

STATE OF NEW YORK
DIVISION OF TAX APPEALS

In the Matter of the Petition	:	
of	:	
CHARALAMBOS AND PARASKEVI BALLIS	:	AMENDED
for Redetermination of a Deficiency or for	:	DETERMINATION
Refund of New York State and New York City	:	DTA NO. 814182
Personal Income Taxes under Article 22	:	
of the Tax Law and the New York City	:	
Administrative Code for the Years 1983 and 1984.	:	

Petitioners, Charalambos Ballis and Paraskevi Ballis, 15-74 216th Street, Bayside, New York 11360, filed a petition for redetermination of a deficiency or for refund of New York State and New York City personal income taxes under Article 22 of the Tax Law and the New York City Administrative Code for the years 1983 and 1984.

A hearing was held before Marilyn Mann Faulkner, Administrative Law Judge, at the offices of the Division of Tax Appeals, 500 Federal Street, Troy, New York, on April 23, 1996 at 1:30 P.M., with all briefs to be filed by August 21, 1996, which date commenced the six-month period for the issuance of this determination. At hearing, petitioners appeared by Chris Pysros, CPA, and the Division of Taxation appeared by Steven U. Teitelbaum, Esq. (Donna M. Gardiner, Esq., of counsel). Petitioner did not file a brief; the Division of Taxation filed a brief.

ISSUE

Whether the Division of Taxation properly used a source and application of funds method to reconstruct petitioners' income on audit.

FINDINGS OF FACT

1. The Division of Taxation requested proposed findings of fact that have been incorporated in the following findings of fact unless otherwise indicated.
2. Petitioners, Charalambos Ballis and Paraskevi Ballis, filed a New York State joint income tax return for 1983 in March of 1984. In that return they reported joint income in the

amount of \$17,404.00. Attached to the return were W-2 forms confirming that Mrs. Ballis earned \$10,400.00 from STA Parking Corporation and \$1,300.00 from Hara Foods, Inc., and that Mr. Ballis earned \$1,554.00 from STA Parking Corporation and \$4,150.00 from Hara Foods, Inc. Petitioners did not file a State income tax return for 1984.

3. Mr. Ballis purchased Hara Foods, Inc. in January of 1983 for \$25,000.00,¹ plus a security deposit of \$5,024.45 to be paid in three monthly installments of \$1,674.85 for a total payment of \$30,024.45. The purchase agreement required a \$5,000.00 payment upon execution of the purchase agreement. Essentially, Mr. Ballis purchased a leasehold and certain fixtures and equipment of a luncheonette/restaurant in which Mr. Ballis thereafter worked as the cook and his wife handled customers.

4. At some point after the purchase, Mr. and Mrs. Ballis became stockholders in Hara Foods, Inc., each owning 10 shares of the 20 shares of common stock in the business. Petitioners sold their 20 shares of stock for \$70,000.00 in October of 1984. According to the stock purchase agreement, the purchasers were to pay petitioners a \$5,000.00 payment on November 1, 1984, December 1, 1984 and January 1, 1985, respectively, and 60 payments in the amount of \$1,168.59 commencing November 1, 1984 and then monthly thereafter.

5. In 1987, the Division of Taxation and Finance ("Division") conducted an audit of petitioners' 1983 and 1984 personal income tax returns. This audit followed from the Division's audit of Hara Foods, Inc. In an affidavit, the Division's auditor explained the reason for the audit as follows:

"I believed that these taxpayers underreported their tax liability based upon the fact that for the tax year 1983, the taxpayers reported income of \$17,404, however, in January of 1983, the taxpayers purchased a luncheonette for approximately \$30,000. Immediately, I could not comprehend how someone could buy a business for \$30,000 at the beginning of 1983 and report only \$17,404 in income. Accordingly, I began an audit of these taxpayers and requested certain documentation in order to verify their filed tax returns."

