STATE OF NEW YORK

TAX APPEALS TRIBUNAL

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| In the Matter of the Petition | : | |
| of | : | |
| **MORANO'S JEWELERS OF FIFTH AVENUE, INC.** | : | DECISION<br>DTA No. 800971 |
| for Revision of a Determination or for Refund of Sales and Use Taxes under Articles 28 and 29 of the Tax Law for the Period March 1, 1980 through November 30, 1982. | : | |

Both the Division of Taxation and petitioner Morano's Jewelers of Fifth Avenue, Inc., 751 Fifth Avenue, New York, New York 10022 filed exceptions to the determination of the Administrative Law Judge issued on August 9, 1990 with respect to a petition for revision of a determination or for refund of sales and use taxes under Articles 28 and 29 of the Tax Law for the period March 1, 1980 through November 30, 1982. Petitioner appeared by Stanley A. Teitler, Esq. The Division of Taxation appeared by William F. Collins, Esq. (Patricia L. Brumbaugh, Esq. and Michael B. Infantino, Esq., of counsel).

The Division of Taxation filed a brief on exception. Oral argument, at the request of both parties, was heard on July 18, 1991.

After reviewing the entire record in this matter, the Tax Appeals Tribunal renders the following decision.

## *ISSUE*

Whether the Division of Taxation properly assessed sales tax on petitioner's claimed out-of-state sales for the period at issue.

## *FINDINGS OF FACT*

We find the facts as determined by the Administrative Law Judge. These facts are set forth below.

On January 31, 1984, pursuant to a field audit of petitioner, Morano's Jewelers of Fifth Avenue, Inc. ("Morano's"), the Division of Taxation issued to Morano's a Notice of

Determination and Demand for Payment of Sales and Use Taxes Due in the amount of $285,712.29, plus interest, for a totalamount due of $375,773.65 for the period March 1, 1980 through November 30, 1982.[1]

Previously, on June 8, August 22, and December 15, 1983, Morano's, by its accountant, Michael Justus, CPA, executed consents extending the period of limitation for assessment of sales and use taxes whereby it agreed that such taxes for the audit period could be assessed at any time on or before September 20, 1983, December 20, 1983 and June 20, 1984, respectively.

The audit commenced in February 1983. The auditor, John McCarthy, had been a tax auditor with the Division of Taxation for approximately 22 years and had experience in performing audits of jewelry stores. In April of 1983, the auditor met with Mr. Justus who, between April and August 1983, provided the following books and records: sales tax returns and related worksheets, Federal and State income tax returns and related worksheets, sales journal, cash receipts journal, sales invoices, check disbursements journal, general ledger, and United Parcel Service ("UPS") books for the purpose of documenting nontaxable sales. The auditor stated at the hearing that he received all books and records which were requested.

With respect to Morano's claimed nontaxable sales, the auditor selected the month of September 1982 to perform a test of taxable and nontaxable sales. Morano's accountant, Mr. Justus, orally agreed in or about May 1983 to this test period and, in furtherance thereof, he produced Morano's cash receipts book and UPS receipts for that month. Upon review of these claimed nontaxable sales, the auditor initially considered them as nontaxable based upon out-of-state deliveries as verified by the UPS book.

Subsequently (in or about November 1983), the District Office Audit Bureau ("DOAB") in Albany implemented a new audit policy known as the Special Jeweler's Project in which several

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[1]On the same date, a notice of determination was issued to Morano's for sales tax due on leasehold improvements, machinery and equipment, furniture and fixtures and expense purchases ($19,770.06 plus interest) for the same audit period. This assessment was not protested and testimony was offered at the hearing to the effect that such assessment had been agreed to and paid, in full, by Morano's.

