December 31, 1993, for the lease of basement space and Apartment 3B at 166 East 88th Street, New York, New York. The amount of rent charged for the first 3 months of 1992 was \$600.00, and beginning June 1, 1992 until year end, the rent increased to \$3,133.33 per month. The amount of rent to be paid during 1993 was \$3,133.00 per month for the first six months of the year, and \$2,600.00 for the latter six months (which payments were substantiated by copies of canceled checks drawn on Sure's account). According to the document, the rented premises were to be used as a sales and business office for the company. The lease does not state the nature of Sure's business, other than "sales." The basement was for storage.¹¹

¹¹We have modified finding of fact "11" of the Administrative Law Judge's determination to more clearly reflect the record and to delete from the findings the following matter which is immaterial to the disposition, and which is instead made a footnote: "Petitioner submitted a quotation issued to Helm Medical Imaging, at the Brooklyn, New York address of 1021-1023 Avenue Z, by Picker International for a Computed Tomography Scanner. The quotation for the equipment, dated September 10, 1992, and was signed by petitioner on September 24, 1992, requested delivery on December 15, 1992, was in the amount of \$655,000.00. Attached to the quotation was a copy of a check #165 drawn on what appears to be a personal checking account of petitioner. Although difficult to discern, the date on the check appears to be September 24, 1992. The memo indicates that it was a 5% down payment on the Picker product (by reference to the quotation document number). The amount listed was \$21,960.00. A second copy of the same check shows that it was canceled by petitioner's bank. However, it was revealed at the hearing that ultimately petitioner was never able to take delivery of the machinery due to a problem with the leased space in which it was to be operated." This matter is deemed extraneous because it does not relate to Sure.

"Finally, petitioner submitted pictures of a building with the name 'Nathan Hale Court' over its archway. The pictures contained no identifying notations. Petitioner did not indicate the meaning of the submission."

The 12/31/92 G/L for Sure was submitted by petitioner post-hearing. Since this was the only year-end G/L submitted for the years under audit, it was reviewed in some detail. The document was dated February 11, 1993. The ledger entries were divided into six departments; however, there were postings noted only to Departments #1 and #2. No explanation was provided as to the purpose of the different departments or why only Department #2 entries were reported on the tax return. In attempting to trace the general ledger balances to the tax return's balance sheet and income and expense items, certain significant discrepancies were noted:

Item	Amount Posted to Dept. #2 of the General Ledger	Total Amount Posted to the General Ledger	Amount per Tax Return
Shareholder L/P-A (Loans from shareholder)	N/A	\$579,201.30	\$306,915.00
Commission Income	\$27,597.40	115,569.40	95,436.80
Cash Expenses	15,750.00	342,939.28	0.00
Direct Labor	19,912.00	46,081.00	19,912.00
Salaries-Office	16,633.85	16,633.85	206,633.85
Travel	33,995.09	54,140.73	13,497.23
Supplies	18,359.01	19,684.01	31,783.28

In the case of other expenditures, the amounts posted to Department #2 (which differed from the total amounts posted to the General Ledger except for Advertising, Depreciation and Rent) could be traced to the tax return: Commissions, Accounting and Legal, Advertising, Depreciation, Dues and Subscriptions, Employee Benefits, Insurance, Rent, Telephone and Utilities. There was no explanation provided as to why some items could be directly traced to

the tax return, and why others differed so greatly.

A second General Ledger for the same period was submitted by petitioner, dated March 3, 1993. An attachment appears to have adjusting entries on a sheet entitled General Journal, dated February 11, 1993, which do not appear on the former G/L. Both versions of the G/L and canceled checks revealed that during 1992 petitioner wrote checks payable to "Cash" over the course of the 1992 year which totaled approximately \$343,000.00. Petitioner endorsed and cashed the checks. In the G/L dated March 3, 1993, the cash withdrawn by checks from Sure totaling \$342,939.28 are reclassified: \$240,000.00 is charged to Salaries-Officers bearing a notation "Herb drew 1992," and \$102,939.28 is charged to Shareholders L/P with the notation "Eric drew 1992." Cash expenses were then eliminated in this version as an expense category. Although this appears to be a revised version of the 12/31/92 General Ledger, no clarification was provided as to why differing versions were submitted as evidence, or why, for example, appropriate charges to salaries were not entered into the books of record all throughout the year. Although the audit file refers to "1099 income" attributed to Mr. Lazar, there was no evidence of Form 1099 being provided by Sure to Mr. Lazar for any of the years in question.

