

STATE OF NEW YORK
TAX APPEALS TRIBUNAL

In the Matter of the Petition	:	
of	:	
NINA SPALLINA T/A NINA'S CORNER	:	DECISION
for Revision of a Determination or for Refund	:	DTA Nos. 806651
of Sales and Use Taxes under Articles 28 and 29	:	& 806652
of the Tax Law for the Period June 1, 1984	:	
through February 28, 1987.	:	

The Division of Taxation filed an exception to the determination of the Administrative Law Judge issued on January 4, 1991 with respect to the petition of Nina Spallina T/A Nina's Corner, 133 McClean Avenue, Staten Island, New York 10305 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 June 1, 1984 through February 28, 1987. Petitioner appeared by Murray Selman, C.P.A. The Division of Taxation appeared by William F. Collins, Esq. (Gary Palmer, Esq., of counsel).

The Division of Taxation filed a brief in support of its exception. Petitioner filed a brief in response. Oral argument, at the Division of Taxation's request, was heard on September 5, 1991.

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

ISSUES

I. Whether the audit methodology employed by the Division of Taxation was reasonably calculated to reflect tax due from petitioner.

II. Whether, if the audit methodology was reasonable, petitioner has established that the results obtained were incorrect.

FINDINGS OF FACT

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

The Division of Taxation ("Division") issued to petitioner, Nina Spallina, two notices of determination and demands for payment of sales and use taxes due dated February 24, 1988. One notice assessed tax due for the period June 1, 1984 through February 28, 1987 of \$72,601.31 plus penalty and interest.¹ The other notice assessed an additional penalty of \$4,627.74 for the period June 1, 1985 through February 28, 1987.

Petitioner requested a conciliation conference with the Division to address both notices issued to her. By the issuance of a conciliation order dated December 23, 1988, the Division denied petitioner's request with regard to that notice which assessed tax due, on the ground that the request was not timely made. At hearing, the Division conceded that there were timely requests for a conciliation conference with regard to both notices, and it withdrew its contention that the Division of Tax Appeals lacked subject matter jurisdiction over these matters.

The audit of petitioner's business, Nina's Corner, began in May 1987. On May 21, 1987, two auditors visited Nina's Corner and found it to be a pizzeria, selling pizzas, sandwiches, calzones, and prepared dinners. The store was very small, but there were three tables and a counter to serve customers. There were three employees on the premises at the time of the auditor's visit. Apparently, the auditors did not identify themselves or speak with the employees at this time. The auditors obtained a copy of a menu showing prices of each item sold.

On or about May 27, 1987, the Division mailed a letter to petitioner scheduling an audit appointment and requesting books and records for the period June 1, 1983 through February 28, 1987, including: journals, ledgers, sales invoices, purchase invoices, cash register tapes, exemption certificates and all other sales tax records. In addition, oral requests were made for petitioner's Federal income tax returns, bank statements, purchase invoices and cash register tapes. Petitioner's accountant provided the Division with records of bank deposits, Federal income tax returns and copies of 1986 purchase invoices. Petitioner's accountant informed the

¹On August 3, 1987, petitioner executed a consent extending the period of limitation for assessment of sales and use taxes for the period June 1, 1984 through November 30, 1984 to March 20, 1988.

Division that he prepared petitioner's sales tax returns by estimating taxable sales as a percentage of gross sales. Petitioner never furnished the Division with any records of individual sales.

During the course of the audit, petitioner's accountant informed the Division that Nina's Corner was operated as a combination delicatessen and grocery store during the audit period and that it was not operated as a full-time pizzeria. To test this statement, the auditor consulted yellow pages of the 1985 Staten Island telephone directory. He found a one-quarter page advertisement holding the business out as Nina's Pizzeria. According to the advertisement, Nina's sold small (14 inch), medium (16 inch) and large (19 inch) pizzas, complete dinners, soups, salads, calzones and hero sandwiches. Petitioner advertised her hours as 11:00 A.M. to midnight during the week and 4:00 P.M. to 11:00 P.M. on Sundays. She also offered free delivery and catering. Because of this advertisement, and because the business was not operated as a grocery at the time of the auditor's visit, the Division concluded that petitioner operated as a pizzeria throughout the audit period.

