

STATE OF NEW YORK
TAX APPEALS TRIBUNAL

In the Matter of the Petition :
of :
PIZZA WORKS, INC. : DECISION
for Revision of a Determination or for Refund :
of Sales and Use Tax under Articles 28 and 29 :
of the Tax Law for the Period March 1, 1981 :
through February 29, 1984 :
:

The Division of Taxation filed an exception to the determination of the Administrative Law Judge issued on January 25, 1990 with respect to the petition of Pizza Works, Inc., 1376 Lexington Avenue, New York, New York 10028 with respect to its petition for revision of a determination or for refund of sales and use tax under Articles 28 and 29 of the Tax Law for the period March 1, 1981 through February 29, 1984 (File No. 802463). Petitioner appeared by its president, Aristides Matsis. The Division of Taxation appeared by William F. Collins, Esq. (Gary Palmer, Esq., of counsel).

Briefs were submitted by both parties. Oral argument was heard, at the request of the Division of Taxation, on September 26, 1990.

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

ISSUES

I. Whether the Division of Taxation is estopped from finding that petitioner's records were inadequate.

II. Whether the Administrative Law Judge erred in determining that the markup audit performed by the Division of Taxation did not have a rational basis.

III. Whether a penalty should be sustained under Tax Law § 1145(a)(1)(i) for the failure to file returns or pay over sales taxes.

FINDINGS OF FACT

We find the facts as determined by the Administrative Law Judge except for findings of fact "3(a)", "4", "5(a)", "5(c)", "5(e)", "7" and "9" which have been modified. The Administrative Law Judge's findings of fact and the modified findings of fact are set forth below.

Petitioner operates a pizzeria at Lexington Avenue near 91st Street on the upper East side of Manhattan. It has tables and a capacity of about 15 people. Petitioner sells pizza, soda, ice cream and ices, and also has four video game machines. (The receipts from the video game machines are not in dispute in this case.) Its owner and sole employee is Aristides Matsis. Petitioner reported sales for the audit period of \$150,204.00 and paid sales tax of \$12,569.00.

Petitioner did not maintain a cash receipts book. It had a cash register but it did not use tapes in the register. It gave no sales slip or similar statement to its customers. Sales tax returns were prepared from bank statements. Petitioner had records of purchases of flour from its supplier, Ferro Foods. Petitioner had no records of purchases of soda, ice cream or ices. It had bank statements and cancelled checks. During the audit petitioner furnished the auditor with computer sheets, purchase invoices for flour, cancelled checks, bank statements, receipts from video game machines, sales tax returns and worksheets, income tax returns and miscellaneous papers.

Petitioner relied on an official publication of the Division of Taxation, publication 752, entitled "Record Keeping For Sales Tax Vendors" in choosing its recordkeeping functions. That publication, a leaflet sent to all newly-registered sales tax vendors, states:

"[Y]ou must keep accurate records that contain all the information you need to prepare your returns and to verify their accuracy in case you are audited. No one set of record keeping rules can apply to all vendors; however, your records must be geared to your particular operation and any record keeping equipment you use."

That publication further states, in regard to cash registers, merely that "totals should be figured daily". It makes no reference to individual sales and tells the taxpayer that "if you do not use a

cash register, you can use any system that allows you to keep a complete and accurate record of taxable and exempt sales."

We modify finding of fact "3(a)" of the Administrative Law Judge's determination to read as follows:

The auditor found that petitioner's sales as reported on its sales tax returns were less than gross sales as reported on its Federal income tax returns. However, the auditor rejected the sales figures on petitioner's income tax returns (which also included receipts from nontaxable video game sales) because other audit methods yielded a "higher sales figure." The auditor checked the bank accounts and purchases of flour. He made at least six trips to petitioner's place of business on this audit.¹

An initial audit based on purchases of flour had assumed that only one pound of flour was used in each pizza. The computations for this are not in the record but led to a computation of tax due of \$20,922.88. This methodology was abandoned by the auditor.