¹In the Division's proposed Finding of Fact "2", it stated that paragraph 2 of the purchase agreement stated a purchase price of \$28,000.00. Although the \$28,000.00 was typed in as the purchase price, this amount was crossed out and replaced in handwritten form with the total purchase price of \$25,000.00.

6. The auditor determined that because he did not receive from the taxpayers sufficient information to verify the accuracy of the 1983 tax return, he conducted an indirect audit² to determine petitioners' personal living expenses for the years 1983 and 1984. The auditor based his estimates on bank statements provided by petitioners and information from the Federal Bureau of Labor Statistics concerning the annual costs for a four-person family for the years 1983 and 1984. In his affidavit, the auditor stated that he could no longer find a copy of the information from the Federal Bureau of Labor Statistics on which he relied for his estimates. Instead, he provided a copy of the tables for the years 1980, 1981 and 1982 from the Federal Bureau of Labor Statistics.

7. For 1983, the auditor reconstructed petitioners' living expenses. Included in his estimates was the amount of expenses reported by petitioners in their 1983 tax return such as mortgage payments, taxes, medical expenses and contributions. The auditor added to the reported expenses of \$13,203.00 the following amounts allegedly based on tables from the Federal Bureau of Labor Statistics:

Food	\$ 5,600.00
Utilities	3,200.00
Repairs and maintenance	375.00
Transportation	720.00
Clothing	1,000.00
Personal care	550.00
Other Family consumption	1,400.00
Vacations	<u>2,500.00</u>
Total	\$15,345.00

In the copy of the tables from the Federal Bureau of Labor Statistics ("FBLs") for 1980, 1981 and 1982, the following annual costs for a lower level budget family of four in New York City were set forth as follows:

	<u>Food</u>	<u>Auto</u>	<u>Non-auto</u>	<u>Clothing</u>	<u>Personal Care</u>	<u>Other Family Consumption</u>
1980	\$4,651	\$1,654	\$ 969	\$832	\$362	\$644
1981	4,956	1,829	1,087	827	387	701
1982	5,253	1,939	1,152	877	410	743

²In his workpapers, the auditor referred to this indirect method as the "source and application of funds".

A comparison between the FBLS tables for the lower budget level family of four and the intermediate budget level family of four for 1982 shows the following:

	<u>lower budget level</u>	<u>intermediate budget level</u>
Food	\$5,253.00	\$6,973.00
Auto owners	1,939.00	
Non-auto	1,152.00	
Transportation		2,707.00
Clothing	877.00	1,261.00
Personal care	410.00	549.00
Other family consumption	743.00	1,374.00
Housing	2,964.00	
Homeowner		7,120.00
Renter		3,533.00

The Federal Bureau of Labor Statistics' tables had no separate categories for "utilities", "repairs and maintenance" or for "vacations". Estimates under these categories, however, were included in the auditor's workpapers in determining petitioners' living expenses.

8. The auditor also added to the reported and estimated expenses costs with respect to the purchase of Hara Foods, Inc. such as the \$25,000.00 purchase price, \$5,000.00 security deposit, \$2,500.00 in estimated legal fees, and \$1,250.00 in estimated broker's fees. The total amount of income estimated for petitioners for 1983 was \$62,323.00. Subtracting out the \$17,404.00 of reported income, the auditor found unreported income for 1983 in the amount of \$44,919.00 and a State and City income tax deficiency in the amount of \$7,377.77. The auditor determined that because the understated income was more than 25% of New York State adjusted gross income, the tax deficiency could be assessed within six years after the 1983 return was filed under Tax Law § 683(d)(1).

9. For 1984, the auditor estimated petitioners' living expenses based on bank statements³ and his estimated personal expenses for 1983 (\$15,345.00) increased by 10% for

³Petitioners had a checking account with Manufacturers Hanover Trust. The Division submitted into the record bank statements beginning with the period November 19, 1983 and ending with the period January 1985.

inflation. To that amount, he added long-term capital gain of \$20,000.00⁴ with respect to petitioners' sale of the stock in Hara Foods, Inc. in 1984. In the workpapers, the auditor noted that as of September 23, 1987, petitioners did not file a return as requested and did not make an election for the installment sale.