Other than the observation which took place on May 21, 1987, the Division's only contact with petitioner consisted of telephone calls between the auditor and petitioner's accountant and documents exchanged by mail.

The auditor who conducted this audit was supplied by the Division with a schedule of mozzarella cheese purchases made by petitioner. The schedule lists weekly purchases for the period December 5, 1985 through February 27, 1986. For each week, it shows an invoice number, total invoice amount, pounds of mozzarella cheese purchased, and the dollar amount of the cheese purchases. There are also columns on the schedule for flour purchases and pizza box purchases, but these columns are blank. The total invoice amounts for these periods was \$8,393.45, while total mozzarella cheese purchases amounted to \$7,266.28. The supplier is identified as C & F Dairy. The auditor who conducted this audit did not prepare this schedule and did not know how it was prepared.

The Division compared cheese purchases taken from petitioner's 1986 purchase invoices with the information provided by petitioner's supplier and concluded from this that the invoices

supplied by petitioner were incomplete.² Because of this and petitioner's failure to provide any records of sales, the Division decided to estimate petitioner's taxable sales using an indirect audit method.

The information from petitioner's supplier, showing that for the period December 1, 1985 through February 28, 1986, petitioner purchased 4,753 pounds of mozzarella at a cost of \$7,266.28, became the basis for a test period audit.

The Division obtained a recipe for the commercial preparation of pizza at the public library. The recipe is published in Food Products Formulary, Vol. II, by Tressler and Sultan. It calls for 12 ounces of dough to be used with 3 ounces of mozzarella and other ingredients to make one pizza. The Division estimated that petitioner would use 8 ounces of mozzarella to make one medium sized (16 inch) pizza. The difference between the recipe and the Division's estimate was meant to give an allowance for waste, self-use, spoilage, the use of cheese in products other than pizza and other variables.

The Division estimated that petitioner sold 9,506 medium sized pizzas in the test period by dividing the number of pounds of cheese purchased by petitioner by .5. The number of pizzas sold was multiplied by \$5.60, the price of a medium sized pizza as shown on the menu obtained by an auditor in May 1987, to estimate pizza sales for the test period of \$53,234.00.

The Division estimated that sales of all other items (soda, sandwiches, dinners, etc.) were 25 percent of pizza sales, or \$13,308.00. Thus, total sales for the test period were estimated to be \$66,542.00.

Total taxable sales reported by petitioner for the same period were \$1,796.00. The difference between audited taxable sales and reported taxable sales was deemed to be additional taxable sales of \$64,746.00. An error rate of 36.05 was calculated by dividing additional taxable sales by reported taxable sales.

²The extent of the difference is not established by the record. The supplier information shows cheese purchases of \$4,871.68 for the months of January and February 1986. The auditor testified that "purchases supplied by the vendor for the entire year 1986 for cheese, total \$25,646.90" (Transcript, p. 27). The Field Audit Narrative states that purchase invoices provided by petitioner totalled \$2,564.90 for the entire year. Since neither party offered the invoices themselves, or a schedule of the invoices, into evidence, this disparity cannot be reconciled.

To determine petitioner's unreported taxable sales, the Division increased reported taxable sales for the audit period by the error rate, calculating total additional taxable sales of \$880,016.00 with a tax due on that amount of \$72,601.31.

Petitioner provided the Division with Federal income tax returns for the years 1983 through 1986. On the 1985 and 1986 return, petitioner identifies the main business activity of Nina's Corner as that of a grocery. Petitioner also supplied the Division with bank statements for the period June 14, 1983 through February 13, 1987. Generally, gross sales reported to New York State exceeded both gross receipts reported for Federal purposes and bank deposits. Federal gross receipts reported for 1984, 1985 and 1986 totaled \$128,551.00. Gross sales reported on sales tax returns for the period June 1, 1984 through February 28, 1987 totaled \$135,336.00. Bank deposits for the period June 15, 1983 through February 13, 1987 totaled \$111,147.00.

