

STATE OF NEW YORK  
TAX APPEALS TRIBUNAL

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In the Matter of the Petition :  
of :  
**MICHAEL T. WAPLES** : **DECISION**  
**D/B/A JACK'S RESTAURANT** :  
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 September 1, 1981 :  
through February 28, 1985. :

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Petitioner, Michael T. Waples, d/b/a Jack's Restaurant, 117 Main Street, Vestal, New York 13850, filed an exception to the determination of the Administrative Law Judge issued on January 6, 1989 with respect to his 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 September 1, 1981 through February 28, 1985 (File No. 802575). Petitioner appeared by Frederick A. Griffen, Esq. The Division of Taxation appeared by William F. Collins, Esq. (Deborah J. Dwyer, Esq., of counsel).

Petitioner filed a brief on exception. The Division filed a letter together with a brief previously submitted to the Administrative Law Judge. Petitioner requested and was granted oral argument; subsequently, however, petitioner submitted on the record.

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

***ISSUE***

Whether the Administrative Law Judge erred in finding that the Division had met its burden of proving fraud.

***FINDINGS OF FACT***

We find the facts as determined by the Administrative Law Judge and such facts are stated below.

On July 15, 1985, following an audit, the Division issued to petitioner, Michael T. Waples d/b/a Jack's Restaurant, a Notice of Determination and Demand for Payment of Sales and Use Taxes Due for the period September 1, 1981 through February 28, 1985 which assessed \$46,482.79 in tax due, plus fraud penalty pursuant to Tax Law § 1145(a)(2) and interest.

During the period at issue petitioner owned and operated Jack's Restaurant, a neighborhood bar and restaurant. Petitioner was the sole proprietor of Jack's. The restaurant portion of the Jack's operation served a lunch/snack menu consisting of sandwiches, hamburgers, sausages, and chicken. During the months of June through October, Jack's operated an outdoor barbecue on its premises on which chicken, hamburgers, sausages, and "spiedies" were cooked and sold to customers. Picnic tables were set up outside. At the time the audit was conducted, petitioner had been in business for about 16 years, and he had, at that time, two part-time employees.

To commence the audit, the Division mailed a letter to petitioner on September 28, 1984 which advised petitioner that his business was to be audited and set an appointment to meet with petitioner on October 4, 1984. On October 4, 1984 petitioner did meet with the Division's representative and at that time advised her that his business had been burglarized on October 1, 1984. Stolen in the burglary, according to petitioner, was his file cabinet which contained all of his business records.

Petitioner reported the burglary to the Vestal Police, and, as part of that report, told the police that along with some cash, rolled coins and loose coins, the burglar had stolen his file cabinet containing his business records.

In the absence of records, the audit proceeded as follows:

a) Petitioner provided the Division with the names of his beer and liquor suppliers during the audit period. These suppliers were, in turn, contacted by the Division and subsequently provided the Division with information regarding petitioner's purchases during the period.

b) The Division used the actual purchase figures provided by each of petitioner's suppliers to determine petitioner's beer and liquor purchases for each of the sales tax periods comprising the original audit period. For certain of the periods the information provided by the suppliers did not indicate any purchases by petitioner. For such periods the Division estimated purchases by petitioner from that supplier by computing an average of petitioner's actual purchases from that supplier made in other periods.

c) Information provided by petitioner's beer and liquor suppliers indicated that petitioner made \$142,020.55 in actual purchases during the original audit period. In addition, the Division determined that petitioner made \$11,475.35 in purchases from his suppliers during the same period, estimated as described above. Total audited purchases from beer and liquor suppliers was therefore \$153,495.90.

d) Petitioner also advised the Division that each week he purchased approximately one case of liquor and 25 cases of beer at retail which were sold at Jack's. The Division estimated such liquor purchases at \$80.00 per week and such beer purchases at \$200.00 per week.

e) The Division then determined petitioner's retail selling prices of beer and liquor from information provided by petitioner. Petitioner advised the Division that he used 3/4 ounces of liquor in his drinks. The Division estimated that 20% of petitioner's sales were made at his happy hour prices and 80% at his regular prices. The Division also made a 15% allowance for spillage.