10. The workpapers showed that petitioners deposited \$20,802.90 in their bank account throughout 1984. Ultimately, the auditor found estimated unreported income of \$39,081.00 with taxable income of \$30,696.00 for 1984,⁵ resulting in a State tax deficiency of \$4,185.99 and a City tax deficiency of \$1,547.17. To this amount, the auditor added penalties under Tax Law § 685(a)(1) for failure to file a tax return, Tax Law § 685(b) for negligence, and Tax Law § 685(a)(2) for failure to pay tax shown on a return. The penalties under Tax Law § 685(a)(2) amounted to \$627.90 and \$232.08, respectively, for State and City tax deficiencies.

11. The Division issued to petitioners a Notice of Deficiency, dated December 28, 1987, for income tax due for 1983 and 1984 in the amount of \$13,110.93, plus a \$2,891.48 penalty and \$4,121.98 in interest, for the total amount of \$20,129.39.

12. The Division issued to petitioners four notices and demands, dated May 6, 1988, as follows:

<u>Assessment No.</u>	<u>Year</u>	<u>Amount</u>	<u>Penalty</u>	<u>Add.pen./int.</u>	<u>Total</u>
A8710044021	1983	\$5,509.94	\$ 275.50	\$288.77	\$8,013.32
A8710044022	1983	1,867.83	93.39	97.90	2,716.47
A8710044023	1984	4,185.99	1,779.05	345.02	7,244.77
A8710044024	1984	1,547.17	657.55	127.52	2,677.72

13. In 1991, the Division levied petitioners' bank accounts to collect the tax owed. At hearing, the Division submitted two checks indicating payments on the levies in the amounts of \$16,713.23 and \$6,697.42 from petitioners' account with Manufacturers Hanover. In a letter

⁴In the workpapers, the auditor miscalculated the capital gain by subtracting the purchase price of \$25,000.00 from the sale price of \$70,000.00 to arrive at the sum of \$50,000.00 when the sum should have been \$45,000.00. Thus, the correct gain is 40% of \$45,000.00 or \$18,000.00.

⁵The auditor subtracted from the unreported income of \$39,081.00 estimated itemized deductions of \$5,985.00 and three exemptions in the amount of \$2,400.00.

dated January 26, 1993 to the Division, petitioners alleged that the Division levied on two savings accounts in 1991 withdrawing all of their savings which aggregated almost \$46,000.00. The Division's counsel stated at the hearing that although the two checks constituted the only evidence she had of collection, petitioners had been levied twice that amount, and therefore, the only issue in dispute involved petitioners' underreporting.

14. Petitioners filed a claim for credit or refund of personal income tax for 1983 in the amount of \$7,377.77, plus penalty and interest, and a claim for credit or refund for 1984 in the amount of \$5,733.16, plus penalty and interest. In both claims, petitioners stated that they did not have any income for 1984 and therefore, filed "a form showing zero", and that they were not aware of any audit until 1987 when they received the notice of deficiency, which they appealed by petition in November 1987.

15. By Notice of Disallowance dated January 14, 1993, the Division denied petitioners' refund requests stating that petitioners did not substantiate their claims.

16. In June of 1995, a conciliation conferee in the Division's Bureau of Conciliation and Mediation Services issued to petitioners a conciliation order sustaining the Notice of Disallowance.