We modify finding of fact "4" of the Administrative Law Judge's determination to read as follows:

The auditor observed the business for one day, September 17, 1984. Petitioner sold 137 slices of pizza at \$1.05, 1 large pie at \$8.50, 3 medium pies at \$5.50, 2 small pies at \$3.50 and extra toppings totaling \$2.50. The total pizza sales as calculated by the auditor came to \$177.50. Petitioner also sold 44 small sodas at \$.80, 11 medium sodas at \$.95 and 10 large sodas at \$1.00. These sales totaled \$56.65. Petitioner also sold 5 ice creams at \$1.00 and 6 "ices" at \$.80, for a total of \$9.80. From this observation test, the auditor computed that soda sales amounted to 31.93% of pizza sales and that other sales (ice cream and ices) amounted to 5.52% of pizza sales. Petitioner disagrees with these figures for soda and other sales claiming that they were valid only on the warm day on which they were observed. This observation

¹The Administrative Law Judge's finding of fact "3(a)" read as follows:

"3(a). The auditor found that petitioner's sales as reported on its sales tax returns were consistent with its sales as reported on its Federal income tax returns. However, the auditor rejected the sales figures on petitioner's income tax returns (which also included receipts from nontaxable video game sales) because other audit methods yielded a "higher sales figures." The auditor checked the bank accounts and purchases of flour. He made at least six trips to petitioner's place of business on this audit.

Finding of fact "3(a)" has been modified to more accurately reflect the record below.

test was used to determine the ratio of soda, ices and ice cream sales to pizza sales for the entire audit period.²

We modify finding of fact "5(a)" of the Administrative Law Judge's determination to read as follows:

The determination of tax was based primarily on petitioner's records of purchases of flour used in making pizza. To this figure was added an amount for soda and other sales based upon the observation test (see Finding of Fact "4"). Petitioner purchased 52,600 pounds of flour for the audit period. The auditor assumed that 1.56 pounds of flour was used in each pizza yielding 33,716 pies of 8 slices each or 269,696 slices. (The auditor found that petitioner purchased 18,200 pounds of flour, about 35%, for the three quarters ending November 30, 1981, 17,300 pounds, about 33%, for the four quarters ending November 30, 1982, 13,200 pounds, about 25%, for the four quarters ending November 30, 1983 and 3,900 pounds, about 7%, for the one quarter ending February 28, 1984.) The auditor assumed the price of a slice was 70¢ in the first three quarters of the audit period, 80¢ in the next four quarters, 90¢ in the next four quarters and \$1.00 in the last quarter. These figures were assumed so as to account for inflation. These assumed prices include sales tax. The total pizza sales thus computed came to \$217,188.00. This calculation includes no specific amount for waste.³

²The Administrative Law Judge's finding of fact "4" read as follows:

"4. The auditor observed the business for one day, September 17, 1984. Petitioner sold 137 slices of pizza at \$1.05, 1 large pie at \$8.50, 3 medium pies at \$5.50, 2 small pies at \$3.50 and extra toppings totaling \$2.50. The total pizza sales as calculated by the auditor came to \$177.50. Petitioner also sold 44 small sodas at \$.80, 11 medium sodas at \$.95 and 10 large sodas at \$1.00, these sales totaled \$56.65. Petitioner also sold 5 ice creams at \$1.00 and 6 "ices" at \$.80 for a total of \$9.80. From this observation test the auditor computed that soda sales amounted to 31.93% of pizza sales and that other sales (ice cream and ices) amounted to 5.52% of pizza sales. Petitioner disagrees with these figures for soda and other sales claiming that they were valid only on the warm day on which they were observed. However, it is also true that on colder days other drinks, such as coffee, would be sold, and petitioner has not provided any alternative figures for this segment of his business. This observation test was used at the hearing to determine a tax for the whole audit period (see Finding of Fact "9[a]").

Finding of fact "4" has been modified to more accurately reflect the record below.

³We modified the Administrative Law Judge's finding of fact "5(a)" by adding the word "specific" to the last sentence of the finding.

The weight of each pizza was determined by the auditor on petitioners premises. The auditor weighed seven pizzas. They each weighed either 2.5 or 2.75 pounds. The average was 2.6 pounds.