During the audit period, Nina's Corner operated as a combination grocery and delicatessen, selling cheese, tomato sauce, uncooked pizza dough, milk, newspapers and a few other small items, as well as prepared pizzas and sandwiches. It was located in a small building next door to the home of petitioner and her husband. The business's telephone and other utilities were connected to the home and billed as one account. A sign on the side of the building indicates that the business sold bread, milk, soda and bagels in addition to pizza. The space occupied by the business was approximately 11 feet by 15 feet. There were no tables or chairs on the premises. There was a counter and a large refrigerator where milk and other perishables were kept. There was only one pizza oven on the premises. Prepared pizzas and pizza slices were sold in the late afternoon and evening and were delivered by petitioner's husband in the family car. He delivered five to six pizzas per evening.

In January 1987, petitioner's son joined the business. At that time, a corporation, named Spallina's Corner, Inc., was formed to operate the business, the inside of the building was renovated, tables and chairs were added, and the business discontinued its sales of grocery items and began selling dinners and other prepared foods exclusively. Beginning in March 1987, the

corporation began filing sales tax returns under its own name, with a separate certificate of authority. Thus, the business was operated differently during the audit period than at the time the audit was conducted.

Petitioner opened her business in 1979 or 1980. She always planned to convert her business into a full-time pizzeria; therefore, she placed an advertisement in the yellow pages of the telephone directory, paying approximately \$400.00 per month for this service. She was convinced by a telephone company salesperson that it was essential to maintain this advertisement if she ever wanted to operate exclusively as a pizzeria.

During the audit period, petitioner purchased cheese from C & F Dairy for herself and for a Mr. Borillo. Mr. Borillo owned and operated a pizzeria in Philadelphia. He knew that he would be able to purchase cheese at a lower price from C & F than he could buy it in Philadelphia; however, C & F would not deliver to Philadelphia. An arrangement was worked out whereby C & F sales to Mr. Borillo were delivered to him at Nina's Corner. This arrangement benefitted petitioner as well because it allowed her to purchase cheese from C & F at a lower price than she would otherwise be able to do. C & F Dairy billed petitioner for all cheese delivered to her. The C & F invoices did not separately state the purchases made by Mr. Borillo; however, there were informal notations attached to the invoices, indicating the amounts of Mr. Borillo's purchases. Petitioner paid for all cheese delivered to her, and in turn, she was paid by Mr. Borillo in cash. Petitioner did not keep records of her transactions with Mr. Borillo. A letter from C & F indicates that four to five cases were delivered at a time for Mr. Borillo. Petitioner's son testified that each C & F bill had a piece of paper attached "saying that Borillo picked up three or four, or five cases of cheese that week" (transcript, p. 82). The schedule of information taken from petitioner's supplier indicates that there were weekly deliveries of cheese.

Petitioner's sales tax returns were prepared by her accountant, Murray Selman. They met at least once per quarterly period in her home or in the store. Apparently, all of petitioner's bills were paid in cash. He reviewed petitioner's bank statements, purchase invoices and any other records she had of cash payments. The accountant calculated petitioner's gross sales by adding

together bank deposits, cash purchases and payments to petitioner and her husband. Based on what he was told by petitioner he estimated taxable sales to be approximately 20 percent of gross sales. Petitioner did not maintain any records of sales or complete records of purchases.

