

STATE OF NEW YORK
TAX APPEALS TRIBUNAL

In the Matter of the Petitions :
of :
AR & RA FOODS, INC. :
AND ALAN REICH, AS AN OFFICER OF : **DECISION**
AR & RA FOODS, INC. :
for Revision of Determinations or for Refund :
of Sales and Use Taxes under Articles 28 and 29 :
of the Tax Law for the Period June 1, 1983 :
through November 30, 1986. :
:

Petitioners AR & RA Foods, Inc. and Alan Reich, as an officer of AR & RA Foods, Inc., 528 South Broadway, Hicksville, New York 11801, filed an exception to the determination of the Administrative Law Judge issued on August 9, 1990 with respect to their petition for revision of determinations or for refund of sales and use taxes under Articles 28 and 29 of the Tax Law for the period June 1, 1983 through November 30, 1986 (File Nos. 805765 and 805771). Petitioners appeared by Cole, Hartman & Company, Inc. (Lawrence R. Cole, CPA). The Division of Taxation appeared by William F. Collins, Esq. (Angelo Scopellito, Esq., of counsel).

The Division of Taxation filed a letter in response to petitioners' exception. Oral argument, at the request of petitioners, was heard on January 30, 1991.

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

ISSUE

I. Whether, as the result of a field audit, the Division of Taxation properly determined additional sales tax due against petitioner AR & RA Foods, Inc. and against petitioner Alan Reich as an officer thereof.

II. If so, whether petitioners have, nonetheless, established any basis warranting reduction or cancellation of penalties imposed.

FINDINGS OF FACT

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

On March 17, 1986 the Division of Taxation ("Division") issued a letter to petitioners, AR & RA Foods, Inc. and Alan Reich, advising that a field audit of the corporation's sales and use tax returns for the period "June 1, 1983 through the present" was to be conducted.¹ This letter scheduled the field audit for April 3, 1986 and stated that "all books and records pertaining to your Sales Tax liability for the period under audit should be available. This would include journals, ledgers, sales invoices, purchase invoices, cash register tapes, exemption certificates and all Sales Tax records. Additional information may be required during the course of the audit." An attached check list provided further specifics as to those records which would be required to be available for audit. Petitioners' accountant responded to this letter and, after certain delays at his request, the audit was actually commenced on July 8, 1986.

The auditor reviewed petitioners' records, noting that petitioners lacked certain source documents pertaining to sales. More specifically, petitioners did not retain any cash register tapes nor did petitioners have any guest checks or sales invoices. The auditor also noted that since petitioners made payouts from the cash register for certain purchases and since purchase invoices were not sequentially ordered, it was not possible to verify, despite petitioners' assertions to the contrary, whether all purchase invoices were in fact present. The auditor thus determined petitioners' records to be insufficient for purposes of conducting an audit or verifying taxable sales and sales tax liability. Accordingly, the auditor decided to resort to indirect auditing methodologies, in this case an observation test of taxable sales, as a means of

¹Testimony at hearing clarified that the audit period "June 1, 1983 through the present" was meant to span the period June 1, 1983 through the sales tax quarterly period ending most immediately before the audit letter's March 17, 1986 issuance date - - i.e., the quarterly period ended February 28, 1986.

determining petitioners' sales tax liability. Petitioners' representative was advised that an observation test would be conducted on Thursday, October 6, 1986 from the time the business opened until approximately 5:00 P.M.

Petitioner AR & RA Foods, Inc. operates a delicatessen, selling cold cuts, sandwiches, salads, coffee, cigarettes, soda and certain grocery items. On the day of the observation, the auditor and one assistant recorded taxable sales of \$978.90. Gross sales as recorded in petitioners' "day book" totalled \$1,589.95. The auditor noted initially that such gross sales were 177.5% greater than average daily reported gross sales (reported gross sales divided by the total number of days in the audit period).

In conducting the audit, the following methodology and computations were employed:

(a) A review of daily gross sales per petitioners' day book for the months of January and July 1984 was made to calculate the

percentage of each day's gross sales to total weekly gross sales. Thursday sales were calculated as 16.36% of weekly sales.

(b) Gross sales on the (Thursday) observation day (\$1,589.95) were divided by the Thursday percentage of weekly gross sales (16.36%) to arrive at weekly gross sales of \$9,718.52. This latter figure was multiplied by the 182 weeks in the audit period to arrive at audited gross sales of \$1,768,771.00.

(c) Taxable sales of \$978.90, as observed, were adjusted for each day's percentage of sales (see Finding of Fact "4-a") to arrive at taxable sales for each day of the week. The resulting adjusted daily amounts were totalled to arrive at weekly taxable sales of \$5,211.14. This figure was multiplied by the 182 weeks in the audit period resulting in audited taxable sales of \$948,427.00.

(d) Audited taxable sales (\$948,427.00) compared to audited gross sales (\$1,768,771.00) results in a taxable ratio of 53.6%. Such percentage was applied to audited gross sales, as allocated per quarterly period, to obtain audited taxable sales per quarter and, in turn, tax due was computed thereon. After allowing credit for tax paid, the liability at issue herein remained.