A review of the checks submitted for tax year 1992 shows payments made to numerous individuals for "phlebotomy work." No explanation was provided at the hearing with regard to why Sure was making payment for such services and posting the same to the General Ledger account called "Direct Labor." The Division disallowed such expenses as a deduction to Sure, but believed there was some connection to petitioner's employment by Sheil, and allowed the payments as an unreimbursed employee business expense. The amount allowed by the Division was \$19,912.00 for tax year 1992. A similar adjustment was made in the amount of \$10,612.00

for tax year 1993. Although the corresponding checks do not bear any notation and the record is unclear that the direct labor charge for 1993 also represents payments for phlebotomy services, it is likely that the Division made the same adjustment as 1992.

Checks written to Amoco, Exxon, Chrysler Credit and Nissan which were posted to the General Ledger account "Automobile Expenses" appear to have an obvious automobile expense connection. However, there was no explanation provided as to the nature of the payments, the connection to a particular vehicle, or the business purpose. There were additional postings to the Automobile Expense account that appear in the General Ledger to unidentified individual names, with no obvious connection to the business, and no explanation as to the nature of the expense and its connection to Sure. Furthermore, there is no documentation or other substantiation provided.

We make the following additional finding of fact:

Mr. Lazar testified, when questioned by the Administrative Law Judge, that when Sheil made salary payments to Eric Moskowitz, it was also paying Sure, because they are one and the same (Tr., p. 167).

THE DETERMINATION OF THE ADMINISTRATIVE LAW JUDGE

The Administrative Law Judge began by pointing out that it was petitioner's burden to prove the material facts which establish his entitlement to the business deductions of his wholly-owned Subchapter S corporation, the losses resulting therefrom, and the employee business deductions of his personal income tax return (Tax Law § 689[e]). The Administrative Law Judge concluded that petitioner did not meet this burden with respect to any of the issues raised in the case.

The Administrative Law Judge noted that the starting point for determining New York personal income tax liability is a taxpayer's Federal adjusted gross income ("AGI"). A taxpayer's New York itemized deductions are derived from the deductions taken from Federal AGI, with modifications not in issue here. Since the New York State personal income tax is patterned after the Federal income tax laws, the Administrative Law Judge followed the guidance of the Internal Revenue Code ("IRC") with respect to the deductibility of the various expenses.

In particular, she noted, an S corporation's income and losses are passed through to its shareholders and taken into account by them in determining their individual tax liability. Such was the case here, where significant S corporation losses were factored into petitioner's Federal AGI, raising questions at the audit level. The losses resulted from alleged business deductions of Sure which far exceeded the income received and reported by that company. The primary issues examined by the Division's auditor were whether this corporation was actually carrying on a "trade or business," and, if so, whether the business deductions were ordinary, necessary and substantiated.

The Administrative Law Judge noted that neither the IRC nor the regulations define what is meant by a "trade or business," but the phrase generally refers to an activity carried on for profit. A profit motive must be present, and some type of economic activity must be conducted (2 Stand Fed Tax Rep [CCH] ¶ 8471.1075).

The Administrative Law Judge pointed out that deductions are a matter of legislative grace and a taxpayer must be able to show that the deduction sought comes within the express provisions of the statute (*New Colonial Ice. Co. v. Helvering*, 292 US 435). Internal Revenue Code § 162(a) allows a taxpayer to deduct all ordinary and necessary business expenses paid or

incurred during the taxable year *in carrying on any trade or business*, including, for example, a reasonable allowance for salaries or other compensation for personal services actually rendered (IRC § 162[a][1]). An ordinary expense, she explained, is one that is common and acceptable in the particular business. A necessary expense is an expense that is appropriate and helpful in carrying on a trade or business. Business expenses include those incurred by an employee, and may qualify as unreimbursed employee expenses, deductible as miscellaneous itemized deductions, subject to two percent of the employee's AGI. No deduction is allowed for personal, living or family expenses (IRC § 262).

Regarding proof of deductions, the Administrative Law Judge noted:

A taxpayer must substantiate any deductions claimed and bear the burden of substantiation. Taxpayers are required to maintain adequate records sufficient to enable the Commissioner [of Internal Revenue] to determine the taxpayer's correct tax liability. . . . [*Cohan v. Commissioner*, 39 F2d 540].

