STATE OF NEW YORK

DIVISION OF TAX APPEALS

In the Matter of the Petition	:	
of	:	
CLAUDE R. McGAUGHEY, III, AND MARY J. McGAUGHEY	:	DETERMINATION
	:	DTA NO. 814265
for Redetermination of a Deficiency or for Refund of Personal Income Tax under Article 22 of the Tax Law for the Years 1986, 1987, 1988, 1989, and 1990.	:	
	:	

Petitioners, Claude R. McGaughey, III, and Mary J. McGaughey, 20941 N.E. 38th Avenue, Miami Beach, Florida 33180, 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 1986, 1987, 1988, 1989, and 1990.

A hearing was held before Frank W. Barrie, Administrative Law Judge, at the offices of the Division of Tax Appeals, 500 Federal Street, Troy, New York, on July 2, 1996 at 1:15 P.M., with all briefs to be submitted by October 4, 1996, which date began the six-month period for the issuance of this determination. Petitioners appeared by John Carter Rice, Esq. The Division of Taxation appeared by Steven U. Teitelbaum, Esq. (Michael J. Glannon, Esq., of counsel).

ISSUE

Whether reasonable cause exists to warrant cancellation of penalties asserted for the late filing and late payment of petitioners' tax returns for 1986, 1987, 1988, 1989, and 1990.

FINDINGS OF FACT

1. Petitioner Claude R. McGaughey, III ("petitioner")[1] is a widely known trainer of thoroughbred racehorses, who has succeeded in a singularly difficult enterprise that requires special knowledge and experience, because in Mr. McGaughey's words, "I deal with something that can't talk" (tr., p. 54).

2. During the years at issue, petitioner was very successful in his position as a private racehorse trainer to the Phipps family of Roslyn, New York, which, according to Mr. McGaughey was a "dream" job because of the family's stature and their well-bred horses provided for training. Mr. McGaughey was not a salaried employee of the Phipps family, but rather he performed his duties as an independent contractor whose income depended upon the success of the horses he trained:

> "[W]e get a percentage of what the horse makes. What his earning capabilities are are what our earning capabilities are" (tr., p. 54).

3. Petitioner reported his income as a racehorse trainer for 1986, 1987, 1988, and 1990 as "farm income" on a Federal Schedule F to Form 1040.[2] The respective schedules F show the following amounts for gross income, total deductions and net farm profit:

Year	Gross Income	Total deductions	Net farm profit
1986	$2,319,235.00	$2,068,396.00	$ 250,839.00
1987	2,381,902.00	2,162,083.00	219,819.00
1988	2,833,268.00	2,145,530.00	687,738.00
1989	---	---	1,266,358.00[3]
1990	2,745,452.00	2,266,832.00	478,620.00

4. The amounts shown above for "total deductions" each include a substantial expense for "labor hired": $783,702.00 in 1986, $836,695.00 in 1987, $939,855.00 in 1988, and

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[1]Mary J. McGaughey, the former wife of Mr. McGaughey, is a petitioner solely as a result of filing joint tax returns with Mr. McGaughey. Any reference to "petitioner" in this determination is to Mr. McGaughey.

[2]The Federal Schedule F to the 1989 Form 1040 was missing from the 1989 tax return introduced into evidence.

[3]This amount is taken from Line 19, "farm income", of the 1989 Federal Form 1040. It appears that 1989 was petitioner's most successful year of the years at issue.

$727,770.00 in 1990. Mr. McGaughey, in his capacity as an independent contractor, had approximately 50 employees including two assistant trainers, grooms, hot walkers, exercise riders, blacksmiths, and two night watchmen.