Between the date of the observation test and the ultimate issuance of the deficiencies in question, the auditor and petitioners' representative had various conversations. The auditor offered to perform a second observation test, which offer was rejected by petitioners' representative as too disruptive to petitioners' business. The auditor also testified, although vaguely, about requesting additional records for the last three quarterly periods at issue herein, including a May 6, 1987 request for "more periods of the 1986 day books." This latter request

was met with the response that such day books had not been completed and/or were not available. No further specific evidence was presented with regard to requests for records vis-a-vis extending the audit period. The auditor utilized the same method and percentages in calculating tax due for the last three quarterly periods as was used for the balance of the audit.

On June 11, 1987, the Division of Taxation issued two notices of determination and demands for payment of sales and use taxes due to petitioner AR & RA Foods, Inc. for the audit period spanning June 1, 1983 through November 30, 1986. The first of these notices assessed tax due for such period in the amount of \$35,071.59, based on the above-described field audit results, plus penalty (Tax Law § 1145[a][1][i]) and interest. The second such notice assessed additional "omnibus" penalty only (Tax Law § 1145[a][1][vi]), for the period June 1, 1985 through November 30, 1986.

On the same June 11, 1987 date, the Division of Taxation also issued two notices of determination to petitioner Alan Reich, as an officer of AR & RA Food Co., Inc., identical in amount, period covered and penalty imposition to the two notices issued to the corporate petitioner. The record reveals that validated consents had been executed prior to issuance of the notices such that the timeliness of their issuance is not in question.

Petitioners did not maintain cash register tapes, guest checks, sales invoices or any other records of individual sales. Rather, petitioners entered total sales from the cash registers' daily summary total into a day book (which day book was available at least for a portion of the audit period and was utilized by the auditor as noted). Petitioners' method of filing sales tax returns was to take total sales per quarter from the day book, delete therefrom the amount of sales tax included therein, and apply an estimated taxable ratio thus computing taxable sales and sales tax thereon. Petitioners determined the taxable ratio by totalling and comparing taxable and gross sales for three days each year. Petitioners' taxable ratio as applied during the period at issue ranged from 45% to 50%.

Petitioner Alan Reich is the president and sole shareholder of petitioner AR & RA Foods, Inc. At hearing, petitioner Alan Reich admitted that he was a person under a duty to collect and

remit sales and use taxes on behalf of petitioner AR & RA Foods, Inc., and conceded his personal liability for any taxes determined to be due herein.

OPINION

In the determination below, the Administrative Law Judge held that the audit procedures used by the Division of Taxation (hereinafter the "Division") properly determined the amount of sales tax due from AR & RA Foods, Inc., with the exception of the last three quarterly periods assessed. In cancelling the assessment for these three quarterly periods, the Administrative Law Judge found that there was no clear evidence presented of a request for (and subsequent review of) records for the period March 1, 1986 through November 30, 1986 and, therefore, the Division exceeded its authority in assessing petitioners for such period. The Administrative Law Judge sustained the imposition of penalties except for the last three quarterly periods.

On exception, petitioners argue that their books and records were adequate even though they did not maintain cash register tapes and that the use of the observation test to determine gross sales was invalid.

The Division argues that the record clearly shows that petitioners' sales records were inadequate due to the lack of cash register tapes, thus, it was petitioners' own failure to maintain adequate, accurate and complete books and records which necessitated the resort to the indirect audit method. The Division further argues that petitioners' allegation, that a different audit method could have been used, is insufficient to warrant any adjustments to the audit findings.

We affirm the determination of the Administrative Law Judge.

Section 1135 of the Tax Law requires every person required to collect sales tax to keep records of every sale and of the tax payable thereon. "Such records shall include a true copy of each sales slip, invoice, receipt, statement or memorandum" (Tax Law § 1135[a][1]).

The Division has the authority to determine, "from such information as may be available," the amount of tax actually due from a taxpayer for a given period when any one of its sales tax

returns is either not filed or states an incorrect or insufficient amount of tax due (Tax Law § 1138[a][1]).

When the vendor maintains a comprehensive set of books and records, "such information as may be available" (Tax Law § 1138[a][1]) is restricted to its books and records, and not external indicia, because "the honest and conscientious taxpayer who maintains comprehensive records as required has a right to expect that they will be used in any audit to determine his ultimate tax liability" (Matter of Chartair, Inc. v. State Tax Commn., 65 AD2d 44, 411 NYS2d 41, 43).