In addition to the requirements of § 162, § 274(d) requires strict substantiation of certain expenses including those incurred with respect to any listed property as defined in § 280F(d)(4), which includes any passenger automobile. A taxpayer is required to substantiate expenses for listed property by establishing the amount, time, place, and business purpose of the expense (*see*, § 274[d]). This section supercedes the doctrine in *Cohan v. Commissioner, supra* (*see*, § 1.274-5T[a][4]).¹²

The Administrative Law Judge first addressed whether Sure was operating as a trade or business. When Sure was incorporated in 1990, it appears to have had a valid purpose, i.e., as a company which picked up and transported blood samples from various doctors and medical practices for analysis by Sheil Medical Laboratory. However, when the Medicaid rules were

¹²Quoting the Tax Court holding in *Wilson v. Commissioner* (77 TCM 1923).

changed regarding payments to corporations around February 1992, Sure could no longer be paid for such services, and petitioner, Sure's sole owner, continued to do the same tasks, only then as an employee of Sheil. This change in circumstance left Sure without the business purpose for which it was originally formed. The only testimony provided on this issue was by Herbert Lazar, petitioner's uncle and highly paid consultant. Whether or not Mr. Lazar's business endeavors were successful, he apparently had considerable experience, and it was this experience, Mr. Lazar testified, that formed the basis for his advice to Sure in his consulting capacity. However, the Administrative Law Judge noted, Mr. Lazar was unable to specifically explain the business function of Sure during the years in issue. While questions were repeatedly asked, his responses were vague and evasive. When asked what he did to earn \$450.00/hour, Mr. Lazar was similarly vague. Mr. Lazar's testimony equated petitioner's performance for Sheil with his functions for Sure. Petitioner did not testify on his own behalf; nor did he submit an affidavit to establish facts in support of his case. Petitioner's representative argued that the time and effort put forth by Mr. Moskowitz establishes that he intended for *Sure* to make a profit. He claimed that petitioner worked 7 days a week, 20 hours a day, devoting 100 percent of his time and efforts to ensure that Sure would be successful. When the Administrative Law Judge questioned Mr. Lazar regarding what petitioner did to earn \$710,000.00 (referencing the 1992 W-2 *from Sheil*), Mr. Lazar indicated that petitioner worked 7 days a week, 20 hours a day, providing marketing and other services for the doctors [for *Sheil*]. The Administrative Law Judge found it unlikely that petitioner could be devoting 100 percent of his time and energy to Sure and also to Sheil, especially when he was being paid an extraordinary salary by Sheil.

With regard to petitioner's records, the Administrative Law Judge pointed out that the Division also considered the general ledgers, general journal entries, bank statements, canceled checks and other evidence *to the extent produced* by petitioner. The Administrative Law Judge noted that the records were incomplete and could not be traced in large part to the corporate tax returns. The checks were without explanations that connected such expenditures to a business purpose of Sure, and the deductions were not substantiated by any additional source documentation. Significantly, many expenditures were personal in nature, and no explanation to the contrary was offered by petitioner. The only testimony provided to support the income and expenditures of Sure by Mr. Lazar was often unresponsive, vague and without any independent substantiation. The Administrative Law Judge found that such testimony, without more, was unreliable.

In disallowing petitioner's Subchapter S loss, the Administrative Law Judge stated that the Division reviewed all the facts available surrounding the corporate existence. The Division determined there was no economic substance to Sure, and it was merely a vehicle used to deduct petitioner's personal expenses under the guise of being a legitimate business. The Administrative Law Judge agreed. However, the Administrative Law Judge noted, since it appeared to the Division that some of the expenses claimed by Sure may have actually been incurred by petitioner in his role *as an employee of Sheil*,¹³ the Division permitted the deduction of such expenses as unreimbursed employee expenses.

In this regard, petitioner provided scant information to the Administrative Law Judge regarding Sure's corporate deductions, mostly in the form of canceled checks. Unfortunately,

¹³In a typographical error here the Administrative Law Judge mistakenly referred to Sheil as "Sure."

they were not categorized or otherwise explained. Having received checks for 36 months into evidence *after the conclusion of the hearing*,¹⁴ without the benefit of any explanation or testimony, the Administrative Law Judge found that one would have to make great leaps to connect most of the checks to any business activity of Sure. Even if such connection could be inferred, the Administrative Law Judge stated, there was no source documentation to substantiate the expenses. Further, the Administrative Law Judge pointed out, the documentation reviewed during the audit showed a significant amount of personal expenses being paid using Sure's account. The documentation submitted and reviewed post-hearing by the Administrative Law Judge contained discrepancies when amounts were posted to the general ledger and traced to the tax return; cash drawn out of the company in large sums went to Mr. Lazar, petitioner and petitioner's mother, according to Sure's records; no explanation was provided to connect these expenses to any business activity. Although the Administrative Law Judge viewed it as generous, in view of the lack of proof, the Division permitted some deductions to be taken on petitioner's personal tax return.

Petitioner also argued to the Administrative Law Judge that Sure's deductions should be allowed as start-up costs, which are governed specifically by IRC § 195. Internal Revenue Code § 195 essentially provides that if the definition of "start-up expenditure" is met, the deduction is amortized over a 60-month period *beginning with the month in which the active trade or business begins*. The Administrative Law Judge concluded that in the case of Sure, since the

¹⁴The Administrative Law Judge gave petitioner an additional opportunity to submit evidence in support of his case after the hearing was concluded.

commencement of an active trade or business was never proved, the provisions of IRC § 195 were not available to petitioner.