f) Using the above information and detailed invoices which were supplied by two of petitioner's liquor suppliers the Division developed a liquor markup of 404% of petitioner's cost. The Division also developed a markup for beer of 144.88%. Petitioner's retail purchases of liquor and beer were also marked up pursuant to these percentages. These percentages were then applied to petitioner's audited purchases of beer and liquor, resulting in petitioner's audited taxable sales of liquor and beer for the period September 1, 1981 through August 31, 1984 of \$553,137.82 including sales tax.

g) With respect to outside food sales, the Division, with petitioner's cooperation, determined petitioner's receipts from such sales for a 90-minute period (11:30 A.M. - 1:00 P.M.) on October 12, 1984. Petitioner tallied his receipts during this period and provided his list to the Division. The receipts collected during the test period were determined to be outside food sales per day and were then projected over 5 days per week and 5 months per year throughout the original audit period. With respect to inside food sales, the Division tested such sales for the week of October 29 through November 2, 1984. Petitioner retained guest checks for this period and based on these checks total receipts were \$330.75. This weekly total of inside sales was then projected throughout the original audit period. Inside and outside audited food sales for the period September 1, 1981 through August 31, 1984 amounted to \$63,661.50, including sales tax.

h) Petitioner's total audited taxable sales for the period September 1, 1981 through August 31, 1984 thus totaled \$576,447.96, after subtracting out sales tax.

On December 5, 1984, in response to a Division inquiry, petitioner advised that his records which were reported stolen had not been recovered. In April of 1985, the Division updated the audit to include the period September 1, 1984 through February 28, 1985. Audited beer and liquor purchases for these two quarters were estimated based on audited purchases of the previous periods and were marked up in accordance with the percentages determined on audit. Audited food sales were estimated for these two quarters based upon audited food sales of the previous periods. The extension of the audit resulted in an additional \$105,413.25 in audited taxable sales and a total audited taxable sales figure of \$681,861.21 for the period September 1, 1981 through February 28, 1985. From this audited taxable sales amount, the assessment set forth in the notice of determination herein was calculated. The Division did not request records from petitioner prior to its extension of the audit to February 28, 1985.

Following a prehearing conference with petitioner's representative the Division adjusted the deficiency herein to allow for one ounce of liquor in drinks served in Jack's during the entire audit period. This adjustment resulted in a markup on liquor purchases of 282 percent, and an adjustment of the tax deficiency herein to \$43,762.66. Petitioner maintained no bank accounts of

any kind during the audit period. As a result, he paid his suppliers and his employees in cash. The sales tax audit herein was petitioner's first.

For the period September 1, 1981 through February 28, 1983 petitioner consistently filed his quarterly sales tax returns late. Petitioner filed these returns from about 1½ months to 5 months after their respective due dates, and reported on these returns taxable sales ranging from \$760.00 to \$1,155.00. Petitioner prepared, signed and filed these returns.

For the period March 1, 1983 through May 31, 1984 petitioner failed to file sales tax returns. In response to such failure, the Division issued to petitioner delinquency assessments based upon his taxable sales reported on prior returns and increased by an arbitrary percentage. Petitioner paid the delinquency assessments issued in respect of these periods. Petitioner filed returns for the period June 1, 1984 through November 30, 1984 and reported taxable sales of \$1,925.00 and \$3,006.00 for these periods. The record does not indicate whether these returns were timely filed. With respect to the final period at issue herein, December 1, 1984 through February 28, 1985, no return was filed and no payment was made. Petitioner did not file New York State personal income tax returns for the years 1982 or 1983. The record does not indicate whether income tax returns were filed for other years. Petitioner did not file any withholding tax returns during the period at issue and paid no withholding tax over to the State. Petitioner was cooperative with the Division throughout the course of the audit. Petitioner did not personally appear at the hearing in this matter.

At the commencement of the hearing, the Division asserted, as an alternative to the fraud penalty, the penalty for failure to file a return or pay tax imposed under Tax Law § 1145(a)(1). This alternative penalty was not asserted in either the notice of determination or the Division's answer. Petitioner's representative objected to this assertion of delinquency penalty.