We modify finding of fact "5(c)" of the Administrative Law Judge's determination to read as follows:

The amount of flour in each pizza, 1.56 pounds, was based upon a laboratory analysis from another audit. (The field audit report indicated that this "also takes in consideration for waste.") This amount is consistent with a recipe produced by petitioner, and used by it, which called for 10 pounds of flour and 6 pounds, 6¼ ounces of other ingredients. This amounts to 61.5% of flour by weight. Sixty percent of petitioner's pies of 2.6 pounds amounts to 1.566 pounds.⁴

A laboratory analysis of pizza dough performed during another audit had shown the weight of all solids (primarily flour) to be over 60% of the weight of the dough. Petitioner has argued persuasively that this laboratory analysis must have been performed after some delay during which fermentation would have caused an increase in the liquid portion of the dough over what it would have been if the dough had been used to make a pizza. Therefore, petitioner argues the solid portion of the pizza dough used was actually higher than the 60% arrived at by the laboratory test. However, this analysis will not determine the result in this case.

We modify finding of fact "5(e)" of the Administrative Law Judge's determination to read as follows:

⁴The Administrative Law Judge's finding of fact "5(c)" read as follows:

"(c) The amount of flour in each pizza, 1.56 pounds, was based on a finding of another auditor in a different and unspecified case. (The field audit report indicated that this "also takes in consideration for waste". The auditor, however, has retracted from that position, see Finding of Fact "7"). This amount is consistent with a recipe produced by petitioner and used by it which called for 10 pounds of flour and 6 pounds, 6¼ ounces of other ingredients. This amounts to 61.5% of flour by weight. Sixty percent of petitioner's pies of 2.6 pounds amounts to 1.566 pounds."

Finding of fact "5(c)" has been modified to more accurately reflect the record below.

Using the ratios for soda sales and other sales developed in the observation test of September 17, 1984, the auditor found that soda sales came to \$69,343.00 and other sales were \$11,982.00.⁵

The inflation of petitioner's prices over the audit period were correctly, or at least adequately, estimated by the auditor. Those increases (presumably allowing for the rounding off of prices) were of 10 cents a pizza slice per year. Petitioner's evidence that the inflation factor should be at least 13.6% (and even higher because of its location in New York City) is found to be invalid. Petitioner has produced pages from the Statistical Abstract of the United States for 1988, table number 738, showing the consumer price index. There is a column for "food away from home" which lists index figures for each year. For instance, it lists 267 for 1980 and 291 for 1981, the first year of the audit. Petitioner's method would interpret these tables, by subtracting the two index figures, as indicating a change of 24% for the single year. In justification of this subtraction procedure petitioner quotes from page xvi of the Abstract the language "at the end of a compounding period the amount of accrued change...is added to the amount which existed at the beginning of the period". However, the quoted language is not relevant to this computation. That quote occurs under the heading "average annual percent change" which is a heading not used in the cost of living index referred to in this case. Also the quoted language merely explains that when such figures are shown the changes are assumed to occur at the end of each year instead of occurring ratably on each day during the year. The correct calculation of inflation is, as argued by the Division of Taxation, to subtract the first index figure from the second as petitioner does, but then divide the result by the first index figure. In the example above this would result in inflation between 1980 and 1981 of 9%. This is actually lower than the auditor assumed.

The total of all sales came to \$298,513.00. As this included sales tax the sales tax was taken out and a taxable sales figure of \$275,880.00 was arrived at. Petitioner had reported sales of (as transcribed by the auditor) \$150,204.00. The additional sales were \$125,676.00 and the additional tax due was \$10,284.54.

⁵We modified the Administrative Law Judge's finding of fact "5(e)" by changing an amount from \$60,343.00 to \$69,343.00 to reflect the record.

A Notice of Determination and Demand for Payment of Sales and Use Tax was issued against petitioner on June 20, 1985 in the amount of \$10,285.28 plus penalty of \$2,498.89 and interest \$4,318.96 for a total amount due of \$17,103.13. The penalty was computed under Tax Law § 1145(a)(1)(i) at 25% of tax due. The calculation of tax underlying this determination was withdrawn by the auditor during the hearing and a new figure for tax due was substituted.

Two consents had been signed extending the period of limitations to December 20, 1984 and to June 20, 1985.