5. Although Mr. McGaughey commenced his duties as the private racehorse trainer for the Phipps family in late 1985, he did not file New York State income tax returns or pay any New York State income tax for the years in issue until early October 1991. Petitioner testified that he "didn't know that I had any liability to New York, because I thought I was a Kentucky resident" (tr., p. 79). Petitioner became aware of his obligation to pay New York State income tax as a nonresident only after the Division of Taxation ("Division") contacted him in 1990. At that time, the Division sent petitioner a questionnaire concerning the applicability of New York income tax on petitioner's income earned within New York. Petitioner responded promptly to the Division's questionnaire. The record is somewhat vague concerning what then transpired. According to letters from petitioner's former accounting firm, Amick & Helm, the Division "then served notice that . . . income earned within the State was taxable to New York." It is unclear whether notices of deficiency or statements of audit adjustment were issued to petitioner. In response, petitioner cooperated with the Division, prepared nonresident New York State income tax returns, which were filed in early October 1991, and remitted tax due plus interest.

6. Petitioner's nonresident income tax returns for the years at issue were all dated September 20, 1991 by petitioner's former accountant, Jimmy W. Monroe of Amick & Helm, a Louisville, Kentucky accounting firm, as the preparer. These returns show the following allocation of petitioner's "farm income" to New York State:

Year	Federal Amount	New York State amount	Percentage allocated to New York
1986	$ 250,839.00	$162,418.00	65%
1987	219,819.00	125,473.00	57%

1988	687,738.00	434,857.00	63%
1989	1,266,358.00	787,548.00	62%
1990	478,620.00	280,184.00	59%

Petitioner's income in New York was from his share of the winnings at Belmont, Saratoga and Aqueduct racetracks of the thoroughbreds that he trained for the Phipps family as well as a few horses owned by others.

7. Petitioner paid New York State income tax plus interest in the following amounts for the years at issue:

Year	Tax	Interest[4]
1986	$14,415.00	$6,534.33
1987	9,841.00	3,422.67
1988	35,328.00	9,456.42
1989	60,930.00	9,623.24
1990	21,145.00	not disclosed in the record

8. Petitioner attempted to negotiate the cancellation of penalties with the Division. However, by a letter dated April 28, 1993, a tax technician advised that the penalties "must be sustained" and that petitioner's "only recourse" was to pay the penalties and file a claim for refund. Petitioner paid the penalties for the late filing and late payment of his tax returns for 1986 through 1990.

9. Petitioner, by his attorney, filed five refund claims, each dated December 10, 1993, for the five years at issue. Petitioner sought the refund of penalties paid, plus accrued interest on such amounts, as follows:

Year	Amount of refund claim
1986	$ 6,846.90
1987	4,182.25
1988	13,248.00
1989	19,192.95
1990	1,227.46

[4]The amounts shown under the column for interest were taken from the notice and demand dated April 9, 1992 and consolidated statement of tax liabilities also dated April 9, 1992 that were attached to the petition.

10. In response, the Division issued a Notice of Disallowance, dated March 31, 1994, which provided the following explanation for rejecting petitioner's refund claims:

> "Our regulations list specific grounds for establishing reasonable cause for abatement of penalty imposed for failure to comply with the New York State Tax Law. Lack of awareness or ignorance of the Law is not a consideration for establishing reasonable cause."

11. In managing his racehorse training enterprise which was based in New York, petitioner depended on professionals because he focused almost entirely on rebuilding the Phipps's stable. He retained James E. Hilt as his office manager and bookkeeper. Mr. Hilt had performed similar services for Angel Penna, a racehorse trainer who was petitioner's predecessor as the private racehorse trainer for the Phipps family. In addition, in 1985 petitioner was advised by his friend, Woody Stephens, to retain Mr. Hilt. Petitioner described Mr. Stephens as "the most powerful trainer in racing" at that time (tr., p. 34). In an affidavit dated August 1, 1994, Mr. Hilt described his responsibilities as follows:

> "[K]eeping of financial records; preparation of invoices; issuance of checks; advising trainers regarding accounts payable and receivable; management of payrolls, workers compensation, unemployment and withholding tax matters; and assembly of records and consultations with accountants for the preparation of federal and state tax returns."