of the largest jewelry stores (and in some cases, other vendors such as furriers) which sold high-priced merchandise with a large volume of out-of-state sales were to be subjected to a greater degree of scrutiny in order to verify that such merchandise was actually sold and shipped out of state and was, therefore, not subject to State and/or City sales tax. As a result thereof, the auditor was instructed by his supervisor to "put the audit on hold" despite the fact that he had found nothing improper or questionable with respect to Morano's sales tax returns for the audit period. In December 1983, the auditor and his supervisor went to Mr. Justus's office at which time he requested access to Morano's records for September and October 1982 for the stated purpose of sending letters to Morano's customers in order to verify the claimed out-of-state sales. An appointment was set up for January 23, 1984 at which time said customer records were to be made available. On January 23, 1984, the auditor was informed by Mr. Justus that Morano's attorney had recommended that the records not be again made available. Upon advising his office of the refusal of Morano's accountant to turn over the records, the auditor received a telephone call from James Nuttal of DOAB who directed him to prepare and issue an assessment against Morano's disallowing all out-of-state sales for the audit period. For the audit period, Morano's had claimed on its sales tax returns, out-of-state sales in the amount of $3,521,705.00, including $150,026.84 in sales for September 1982. Tax due thereon at the applicable rate (8 or 8¼ percent) was determined to be $285,712.29 (including $12,377.21 for September 1982) which amount was assessed pursuant to the notice of determination issued to Morano's on January 31, 1984.

When Morano's books and records were initially examined by the auditor, only the sales invoices and UPS documents for September 1982 were scrutinized pursuant to the oral agreement between the auditor and Mr. Justus to utilize that month as a test period. All claimed nontaxable sales for said month resulted from out-of-state sales. The auditor stated that, in making his request in December 1983 to re-examine Morano's records, he asked for sales invoices, etc. for October 1982 as well as September 1982 in order to determine whether claimed nontaxable sales were due to diplomatic sales or any other type of nontaxable sale.

The audit was concluded and the audit file was sent to Albany in June 1984. On three separate occasions, the auditor was instructed by his supervisor to revise his comments which were set forth in the audit narrative contained within the audit report.

***OPINION***

The Administrative Law Judge, while finding that the audit procedures employed were not laudable and that petitioner may well have had valid concerns over the effect of the Division of Taxation (hereinafter the "Division") sending verification letters to petitioner's customers concerning their transactions with petitioner, determined that: the Division, having obtained consents from petitioner to extend the period of limitation for assessment until June 20, 1984, was authorized to issue an assessment at any time up to that date; being denied permission to reexamine petitioner's books and records within the audit period, the Division was authorized to estimate petitioner's taxable sales; the method of assessment, i.e, deeming all of petitioner's out-of-state sales taxable, was, except for September 1982, the period for which the Division had examined petitioner's records, reasonably calculated to reflect the taxes due; the burden of proof was on petitioner to prove the audit methodology erroneous; petitioner, at hearing, had the opportunity to meet the burden of proof by the introduction of its books and records but failed to do so.

Petitioner, on exception, reiterates its assertions at hearing, namely, that: it made all requested books and records available to the auditor upon his request; the auditor, pursuant to an agreement with petitioner, conducted a test period audit using the records for September 1982; and the auditor was satisfied that out-of-state sales were properly documented and indicated that no tax would be assessed on such basis. Thereafter, the auditor, following directions from his supervisor, requested access to the same books and records for purposes of third party verification.

Petitioner contends that the audit had been completed and that petitioner was within its rights to deny the Division subsequent access to its records for a "reaudit," particularly, in light of the Division's stated intent to send verification letters to petitioner's customers. Petitioner terms

such action a "fishing expedition" by the Division and contends such action was improper since there was not "one scintilla of evidence that triggered a finding by the State that maybe there is what we would call sufficient or reasonable probable cause or some cause to believe that the tax returns were not accurate. And that is the nub of the case" (Oral Arg. Tr., pp. 5-6). Petitioner acknowledges the right of the Division to request and examine petitioners books and records but asserts "[t]he state has no right, absent evidence of wrongdoing or tax improprieties, to go out and contact every customer to see whether or not appropriate sales tax was paid on an item of jewelry" (Oral Arg. Tr., pp. 5-6).

Finally, petitioner asserts that the Administrative Law Judge erred in stating that petitioner had the opportunity at hearing to prove the assessment erroneous through the introduction of its books and records because the relevant books and records were in the hands of the Manhattan District Attorney. Petitioner asserts that the records were accessible to the Division and by implication, at least, asserts that the Division erred in not securing the records for purposes of the audit.

The Division, on exception, asserts that it was authorized to request access to petitioner's books and records for purposes of verification and that the Administrative Law Judge erred in cancelling that portion of the assessment for the period September 1982.

