STATE OF NEW YORK

DIVISION OF TAX APPEALS

In the Matter of the Petition	:	
of	:	
JOSEPH AND MIRIAM DREBIN	:	DETERMINATION DTA NO. 812816
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 1982 through 1987.	:	

Petitioners, Joseph and Miriam Drebin, 3910 Bedford Avenue, Brooklyn, New York 11229, filed a petition 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 1982 through 1987.

A hearing was held before Joseph W. Pinto, Jr., Administrative Law Judge, at the offices of the Division of Tax Appeals, 500 Federal Street, Troy, New York, on May 2, 1995 at 1:15 P.M., with all briefs to be submitted by August 7, 1995, which date began the six-month period for the issuance of this determination. Petitioner appeared by Isaac Sternheim, CPA. The Division of Taxation appeared by Steven U. Teitelbaum, Esq. (Kenneth J. Schultz, Esq., of counsel).

ISSUE

I. Whether the Division of Taxation properly attributed additional income to petitioners due to constructive dividends or additional unreported wages from Intercity Electrical Contracting Corporation and Century Electrical Contracting Corporation.

II. Whether the Division of Taxation is prohibited by the period of limitations on assessment of additional taxes pursuant to Tax Law § 683 from issuing assessments for any of the years in issue.

III. Whether petitioners are liable for penalties pursuant to Tax Law § 685(p).

FINDINGS OF FACT

1. Petitioner Joseph Drebin was a director of Century Electrical Contracting Corporation ("Century") and Intercity Electrical Contracting Corporation ("Intercity") and the vice president of Intercity during the years 1982 through 1987.

Sometime prior to December 1988, a Superior Court information was issued against Century, Intercity and Joseph Drebin, alleging that they had, with intent to evade payment of corporate income taxes, failed to file a corporate income tax return for the consecutive taxable years of 1984, 1985 and 1986, resulting in an unpaid tax liability with respect to each of the years. Further, the District Attorney of the County of New York accused the defendants of committing the crimes of repeated failure to file returns and repeated failure to pay utility or corporate taxes for the years 1984, 1985 and 1986, in violation of Tax Law § 1803 and New York City Administrative Code § 11-4003.

2. In a letter from Assistant District Attorney Roslynn Mundell to defendants' attorney, Jacob Laufer, dated December 19, 1988, the terms of a plea agreement between the District Attorney and the defendants were set forth in detail. The defendants included Intercity, Century, Label Drebin (petitioner's father) and Joseph Drebin. The calendar years covered by the plea agreement were 1982 through 1987. Both Century and Intercity agreed to be prosecuted in accordance with the Superior Court information and pled guilty to one count of repeated failure to file corporate taxes, in violation of Tax Law § 1803, an E felony, and one count of repeated failure to file utility tax or corporate taxes in violation of section 11-4003 of the New York City Administrative Code.

The corporate taxes determined to be due from the two corporations for the years 1982 through 1987 were based upon combined earnings for both corporations reached in an agreement between the District Attorney's office and the representatives of the defendants, to wit: Max Wasser, CPA and Jacob Laufer, Esq. The combined earnings and tax thereon for the two corporations for the years in issue were determined to be as follows:

	Gross Receipts	Net Profit	NYS Tax	NYC Tax
1982	$ 85,132	$ 21,283	$ 2,124	$ 1,911
1983	811,238	202,809	20,281	18,253
1984	1,252,276	313,069	31,307	28,176
1985	990,523	247,631	24,763	22,287
1986	746,654	186,663	18,666	16,800
1987	849,252	212,313	21,231	19,198

These figures appear in the record in a letter from Mr. Laufer to Mr. Wasser, dated December 29, 1988.

In a letter from Assistant District Attorney Mundell to Assistant Commissioner Bruce Kato of the New York City Department of Finance, dated January 13, 1989, Ms. Mundell described how the amounts of tax were calculated. She explained that the amount of tax was calculated on a net profit figure established by deducting 75% from the amount of gross income as the cost of goods sold. This deduction was based on standards established by Dun and Bradstreet for the cost of doing business for this type of company operating in the New York City area. Three methods of calculating gross income were compared by the District Attorney's office, to wit: bank deposits were included as gross income; "FISA" records showing all payments to both corporations on City contracts; and gross income figures submitted by Label Drebin's accountant. Since the figures submitted by the accountant, Max Wasser, were reasonable in comparison to the amounts arrived at using the other methods, they were accepted.