Relying on Mr. Hilt, petitioner felt comfortable directing his energies away from the business aspects of his operation to the actual training of the 45 horses that the Phipps family boarded at a barn at Belmont racetrack. Beginning his lengthy workdays at 5:30 A.M., petitioner could focus on producing winners.

12. Petitioner's accountants, Amick & Helm, failed to advise petitioner and his bookkeeper that petitioner was required to file New York State nonresident income tax returns. Mr. Hilt in his affidavit noted as follows:

> "At no time were either Mr. McGaughey or myself advised by Amick & Co. that the filing of non-resident personal income taxes was required under New York State law and in fact, we were both assured by them that all state and federal laws had been complied with."

In contrast, a letter dated January 10, 1992 of J.W. Monroe, a partner of Amick & Helm, and a letter dated April 17, 1992 of Eugene A. Gilles, II, a certified public accountant associated with the firm, do not accept responsibility for petitioner's failure to file the required New York tax returns. The accountants merely noted petitioner's ignorance of the law without taking responsibility for his lack of knowledge, both utilizing the same careful language:

> "[Petitioners] were not cognizant of the fact that they should file New York income tax returns on the portion of their income which had been earned within the State of New York. Consequently, for the years in question, they reported all their income to the State of Kentucky for taxation and payment."

13. After studying business for two years at the University of Mississippi, petitioner, at the age of 19, started to work with racehorses in the midwest in the capacity of an apprentice. In 1979, at the age of 28, petitioner became a racehorse trainer in Kentucky after having worked as an apprentice in the business in New York for about five years. By 1981 or 1982, as the result of a growing business as a racehorse trainer, petitioner hired Amick & Helm as his accountants. This firm was highly recommended by petitioner's mentor, Warner Jones, chairman of the board of Churchill Downs, who also utilized their professional accounting services.

14. Up to 1985, petitioner trained racehorses exclusively out of Kentucky. Petitioner had a large public stable with up to 90 horses in training from many different owners. Mr. McGaughey traveled extensively with the racing circuit and, in 1985, raced horses in Illinois, Arkansas, and occasionally in California, Louisiana, Florida, Ohio, as well as in Saratoga, New York, thereby earning income in different states. Nonetheless, petitioner did not pay income tax as a nonresident to any state. Rather, he paid income tax as a resident to Kentucky on all of his income apparently based upon the advice of Amick & Helm. Petitioner, did not question the advice and, in good faith, believed that his only state income tax liability was to Kentucky since he was a resident of Kentucky. He maintained this belief during the years at issue while conducting his horse-training operation based in New York.

15. Petitioner lived rent-free in a house owned by the Phipps located on their estate on Long Island. Petitioner maintained his primary home in Kentucky until 1989, when he sold his residence in Louisville and bought a home in Florida. Nonetheless, it is observed that petitioner spent a major part of each of the years at issue in New York. During May, June and most of July, he raced horses at Belmont on Long Island, in late July and August he was at Saratoga, during September and a portion of October he raced horses at Belmont, and spent the balance of the year at Aqueduct. In the winter months and in April, he raced horses in Florida and Kentucky, respectively.

SUMMARY OF THE PARTIES' POSITIONS

16. Petitioner contends that when he became the racehorse trainer for the Phipps family, he acted reasonably in ensuring that he handled his tax obligations correctly by hiring James E. Hilt as his office manager and bookkeeper, and the Kentucky firm of Amick & Helm as his accountants. Both Mr. Hilt and the accounting firm specialized in thoroughbred racing operations and were highly regarded by prominent individuals involved in thoroughbred racing. Petitioner characterizes his late filing and late payment of New York tax returns as an innocent mistake and contends that "the harsh penalty is not justified, where no intention to evade or even neglect existed . . ." (Petitioner's brief, p. 7). Petitioner paid tax to Kentucky, and, although he was entitled to a refund from Kentucky of amounts paid to that state on income taxable in New York, he would not be able to recoup from Kentucky the significant interest assessed by the Division. Further, petitioner argues that the Division can assess penalty only if the taxpayer cannot show reasonable cause and fails to demonstrate a lack of willful neglect. Petitioner's position is that he diligently pursued all reasonable avenues available to him to ascertain and fulfill his obligations to New York and the several other jurisdictions in which he conducted training activities.