We deal first with the issue of whether the Division, having once during the audit examined petitioner's books and records concerning out-of-state sales and concluded that such sales appeared to be documented, could seek further access to such records for purposes of verifying the information contained in such records. We affirm the determination of the Administrative Law Judge on this issue.

The Division here instituted a new audit policy known as the "Special Jeweler's Project" which focused on several of the largest jewelry stores (and in some cases, other vendors such as furriers) which sold high priced merchandise and had a large volume of out-of-state sales. The focus of the policy was to verify that the information in petitioner's books and records was a true

reflection of petitioner's sales activities and that such merchandise was actually sold and shipped out-of-state and, therefore, not subject to State and/or City sales tax.

The new policy was instituted during the audit of petitioner. However, the Division's request for further access to petitioner's records took place within the period of limitations and was part of a continuing audit. We find no legal basis to conclude, as petitioner would have us do, that verification of a taxpayer's books and records by the Division is dependent upon a finding of impropriety or wrongdoing as a result of the examination of the books and records, or that the mere passage of time after an initial examination of records precludes efforts by the Division, within the audit period and prior to issuance of a Notice of Determination, to verify such records.[2]

Verification of books and records is an integral, accepted part of the audit process (see, Matter of Giordano v. State Tax Commn., 145 AD2d 726, 535 NYS2d 255, lv denied 44 NY2d 645, 402 NYS2d 74 [the former State Tax Commission was not required to accept the total accuracy of the records produced by petitioner since they were self-serving and not subject to independent verification]). In Matter of On the Rox Liqs. v. State Tax Commn. (124 AD2d 402, 507 NYS2d 503, 505), the court rejected the claim that the retention of an exempt organization certificate file which did not reflect specific sales to specific exempt organizations was adequate proof. The court stated, "to state the proposition is to refute it. Carried to its logical conclusion, this course of reasoning justifies the patently unacceptable consequence of exempt sales, without providing any documentation whatsoever to verify those sales" (emphasis added).

The law in this State is quite clear that "[t]hose required to collect sales tax must maintain records which 'shall be available for inspection and examination at any time upon demand' by the [Division]" (Matter of Continental Arms Corp. v. State Tax Commn., 72 NY2d 976, 534 NYS2d

[2]Section 1142(4) of the Tax Law - General Powers of the [Commissioner] - authorizes and empowers the Commissioner "to prescribe methods for determining the amount of receipts . . . and for determining which of them are taxable and which are nontaxable." The "Special Jeweler's Project" audit policy clearly falls within such authority.

362, 363 citing Tax Law § 1135[d],[3] emphasis in original). Where the taxpayer frustrates the accomplishment of an unabridged audit by refusing to make those records available upon demand, the Division is authorized to use a method reasonably calculated to estimate the tax liability of petitioner (Matter of Continental Arms Corp. v. State Tax Commn., supra, 534 NYS2d 362, 363).

In our view, petitioner's refusal to allow the Division further access to its books and records "frustrated" the accomplishment of the audit within the meaning of Continental Arms Corp. Thus, the Division was free to estimate petitioner's liability from such information as was available to it (Tax Law § 1138[a][1]).

We agree with the Administrative Law Judge that under these circumstances, i.e., the inability to verify out-of-state sales, the method used by the Division to estimate petitioner's taxable sales through the disallowance of all of its out-of-state sales was reasonable and proper (see, Matter of On the Rox Liqs. v. State Tax Commn., supra).

We also reject petitioner's assertion that since its books and records concerning out-of-state sales were in the hands of the District Attorney, they were accessible to the Division and that the Division should have endeavored to secure them for purposes of the audit.

Clearly, the obligation is on petitioner to furnish the records upon demand. There is no obligation upon the Division to follow alternative means to access such records (Matter of Continental Arms Corp. v. State Tax Commn., supra). Similarly, there is no obligation on the Division to accept an offer from petitioner of third party assistance to do verification.[4] In any event, the decision in the criminal contempt proceedings against petitioner (In re Grand Jury Subpoena Duces Tecum Served Upon Morano's of Fifth Avenue, 144 AD2d 252, 533 NYS2d 869) does not support petitioner's claim that all of the pertinent records were in the hands of the District Attorney. At most, the decision indicates that petitioner turned over some of its records.

