

STATE OF NEW YORK
DIVISION OF TAX APPEALS

In the Matter of the Petition :
of :
JAMES R. SHOLLY AND KATHLEEN V. SHOLLY :
for Redetermination of a Deficiency or for :
Refund of Personal Income Tax under Article 22 :
of the Tax Law for the Years 1978 through 1980. :

DETERMINATION

In the Matter of the Petition :
of :
HAWK & DOVE RESTAURANT CORP. :
for Redetermination of a Deficiency or for :
Refund of Corporation Franchise Tax under :
Article 9-A of the Tax Law for the Years :
1978 through 1980. :

Petitioners James R. Sholly and Kathleen V. Sholly, 836 Locust Avenue, Bohemia, New York 11716, filed a petition for redetermination of a deficiency or for refund of personal income tax under Article 22 of the Tax Law for the years 1978 through 1980 (File No. 801151).

Petitioner Hawk & Dove Restaurant Corp., 1290 Smithtown Avenue, Bohemia, New York 11716, filed a petition for redetermination of a deficiency or for refund of corporation franchise tax under Article 9-A of the Tax Law for the years 1978 through 1980 (File No. 801152).

A consolidated hearing was held before Brian L. Friedman, Administrative Law Judge, at the offices of the Division of Tax Appeals, Two World Trade Center, New York, New York, on June 20, 1988 at 1:15 P.M., with all briefs to be submitted by October 10, 1988. Petitioners appeared by Kaplan and Kaplan, P.C. (Morris A. Kaplan, Esq., of counsel). The Division of Taxation appeared by William F. Collins, Esq. (Kevin A. Cahill, Esq., of counsel).

ISSUES

I. Whether the Division of Taxation properly used the results of a sales tax audit, which were agreed to by petitioner James R. Sholly, president of petitioner Hawk & Dove Restaurant Corp., to adjust said corporation's franchise tax liability for the years at issue.

II. Whether notices of deficiency were timely issued to petitioners James R. Sholly and Kathleen V. Sholly and to petitioner Hawk & Dove Restaurant Corp. for the years 1978 and 1979.

III. Whether, based upon a cash availability analysis, the Division of Taxation properly

found additional funds of petitioners James R. Sholly and Kathleen V. Sholly subject to personal income tax.

IV. Whether petitioners have established that funds were embezzled from Hawk & Dove Restaurant Corp.

V. Whether, pursuant to the "innocent spouse" provisions of Tax Law § 651(b)(former [5]), petitioner Kathleen V. Sholly should be relieved of liability for any deficiencies of personal income tax.

VI. Whether penalties asserted against petitioners should be reduced or abated.

FINDINGS OF FACT

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

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

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

The Sales Tax Audit

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

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

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

An analysis of liquor and wine purchases for the period November 6, 1980 to December 4,

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

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

4. Total taxable sales were, therefore, calculated as follows:

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

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

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

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

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

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

Due to these adjustments, audited taxable sales were recomputed to be \$469,700.01. After credit for reported taxable sales of \$264,654.00, additional taxable sales were determined to be \$205,046.01 with additional tax due thereon in the amount of \$14,353.22. Petitioners agreed to the revised assessment.¹

The Corporation Franchise Tax Audit

6. The additional sales determined to have been made by Hawk & Dove were applied as

¹It is not clear from the record herein whether or not the sales tax assessment was paid by petitioners.

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

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

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

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

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

The Income Tax Audit

7. Petitioners James R. Sholly and Kathleen V. Sholly filed joint New York State resident income tax returns for each of the years at issue herein. Initially, the additional gross sales determined from the sales tax audit of Hawk & Dove were attributed to these petitioners as constructive dividends which increased their personal income tax liability accordingly. On May 31, 1983, a Statement of Personal Income Tax Audit Changes was issued to James and Kathleen Sholly asserting a deficiency of personal income tax for 1978, 1979 and 1980 in the amount of \$22,980.97, plus penalty and interest. Subsequently, a conference was held wherein it was decided that an audit based upon a cash availability analysis would be conducted. Federal returns, bank accounts, checks and certain other financial data such as mortgage statements, were made available and were examined by the auditor. The following is a summary of the cash availability analysis:

<u>Cash In</u>	<u>1978</u>	<u>1979</u>	<u>1980</u>
Salary (net)	\$ 5,800	\$ 7,160	\$ 7,580
Federal tax refund	1,000	1,432	1,802
State tax refund	<u>200</u>	<u>298</u>	<u>425</u>
Total	\$ 7,000	\$ 8,890	\$ 9,807

Cash Out

Deposits (checking account)	\$ 7,894	\$11,740	\$ 7,479
Cash living	<u>16,865</u>	<u>19,280</u>	<u>19,375</u>
Total	\$24,759	\$31,020	\$26,854
Cash shortage	\$17,759	\$22,130	\$17,047

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

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

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

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

While the aforesaid explanation stated that the adjustments were constructive dividends, said adjustments were, in fact, the result of the cash availability analysis performed. The Division of

Taxation categorized the adjustments as constructive dividends based upon its determination that all of petitioners' income was derived from Hawk & Dove.

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

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

10. As indicated in Finding of Fact "1", supra, John Sholly, brother of petitioner James R. Sholly, was a shareholder of Hawk & Dove, but he neither worked there nor did he receive income from the business. During the years at issue, John Sholly lived in and owned a 50 percent interest in the home wherein petitioners and their children resided. John Sholly paid a minimum of 50 percent of all housing expenses (mortgage and utilities) for each of the years at issue. In addition, he contributed approximately \$75.00 per week toward food and other living costs.

SUMMARY OF PETITIONERS' POSITION

11. Petitioners allege as follows:

(a) The Division of Taxation has the burden of proving that the taxpayers omitted in excess of 25 percent of the gross income on their returns or reports in order to avail itself of the six-year statute of limitations.

(b) While the results of the sales tax audit of Hawk & Dove were agreed to, petitioners were totally unaware that said results would be used to assert deficiencies of other taxes. Petitioners assert that certain auditors and/or other employees of the Division of Taxation threatened to close down the Hawk & Dove if the sales tax assessment was not agreed to and paid in full. Petitioners also assert that the auditor failed to take into consideration certain other specials and discounts which would have decreased audited taxable sales.

(c) Petitioners contend that, during the years at issue, funds were embezzled from Hawk & Dove. No police report concerning such embezzlement was ever filed, nor does the proprietor, James R. Sholly, suspect any of the family members/employees who worked at the business premises.

(d) Pursuant to Tax Law § 651(b) (former [5]), petitioner Kathleen V. Sholly is entitled to "innocent spouse" status. At the hearing held herein, said petitioner stated that she did not believe that her husband (petitioner James R. Sholly) ever concealed any income from her nor did she believe that any such income was ever utilized by her husband for anything other than the support of his family. Petitioner James R. Sholly stated that at no time did he ever conceal income from his wife or use his financial resources for other purposes than to support his family.

(e) Petitioners James R. Sholly and Kathleen V. Sholly allege that the "cash in" calculated by the Division of Taxation in its cash availability analysis should be increased by

amounts contributed by various family members during the years at issue.

(f) Petitioners James R. Sholly and Kathleen V. Sholly contend that there was no evidence presented to support the Division of Taxation's position that they received constructive dividends from Hawk & Dove. It should be noted, however, that the Division of Taxation's assertion of a deficiency of personal income tax was based not on constructive dividends from Hawk & Dove, but on an independent cash availability analysis.

CONCLUSIONS OF LAW

A. Where there is some factual basis for deciding that the tax returns as filed do not accurately reflect the true income received by a taxpayer, the Division of Taxation may determine proper income using indirect methods (see ___, Holland v. United States, 348 US 121, 131-132). The sales tax audit conducted by the Division of Taxation revealed additional sales tax due from Hawk & Dove and provided a factual basis for determining that the income reported by Hawk & Dove on its corporation franchise tax reports was not accurate and the Division of Taxation, therefore, properly used the sales tax audit findings to calculate additional corporation franchise tax. No provision of the Tax Law or regulations promulgated thereunder precludes the Division of Taxation from utilizing the results of an audit conducted under one article of the Tax Law in an audit conducted under another article (Matter of Castaldo, State Tax Commission, February 15, 1985).