17. The Division maintains that petitioner's testimony that he was unaware of his New York income tax liability "borders on the incredible" (Division's brief, p. 2). Further, the

Division contests petitioner's contention that he did everything he could to see that his New York tax obligations were met:

> "Petitioners never contacted a New York attorney, CPA or licensed accountant to discuss their New York tax obligations. Petitioners never contacted the New York Tax Department nor did anyone do so on their behalf to inquire about the income tax ramifications of Mr. McGaughey's horse training business in New York. Furthermore, petitioners hired Mr. Hilt as the New York bookkeeper without knowing anything about his professional qualifications and they continued to use Kentucky accountants to prepare tax returns. They certainly did not do everything possible to insure that petitioners' income tax obligations were met" (Division's brief, p. 3).

Further, the Division argues that it is irrelevant that petitioner willingly paid the taxes due once he was contacted by the Division in 1990 because such cooperation does not alter the fact that petitioner failed to meet his tax reporting obligations.

CONCLUSIONS OF LAW

A. The penalties in this case were assessed in accordance with Tax Law § 685(a)(1) and (2) which provide, in relevant part, as follows:

> "(1) Failure to file tax return.--
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> (A) In case of failure to file a tax return . . . on or before the prescribed date . . ., unless it is shown that such failure is due to reasonable cause and not due to willful neglect, there shall be added to the amount required to be shown as tax on such return five percent of the amount of such tax if the failure is for not more than one month, with an additional five percent for each additional month or fraction thereof during which such failure continues, not exceeding twenty-five percent in the aggregate.
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> * * *
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> (2) Failure to pay tax shown on return.-- In case of failure to pay the amounts shown as tax on any return required to be filed . . ., unless it is shown that such failure is due to reasonable cause and not due to willful neglect, there shall be added to the amount shown as tax on such return one-half of one per cent of the amount of such tax if the failure is not for more than one month, with an additional one-half of one per cent for each additional month or fraction thereof during which such failure continues, not exceeding twenty-five per cent in the aggregate. . . ."

Pursuant to these statutory provisions, if a taxpayer is able to show that the failure to timely file and pay was due to reasonable cause and not due to willful neglect, penalties may be abated.

B. The Division in its income tax regulations has promulgated the following catchall provision concerning what constitutes "reasonable cause":

> "Any other cause for delinquency which would appear to a person of ordinary prudence and intelligence as a reasonable cause for delay and which clearly indicates an absence of willful neglect may be determined to be reasonable cause. Ignorance of the law, however, will not be considered as a basis for reasonable cause" (20 NYCRR 107.6[d][4]).

C. Petitioner has argued that the Division can assess penalty only if the taxpayer cannot show reasonable cause and fails to demonstrate a lack of willful neglect. This argument is based on the incorrect belief that the issue to be resolved is whether penalties should be imposed, when the precise issue is whether penalties should be abated. This distinction is not a matter of mere semantics. Rather, the Tax Appeals Tribunal has noted that, in the first instance, the imposition of penalty is mandatory and not discretionary on the part of the Division:

> "By first requiring the imposition of penalties (rather than merely allowing them at the Commissioner's discretion), the Legislature evidenced its intent that filing returns and paying tax according to a particular timetable be treated as a largely unavoidable obligation [citation omitted]" (Matter of MCI Telecommunications Corp., Tax Appeals Tribunal, January 16, 1992, confirmed 193 AD2d 978, 598 NYS2d 360).