Penalties were imposed by the Division pursuant to Tax Law § 685(b), where a deficiency arises due to negligence or intentional disregard of Article 22 of the Tax Law, and Tax Law § 685(p), for the substantial understatement of the income tax liability for each of the tax years in issue. Petitioner did not allege the impropriety of such penalties or introduce any evidence to support their abatement.

The Administrative Law Judge sustained the notice of deficiency, including penalties.

ARGUMENTS ON EXCEPTION

On exception petitioner argues that his books and records were adequate to substantiate Sure's expenses and argues that Sure was a viable business entity.

Petitioner claims that the Division's auditor admitted that his audit was arbitrary and the Administrative Law Judge never addressed that issue although raised by petitioner throughout the case. Petitioner also argues that Mr. Lazar's testimony regarding the deductibility of Sure's expenses should have been given credence by the Administrative Law Judge . Petitioner seeks a finding that Sure's payments to Mr. Lazar were ordinary and necessary business expenses. Petitioner also argues that he should have been given credit for Sure's start-up expenses and penalties should be abated.

Finally, although not raised on exception, petitioner argues that the Administrative Law Judge's *ex parte* review of the documents submitted by petitioner after the hearing "deprived the petitioner of any input whatsoever, including an opportunity to answer any questions the Judge may have had on the items she was auditing" (Petitioner's brief on exception, p. 2).

The Division maintains that it properly disallowed expense deductions which were not ordinary and necessary business expenses or could not be verified by petitioner. The basis for disallowance of expenses at the corporate level was due to the fact that Sure lacked the requisite profit motive. Other deductions as an employee were disallowed due to lack of substantiation. The Division argues that petitioner has not established any basis for abatement of penalties, or carried his burden of proving that the Division's conclusions are erroneous.

OPINION

We affirm the determination of the Administrative Law Judge. A taxpayer must substantiate any deductions claimed and bears the burden of substantiation (*Wilson v. Commissioner, supra*).

Although given ample opportunity to prove that Sure was engaged in a trade or business, petitioner never did so. We agree with the Administrative Law Judge that Mr. Lazar's testimony was inadequate to establish the nature of Sure's business or the specifics of his "consulting" activities. We note that petitioner's representative failed to offer documentary evidence during the hearing to substantiate any of petitioner's claims. Moreover, petitioner's representative was granted an opportunity to submit documentation post-hearing with copies to the Division to substantiate Sure's deductions (Tr., p. 200). Petitioner and the Division were also given an opportunity to file briefs to explain their respective positions concerning the documents submitted and the case generally (Tr., pp. 205-206). Both parties did so. Therefore, petitioner's claim that he was deprived of any input or opportunity to explain the documents he submitted post-hearing is baseless. Even though given this additional time to submit evidence to

substantiate Sure's deductions and to establish that the company was engaged in a trade or business, the documents submitted do neither.

Petitioner's argument that Sure's start-up costs should be allowed as deductions is also without merit (IRC § 195). As the Administrative Law Judge pointed out, to receive this deduction, one must first prove the establishment of a trade or business and that it incurred start-up expenditures (and when). Petitioner did not carry his burden of proof on this issue.

Petitioner's argument that the auditor admitted that his audit was arbitrary is not supported by the record.

Penalties were imposed by the Division pursuant to Tax Law § 685(b) for a deficiency arising due to negligence or intentional disregard of Article 22 of the Tax Law, and Tax Law § 685(p), for the substantial understatement of the income tax liability for each of the tax years in issue. Petitioner offered no evidence that would establish reasonable cause for the abatement of penalties. In any event, petitioner did not raise the issue of abatement of penalties before the Administrative Law Judge. Abatement of penalty is a factual issue which may not be raised for the first time on exception (*Matter of Otero*, Tax Appeals Tribunal, September 21, 2000; *Matter of Howard Enters.*, Tax Appeals Tribunal, August 4, 1994). Therefore, penalties are sustained.

Accordingly, it is ORDERED, ADJUDGED and DECREED that:

1. The exception of Eric Moskowitz is denied;
2. The determination of the Administrative Law Judge is affirmed;
3. The petition of Eric Moskowitz is denied; and
4. The Notice of Deficiency dated March 25, 1996 for tax years 1992, 1993 and 1994 is sustained.

DATED: Troy, New York
November 2, 2000

/s/Donald C. DeWitt

Donald C. DeWitt
President

/s/Carroll R. Jenkins

Carroll R. Jenkins
Commissioner

/s/Joseph W. Pinto, Jr.

Joseph W. Pinto, Jr.
Commissioner