We modify finding of fact "7" of the Administrative Law Judge's determination to read as follows:

A recomputation of the tax determined to be due under the purchase audit was done by the auditor (after the hearing was under way) to provide for a waste factor. The 52,600 pounds of flour purchased was reduced by 15%, or 7,845 pounds, for waste. The 15% figure was based upon the experience of the auditors in the office of the auditor who conducted this audit. The result was 44,755 pounds. The proportion of total purchases to be accounted for, in each pricing period, is the same as the proportion used in the primary audit: 35%, 33%, 25% and 7%.) The flour was assumed to be purchased over the audit period as follows: 15,515 pounds for the three quarters ending November 30, 1981, 14,705 pounds for the four quarters ending November 30, 1982, 11,220 pounds for the four quarters ending November 30, 1983, and 3,315 pounds for the one quarter ending February 28, 1984. The pies made, at 1.57 pounds of flour per pie, were calculated to be 9,882, 9,386, 7,146 and 2,111 respectively, for the four periods. The selling prices of the pizza were found to be \$5.60, \$6.40, \$7.20 and \$8.00, respectively, for the four periods. The receipts were calculated to be \$55,339.00, \$59,946.00, \$51,451.00 and \$16,888.00, respectively, for the four periods, or \$168,420.00 in total. Sales of soda were estimated to be 31.93% of pizza sales, or \$53,777.00. Miscellaneous sales were estimated to be 5.52% of pizza sales, or \$9,297.00. Gross receipts thus came to \$231,494.00. After an 8% tax was taken out, taxable sales amounted to \$214,346.00. The sales reported on the returns filed (as transcribed by the auditor) were \$151,294.00. (Note that this figure differs from the one reported above. The difference arises from transcribing different figures reported for February 1984 sales. The returns necessary to resolve this difference are not in evidence.) The subtraction of \$151,294.00 in taxable sales leaves net additional sales of \$63,052.00 with tax due thereon at 8.25% of \$5,202.00.⁶

⁶The Administrative Law Judge's finding of fact "7" read as follows:

"7. A recomputation of the tax determined to be due under the purchase

Petitioner conducted its own test of waste, done over a six-day period, and found that it sold 85 pies. Thus waste was 3½ pies for miscuts, 3 pies for employee meals, 7 overbaked pies, 10 pies for stale dough, 8¼ pies for stale slices, 15 pies for failed dough and 6¾ pies for leftovers at closing, for a total of 53½ pies wasted. This showed that the number of pies actually sold was 61% of all pies made (the figure of 65% supplied by petitioner was miscalculated). The waste factor would thus be 39%, or more than twice the 15% figure assumed by the auditor in a recomputation of the tax. Since the 15% waste allowance reduced the additional tax due by about \$5,000 (from \$10,283 to \$5,202.00), it can be inferred without detailed computation that a waste factor of more than two and a half times as much would reduce the additional tax due by \$12,500, or to less than zero.

We modify finding of fact "9" of the Administrative Law Judge's determination to read as follows:

The result of the observation test of one day was projected by the auditor on an annual basis assuming that petitioner was open

audit (finding of fact "5") was done by the auditor (after the hearing was under way) to provide for a waste factor. The 52,600 pounds of flour purchased (finding of fact "5[a]") was reduced by 15%, or 7,845 pounds, for waste. The 15% figure was based on the auditor's own experience. The result was 44,755 pounds. The proportion of total purchases to be accounted for in each pricing period is the same as the proportion used in the primary audit: 35%, 33%, 25% and 7%.) The flour was assumed to be purchased over the audit period as follows: 15,515 pounds for the three quarters ending November 30, 1981, 14,705 pounds for the four quarters ending November 30, 1982, 11,220 pounds for the four quarters ending November 30, 1983, and 3,315 pounds for the one quarter ending February 28, 1984. The pies made, at 1.57 pounds of flour per pie, were calculated to be 9,882, 9,386, 7,146 and 2,111 respectively, for the four periods. The selling prices of the pizza were found to be \$5.60, \$6.40, \$7.20 and \$8.00, respectively for the four periods. The receipts were calculated to be \$55,339.00, \$59,946.00, \$51,451.00 and \$16,888.00, respectively, for the four periods, or \$168,420.00 in total. Sales of soda were estimated to be 31.93% of pizza sales, or \$53,777.00. Miscellaneous sales were estimated to be 5.52% of pizza sales, or \$9,297.00. Gross receipts thus came to \$231,494.00. After an 8% tax was taken out, taxable sales amounted to \$214,346.00. The sales reported on the returns filed (as transcribed by the auditor) were \$151,294.00. (Note that this figure differs from the one reported in Finding of Fact "5". The difference arises from transcribing different figures reported for February 1984 sales. The returns necessary to resolve this difference are not in evidence.) The subtraction of \$151,294.00 in taxable sales leaves net additional sales of \$63,052.00 with tax due thereon at 8.25% of \$5,202.00."