B. Tax Law § 683(d)(1) provides that where a taxpayer omits from adjusted gross income an amount in excess of 25 percent of the amount stated on the return filed, personal income tax may be assessed within six years after the return was filed. Tax Law § 1083(d) contains a similar provision with respect to the corporation franchise tax, i.e., a six-year statute of limitation for omission from gross income of an amount in excess of 25 percent of the amount stated on the franchise tax report. Petitioners contend that the Division of Taxation has the burden of proving, by a preponderance of the evidence, that the six-year statute of limitations is applicable herein. In support of this contention, petitioners cite Federal cases such as Reis v. Commissioner (1 TC 9) and Bardwell v. Commissioner (38 TC 84). While it is true that the aforesaid cases do provide that the Internal Revenue Service must prove, by a preponderance of the evidence, that there has been an omission from gross income of more than 25% and, in furtherance of such burden of proof, must prove the taxpayer's gross income (see ___, Jones v. Commissioner, 10 TCM 1234), a distinction may be drawn with respect to New York State tax matters.

Rule 142(a) of the Tax Court Rules of Practice provides, in pertinent part, as follows:

"The burden of proof shall be upon the petitioner, except as otherwise provided by statute or determined by the Court; and except that, in respect of any new matter, increases in deficiency, and affirmative defenses, pleaded in his answer, it shall be upon the respondent."

As indicated in petitioners' memorandum of law, the courts have shifted the burden of proof to the respondent (IRS) in matters relating to the applicability of the six-year statute of limitations. The courts have not, however, shifted this burden of proof to the Division of Taxation in New York State tax matters. Moreover, statutes (Tax Law § 689[e]; § 1089[e]) specifically place the burden of proof on the petitioner with certain exceptions not applicable herein. These exceptions do not include the application of the six-year statute of limitations (Tax Law § 683[d][1]; §

1083[d]). It is, therefore, held that it is petitioners who must bear the burden of proving that they have not omitted more than 25 percent of gross income and that the six-year statute of limitations is not applicable.

Petitioners agreed to the sales tax audit findings and, as indicated in Conclusion of Law "A", supra, the Division of Taxation is within its authority to utilize the results of the sales tax audit to assert deficiencies of other taxes. With respect to the deficiencies of corporation franchise tax, petitioners have failed to sustain their burden of proving that they did not omit in excess of 25 percent of the gross income stated on the corporation franchise tax reports filed for the years at issue. As such, the six-year statute of limitations is found to be applicable. The notices of deficiency issued for the years 1978 and 1979 were, therefore, timely issued.

C. With respect to the deficiencies of corporation franchise tax asserted to be due herein, petitioner Hawk & Dove has failed to meet its burden of proof under Tax Law § 1089(e) to show that there were additional costs or expenses associated with the additional sales determined to have been made by the corporation as a result of the sales tax audit performed. While petitioners have alleged that they were entitled to additional allowances for discounted sales and other bar "specials", they have produced no evidence to substantiate these allowances. It must be noted that, subsequent to the sales tax audit and prior to the issuance of the sales tax assessment, a conference was held wherein certain additional allowances were made. Now that such findings were utilized in asserting corporation franchise tax deficiencies, petitioners seek further reductions in taxable sales. Petitioners have, however, failed to sustain their burden of establishing that either the audit method or the amount of sales and use tax assessed was erroneous (see Surface Line Operators Fraternal Organization, Inc. v. Tully, 85 AD2d 858). The notices of deficiency issued March 2, 1984, asserting deficiencies of corporation franchise tax for the years 1978, 1979 and 1980 are, therefore, sustained in full.

D. As to the deficiencies of personal income tax asserted against petitioners James R. Sholly and Kathleen V. Sholly, such petitioners have failed to sustain their burden of proving that they did not omit in excess of 25 percent of adjusted gross income included on their returns for the tax years 1978 and 1979. It is hereby found that such six-year statute of limitations applies and that the Notice of Deficiency issued on March 26, 1984 for tax years 1978 through 1980 was timely issued for each of these tax years.

Petitioners are, however, entitled to adjustments in the amounts asserted to be due for each of the years at issue. The evidence presented clearly indicates that petitioner James R. Sholly's brother, John Sholly, was a 50 percent owner of the residence wherein petitioners resided and that John Sholly contributed both to the housing and living expenses of these petitioners. As indicated in Finding of Fact "10", supra, John Sholly paid 50 percent of the mortgage and utilities expenses and, in addition thereto, contributed \$75.00 per week toward food and other living expenses. The Division of Taxation's cash availability analysis must, therefore, be revised as follows:

(a) Mortgage expenditures are reduced by 50 percent to \$2,682.50 for 1978, \$2,675.00 for 1979 and \$2,491.50 for 1980.

