

STATE OF NEW YORK

DIVISION OF TAX APPEALS

In the Matter of the Petition	:	
of	:	
Michael J. Fahy	:	DETERMINATION
for Redetermination of a Deficiency or for	:	
Refund of Personal Income and Unincorporated	:	
Business Taxes under Articles 22 and 23 of the	:	
Tax Law for the Years 1972 and 1973.	:	

Petitioner, Michael J. Fahy, R.D. 2, Sauquoit, New York 13456, filed a petition for redetermination of a deficiency or for refund of personal income and unincorporated business taxes under Articles 22 and 23 of the Tax Law for the years 1972 and 1973 (File No. 800078).

A hearing was held before Timothy J. Alston, Administrative Law Judge, at the offices of the Division of Tax Appeals, 207 Genesee Street, Utica, New York, on October 19, 1988 at 9:15 A.M. Petitioner appeared pro se. The Audit Division appeared by William F. Collins, Esq. (Mark Volk, Esq., of counsel).

ISSUES

I. Whether the Audit Division properly determined additional tax due from petitioner by a bank deposits plus cash expenditures method of determining gross receipts from petitioner's business, and by disallowing certain deductions claimed on petitioner's returns.

II. Whether the imposition of the fraud penalty herein pursuant to Tax Law § 685(e) was proper.

FINDINGS OF FACT

1. On October 13, 1978, following an audit, the Audit Division issued to petitioner, Michael J. Fahy, a Notice of Deficiency which asserted total additional personal income and unincorporated business taxes due of \$4,289.90 for the years 1972 and 1973, plus fraud penalty pursuant to Tax Law § 685(e). A Statement of Audit Changes, dated August 22, 1977, and issued to petitioner more specifically set forth petitioner's asserted liability as follows:

	<u>1972</u>	<u>1973</u>
Personal Income Tax Due	\$574.27	\$2,158.88
Unincorporated Business Tax Due	333.45	1,223.30
Penalty Due @ 50%	453.87	1,691.09

2. Petitioner filed documents with the Audit Division, dated April 15, 1973 and April 15, 1974, which consisted of New York State income tax resident returns (Form IT-201) for 1972 and 1973. The IT-201 for 1972 had petitioner's name, address, social security number and occupation ("self-employed") filled in. On line 8 ("Exemptions") petitioner wrote in "\$650.00". The form was signed by petitioner and dated. The rest of the form was blank. The IT-201 for 1973 listed petitioner's name, address, social security number, county of residence and filing status. Written on the lines along the right side of the form were the words "Fifth Amendment". Attached to one of the IT-201's (the record is unclear as to which) was a statement by petitioner that the personal income tax was unconstitutional and therefore he refused to pay. He also attached to the return various newspaper articles regarding the abortion issue and a statement (attached to the return as Exhibit "A") which listed various reasons why the income tax was improper. Among the reasons listed were the following:

"I wish to state that I earned less than \$600.00 in constitutional, lawful United States money in the year 1970, and therefore owe no income tax. (Exhibit B [attached to the return])

I further wish to state that even if I had earned \$600.00 in lawful United States money, I would have to refuse payment of any income tax because I would be compelled thereby to participate in a program which is killing thousands of unborn children. This would be a violation of my rights under the first amendment which states, 'Congress shall make no law respecting an establishment of religion, or prohibiting the free exercise thereof;.....'

Exhibit 'C' [attached to the return] makes it abundantly clear that the highest authority of the Catholic Church, of which I am a member, look upon abortion as murder and Exhibit 'D' [attached to the return] makes it clear that both New York State and the Federal Government are using tax money to pay for abortions.

* * *

The Communist Manifesto, written by Karl Marx in 1948 [sic], lists 10 specific planks that will destroy the God-given rights of Americans to life, liberty and the pursuit of happiness--guaranteed by the Constitution of the United States. Their program for destruction of Sovereign America lists the number 2 method as: 'A heavy progressive or graduated income tax.' Number 5: 'Centralization of credit in the hands of the state by means of a national bank with State capital and an exclusive monopoly.' Today, both programs are accomplished fact [sic].

The Federal Reserve Banks create Federal Reserve notes (promises to pay) simply by bookkeeping entries, paying only for costs of paper and ink which is less than 1¢ per note, yet it was only ten months after the 16th Amendment was ratified, Law 12 USC 531 exempted the Federal Reserve Banks from paying taxes on income -- a gross discrimination.

* * *

The U.S. government printing offices has printed documentation that there are over 350,000 tax exempt organizations. There are fourteen in the Rockefeller family. Nelson Rockefeller, New York's Governor, paid only \$685 income taxes for the year '66.

The XVI Amendment says 'The Congress shall have power to lay and collect taxes on incomes, from whatever source derived.....'"