Mr. Selman was familiar with petitioner's business operations. In preparing tax returns, he reviewed some purchase invoices from C & F Dairy which included notations regarding purchases made by Mr. Borillo. He discussed the business operations with petitioner and her son. When petitioner's son decided to enter the business run by his parents, Mr. Selman advised him to form a corporation for the operation of the business. He also advised him to discontinue operating Nina's Corner as a grocery and part-time pizzeria, and to begin operating only as a pizzeria with a wider variety of menu items and with seating space on the premises. Based on his familiarity with the business, information supplied by petitioner and her son and his review of purchase invoices during the audit period, Mr. Selman calculated petitioner's cheese purchases and sales for the test period used by the Division. Purchases by Mr. Borillo from C & F Dairy amounted to 1,976 pounds for the test period. This was based on deliveries of four cases of cheese per week containing 38 pounds of cheese per case. Cheese sold in bulk as a grocery item totaled 1,560 pounds, or twenty pounds per day. Waste and self-use was estimated at 164 pounds of cheese for the test period. The balance of petitioner's cheese purchases, 1,053 pounds, was used as a basis to estimate pizza sales.

Mr. Selman estimated petitioner's sales for the audit period, again based on his own familiarity with the business and information provided by petitioner. He estimated that petitioner used approximately 1¼ pounds of cheese per medium sized pizza. Dividing this into cheese purchased during the test period for use in making pizzas (1,053 pounds), he calculated that petitioner sold 842.4 pizzas during the test period at a price of \$5.60 per pizza. Thus, pizza sales for the test period were computed to be \$4,718.00. Mr. Selman increased this amount by 15 percent to account for sales of soda and prepared sandwiches, thus estimating total taxable sales for the test period of \$5,426.00. He multiplied this number by 12 to estimate taxable sales for the

audit period of \$65,112.00, with a tax due on this amount of \$5,371.74. For the audit period, petitioner reported taxable sales of \$24,411.00.

OPINION

The Administrative Law Judge determined that petitioner failed to maintain adequate books and records and that the Division properly resorted to determining petitioner's taxable sales based on external indices. However, the Administrative Law Judge determined that the purchase markup method chosen by the Division was not properly applied to petitioner because, under the circumstances, the audit failed to take into account facts directly related to petitioner's business. Specifically, the Administrative Law Judge determined that petitioner, through her own credible testimony and that of her son and her accountant, who was familiar with the business, as well as through pictures of the sign appearing on the face of the business premises and her Federal tax returns which identified the main business activity of Nina's Corner (hereinafter "Nina's") as a grocery, established that during the audit period her business operated as a grocery which sold some pizza and was not operated solely as a pizzeria as asserted by the Division.

The Administrative Law Judge found the situation here similar to that in Matter of Ristorante Puglia, Ltd. v. Chu (102 AD2d 348, 478 NYS2d 91) and determined that under the facts and circumstances of the case the appropriate remedy was to modify the audit by making an allowance for the fact that petitioner did not use all the cheese shown on the purchase invoices inspected by the Division as a pizza ingredient.³

³In Matter of Ristorante Puglia, Ltd. v. Chu (*supra*), the Court determined:

"Here, in our view, the methodology employed was unreasonable because it was not calculated to accurately reflect the tax due. The bureau's auditor knew that Ristorante purchased food and supplies for the restaurant in Manhattan as well as the restaurant in Brooklyn. Yet, the canvass statement sent to suppliers did not request the suppliers to state whether the sales were for the Manhattan restaurant, the Brooklyn restaurant or both. Next, suppliers should have been asked what sales were made directly to the taxpaying entity that operated the Brooklyn eatery. More important, to arrive at the best estimates, the bureau should have deducted from the sales made by Ristorante the taxable sales reported by the second restaurant. Since the record contains clear and convincing evidence that the canvass results reflected purchases by Ristorante for two restaurants, the determination of taxable sales by applying

(continued...)

The Administrative Law Judge, based on the testimony of petitioner's son, the statements of petitioner's accountant, who was familiar with petitioner's business for the period at issue, and a letter from petitioner's cheese supplier confirming petitioner's allegations, determined that approximately 1,976 pounds of cheese shown on invoices for the test period were actually delivered to petitioner for another party, Mr. Mike Borillo.