At hearing the Division introduced into the record purchase information obtained from petitioner's beer and liquor suppliers. As stated previously, from this information the Division determined that petitioner had actually made purchases totaling \$142,020.55 from his beer and liquor suppliers for the original audit period at issue (Finding of Fact "5[c]"). Included in this

information were detailed purchase invoices showing \$88,610.29 in beer purchases by petitioner from one of his beer suppliers and \$4,314.94 in purchases from two of petitioner's liquor suppliers during the audit period. The purchase information provided by petitioner's other suppliers consisted of summary purchase information or detailed information of uncertain origin.

### ***OPINION***

In the determination below, the Administrative Law Judge determined that in the absence of petitioner's books and records the Division of Taxation properly resorted to external indices to determine petitioner's liability for the initial audit period of September 1, 1981 through August 31, 1984. As to the period of September 1, 1984 through February 28, 1985, the Administrative Law Judge held that the use of external indices was improper because the Division did not request petitioner's records for this period. Accordingly, the Administrative Law Judge cancelled the deficiency for this period. The Administrative Law Judge further concluded that the Division had sustained its burden of proving by clear and convincing evidence that the imposition of the fraud penalty pursuant to Tax Law § 1145(a) was proper.<sup>1</sup>

On exception, petitioner challenges the Administrative Law Judge's conclusion that proof of fraud had been established by clear and convincing evidence. Specifically, petitioner assigns error to the Administrative Law Judge's finding that petitioner's willful intent to evade taxes was demonstrated by his consistent and substantial underreporting of taxable sales for the period of September 1, 1981 through August 31, 1984. Petitioner further argues that the amount he paid to satisfy certain delinquency notices may not be used as a basis to show that substantial and consistent underreporting had occurred. Additionally, petitioner asserts that the Administrative Law Judge erred in finding that petitioner's failure to maintain a bank account, the resulting "cash only" business dealings with suppliers and employees and petitioner's failure to file returns for certain periods and late filings for other periods at issue further evidenced his fraudulent intent to evade the payment of taxes in question.

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<sup>1</sup>In view of the finding of fraud, the Administrative Law Judge did not address the question of whether the Division could properly raise the negligence penalty as an alternative to the fraud penalty for the first time at the commencement of the hearing.

In response, the Division contends that the evidence demonstrates substantial and consistent underreporting of taxable sales by petitioner during the years at issue. The Division asserts that the magnitude of this pattern of underreporting of income, considered in conjunction with the other indicia of fraud evident in petitioner's course of conduct, demonstrates petitioner's willful intent to evade payment of the taxes at issue. The Division requests that we uphold the determination of the Administrative Law Judge.

We affirm the determination of the Administrative Law Judge.

Tax Law § 1145(a)(2) provides for the imposition of a civil penalty if the failure to file a return or pay over any tax is due to fraud. The burden of proving fraud by clear and convincing evidence has consistently been interpreted to reside with the Division (see, Matter of Ilter Sener d/b/a/ Jimmy's Gas Station, Tax Appeals Tribunal, May 5, 1988; Matter of A. Charles Cinelli, Tax Appeals Tribunal, September 14, 1989). We have held that imposition of the fraud penalty requires "clear, definite and unmistakable evidence of every element of fraud, including willful, knowledgeable and intentional wrongful acts or omissions constituting false representations, resulting in deliberate nonpayment or underpayment of taxes due and owing" (Matter of Ilter Sener d/b/a/ Jimmy's Gas Station, *supra*, quoting Matter of Shutt v. State Tax Commn., State Tax Commn., July 13, 1982; see, Matter of Cousins Service Station, Inc., Tax Appeals Tribunal, August 11, 1988). On the record presented here, we conclude that the Division has proven by clear and convincing evidence that petitioner acted with willful intent to fraudulently deprive the State of the sales and use taxes owed.