3. The Audit Division subsequently attempted to audit petitioner with respect to his 1972 and 1973 tax liability. At that time, petitioner was under investigation by the Audit Division regarding his tax liability for 1969 through 1971. Petitioner did not cooperate with the Audit Division and the matter was subsequently referred for criminal prosecution. Following a trial, petitioner was convicted in Oneida County Supreme Court on November 24, 1976 of two counts of failure to file New York State income tax resident returns with intent to evade payment thereon and two counts of failure to file New York State unincorporated business tax returns with intent to evade payment thereon. All four counts upon which petitioner was convicted were misdemeanors. Petitioner was convicted in respect of his 1972 and 1973 personal income and unincorporated business tax liability.

4. On December 30, 1976, petitioner was sentenced to pay a fine of \$500.00 on each count, for a total of \$2,000.00, and to file personal income and unincorporated business tax returns for 1972 and 1973. He was also placed on probation for one year.

5. On May 3, 1977, petitioner was ordered by the court to pay the fines and to file the returns for the years in question by June 6, 1977.

6. Petitioner filed personal income and unincorporated business tax returns for 1972 and 1973 on June 21, 1977.

7. On July 20, 1977, petitioner's probation was revoked and he was sentenced to 90 days in the Oneida County Jail. At that time, the court signed a show cause order returnable on August 3, 1977, and an order staying the execution of the sentence.

8. On or about August 1, 1977, petitioner paid the fines imposed by the court and, on August 22, 1977, he paid tax, interest to August 15, 1977, and 50 percent penalty in respect of the amounts shown due on the returns filed on June 21, 1977.

9. On August 31, 1977, the sentence imposed on July 20, 1977 was vacated and the original sentence imposed on December 30, 1976 was reinstated. Petitioner had filed returns for 1972 and 1973 and paid fines as ordered by the court. He had also submitted to an audit pursuant to court order.

10. The audit resulting in the deficiency herein was commenced on or about August 8, 1977. The audit was conducted in respect of petitioner's returns for 1972 and 1973, which were filed on June 21, 1977. During 1972 and part of

1973, petitioner owned and operated "M. J. Fahy Kitchens", a sole proprietorship engaged in the business of selling kitchen equipment. On audit, the Audit Division examined petitioner's available books and records, including both his personal and business bank statements. The Audit Division determined that petitioner's records were "disorganized and not well-related to records of income and expense".

11. The Audit Division's review of petitioner's records for 1972 resulted in the following adjustments:

(a) Petitioner's gross receipts were reconstructed by totaling deposits in petitioner's business checking account and totaling his cash expenses per his books. Audited gross receipts were thus determined to be \$183,597.42, as compared to reported gross receipts of \$173,576.36.

(b) Petitioner's cost of goods sold was increased to \$126,452.01 from \$121,594.44 because of computational errors in petitioner's records.

(c) The Audit Division reduced petitioner's claimed auto expenses of \$5,130.00 to \$2,700.00 based on the existing standard mileage rates.

(d) The Audit Division also disallowed petitioner's bad debt deduction of \$950.02. The Audit Division contended that, as a cash basis taxpayer, petitioner was not entitled to that deduction.

(e) Further, the Audit Division disallowed \$552.59 of petitioner's claimed utilities expense deduction of \$3,572.85. This disallowance amounted to 80 percent of \$690.73 in utilities expenses paid on petitioner's personal residence and claimed as a business deduction.

(f) The above-noted adjustments for 1972 resulted in an increase in petitioner's taxable income for personal income tax purposes of \$9,096.10 and (after a 20 percent allowance for petitioner's personal services) an increase in petitioner's taxable business income for unincorporated business tax purposes of \$7,276.88.

12. The audit of petitioner's 1973 records resulted in the following adjustments:

(a) Petitioner's gross receipts were reconstructed by totaling business checking account deposits, cash expenses per books, and the sale of the business's inventory. Audited gross receipts thus totaled \$102,471.38. Reported gross receipts were \$72,797.51. Regarding the sale of inventory, petitioner terminated his sole proprietorship on June 7, 1973 and sold his inventory to Fahy Kitchens, Inc., a corporation controlled by his wife. In exchange for the inventory, petitioner received a note in the amount of \$15,184.98.

(b) Petitioner's reported cost of goods sold was increased by \$8,687.19 to \$59,614.09. This adjustment resulted from computational errors in petitioner's records and the reduction in petitioner's ending inventory to zero because of the sale of the proprietorship's inventory to the corporation.

(c) The Audit Division also disallowed \$270.15 of petitioner's utilities expense deduction of \$1,931.28. As with the audit of the 1972 returns, this disallowance represented 80 percent of \$337.69 in utilities expenses paid on petitioner's personal residence and claimed on his return as a business deduction.

(d) The Audit Division also determined that \$8,100.00 of commissions earned by petitioner as a salesman for Fahy Kitchens, Inc. were properly subject to unincorporated business tax.