17. Mr. and Mrs. Ballis filed a petition, dated July 10, 1995, stating:

"We submitted copies of Income Tax returns for 1983 showing no income for the entire year and for 1984 showing that we never realized any capital gains from the sale of HARA FOODS, INC."⁶

18. The Division filed an answer, dated September 13, 1995, affirmatively stating that petitioners' 1983 tax return failed to accurately reflect their State and City taxable income; that petitioners failed to file a 1984 State and City tax return; that on October 24, 1991, the Division

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Although petitioners implied in their statement that they had filed a 1984 tax return, at hearing Mr. Ballis testified that he did not file a 1984 return because he did not have any income in 1984. In addition, in the field audit report, the auditor noted that petitioners filed a timely 1983 tax return but no tax return for 1984. He therefore recommended in that report penalties only for failure to file a tax return under Tax Law § 685(a)(1) and for negligence under Tax Law § 685(b).

levied two of petitioners' bank accounts in the amounts of \$16,713.23 and \$6,697.42; and that petitioners have the burden of proving the tax deficiencies were erroneous.

19. At the commencement of the hearing held on April 23, 1996, the parties stated the issues in the case. Essentially, the Division's counsel explained how the audit was conducted and concluded that the issue was simply a case of underreporting of income. The Division's counsel stated that:

"[o]bviously, the taxpayers lived somewhere, had to eat, had to get back and forth from work, had clothing expenditures, had income other than the \$17,000 that was reported on the income tax return." (Tr. p.19.)

Petitioners' representative stated:

"First of all, the only -- we thank [the Division's counsel] with providing us with all this additional information. This is the first time we've seen that, except the notice of assessment that was issued in September '87 which we actually receive it in '91. We didn't have any idea why they making these assessments. . . . Now I have a clear picture from the affidavit of . . . the auditor.

* * *

"[B]ecause before we file petitions but we didn't have any idea for which reason the assessments were made so we don't know exactly what we're talking about. Now, based on this information, we know exactly and we have some explanation for that." (Tr. pp. 15-16.)

20. At hearing, Mr. Ballis testified that in 1983 he borrowed from his two brothers-in-law, Constandinos Kessissoglou and George Zacharias, \$15,000.00 each in order to purchase the luncheonette. He explained the origin of the \$30,000.00 as follows:

"That wasn't money from my pocket to report that I made. The money, that is what they claimed that I had more income than I report. The original income that I reported to the State was \$17,300, and they questioned -- State question me, where you get the \$30,000 to buy the place. So the \$30,000 I borrow from two of my family people." (Tr. p.23.)

In support of his testimony, two post-hearing affidavits were submitted. In an affidavit by George Zacharias, he stated that in January of 1983 he loaned Mr. Ballis \$15,000.00 to purchase the luncheonette and was repaid in 1984. In an affidavit by Ekaterini Kessissoglou, she stated that she and her ex-husband, Constantinos Kessissoglou, loaned \$15,000.00 to Mr. Ballis in January of 1983 and that the loan was subsequently repaid in 1984.

21. Mr. Ballis testified that after approximately six months of operating the luncheonette, he and his wife sold Hara Foods, Inc.; that he received a \$10,000.00 payment, which he paid over to his two brothers-in-law on the loans, as well as two or three monthly payments, before the purchasers defaulted on further payments;⁷ and that at some point in 1983 he and his wife moved out of their split-level home due to financial hardship to live with his wife's parents.⁸

22. Mrs. Ballis gave birth to a child in September of 1983. Mr. Ballis further testified that neither he nor his wife attempted to collect unemployment after the business was sold; that neither he nor his wife had employment during 1984; that during the time they lived with his wife's parents they paid no rent and were provided with food; and that the only income they had during 1984 was rental income of approximately \$2,300.00 per month from renting the basement and upstairs of their home.⁹ Mr. Ballis explained his ignorance of the tax law as follows:

"A. . . . now, for '84 they tell me that I didn't make no tax return. They're right because I don't have any income. The only income I have from the house. I think those things are not income declarable.

"Q. How long were you here at that time?

"A. I was new. I didn't know." (Tr. p.23.)

⁷The Division submitted into the record copies of 41 promissory notes each in the amount of \$1,168.59 and payable to petitioners from May 1, 1986 through October 1, 1989. There is no evidence in the record that these payments were made to petitioners.