Petitioners submitted a Dun & Bradstreet Corporation report for fiscal year ended June 1985 for special trade contractors which indicated a gross margin percentage of 28.24. It also submitted a Robert Morris Associates "Annual Statement Study" for electrical contractors for fiscal years ended March 31, 1982, 1983, 1984, 1985 and 1986, indicating gross profits of 23.9, 23.8, 23.5, 23.6 and 24.0, respectively. Profit before taxes for the same periods according to the Annual Statement Study was listed to be 3.5, 2.5, 1.8, 2.3 and 3.1, respectively. Gross profit was defined to be the difference between contract revenues and cost of sales. Profit before taxes was defined as operating profit minus all other expenses.

Intercity agreed to execute a confession of judgment acknowledging the debt due and owing of $118,372.00 to the New York State Department of Taxation and Finance and $106,625.00 to the New York City Department of Finance, representing the combined unpaid corporate taxes for both Century and Intercity for the calendar years 1982 through 1987. They also agreed to pay restitution and a criminal fine of $100,000.00.

Petitioner Joseph Drebin also agreed to waive indictment and be prosecuted by Superior Court information to lesser included crimes of repeated failure to file corporate tax returns with the City and State of New York with respect to Intercity. Joseph Drebin also agreed to a sentence of conditional discharge with the condition that a criminal fine of $50,000.00 be paid in three yearly installments.

The District Attorney's office agreed not to prosecute Label Drebin for his participation in the failure to file returns on behalf of Intercity and Century.

3. On December 22, 1988, Joseph Drebin, on behalf of himself and the two corporations, executed waivers of indictment, indicating acceptance of the plea agreement.

On January 4, 1989, the defendants Intercity, Century and Joseph Drebin appeared before the Honorable John A. K. Bradley, Justice of the Supreme Court, and entered their pleas as described above. In addition, Intercity, by its vice president, Joseph Drebin, executed confessions of judgment on the amounts admitted to be due and owing to the State and City of New York in the sums of $118,372.00 and $106,625.00, respectively.

A memorandum from Paul Giskin, Associate Fraud Investigator with the New York City Department of Finance, dated March 2, 1989, reported some of the details of the investigation performed with regard to Century, Intercity and Joseph Drebin. He stated that information obtained from the New York City Department of Housing, Preservation and Development ("HPD") indicated that the two companies received in excess of $3,400,000.00 between 1983 and 1987 in contract work performed for HPD. During this period, neither corporation filed any corporation tax returns. Despite numerous attempts to contact the principals of the corporations, Carl Weiss of Century and Label Drebin of Intercity, including subpoenas for tax

returns, workpapers, etc., no documents were produced. Given the evidence of tax fraud, the case was referred to the Manhattan District Attorney's Office for criminal prosecution.

Both confessions of judgment executed by petitioner Joseph Drebin stated that the confessions were made without prejudice to claims by both the New York State Department of Taxation and Finance and the New York City Department of Finance for accrued interest and/or civil penalties.

4. The Division of Taxation ("Division") sent an appointment letter to petitioners on November 21, 1989, which requested documents pertaining to petitioners' personal income tax returns for the years 1986 and 1987. The letter also enclosed a power of attorney form in case petitioners chose to appear by a representative.

In fact, in response to this letter, Mr. Max Wasser called on December 4, 1989 to reschedule the appointment and to say that he would be forwarding a power of attorney. The power presented to the Division by Mr. Wasser on January 4, 1990 was invalid because he signed as both representative and notary public. Despite repeated requests by the Division for a properly executed power of attorney, Mr. Wasser never produced one.

Despite his dilatory tactics regarding the power, Mr. Wasser continued to be involved in the criminal case and this matter involving petitioners. On March 2, 1990, Mr. Wasser commented to the auditor that the excess income received by petitioner and his father, Label, was given to charity, but he never submitted any proof of this as requested by the Division. However, the Division interpreted this to mean petitioners had received the income.

5. The Division assumed that the excess unreported income of the corporations was distributed to the Drebins as constructive dividends in light of the fact that Intercity was a corporation closely held by the Drebins; however, petitioners never provided any corporate documents to establish the relationships between petitioner Joseph Drebin and the corporations. With this complete lack of information and stonewalling by petitioners, the Division assessed them for the entire amount of the additional income which resulted from the corporations' additional unreported income which remained unaccounted for.

Petitioners' gross income for each of the years 1982 through and including 1987 was increased by the net profit figure calculated by the District Attorney's office, as set forth above in Finding of Fact "2 ", and petitioners' taxable income was adjusted accordingly and the New York State and New York City tax liabilities recomputed. A Statement of Personal Income Tax Audit Changes for the years 1982 through 1987, dated September 12, 1990, was sent to petitioners on September 18, 1990 setting forth in detail the additional tax, penalties and interest due.