(e) With respect to petitioner's schedule D for 1973, the Audit Division allowed petitioner's claimed short-term capital loss of \$375.50 on a silver contract and disallowed a claimed long-term capital loss of \$1,896.00 on First Federated Community Trust stock. The long-term loss was disallowed because the company's stock was not declared valueless in 1973. The company was placed in receivership and petitioner received consideration for his stock in 1975 and 1976. The Audit Division also disallowed a long-term capital gain on petitioner's sale of inventory to Fahy Kitchens, Inc. As noted above, on audit, the proceeds of this sale were included as part of petitioner's gross receipts (and therefore were treated as ordinary income). Since, following the audit, petitioner had a short-term capital loss, petitioner's reported capital gain modification of \$507.93 was reversed.

(f) As a result of the foregoing adjustments, petitioner's taxable income for personal income tax purposes was increased by \$18,209.29 and his taxable business income for unincorporated business tax purposes was increased by \$24,933.83.

13. The audited returns herein were prepared by G. M. Morgan, petitioner's accountant, and signed by petitioner.

14. At hearing, petitioner presented no evidence to refute any of the specific adjustments to his taxable income made on audit by the Audit Division. Petitioner reiterated his constitutional and moral objections to the imposition of the personal income and unincorporated business taxes which were attached to his original 1972 and 1973 "returns" and summarized, in part, at Finding of Fact "2".

CONCLUSIONS OF LAW

A. Given the condition of petitioner's books and records (Finding of Fact "10"), the Audit Division's reconstruction of petitioner's gross receipts by use of his bank statements and cash expenditures was proper. Under such circumstances, the Audit Division was authorized to determine petitioner's income by whatever method would clearly reflect petitioner's income (see _____, Matter of William T. Kelly, State Tax Commn., December 31, 1984; DiLando v. Commr., 34 TCM 1046, 1050). The use of bank deposits and cash expenditures is well-established as an acceptable method of income reconstruction (see generally, 10 Fed Tax Coordinator (RIA) ¶ G-2925 - 2927). Petitioner presented no evidence to show that the use of this method to determine gross receipts was in any way improper.

Additional justification for the Audit Division's use of an indirect audit method to determine petitioner's gross receipts is petitioner's criminal conviction on tax evasion charges. Where there is some factual basis for determining that a return as filed does not accurately reflect the true income received by a taxpayer, the use of an indirect audit method is proper (see _____, Matter of Gitlitz, State Tax Commn., May 6, 1983; Holland v. United States, 348 US 121, 131-

132). Accordingly, petitioner's conviction justified the gross receipts reconstruction method employed herein.

With respect to the other adjustments to petitioner's returns made on audit, petitioner failed to show that such other adjustments were improper.

B. For purposes of both Article 22 and former Article 23¹, Tax Law § 685(e) imposes a penalty equal to 50 percent of the deficiency "[i]f any part of a deficiency is due to fraud". Petitioner's conviction for failure to file New York State personal income tax returns with intent to evade payment thereon and failure to file unincorporated business tax returns with intent to evade payment thereon for 1972 and 1973 estops petitioner from contesting the civil fraud penalties asserted herein (see ___, *Matter of Cardinal Motors, Inc.*, State Tax Commn., July 8, 1983; *Gray v. Commr.*, 708 F2d 243).²

It should be noted that petitioner's fraud was in no way purged by his filing, in 1977, of personal income and unincorporated business tax returns for the years at issue. The fraud was committed when the original "returns" (Finding of Fact "2") were filed in 1973 and 1974 (see ___, *Badaracco v. Commr.*, 464 US 386, 394).

"Any other result would make sport of the so-called fraud penalty. A taxpayer who had filed a fraudulent return would merely take his chances that the fraud would not be investigated or discovered, and then, if an investigation were made, would simply pay the tax which he owed anyhow and thereby nullify the fraud penalty."
(*George M. Still, Inc. v. Commissioner*, 19 TC 1072, 1077, *affd* 218 F2d 639.)

C. With respect to petitioner's religious and moral objections to the imposition of the personal income and unincorporated business taxes, such objections have been rejected by the courts (see ___, *Fahy v. Commr.*, 43 TCM 387, 393) and are rejected herein. Petitioner's other constitutional objections are patently frivolous (see ___, *Fahy v. Commr.*, *supra* at 393).

¹Article 23 of the Tax Law (§§ 701 to 723) was repealed by L 1978, ch 69, § 7, eff. December 31, 1982. Tax Law (former) § 722(a) applied the penalty provisions of Tax Law § 685 to Article 23.

²When analyzing state statutes modeled after Federal statutes, it is proper to look to Federal cases for guidance (*Matter of Levin v. Gallman*, 42 NY2d 32). The income tax fraud penalty provisions were modeled after similar Federal statutes (see I.R.C. § 6653) and were extended to "mark another step in the process of conforming the State's income tax laws to comparable provisions of Federal law...." (See, L 1962, ch 1011; Memorandum of State Department of Taxation and Finance, 1962 McKinney's Session Laws of NY, at 3536-37; *see also*, Tax Law § 685.)

D. The petition of Michael J. Fahy is in all respects denied and the Notice of Deficiency, dated October 13, 1978, is sustained.

DATED: Albany, New York
February 9, 1989

/s/ Timothy J. Alston
ADMINISTRATIVE LAW JUDGE