Finding of fact "7" has been modified to more accurately reflect the record below.

six days a week. There are 13 weeks in a calendar quarter and the audit covered 12 quarters. The net sales (after taking out the sales tax included in the pies), thus, came to \$210,935.40. This is an increase of \$60,731.40 over reported taxable sales. A sales tax on this at 8¼% would amount to \$5,010.30. Since this is computed entirely on the basis of current prices, it does not contain an adjustment for inflation.⁷

Mr. Matsis asserted that petitioner paid all sales taxes due.

The penalty was asserted because the total receipts as found by the auditor were substantially more than the tax reported.

OPINION

The Administrative Law Judge determined that the markup audit performed by the Division of Taxation (hereinafter the "Division"), and modified at the hearing, was flawed because it applied a 15% waste factor which the Administrative Law Judge found to be based on

⁷The Administrative Law Judge's finding of fact "9" read as follows:

"9. (a) At the hearing the result of the observation test of one day (see Finding of Fact "4") was projected by the auditor on an annual basis assuming that petitioner was open six days a week. There are 13 weeks in a calendar quarter and the audit covered 12 quarters. The net sales (after taking out the sales tax included in the pies) thus came to \$210,935.40. This is an increase of \$60,731.40 over reported taxable sales. A sales tax on this at 8¼% would amount to \$5,010.30. Since this is computed entirely on the basis of current prices it does not contain an adjustment for inflation.

"(b) This observation test can be adjusted for inflation so as to reflect the fact that the sales in the earlier period would have been at lower prices. (It need not be adjusted for waste since any wasted amounts would have not been sold and thus would not have been counted by the auditor.) This can be done simply by assigning the \$210,935.00 of sales to each of the pricing periods assumed by the auditor. (35% of purchases during the first three quarters when the price was 70¢ a slice, 33% of the purchases during the next four quarters when the price was 80¢, 25% of the purchases during the next four quarters when the price was 90¢ and 7% of the purchases were during the last quarter when the price was \$1.00.) The sales of \$210,935.00 found according to this observation audit can thus be distributed: \$73,027.00 in the first three quarters; \$69,609.00 in the next four quarters; \$52,739.00 in the next four quarters; and \$14,765.00 in the last quarter. The prices in each of these four periods were less than the \$1.05 price of the observation test by 33.3%, 23.8%, 14.8% and 4.8% respectively and should result in reduced sales in each period of \$24,609, \$16,567, \$7,541 and \$709 for a total reduction of \$49,426. This must be subtracted from the calculated sales of \$210,935.00 so as to arrive at net sales of \$151,510.00. This is only \$1,306.00 or less than one percent more than the \$150,204.00 reported on the return. A sales tax on this at 8¼% would be \$107.75."

Finding of fact "9" has been modified to accurately reflect the record below.

nothing more than the auditor's own experience. Due to his concern over the validity of the waste factor, the Administrative Law Judge set aside the markup audit and calculated the tax due by applying the results of a one day observation test performed by the Division of petitioner's business. The Administrative Law Judge modified this observation test by making an adjustment for inflation. After this adjustment, the Administrative Law Judge found only a 1% deficiency in tax due and, determining that such a deficiency was insignificant, cancelled the assessment. Since the Administrative Law Judge cancelled the assessment, he found it unnecessary to address petitioner's claim that the Division was estopped from requiring petitioner to keep records of every sale by the statements in Publication 752, "Record Keeping for Sales Tax Vendors."

On exception, the Division asserts that it had the right to estimate tax due from petitioner because petitioner did not have adequate books and records and that the markup audit performed was reasonable. Therefore, the Division argues it was not permissible for the Administrative Law Judge to substitute the results of the observation test for the markup audit. Finally, the Division argues that penalty should be sustained because petitioner offered no reason why penalty should be abated.