6. The Division issued a Notice of Deficiency to Joseph and Miriam Drebin, dated March 14, 1991, which assessed additional tax, penalty and interest in the sum of $441,278.57 for the years 1982 through 1987. The Division assessed fraud penalty pursuant to Tax Law § 685(e)(1) for all of the years in question. Additional penalty due to fraud pursuant to Tax Law § 685(e)(2) as well as penalty for substantial understatement of liability pursuant to Tax Law § 685(p) were imposed for tax years 1985 through 1987.

7. Petitioners filed an application for a conference in the Bureau of Conciliation and Mediation Services which was held on November 24, 1993. An Order was issued on April 8, 1994, which sustained the tax deficiency in its entirety but modified the penalties assessed by permitting the assessment of only Tax Law § 685(p) penalty for the years 1985, 1986 and 1987.

8. Petitioners submitted the affidavit of Joseph Drebin, acknowledged May 24, 1995, in which he stated that he was not an officer of either Intercity or Century between January 1, 1982 and December 31, 1987.

STATEMENT OF PETITIONERS' POSITION

9. Petitioners contend that the Division's assessment did not have a rational basis and that its reliance on the criminal convictions was in error. Petitioner argues that Joseph Drebin pled guilty only to protect his father, Label Drebin.

Petitioners believe that since the Division has not proven fraud it is barred from assessing tax by the limitations on assessment for the years 1982 and 1983.

Petitioners contend that the net profit figures used by the Division to recompute petitioners' tax liability for the years in issue were "arbitrary, capricious and ridiculous."

CONCLUSIONS OF LAW

A. The first issue which must be addressed is that of limitations on assessment. Tax Law § 683(a) provides that any tax under Article 22 shall be assessed within three years after the return was filed with the exception of those situations where the return is a false or fraudulent return, for which assessment can be made at any time (Tax Law § 683[c][1][B]) and those situations where there is an omission of income where the omitted income is in excess of 25% of the adjusted gross income, for which there is a six-year statute of limitations (Tax Law § 683[d][1]).

Because the years 1982, 1983 and 1984 are not within the three-year period described in Tax Law § 683(a), one of the exceptions listed above must apply for the assessment to stand, as they were alleged to have applied in the Division's notice of deficiency. As set forth in the facts, the Division asserted fraud penalty for the years 1982 and 1983 and the substantial understatement of tax liability penalty for the year 1984.

The Bureau of Conciliation and Mediation Services ("BCMS") issued an order in this case on April 8, 1994, which cancelled all penalties for the years 1982, 1983 and 1984, effectively denying the Division the right to assess any taxes for those years due to the time limitation placed on assessments by the statutes referred to above. The regulation at 20 NYCRR 4000.5(c)(4) clearly states that in the absence of a showing of fraud, malfeasance or misrepresentation of a material fact, a conciliation order will be binding on the Division of Taxation and petitioner. The order will not be binding on a petitioner if a petition for hearing concerning the notice is timely filed.

It is not known why the conferee cancelled the penalty which made it possible for the Division to assess tax for the years 1982, 1983 and 1984 and then sustained the tax for those periods. However, whether a conscious decision or error, the fact remains that the penalties were clearly cancelled and that must be sustained to the detriment of the Division, as the

Division cannot raise issues at hearing which were decided in favor of petitioner at the BCMS conference.

Because the Division cannot rely on any exception to the three-year statute of limitation, the years 1982, 1983 and 1984 are beyond the period of limitation on assessment stated in Tax Law § 683(a) and the tax assessed for those years must be cancelled.

B. Petitioners contend that the audit of the income of Intercity and Century was in error and suggest that a different external index should have been employed by the Division to attain a more precise result, in the complete absence of books and records of either corporation and in light of the fact that the corporations' own accountant and attorney submitted adjusted gross income figures which confirmed the accuracy of the three methods utilized by the District Attorney's office.