⁸Petitioners reported in 1983 interest expenses with respect to the mortgage on their home in the amount of \$6,545.00. In the Division's proposed Findings of Fact "6" and "7", it included petitioners' address and the address of Mrs. Ballis's parents. These addresses were not included in the Findings of Fact because they are irrelevant to the determination. The Division also proposed a finding that petitioners purchased their home in 1983. However, Mr. Ballis testified that he could not remember the exact date of purchase but that he owned the home by 1983. Therefore, this proposed finding is excluded from the determination.

⁹In proposed Findings of Fact "6" and "7", the Division states that petitioners rented out the basement of their house in 1983 and 1984 and received approximately \$2,300.00 rental income a month during 1983 and 1984. Contrary to these statements, it is unclear from the testimony at what point in 1983, petitioners may have received rental income from their home. It appears that petitioners moved out sometime at the end of 1983. However, it is reasonable from this record to assume that they received rental income for the entire year of 1984.

23. When questioned about his living expenses, he responded as follows:

"Q. When you were living with your mother-in-law, who paid for the food?

"A. Well, my father-in-law and mother-in-law used to take care of those things.

"Q. So they took care of all the food?

"A. Don't forget, we used to get from the rent and the house; they had the rental from there. So combined all together we lived as a family. As a matter of fact, I had my mother-in-law with me for the rest of the time.

"Q. Now where is Woodside [location of petitioners' split-level home] in relation to where the luncheonette was?

"A. If you go from Expressway, right in the Expressway, BQE, going down to Brooklyn Bridge, it was right there.

"Q. Did you have a car?

"A. At that time I had an old car, yes.

"Q. And who would have paid the insurance on the car?

"A. Just like that time two, \$300 a year.

"Q. What about gas?

"A. Gas, small car. You don't need much.

"Q. Tolls?

"A. We don't have no tolls.

"Q. What about parking?

"A. No parking. You got parking from the luncheonette.

"Q. Now, what about clothes, who would buy clothes for the new baby?

"A. We tried to do as much as you can. If you don't have, you don't buy; if you have, you buy." (Tr. pp.31-32.)

24. During the course of the hearing, it became apparent that English is a second language for Mr. Ballis and that in 1983 his residency in the United States was relatively recent.

25. Petitioners submitted a post-hearing affidavit by Sotiria Haracoglou, Mrs. Ballis's mother, in which she stated that during 1983 petitioners and their child lived with her at her home "at no cost due to his financial hardship."¹⁰

CONCLUSIONS OF LAW

A. The courts have upheld the Division of Taxation's use of indirect methods in reconstructing income such as the source and application of funds or cash availability method (see, Matter of Giuliano v. Chu, 135 AD2d 893, 521 NYS2d 883; Matter of Jacobson v. State Tax Commission, 129 AD2d 880, 514 NYS 2d 145; Matter of Clark v. Bouchard, 103 AD2d 899, 478 NYS2d 131). Although there are differences between the two methods (see, Matter of Metzger, Tax Appeals Tribunal, February 11, 1993), in both methods there is a comparison between expenditures and income assuming that any excess of expenditures over income represents unreported income unless shown otherwise.

Although a tax determination must have a rational basis to sustain review, the Division's issuance of an income tax deficiency is presumed correct as long as no evidence is introduced to challenge the deficiency (Matter of Metzger, *supra*, citing Matter of Leogrande v. Tax Appeals Tribunal, 187 AD2d 768, 589 NYS2d 383; Matter of Tavolacci v. State Tax Commission, 77 AD2d 759, 431 NYS2d 174). In response to taxpayer inquiries at hearing, the Division has the obligation to describe the audit methodology used, and as described, that method must be rational (*id.*, citing Matter of Atlantic and Hudson Ltd. Partnership, Tax Appeals Tribunal, January 30, 1992).