Consequently, the penalties were correctly imposed against petitioner in the first instance as a result of his failure to file returns and pay tax in a timely fashion, and petitioner faces the "onerous task" of proving that his failure was due to reasonable cause and not willful neglect (Matter of Philip Morris, Inc., Tax Appeals Tribunal, April 29, 1993).

D. Petitioner contends that his reliance on an office manager/bookkeeper and a Kentucky accounting firm, who were both highly regarded by prominent individuals involved in thoroughbred racing, was sufficient to establish reasonable cause for his failure to file and pay on a timely basis. He points to several decisions of the former State Tax Commission in support of this contention. However, decisions of the State Tax Commission are not binding on the Division of Tax Appeals (see, Matter of Racal, Tax Appeals Tribunal, May 13, 1993; Nathel v. Commr. of Taxation and Finance, ___ AD2d ___, 649 NYS2d 196). Moreover, a review of the decisions cited by petitioner show that they are conclusory, contain few facts and little

analysis, and are not particularly on point. In Matter of Cloutier (State Tax Commission, December 13, 1978) and Matter of Werner (State Tax Commission, February 28, 1977), the former Commission decided that an interior decorator and a stockbroker in over-the-counter securities, respectively, were liable for unincorporated business tax but cancelled penalties because these taxpayers believed in good faith that they were professionals exempt from unincorporated business tax. It is even more difficult to see any relevance in the decision by the former State Tax Commission in Matter of Arbesfeld (March 7, 1977, confirmed 62 AD2d 627, 406 NYS2d 146, lv denied 46 NY2d 705, 413 NYS2d 1025), where there is no discussion of any sort concerning the imposition or abatement of penalties. In Matter of Burd (State Tax Commission, August 6, 1976), the former Commission decided that the taxpayers' "reliance upon their accountant to prepare and submit for them all required New York State income tax returns, based upon 40 years' satisfactory experience with that Certified Public Accountant, constituted reasonable cause for failure to file 1970 and 1971 income tax returns and pay the tax due thereon." However, the taxpayers in Burd had relied on the same accountant to assist them in filing New York returns in the past, facts very different from those at hand.

Finally, petitioner cites Allen v. State Tax Commn. (126 AD2d 51, 512 NYS2d 916) which also provides little guidance. In Allen, the Court remitted the matter to the former State Tax Commission for further consideration because the Commission had failed to consider the abatement of penalties imposed against the taxpayer because tax had not been paid in full. It is observed that the taxpayer in Allen was the executive director of a nonprofit hospital in Harlem, which had remained in operation despite the hospital's inability to pay over to the State withholding taxes.

E. In contrast, the decision by the Tax Appeals Tribunal in Matter of Koether (December 15, 1994) provides clear guidance in determining whether penalties should be abated. In Koether, the Tribunal indicated that a careful weighing of facts and circumstances is necessary to determine whether a taxpayer "acted with ordinary business care and prudence in

attempting to ascertain his tax liability and that penalties should be abated." In reversing the administrative law judge, the Tribunal abated penalties for failure to file a return and failure to pay tax shown on a return required to be filed.

The Koether matter involved the tax liability to New York of a nonresident for certain income, amounting to approximately $2 million for the six years at issue, from a New York limited partnership engaged in the stock brokerage business. Mr. Koether was the registered representative in charge of the partnership's New Jersey office. He worked solely in the New Jersey office and at no time did he have an office in New York. Mr. Koether, as a limited partner, had invested approximately $75,000.00 in cash and securities in the New York partnership and, during the years at issue, received interest on his capital invested totalling nearly $100,000.00.

The Tribunal in Koether affirmed the administrative law judge's conclusion that the taxpayer, as a limited partner, was properly treated as a partner in the brokerage firm. The Tribunal noted, in particular, that (i) the amount of interest received on Mr. Koether's capital investment depended upon the partnership's net earnings, and (ii) the partnership filed New York State partnership returns which contained a New York State nonresident partnership allocation schedule listing petitioner as a partner and listing specific dollar amounts which should have been reported on New York State personal income tax returns. However, the findings of fact in Koether indicate that neither the taxpayer nor his accountant were ever provided with a contemporaneous copy of the partnership's New York allocation computation schedule.