In response, petitioner argues that it is entitled to rely on Publication 752. Petitioner claims that this publication states that the kind of records a taxpayer can keep is within its discretion. Petitioner also claims that the markup audit was unreasonable because it relied on information from anonymous sources instead of the more reliable direct observation of petitioner's business. Finally, petitioner claims that it does not owe penalty.

We reverse the determination of the Administrative Law Judge.

First, it is clear that the Division had the right to resort to an external index for the purpose of estimating the tax due from petitioner. Section 1135(a)(1) of the Tax Law requires a vendor to keep records of every sale and of the tax payable thereon. The only records of sales offered by petitioner were its bank statements. The Division is entitled to request source documents to verify the amounts stated in such self-serving documents and absent such source documents the Division may resort to external indices to estimate tax (see, Matter of Club Marakesh v. Tax

Commn. of State of New York, 151 AD2d 908, 542 NYS2d 881, 883, lv denied 74 NY2d 616, 550 NYS2d 276).

We also find totally without merit petitioner's contention that Publication 752, "Record Keeping for Sales Tax Vendors" indicates that it is up to the vendor's discretion to determine what books and records should be kept for sales tax purposes and that petitioner reasonably relied on this statement. In fact, as set forth above, Publication 752 states "you must keep accurate records that contain all the information you need to prepare your returns and to verify their accuracy in case you are audited." Since petitioner maintained no records that verify the accuracy of its returns, we find its purported reliance on the publication unpersuasive. To the extent that the publication left questions unanswered, i.e., exactly what records would be required for petitioner's particular operation, petitioner could have sought further detail from the Division's regulations (20 NYCRR 533.2) or from other sources in the Division.

Next we turn to the question of whether the markup audit performed was reasonably designed to estimate taxes (see, Matter of W. T. Grant Co. v. Joseph, 2 NY2d 196, 159 NYS2d 150, 157, cert denied 355 US 869, 2 L Ed 2d 75). The Administrative Law Judge set aside the markup audit because of his concern over the validity of the 15% waste factor offered by the Division as an adjustment to the audit at the hearing. Contrary to the Administrative Law Judge's statement, the auditor stated that the 15% waste factor was based on the experience of his office which allowed a 10 to 15 percent waste factor to cover all sources of waste in a pizza parlor (Tr., p. 43) (cf., Matter of Shop Rite Wines & Liquors, Tax Appeals Tribunal, February 22, 1990 [where the waste allowance was modified because the auditor was unable to describe the source of the waste factor applied]). Petitioner did not attempt to show that the office experience relied on by the auditor was not comparable to petitioner's business, but instead testified as to its own test which estimated waste at 39%. We conclude that at best petitioner's evidence indicates imprecision in the audit results, but this is not sufficient to establish by clear and convincing evidence that the amount assessed is erroneous (Matter of Meskouris Bros. v. Chu, 139 AD2d 813, 526 NYS2d 679, citing Matter of Surface Line Operators Fraternal Org. v. Tully, 85 AD2d

858, 446 NYS2d 451; see also, Matter of Carmine Rest. v. State Tax Commn., 99 AD2d 581, 471 NYS2d 402, 404). Since petitioner's failure to maintain records prevents exactness, exactness in determining the sales tax liability is not required (Matter of Meyer v. State Tax Commn., 61 AD2d 223, 402 NYS2d 74, 78, lv denied 44 NY2d 645, 406 NYS2d 1025). Therefore, we conclude that the markup audit was reasonably designed to estimate the tax due, and the Administrative Law Judge's decision to set aside this audit, and the assessment which resulted from it, was erroneous.

Finally, we agree with the Division that penalty must be sustained because petitioner has not proven any facts that establish reasonable cause for its failure to pay the tax due. Without such grounds, there is no basis to abate the penalty (Tax Law § 1145[a][1][iii]).

Accordingly, it is ORDERED, ADJUDGED and DECREED that:

1. The exception of the Division of Taxation is granted;
2. The determination of the Administrative Law Judge is reversed;
3. The petition of Pizza Works, Inc. is denied; and
4. The Notice of Deficiency dated June 20, 1985, as modified by the Division (see, finding of fact "7" of the Administrative Law Judge's determination) is sustained.

DATED: Troy, New York
March 21, 1991

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

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

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