Based on the credible testimony of petitioner and her son, the statements of petitioner's accountant, who was familiar with the business, and through the schedule prepared by the accountant, the Administrative Law Judge determined that petitioner demonstrated that not all of the cheese purchased for her own use was used in making pizzas, but that a portion (1,560 pounds) was sold as a grocery item during the test period. The Administrative Law Judge concluded that while the schedule prepared by the accountant was hearsay evidence, it was admissible into evidence and could form the basis for a determination if deemed credible and probative (Matter of Gray v. Adduci, 73 NY2d 741, 536 NYS2d 40; Matter of Flanagan v. New York State Tax Commn., 154 AD2d 758, 546 NYS2d 205).

The Administrative Law Judge, relying on the statements of petitioner's accountant, who was familiar with petitioner's business and operating procedures, and the lack of evidence to support the Division's estimate of eight ounces of cheese for each of petitioner's pizzas, accepted petitioner's assertion that twenty ounces of cheese was used in each sixteen inch pizza.

The Administrative Law Judge determined that the Division's use of a 25 percent factor to estimate taxable sales other than pizza was without any basis, and accepted petitioner's estimate that such items amounted to 15 percent of pizza sales on the basis that such result was consistent

³(...continued)

markup percentages to the canvassed purchases necessarily reflects the erroneous calculation of those purchases. Further, [name omitted] the sole meat supplier to both restaurants, testified that his canvassed statement was for purchases intended for both restaurants. Juxtaposed to the proof supplied by petitioners is the evidence offered by the bureau in support of its calculations. Such evidence consisted solely of statements made by 25 nontestifying suppliers, six of which were unsigned and 14 of which were impeached by subsequent affidavits by the same suppliers" (Matter of Ristorante Puglia, Ltd. v. Chu, supra, 478 NYS2d 91, 93).

with the fact that petitioner operated as a grocery store during the audit period, rather than a full-time pizzeria.

Finally, the Administrative Law Judge rejected petitioner's estimate of the amount of cheese used for personal use and waste as not supported by any evidence.

On exception, the Division asserts that the Administrative Law Judge's reliance on Ristorante Puglia is misplaced and that under the circumstances, in particular, the lack of adequate books and records by petitioner, the Administrative Law Judge erred in determining that petitioner, through clear and convincing evidence, proved that the Division's methodology was unreasonable. Specifically, the Division asserts that the Administrative Law Judge did not properly weigh the evidence submitted by the Division and that the record does not support the conclusions of the Administrative Law Judge concerning the nature of petitioner's business operations during the audit period; that only a portion of the cheese was purchased for her own use; that not all of what she purchased for her own use was used in making pizzas; and that she used twenty ounces of cheese in her pizzas.

In sum, the Division asks us to reject the findings of the Administrative Law Judge and accept as reasonable its audit methodology which concluded that in the thirteen week test period (December 1, 1985 through February 28, 1986), petitioner purchased 4,753 pounds of mozzarella cheese for her own use; that petitioner, with one pizza oven, in a business space approximately 11 feet by 15 feet, used all of that cheese to make and sell 9,506 medium size pizzas;⁴ and that, including soda and other items, petitioner had total additional taxable sales of \$880,016.00 for the audit period.

Petitioner asserts that the determination of the Administrative Law Judge is correct in all respects.

We affirm the determination of the Administrative Law Judge.

⁴For the test period, this breaks down to 731 pizzas a week, or 104 pizzas a day, or 8.7 pizzas an hour (based on a twelve hour business day) or one pizza every 6.8 minutes. Prorated on an annual basis, the number is 38,029 pizzas.