The administrative law judge, in addition to holding Mr. Koether liable to New York on income received from the New York partnership, denied the taxpayer's request to abate penalties, because in the words of the Tribunal which summarized the administrative law judge's decision, "petitioner's assertion that he relied on the professional advice of a Certified Public Accountant did not meet the burden of proving that failure to file returns and to pay the

proper amount of tax was due to reasonable cause and not due to willful neglect." The Tribunal reversed the administrative law judge on this issue for the following reason:

> "The facts in this case are that as a registered representative of the partnership for the years prior to those at issue, petitioner had no New York tax liability. Prior to the date on which the income tax returns for the years at issue were due, petitioner consulted with his regular tax accountant, a Certified Public Accountant licensed in both New York and New Jersey [citations omitted]. Petitioner provided his accountant with complete background information regarding, among other things, his status as a registered representative and limited partner in [the partnership], and the Federal schedules K-1 provided to him each year by the partnership's accountants, together with such accountants' cover letter [citation omitted]. Based on this information and his understanding of New York law, petitioner's accountant advised petitioner that he had no New York source income for the years in issue, and that, therefore, petitioner was not required to file New York State or City income tax returns or to pay any such tax for any of the years in issue [references to evidence in the record omitted]. There is no evidence that petitioner was expert in tax matters. [The Tribunal also emphasized that Mr. Koether challenged his partnership status.]
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> "Under the circumstances in this case, we are at a loss to explain what petitioner could have been expected to do beyond what he did. We conclude that petitioner acted with ordinary business care and prudence in attempting to ascertain his tax liability and that penalties should be abated." (Matter of Koether, supra.)

F. In contrast, Mr. McGaughey has not shouldered the burden of proving that he acted with ordinary business care and prudence in attempting to ascertain his tax liability. Rather, the facts and circumstances in the matter at hand are sharply different from the facts and circumstances in Koether which supported the abatement of penalties. Most important is the fact that petitioner spent nearly seven months each year training horses in New York and earned more than 50% of his income from racing horses at New York tracks. In Koether, the taxpayer worked in New Jersey 100% of the time. Further, the legal issue in Koether, whether a limited partner was liable for New York income tax when he worked 100% of the time outside New York, contrasts starkly with petitioner's clear liability to New York for income earned in New York. Other circumstances in the matter at hand also militate against the abatement of penalties, including the fact that the Kentucky accounting firm used by petitioner, as noted in Finding of Fact "12", has not accepted responsibility for petitioner's failure to file the required New York tax returns nor did it ever specifically advise petitioner that he was not required to

file New York income tax returns. In contrast, the accountant in Koether specifically advised the taxpayer that he did not have to file New York returns. In addition, the principle that state income tax is owed to the state where income is earned is not a complicated principle. It seems doubtful that the Kentucky firm was unaware of this principle, and the lack of an explanation why they did not inform petitioner of his obligation to New York undermines petitioner's case. Further, petitioner employed approximately 50 employees in his horse training enterprise, and it is reasonable to presume that he was aware that taxes were withheld from their wages to pay New York income taxes. In sum, petitioner has not met the task of establishing reasonable cause for his failure to file and pay New York income tax.

G. It is further observed that after-the-fact efforts to comply with tax obligation are essentially irrelevant to the issue of failure to file and pay in the first instance (see, Matter of Erskine Xpress, Inc., Tax Appeals Tribunal, February 6, 1997).

H. The petition of Claude R. McGaughey, III, and Mary J. McGaughey is denied, and the Notice of Disallowance dated March 31, 1994 is sustained.

DATED: Troy, New York
March 13, 1997

/s/ Frank W. Barrie
ADMINISTRATIVE LAW JUDGE