(b) Utility expenditures are reduced by 50 percent to \$1,000.00 for 1978, \$1,100.00 for 1979 and \$1,200.00 for 1980.

(c) Total living expenses are reduced by \$3,900.00 (\$75.00 x 52) for each of 1978, 1979 and 1980.

As a result of the aforesaid adjustments, "cash out" is reduced by \$7,582.50 for 1978, by \$7,675.00 for 1979 and by \$7,591.50 for 1980. "Cash shortage" is, therefore, reduced to \$10,176.50 for 1978, \$14,455.00 for 1979 and \$9,455.50 for 1980 and tax due thereon shall be adjusted accordingly.

E. Petitioners' contention that other family members contributed sums of money to defray living expenses is rejected. Affidavits of Robert F. Sholly (father of James Sholly), Patricia A. O'Neil (sister of Kathleen Sholly) and Marie E. O'Neil (mother of Kathleen Sholly) were submitted without further substantiation that such contributions were, in fact, made. Cancelled checks from Mary E. Gorman (sister of Kathleen Sholly) to Kathleen Sholly during 1980 were also submitted by petitioners. Some of these checks were for odd amounts, i.e., \$17.90, \$26.00, \$66.00, \$13.00, \$10.50 and \$48.10. While it is possible that these checks could have been used for specific purchases, most of the checks were made payable to Kathy Sholly (two of the checks were payable to cash). Without testimony and/or further substantiation as to the purposes for which said checks were issued, these, too, must be rejected.

F. Tax Law § 651(b) (former [5][i]) provided that:

"Under regulations prescribed by the tax commission, if

(A) a joint return has been made pursuant to paragraph (2)(A) or paragraph (3) of this subsection for a taxable year and on such return there was omitted from New York adjusted gross income an amount properly included therein which is attributable to one spouse and which is in excess of twenty-five percent of the amount of New York adjusted gross income stated in the return,

(B) the other spouse establishes that in signing the return he or she did not know of, and had no reason to know of, such omission and

(C) taking into account whether or not the other spouse significantly benefited directly or indirectly from the items omitted from New York adjusted gross income and taking into account all other facts and circumstances, it is inequitable to hold the other spouse liable for the deficiency in tax for such taxable year attributable to such omission, then the other spouse shall be relieved of liability for tax (including interest, penalties and other amounts) for such taxable year to the extent that such liability is attributable to such omission from New York adjusted gross income."

Petitioner Kathleen V. Sholly has failed to sustain her burden of proof pursuant to Tax Law § 689(e) to establish that she did not know of and had no reason to know of the omission of income by James R. Sholly or that she had not significantly benefited, directly or indirectly, by such omission. Accordingly, relief under the "innocent spouse" provisions of Tax Law § 651(b) (former [5][i]) is deemed unwarranted.

G. Petitioners have failed to sustain their burden of proof pursuant to Tax Law § 689(e) to establish that funds were embezzled from Hawk & Dove. No police report was filed nor could petitioners establish the amount of loss or any suspects relative thereto.

H. While petitioners assert that penalties upon the deficiencies of personal income tax and corporation franchise tax herein should be abated, they have failed to sustain their burden of proof (pursuant to Tax Law §§ 689[e] and 1089[e]) to establish that their failure to comply with

the provisions of Articles 22 (personal income tax) and 27 (corporate tax procedure) was due to reasonable cause and not due to willful neglect. Said penalties imposed are, therefore, sustained in full.

I. The petition of James R. Sholly and Kathleen V. Sholly is granted to the extent indicated in Conclusion of Law "D"; the Division of Taxation is directed to modify the Notice of Deficiency issued March 26, 1984 accordingly; and, except as so granted, the petition is in all other respects denied.

The petition of Hawk & Dove Restaurant Corp. is denied and the notices of deficiency issued March 2, 1984 are sustained in their entirety.

DATED: Albany, New York
January 20, 1989

/s/ Brian L. Friedman
ADMINISTRATIVE LAW JUDGE