The Tax Appeals Tribunal has spoken to many of petitioners' arguments in its decision in Matter of R & J Automotive. Inc. (Tax Appeals Tribunal, June 15, 1989), where they said:

> "In a sales and use tax audit, resort to external indices as a method of computing sales tax liability must be founded upon a determination of the insufficiency of the taxpayer's record keeping which makes it virtually impossible to verify sales receipts and conduct a complete audit (Chartair, Inc. v. State Tax Commn., 65 AD2d 44, 411 NYS2d 41). This standard, requiring demonstrably inadequate records before an indirect auditing technique may be used, has been explicitly rejected in audits of income for personal income, non-resident earnings and unincorporated business taxes (Matter of Giuliano v. Chu, 135 AD2d 89, 521 NYS2d 883; Matter of Hennekens v. State Tax Commn., 114 AD2d 599, 494 NYS2d 208). The distinction between an income tax audit and a sales tax audit centers on the type of tax being imposed (Hennekens v. State Tax Commn., supra). While sales tax audits seek recovery of taxes imposed directly upon verifiable receipts as evidenced by books and records which are required to be maintained (Matter of Licata v. Chu, 64 NY2d 873, 874, 487 NYS2d 552) audits involving the imposition of tax on income concern the receipt of income which cannot easily be verified by reference to books and records (Matter of Hennekens v. State Tax Commn., supra.) The standard articulated by the courts of New York concerning audits of income is that indirect auditing methods are proper where the taxpayer's income is not accurately reflected in his books and records (see, Matter of Giuliano v. Chu, supra; Matter of Hennekens v. State Tax Commn., supra; Matter of Checho v. State Tax Commn., 111 AD2d 470, 488 NYS2d 859).
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> The New York State reconstruction of income cases have their genesis in the Federal law and cases. In particular, the case of Holland v. United States, (348 US 121), is recognized as the cornerstone of the law concerning reconstruction procedures. In Holland the Court recognized that reconstruction methods in income tax cases serve two primary purposes. First, they serve as a means of testing the accuracy of the books and records that have been presented. Second, they are cogent

> evidence of the amount of income which has been unreported. Further, Holland gave rise to the well settled principle that the fact that books and records appear to be adequate on their face does not preclude the use of reconstruction methods" (see, Schwarzkopf v. Commr., 246 F2d 731, citing Holland v. United States, supra, at 131-132).

As in R & J Automotive, the application of these principles herein to determine the income for corporate franchise tax supports the audit methodology chosen and utilized by the Division to compute the additional tax due. The circumstances of this matter are not sympathetic to petitioners. Petitioner Joseph Drebin signed statements for both corporations as a director of both and a vice president of Intercity, with the authority to bind them to the most grave of consequences, pleading to criminal conduct. The corporations, to this day, through their director, Joseph Drebin, have not produced any records to dispute the Division's findings with regard to the additional income to Intercity and Century. Therefore, it is concluded that petitioners have failed to satisfy their burden of proving by clear and convincing evidence that both the method used to arrive at the assessment and the assessment itself are erroneous (see, Tax Law § 689[e]; Matter of Giuliano v. Chu, supra, 521 NYS2d at 886).

C. The next issue is whether the excess income derived by the corporations was passed through to Joseph Drebin as a constructive dividend or as additional wages which went unreported. The record is sorely lacking in evidence which would shed light on either of the corporations in issue in this regard. This must be construed most stringently against Joseph Drebin, who, as a director of both corporations and vice president of Intercity, had the ability to produce evidence of the corporations' shareholders and the disposition of the excess income received by them. He chose not to produce any evidence of the disposition of the income and chose not to testify in this matter.

The auditor's log referred to a comment by Mr. Wasser that Mr. Drebin had disposed of the income by contributing it to charity. Despite making requests for substantiating documentation of this assertion, the auditor received nothing from petitioners. Since petitioners did nothing to refute the Division's assessment, it was rational for the Division to assume that the corporations' excess income was distributed to the two principals, Mr. Drebin and his father.

It is determined that the additional income was distributed to Mr. Drebin and the assessment of additional tax is sustained for the years 1985, 1986 and 1987.

D. The first entry in the auditor's log in this matter was dated November 21, 1989, when the auditor sent Joseph Drebin an appointment letter, document request and a power of attorney form. The response received to this letter was not from Mr. Drebin but from Max Wasser, who arranged for a meeting at his office and said he would forward the completed power of attorney form to the auditor. A power of attorney was presented to the auditor at the meeting on January 4, 1990, but it was defective because Mr. Wasser notarized his clients' signatures. Although Mr. Wasser continued to represent Mr. Drebin in both the criminal case and this matter, he did not forward a new power to the Division. After a final request on October 31, 1990, the case was closed on November 27, 1990.