In this case, at the commencement of the hearing, petitioners' representative indicated ignorance and confusion as to the basis of the Division's calculation of estimated income for 1983 and 1984. After reviewing the audit workpapers and auditor's affidavit explaining the

¹⁰In proposed Finding of Fact "6", the Division states that Mrs. Haracoglou's affidavit "implies that petitioners lived with her for the entire 1983 year". This statement constitutes a conclusion of law that is not included in these Findings of Fact. In proposed Finding of Fact "9", the Division states that the address listed on petitioners' bank statements was the same address as Mrs. Haracoglou's home at that time. The bank statements have the same street address as the street address identified in Mrs. Haracoglou's affidavit as her home in 1983. However, the street address in the bank statements has the street located in Woodside, New York whereas Mrs. Haracoglou indicated the street address was located in Maspeth, New York.

audit methodology, Mr. Ballis gave testimony and evidence to rebut certain underlying assumptions of the audit. However, because the auditor was not available for cross examination, petitioners were not afforded the opportunity to make further inquiries concerning the individual estimates for each category allegedly taken from the FBSL. Because petitioners did not object to the auditor's unavailability for cross examination, there was no reason to continue the hearing at another date to allow such cross examination. However, the fact that petitioners did not request the auditor's presence to pursue further inquiries as to the auditor's methodology with respect to the FBSL, does not relieve the Division from providing a rational basis on the face of the audit as described through the affidavit and workpapers (see, Matter of Snyder v. State Tax Commission, 114 AD2d 567, 494 NYS2d 183, 184).

In brief, the Division argues that Mr. Ballis's testimony was not enough to show how the auditor's estimate of income was erroneous. Notwithstanding Mr. Ballis's testimony, the auditor's calculation of estimated expenditures based on the Federal Bureau of Labor Statistics ("FBLs") has no rational basis. The auditor could not provide a copy of the table he used from the FBLs for 1983, and instead provided tables for 1980, 1981 and 1982. Aside from this obvious flaw, in reviewing the FBLs tables for 1980 through 1982 (see, Findings of Fact "6" and "7"), the auditor's estimates do not appear to be reliable or reasonably related to those tables. First, it appears that the auditor might have used a FBLs table for 1983 with respect to a "lower budget level family of four" in estimating food costs inasmuch as his estimates for food in 1983 shows a 6.6% cost increase from the estimates for food in 1982. However, the auditor's estimates for items under the categories of "clothing", "personal care" and "other family consumption" show a more than 25% cost increase from the estimates for those items in the 1982 FBSL tables, whereas cost increases from 1980 through 1982 are less than 10%. Second, the auditor made no adjustment for the fact that petitioners' family was not a family of four and only became a family of three in the latter part of 1983 when their first child was born in September. Third, the auditor doubled the amount from the category "other family consumption" from the 1982 FBLs table for the lower budget level family in his estimates.

Fourth, the auditor included estimates for the categories of "utilities", "repairs and maintenance" and "vacations" without identifying his source for these estimates. There are no such categories in the tables from the FBLs provided by the Division.

Notwithstanding the lack of a rational basis on the face of the audit, Mr. Ballis's testimony rebutted certain underlying assumptions of the audit methodology. Mr. Ballis gave credible testimony, supported by affidavits, that the \$30,000.00 used to purchase the luncheonette was obtained as a loan from his two brothers-in-law in 1983. Therefore, this amount of money should be excluded as possible source income in 1983. Mr. Ballis also gave credible testimony that he and his wife lived rent free with his wife's parents for part of 1983 and in 1984, relying on the parents' income, as well as their own, for food. The affidavit from Mrs. Ballis's mother confirms this living arrangement in 1983. Although Mrs. Ballis's mother did not specifically refer to 1984 in her affidavit, her affidavit combined with Mr. Ballis's testimony on the series of events for 1983 and 1984 establish that sometime before November of 1983 petitioners moved in with Mrs. Ballis's parents and continued living there through 1984.