Because the sales tax penalty provisions are modeled after Federal penalty provisions, Federal statutes and case law are properly used for guidance in ascertaining whether the requisite intent for fraud has been established (Matter of Uncle Jim's Donut and Dairy Store, Inc., Tax Appeals Tribunal, October 5, 1989; Matter of Ilter Sener, *supra*). Factors found to be significant include consistent and substantial understatement of tax, the amount of the deficiency itself, a pattern of repeated deficiencies, the taxpayer's entire course of conduct and the taxpayer's failure to maintain bank accounts or adequate records (see, Merritt v. Commr., 301 F2d 484; Bradbury

v. Commr., T.C. Memo 1971-63; Webb v. Commr., 394 F2d 366; see also, Matter of AAA Sign Co., Tax Appeals Tribunal, June 22, 1989). Because direct proof of the taxpayer's intent is rarely available, fraud may be proved by circumstantial evidence, including the taxpayer's entire course of conduct (Intersimone v. Commr., T.C. Memo 1987-290; Stone v. Commr., 56 T.C. 213, 223-224; Korecky v. Commr., 781 F2d 1566). Fraud may not be presumed or imputed, but rather must be established by affirmative evidence (Intersimone v. Commr., supra). Hence, a finding of fraud should not be sustained where the attendant circumstances create at most only a suspicion of fraud (Goldberg v. Commr., 239 F2d 316). The issue of whether fraud with the intent to evade payment of tax has been established presents a question of fact to be determined upon consideration of the entire record (Jordan v. Commr., T.C. Memo 1986-389; see, Matter of AAA Sign Co., supra).

It is well settled that consistent and substantial underreporting of large amounts of taxable income over a period of years is strong evidence of fraud (Merritt v. Commr., supra; Jordan v. Commr., supra). It has also been noted that the mere understatement of income, standing alone, is not sufficient to establish fraud (Intersimone v. Commr., supra). Consequently, in order to establish fraud, it is necessary that other indicia of the taxpayer's specific and willful intent to evade the tax in conjunction with substantial understatement of income must be shown (see, id. [where substantial understatement of income, coupled with the showing that the taxpayer's records were incomplete and inaccurate and that the taxpayer failed to supply the bookkeeper with all relevant data warrants a finding of fraud]). Thus, along with proof of underreporting, the circumstances of the particular case must contain some affirmative indication of the required specific intent to deliberately evade payment of taxes due and owing (see, Korecky v. Commr., supra; Cirillo v. Commr., 314 F2d 478; Uncle Jim's Donut & Dairy Store, Inc., supra).

In sustaining the fraud penalty below, the Administrative Law Judge found the decisive factor to be petitioner's consistent and substantial underreporting of taxable sales for the period September 1, 1981 through August 31, 1984. He found that the magnitude of the underreporting as compared to petitioner's reported or acknowledged sales compelled the inference that

petitioner knowingly and willfully underreported his taxable sales for the period at issue. We agree that substantial underreporting by petitioner has been affirmatively proven by the Division. Contrary to petitioner's contention, we find affirmative evidence in the record, independent of the delinquency assessment and notices of determination, which clearly establishes a pattern of substantial and consistent underreporting by petitioner during the audit period. Evidence obtained and introduced in the record by the Division consisting of detailed and uncontroverted purchase information from petitioner's suppliers clearly shows that petitioner's purchases substantially exceeded reported or acknowledged sales by petitioner. In particular, the detailed purchase invoices from petitioner's suppliers show specific purchases by petitioner in an amount totaling \$92,925.23 during the initial audit period. Over the same period, petitioner reported or acknowledged by payment of delinquency notices only \$14,815.00 in total sales. That uncontroverted evidence thus demonstrates that the specific purchases by petitioner for the initial audit period exceeded his reported or acknowledged sales by more than a factor of six. Although other purchase information may be of vague and uncertain origin, we nonetheless conclude that the balance of the evidence presented by the Division, consisting of the detailed and uncontroverted purchase information from petitioner's suppliers, clearly establishes substantial underreporting of taxable sales by petitioner for the period in question (cf., Matter of Cousins Service Station, Inc., supra, [where evidence submitted by the Division to prove underreporting was found to be insufficient where the evidence consisted of a confirmation report of unknown origin containing unverifiable purchase information]). On these facts, where any mark up of petitioner's purchases would merely increase the underreporting beyond a factor of six, we conclude that petitioner's claim that a mark up audit is imprecise is of no consequence.