Petitioners' representative inferred that the Division had erred in speaking with Mr. Wasser because he was not petitioners' representative by a valid power. However, it was petitioners who referred this matter to Mr. Wasser upon receipt of the appointment letter. They were on notice of the documents requested by the Division and they did not respond to this request. If they now argue that the Division should not have spoken to Mr. Wasser as they requested, then they must answer why they produced no documentation or any other evidence with regard to their personal income tax for the years in issue. Also, on September 18, 1990, the Division sent the Drebins the Statement of Personal Income Tax Audit Changes for the years in issue, 1982 through 1987, dated September 12, 1990, and told them to contact the Division if they did not agree with the statements to arrange for a conference to discuss the audit results and permit them to submit other evidence. The Drebins did not request a conference with the Division at this time and did not present any other evidence. The conclusion to be drawn from this is that the Drebins had no evidence then and had none to submit at hearing. They did not even testify to clarify the simplest of issues and the issue of Mr. Wasser not having a valid power of attorney is of no consequence. The Drebins must suffer the

consequences of their own actions and can not hide behind the specious argument that because Mr. Wasser did not produce a valid power, the assessments are somehow less valid.

Further, because Mr. Wasser was intimately involved in the criminal case against Mr. Drebin, the Division was justified in relying on his statements as to the disposition of the income received by the Drebins from Century and Intercity. If the Drebins wanted to challenge the allegations with documents or testimony, they certainly had ample opportunity to do so throughout the audit, conference and hearing. They did not.

E. The Division based its assessment of the Drebins on excess wages/constructive dividends received from Intercity. The belief was grounded in the knowledge that Joseph Drebin had executed the confessions of judgment as a director of both corporations and the vice president of Intercity and had authority to bind the corporations to the criminal charges asserted against them by the District Attorney's office. The corporations' lawyer and accountant, Jacob Laufer and Max Wasser, provided the gross receipts figures used by the District Attorney's office to calculate the taxes not paid by the corporations during the years in issue, and Mr. Drebin agreed to the taxes calculated in the confessions of judgment and plea agreement as well as to criminal fines on behalf of Intercity of $100,000.00 and a fine of $50,000.00 on his own behalf. The District Attorney's office referred to the corporations' executing waivers of indictment by their boards of directors, which were in fact executed by Mr. Joseph Drebin. Joseph Drebin also stated that he was vice president of Intercity. The fair conclusion reached by the Division was that Joseph Drebin was vice president of Intercity and a member of the boards of directors of both corporations. The only other persons mentioned anywhere in the record as having anything to do with the corporations were Label Drebin, Joseph Drebin's father, as the principal of Intercity, and an individual named Carl Weiss, listed as the principal of Century. The audit report also listed Label Drebin as the sole shareholder of Intercity and it is from Intercity that the additional income was derived.

Generally, in the case of a closely-held corporation, special scrutiny is required because of the unfettered control exercised by a limited number of shareholders (Roschuni v. Commr.,

29 TC 1193, 1201-1202, affd per curiam 271 F2d 267 [5th Cir 1959], cert denied 362 US 988 [where the court scrutinized distributions of corporate earnings and profits of a closely held corporation and found them equivalent to dividends]). Unfortunately, petitioners herein submitted no evidence with regard to their roles with the corporations and chose not to testify. The Division fairly concluded that Joseph Drebin benefited from the excess income to the corporations, which he admitted receiving and concealing from authorities. Since the burden of proof is on petitioners herein (Tax Law § 689[e]; 20 NYCRR 3000.10[d][4]), it was incumbent upon them to prove that Intercity's excess income was not received by them as excess wages or as a dividend. Since they failed to introduce any evidence to refute the Division's theory, it is determined that petitioners did receive the unreported income as excess wages or as constructive dividends if Mr. Drebin was a shareholder.

F. Petitioners were assessed penalty for substantial understatement of liability pursuant to Tax Law § 685(p) for the years 1985, 1986 and 1987, where it was found they understated their income tax for each of those years, and the understatement exceeded the tax required to be shown on the returns for those years by ten percent. The penalty is equal to ten percent of the amount of the underpayment. The statement of personal income tax audit changes sets forth the computation of this penalty for each of the years 1985, 1986 and 1987. Tax Law § 685(p) provides that the Commissioner of Taxation and Finance may waive the penalty on a showing of reasonable cause and that petitioners acted in good faith, but petitioners have not provided any proof whatsoever that either of these criteria existed herein. (See also, 20 NYCRR former 102.7.) Therefore, the penalties are sustained.

G. The petition of Joseph and Miriam Drebin is granted to the extent set forth in Conclusion of Law "A " above, but in all other respects is denied, and the Notice of Deficiency, dated March 14, 1991 is sustained.

DATED: Troy, New York
January 25, 1996

/s/ Joseph W. Pinto, Jr.
ADMINISTRATIVE LAW JUDGE