Inasmuch as the Division has not provided a rational basis for the methodology used in estimating petitioners' expenses for 1983 and 1984,¹¹ and Mr. Ballis has provided credible evidence to undermine the auditor's underlying assumptions that there was other source income in addition to their reported income in 1983, petitioners are entitled to a refund with respect to 1983.¹²

¹¹In his calculation of petitioners' 1984 living expenses, the auditor added a 10% inflation factor to the estimated expenses he calculated for 1983.

¹²It should be noted that the Division avoided the three-year statute of limitation for assessing a tax deficiency under Tax Law § 683(a) by finding that petitioners omitted taxable income in excess of 25% of reported taxable income. Under Tax Law § 683(d), the Division has six years after the return was filed to assert a deficiency under these circumstances. Unless the Division can justify a finding of taxable income in excess of 25% of the reported taxable income, the Division is barred by the three-year statute of limitation from assessing a deficiency in the first instance. However, petitioners did not raise this issue and the statute of limitations defense is waived unless affirmatively raised by the taxpayer (*see, Matter of The Tides Inn Inc.*, Tax Appeals Tribunal, April 2, 1992, citing *Matter of Adamides v. Chu*, 134 AD2d 776, 521 NYS2d 826, 828, *lv denied* 71 NY2d 806, 530 NYS2d 109).

B. However, petitioners erroneously failed to file an income tax return in 1984. By Mr. Ballis's own admission, petitioners received rental income in the amount of approximately \$2,300.00 a month in 1984. This amount accounts for the deposits by petitioners in their bank account in 1984 of approximately \$20,000.00. Mr. Ballis also admitted receiving in 1984 a \$10,000.00 downpayment and two payments in the amount of \$1,168.59 for the sale of the luncheonette. Unfortunately, because petitioners did not elect to report the sale on an installment basis, they were liable for capital gains on the entire amount in 1984 despite the fact that the purchasers subsequently defaulted on the sale payments and petitioners took a loss.¹³

Adding the long-term capital gain to the rental income results in total income of \$45,600.00. The auditor had estimated total income of \$39,081.00 which included interest income of \$214.00. Therefore, adding the interest income of \$214.00 to the income of \$45,600.00 results in total income of \$45,814.00. Taking into account three exemptions (\$2,400.00), mortgage interest expenses (\$5,284.00) and real property taxes (\$701.00) associated with the rental income, and the standard deduction (\$2,500.00) for joint returns in 1984, petitioners' taxable income for 1984 (\$34,929.00) exceeds the auditor's estimates (\$30,696.00) for 1984. Therefore, petitioners are not entitled to a refund with respect to the deficiency for 1984.

C. However, petitioners are entitled to a refund with respect to the penalty asserted under Tax Law § 685(a)(2) for 1984 in the amounts of \$627.90 and \$232.08. Section 685(a)(2) provides the Division with the authority to assert a penalty for failure to pay the tax shown on a tax return. Inasmuch as petitioners did not file a tax return in 1984, this penalty was unwarranted.¹⁴ The Division properly asserted penalties only under Tax Law §§ 685(a)(1) and 685(b) for failure to file a tax return and for negligence.

¹³As noted in footnote "4", the auditor made a mathematical error in calculating the long-term capital gain. Instead of \$20,000.00, the long-term capital gain should be \$18,000.00.

¹⁴Because the Division did not assert a deficiency greater than the deficiency asserted in the Notice of Deficiency at or before the hearing held on April 23, 1996, the Division cannot now claim an offset with respect to a refund of the penalty imposed under Tax Law § 685(a)(2) (see, Tax Law § 689[d][2]).

D. The petition of Charalambos Ballis and Paraskevi Ballis is granted to the extent indicated in Conclusions of Law "A" and "C" and is otherwise denied.

DATED: Troy, New York
February 20, 1997

Marilyn Mann Faulkner
ADMINISTRATIVE LAW JUDGE