To determine the adequacy of a taxpayer's records, the Division must first request (Matter of Christ Cella, Inc. v. State Tax Commn., 102 AD2d 352, 477 NYS2d 858, 859) and thoroughly examine (Matter of King Crab Rest. v. Chu, 134 AD2d 51, 522 NYS2d 978, 979-80) the taxpayer's books and records for the entire period of the proposed assessment (Matter of Adamides v. Chu, 134 AD2d 776, 521 NYS2d 826, 828, lv denied 71 NY2d 806, 530 NYS2d 109). The purpose of the examination is to determine, through verification drawn independently from within these records (Matter of Giordano v. State Tax Commn. State of New York, 145 AD2d 726, 535 NYS2d 255, 256-57; Matter of Urban Liqs. v. State Tax Commn., 90 AD2d 576, 456 NYS2d 138, 139; Matter of Meyer v. State Tax Commn., 61 AD2d 223, 402 NYS2d 74, 76, lv denied 44 NY2d 645, 406 NYS2d 1025; see also, Matter of Hennekens v. State Tax Commn., 114 AD2d 599, 494 NYS2d 208, 209), that they are, in fact, so insufficient that it is "virtually impossible (for the Division of Taxation) to verify taxable sales receipts and conduct a complete audit" (Matter of Chartair, Inc. v. State Tax Commn., supra, 411 NYS2d 41, 43; see, Matter of Christ Cella, Inc. v. State Tax Commn., supra) "from which the exact amount of tax can be determined" (Matter of Mohawk Airlines v. Tully, 75 AD2d 249, 429 NYS2d 759, 760).

Where the Division follows this procedure, thereby demonstrating that the records are incomplete or inaccurate, the Division may resort to external indices to estimate tax (Matter of Urban Liqs. v. State Tax Commn., supra). The estimate methodology utilized must be reasonably calculated to reflect taxes due, but exactness is not required from such a method

(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; Matter of Markowitz v. State Tax Commn., 54 AD2d 1023, 388 NYS2d 176, 177, affd 44 NY2d 684, 405 NYS2d 454).

In the matter at hand, petitioners do not challenge the Division's right to resort to an indirect audit method, but instead, argue that the Division should have done a markup audit, alleging that they had all of their purchase invoices. Our review of the record indicates that petitioners have not proven that they had a complete set of reliable purchase invoices. Petitioner Alan Reich testified that he had no register tapes to verify the receipts for the day and, further, he paid for supplies with cash from the cash register (Tr., p. 59). These statements reveal that the completeness of the purchase invoices was not subject to verification by the Division. The Division cannot be required to rely on such unverifiable records (see, Matter of Vebol Edibles v. State of New York Tax Appeals Tribunal, 162 AD2d 765, 557 NYS2d 678, lv denied 77 NY2d 803, ___ NYS2d ___; Matter of Club Marakesh v. Tax Commn. of State of New York, 151 AD2d 908, 542 NYS2d 881, lv denied 74 NY2d 616, 550 NYS2d 276). Failing to prove the existence of adequate records, petitioners certainly have not proved that the instant audit's failure to utilize such records was erroneous.

Next we address petitioners' argument that the auditor's use of the gross sales figure as recorded by petitioners for the day of the observation should nullify the use of the observation test to project gross sales. The essence of petitioners' claim is that since the auditor used petitioners' books to determine the gross sales on the observation day, the auditor was required to use petitioners' books to determine gross sales for the entire audit period. We find petitioners' contention totally without merit. First, the use of petitioners' records for one purpose, to determine gross sales for one day, does not act as an endorsement of the records for all purposes for the whole audit period. Second, the reliability of petitioners' record of gross sales for the entire audit period was called into question by the record of gross sales made by petitioner during the observation day. The observed day's gross sales were 177.5% higher than the average daily sales. Finally, even without such a discrepancy, we could not require the

Division to accept petitioners' unverifiable, self-serving records of gross sales (see, Matter of Vebol Edibles v. State of New York Tax Appeals Tribunal, supra).

Petitioners' burden is to establish by clear and convincing evidence that the audit method was erroneous (Matter of Surface Line Operators Fraternal Org. v. Tully, 85 AD2d 858, 446 NYS2d 451). Petitioners had the burden to establish error in the audit result (see, Matter of Carmine Rest. v. State Tax Commn., 99 AD2d 581, 471 NYS2d 402) and they failed to establish any such error herein. Where a taxpayer's own failure to maintain adequate, accurate and complete books and records requires resort to indirect audit techniques, exactness is not required of the Division in arriving at its determination (Matter of Meyer v. State Tax Commn., supra). Thus, the consequences of recordkeeping failures in this regard weigh heavily against the taxpayer and we must sustain the use of the observation test (see, Matter of Club Marakesh v. Tax Commn., supra; Matter of Meskouris Bros. v. Chu, 139 AD2d 813, 526 NYS2d 679).

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

Accordingly, it is ORDERED, ADJUDGED and DECREED that:

1. The exception of petitioners AR & RA Foods, Inc. and Alan Reich, as an officer of AR & RA Foods, Inc., is denied;
2. The determination of the Administrative Law Judge is affirmed;
3. The petition of AR & RA Foods, Inc. and Alan Reich, as an officer of AR & RA Foods, Inc., is granted to the extent indicated in conclusions of law "D" and "F" of the Administrative Law Judge's determination but is otherwise denied; and
4. The Division of Taxation is directed to modify the Notices of Determination and Demand for Payment of Sales and Use Taxes Due dated June 11, 1987 in accordance with paragraph "3" above but such notices are otherwise sustained.

DATED: Troy, New York
May 2, 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