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[3]Tax Law § 1135(d) is now § 1135(e), effective L 1989, ch 61, § 237.

[4]Petitioner, at hearing, stated that "[w]e asked in the past this agency and other agencies, to let an independent accounting firm . . . send out a thousand letters saying that they're working for Morano's, they're Morano's accountants; please verify or not verify an out-of-state sale" (Hearing Tr., p. 195).

The decision clearly suggests that some of the pertinent shipping documents were not in existence at the time of the subpoena (In re Grand Jury Subpoena Duces Tecum Served Upon Morano's of Fifth Avenue, supra).[5] Even assuming the pertinent records were in the possession of the District Attorney's office, the record is silent as to petitioner's efforts, if any, to obtain the records or copies thereof from the District Attorney's office for use at the hearing.

We deal next with the Division's assertion that the Administrative Law Judge erred in allowing petitioner's out-of-state sales for September 1982, the test period for which records of such sales were examined.

We reverse the determination of the Administrative Law Judge on this issue.

The request by the Division for access to petitioner's records to verify out-of-state sales covered the entire period of the audit including September 1982. Conversely, the failure of petitioner to provide access to its books and records for purposes of such verification covered the entire period of the audit including September 1982. We see no reason to except September 1982 from the holding that all out-of-state sales were taxable.

Accordingly, it is ORDERED, ADJUDGED and DECREED that:

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[5]The criminal contempt proceeding against petitioner, referred to numerous times by petitioner's representative at hearing, concerned the audit period December 1, 1982 through May 31, 1985, not the March 1, 1980 through November 30, 1982 period at issue here, and arose out of the sales tax investigation by the Division into petitioner's handling of out-of-state sales (in excess of 50% of petitioner's sales). After petitioner refused to allow the auditor to copy the names of out-of-state customers for the purpose of official verification, the matter was referred to the Manhattan District Attorney. On March 26, 1986, the District Attorney issued a grand jury subpoena duces tecum requiring production of records relating to sales, shipping, customers and sales tax for the period September 1, 1981 through November 30, 1985. Petitioner, after failing to have the subpoena quashed, produced some records for the District Attorney. The District Attorney determined that certain categories of records had not been produced and applied to the court for relief. A hearing was held on the limited issue of whether items not produced, but called for in the subpoena, were in existence and under the control of Morano's on the date the subpoena was served. In the evidence adduced was a deposition from Mr. Morano (made in connection with related insurance litigation) that sales invoices were routinely discarded after a year. The result of the hearing was a determination "that many of the documents claimed by the People to have been withheld were in fact in existence and under the control of [Morano's] when the subpoena was served . . . [and] that many of the documents also did not exist at that time" (In re Grand Jury Subpoena Duces Tecum Served Upon Morano's of Fifth Avenue, supra, 533 NYS2d 869, 871). The trial court held that Morano's "willfully disobeyed both the grand jury subpoena and the court's [prior] order of compliance, that Joseph Morano was the custodian of the records, and that [he] failed to comply with the April 28, 1987 order that directed Morano's to comply with the subpoena . . ." (In re Grand Jury Subpoena Duces Tecum Served Upon Morano's of Fifth Avenue, supra, 533 NYS2d 869, 871). The court held Mr. Morano in contempt. The Appellate Division reversed the conviction for criminal contempt on the grounds that the People failed to meet their burden of proving beyond a reasonable doubt that either Appellant willfully disobeyed the court's order to reproduce all the documents called for in the grand jury subpoena duces tecum.

1. The exception of petitioner Morano's Jewelers of Fifth Avenue, Inc. is denied;

2. The exception of the Division of Taxation is granted;

3. The determination of the Administrative Law Judge is modified to the extent that conclusion of law "C" is reversed, but is in all other respects affirmed; and

4. The petition of Morano's Jewelers of Fifth Avenue, Inc. is in all respects denied.

DATED: Troy, New York
January 2, 1992

/s/John P. Dugan
John P. Dugan
President

/s/Francis R. Koenig
Francis R. Koenig
Commissioner

/s/Maria T. Jones
Maria T. Jones
Commissioner