Petitioner argues that the amounts he paid pursuant to the delinquency notices may not be used as a basis to show consistent and substantial underreporting. This is incorrect. Petitioner's underreporting, whether it came about directly because petitioner understated his income on the filed returns or indirectly because he failed to file and was assessed and paid an amount based upon returns filed for other quarters can, in our view, be used to support a finding of fraud. In

any event, as noted above, there is affirmative evidence in the record, independent of the delinquency assessment, which clearly establishes a pattern of substantial and consistent underreporting by petitioner during the audit period.

Petitioner further argues that because the auditor who performed the audit did not testify at the hearing,<sup>2</sup> the evidence with regard to the audit is unreliable hearsay and may not form a basis for the fraud penalty. In rejecting this claim, we note that the technical rules of evidence do not apply in an administrative hearing and that it is beyond question that hearsay can be a basis for an administrative decision (see, Matter of Kucherov v. Chu, 147 AD2d 877, 538 NYS2d 339; Matter of Mira Oil Co. v. Chu, 114 AD2d 619, 494 NYS2d 458, 459, lv denied 68 NY2d 602, 505 NYS2d 1026).

Given the affirmative evidence of substantial and consistent underreporting, we now turn to the issue of whether the record discloses sufficient other indicia of fraud which demonstrate an intent by petitioner to deliberately and willfully evade payment of taxes. In addition to the consistent and substantial underreporting of taxable sales, we find the following additional factors indicative of fraudulent intent on petitioner's part: petitioner's failure to maintain bank accounts during the period at issue, the resulting absence of records of daily receipts and "cash only" business dealings with his suppliers and employees, and petitioner's failure to file sales tax returns for certain periods at issue, his untimely filings for other periods and his failure to file withholding returns for the entire period. We find no fault in the Administrative Law Judge's rejection of petitioner's explanation made to the auditor that petitioner failed to maintain a bank account and as a result dealt solely in cash transactions due to marital difficulties. It is noted that petitioner did not appear at the hearing and, in fact, offered no evidence in support of his claim that his marital problems compelled him to use the financial practices in question. Consequently, we agree with the conclusion reached below that petitioner's financial practices are further indications of petitioner's fraudulent intent. Further, we find that petitioner's failure to credibly explain the absence of his tax and business records is additional support for the finding of fraud.

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<sup>2</sup>The auditor's supervisor appeared and testified at the hearing regarding the details of the audit because the auditor who performed the audit had retired prior to the hearing.

We reject as incredible petitioner's claim that his tax and business records were unavailable at the time of the audit because a burglary had occurred at his office three days prior to the audit. Petitioner attempted to support his claim of burglary by the submission of a copy of a police report purportedly filed by petitioner with the Vestal police department. This report consists of self-serving statements by petitioner as to the circumstances of the burglary. No other evidence of the alleged burglary was produced. Petitioner's unsupported claim of burglary, which we find unworthy of belief, constitutes further evidence of fraud (see, King v. Commr., 37 T.C. Memo 1469, 1478; Mazzoni v. Commr., 451 F2d 197). Accordingly, it is our view that the cumulative impact of these circumstances and petitioner's course of conduct, coupled with the consistent and substantial pattern of underreporting proven here, is sufficient to compel the conclusion that petitioner willfully and intentionally sought to evade payment of taxes legally due.

Accordingly, it is ORDERED, ADJUDGED and DECREED that:

1. The exception of petitioner Michael T. Waples d/b/a Jack's Restaurant is in all respects denied;
2. The determination of the Administrative Law Judge is affirmed;
3. The petition of Michael T. Waples d/b/a Jack's Restaurant is granted to the extent indicated in the Administrative Law Judge's conclusions of law "C" and "H" but in all other respects the petition is denied; and

4. The Division of Taxation shall modify the notice of determination and demand, as adjusted, in accordance with paragraph "3" above, but in all other respects the notice is sustained.

DATED: Troy, New York  
January 11, 1990

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

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

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