Where the records of the taxpayer are insufficient or inadequate to permit an exact computation of the sales and use tax due, the Division is authorized to estimate the tax liability on the basis of external indices (Tax Law § 1138[a][1]; see, Matter of Ristorante Puglia, Ltd. v. Chu, supra; Matter of Surface Line Operators Fraternal Org. v. Tully, 85 AD2d 858, 446 NYS2d 451). However, the methodology selected must be reasonably calculated to reflect the taxes due (Matter of W. T. Grant Co. v. Joseph, 2 NY2d 196, 159 NYS2d 150, cert denied 355 US 869; Matter of Ristorante Puglia, Ltd. v. Chu, supra) but since the taxpayer's failure to maintain records prevents exactness, exactness in the outcome of the audit method is not required (Matter of Meyer v. State Tax Commn., 61 AD2d 223, 402 NYS2d 74, lv denied 44 NY2d 645, 406 NYS2d 1025; Matter of Markowitz v. State Tax Commn., 54 AD2d 1023, 388 NYS2d 176, affd 44 NY2d 684, 405 NYS2d 454; Matter of Lefkowitz, Tax Appeals Tribunal, May 3, 1990). While it is true that "considerable latitude is given an auditor's method of estimating sales under such circumstances as exist" in each case (Matter of Grecian Sq. v. New York State Tax Commn., 119 AD2d 948, 501 NYS2d 219), certain limitations have been placed on this principle. It is necessary that the record contain sufficient evidence to allow the trier of fact to determine whether the audit has a rational basis (Matter of Grecian Sq. v. New York State Tax Commn., supra) and, further, that the record contain specific information identifying the external index employed by the Division in estimating the taxpayer's liability (Matter of Fashana, Tax Appeals Tribunal, September 21, 1989). The burden rests with the taxpayer to show by clear and convincing evidence that the methodology was unreasonable or that the amount assessed was erroneous (Matter of Meskouris Bros. v. Chu, 139 AD2d 813, 526 NYS2d 679; Matter of Surface Line Operators Fraternal Org. v. Tully, supra).

Where a "taxpayer demonstrates that 'the [Division] in stating the account has proceeded upon a principle or theory fundamentally erroneous' the assessment may be set aside (People ex rel. Charles Kohlman & Co. v. Law, 239 NY 346, 352, 146 N.E. 622, 625). The same rule prevails in the Federal courts (Gasper v. Commissioner of Internal Revenue, 6 Cir., 225 F2d 284)" (Babylon Milk & Cream Co. v. Bragalini, 5 AD2d 712, 169 NYS2d 124, 126, affd 5 NY2d

736, 177 NYS2d 717; see also, Matter of Chartair, Inc. v. State Tax Commn., 65 AD2d 44, 411 NYS2d 41).

If the taxpayer proves the methodology unreasonable, he need not prove the proper amount of the assessment (Helvering v. Taylor, 293 US 507).

The record is clear in this case that the resort to an external index was proper since petitioner's records were inadequate. The issue is whether the methodology chosen by the Division was reasonably calculated to estimate petitioner's taxable sales.

After reviewing the allegations presented to us on exception and the record before us, we find no basis for modifying the Administrative Law Judge's determination.

Specifically, we note that the credibility of witnesses is a determination within the domain of the trier of the facts, the person who has the opportunity to view the witnesses first hand and evaluate the relevance and truthfulness of their testimony (see, Matter of Berenhaus v. Ward, 70 NY2d 436, 522 NYS2d 478). While this Tribunal is not absolutely bound by an Administrative Law Judge's assessment of credibility and is free to differ with the Administrative Law Judge to make its own assessment, we find nothing in the record here to justify such action on our part (see, Matter of Stevens v. Axelrod, 162 AD2d 1025, 557 NYS2d 809).

Accordingly, it is ORDERED, ADJUDGED and DECREED that:

1. The exception of the Division of Taxation is denied;
2. The determination of the Administrative Law Judge is affirmed;
3. The petition of Nina Spallina T/A Nina's Corner is granted to the extent indicated in conclusions of law "D," "E," "F" and "G" 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 for the periods June 1, 1984 through February 28, 1987 and June 1, 1985 through February 28, 1987 to the extent indicated in paragraph "3" above, but such notices are otherwise sustained.

DATED: Troy, New York
February 27, 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