

STATE OF NEW YORK
TAX APPEALS TRIBUNAL

In the Matter of the Petition :
of :
SHOP RITE WINES & LIQUORS, INC. : DECISION
AND MRIDULA KHURANA, AS OFFICER :
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, 1983 through February 28, 1986. :

Petitioners Shop Rite Wines and Liquors, Inc. and Mridula Khurana, as officer, 2073 Second Avenue, New York, New York 10029, filed an exception to the determination of the Administrative Law Judge issued on June 21, 1990 with respect to their 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, 1983 through February 28, 1986 (File No. 806762). Petitioners appeared by Mehler & Buscemi, Esqs. (Martin P. Mehler, Esq., of counsel). The Division of Taxation appeared by William F. Collins, Esq. (Gary Palmer, Esq., of counsel).

Petitioners filed a brief on exception. The Division submitted a letter in lieu of a brief. Oral argument was requested by petitioners, but was denied.

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

ISSUES

- I. Whether the markup audit performed on petitioners' products was erroneous.
- II. Whether the auditor was in error for failing to allow a greater percentage for theft and breakage of petitioners' products.

FINDINGS OF FACT

We find the facts as determined by the Administrative Law Judge except for finding of fact "2(g)" which has been modified. We have also made an additional finding of fact. The Administrative Law Judge's findings of fact, the modified finding of fact and the additional finding of fact are set forth below.

On December 10, 1986, the Division of Taxation ("Division") issued to petitioner Shop Rite Wines & Liquors, Inc. ("Shop Rite") a Notice of Determination and Demand for Payment of Sales and Use Taxes Due for the period September 1, 1983 through February 28, 1986, assessing sales tax in the amount of \$59,430.00 plus penalty and interest. On the same date, an identical notice was issued to petitioner Mridula Khurana, as officer of Shop Rite.

The issuance of the statutory notices followed an audit of Shop Rite's business operations for the period September 1, 1983 through February 28, 1986.

By letter dated April 24, 1986, the Division scheduled an audit appointment for May 19, 1986. The letter stated:

"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, such as Federal Income Tax Returns."

At petitioners' request, the initial audit appointment was postponed to June 16, 1986 at the Division's offices.

On June 11, 1986, the auditor visited Shop Rite's business premises. Shop Rite is a retail liquor store located in a relatively high crime area in New York City. The auditor spoke briefly with Mr. Khurana asking him whether prices shown on bottles of liquor and wine included sales tax. Mr. Khurana stated that tax was included in all prices. Whether a sign indicating that prices included tax was visible on the premises is a matter of dispute between the parties. The auditor made a listing of some liquor prices at this time, but apparently did nothing with this information.

On June 16, 1986, Shop Rite's representative delivered to the Division a box containing Shop Rite's books and records for the audit period. The representative did not discuss the audit with the Division at this time. The records provided consisted of a daybook, a cash receipts journal, a cash disbursements journal, a stack of purchase invoices, Federal income tax returns, and State sales tax returns. Cash register tapes were not provided.

An analysis of Shop Rite's records disclosed discrepancies in three areas. Shop Rite's sales as shown on its Federal income tax return for the period August 31, 1984 through July 31, 1985 were higher than sales shown in its daybook for the same period. Bank deposits for the audit period were higher by \$156,972.00 than cash receipts per the daybook. Purchases for the period August 15, 1983 through July 31, 1985 per the Federal return were \$66,265.00 higher than purchases per the daybook. Because of these discrepancies and because Shop Rite did not provide a verifiable record of individual sales, such as cash register tapes, Shop Rite's records were deemed inadequate for audit.

The Division obtained information regarding Shop Rite's wine and liquor purchases from Shop Rite's suppliers. These third-party suppliers reported total purchases by Shop Rite of \$2,163,938.00. This amount was \$339,471.00 higher than the amount shown in Shop Rite's cash disbursements journal.

We modify finding of fact "2(g)" of the Administrative Law Judge to read as follows:

The auditor performed a test period markup audit. Purchase invoices made available for the month of February 1986 provided the cost of wine and liquor to Shop Rite. Selling prices of the items shown on the purchase invoices were obtained from Mrs. Khurana (the wife of petitioner Mridula Khurana) and an unrelated employee. They indicated that some items were sold with tax included in the price and some were not, and the auditor adjusted the selling prices accordingly, i.e., he subtracted the sales tax from those prices where it was included. The auditor calculated a wine markup of 24.49 percent, a liquor markup of 39.02 percent and a combined markup of 28.33 percent. The combined markup was applied to total purchases per third-party verification to calculate audited taxable sales of \$2,776,982.00. Reported taxable sales were subtracted from audited taxable sales to determine additional

taxable sales of \$720,360.00 with a tax due on that amount of \$59,430.00.¹

Following a conciliation conference, the Division agreed to reduce the tax assessment to \$37,277.46. This reduction resulted from several adjustments to purchases. Purchases were reduced by \$7,500.00 to correct an error made by the Gallo Company in its report of Shop Rite's purchases. Purchases were increased by \$48,935.00, representing inventory purchased by Shop Rite from prior owners of the retail store. A two percent allowance for breakage and theft reduced purchases by \$44,107.00. Net inventory on hand at the end of the audit period reduced purchases by \$137,000.00. These adjustments resulted in total purchases of \$2,024,266.00. Shop Rite's representative pointed out that the cost of liquor was higher in June 1986 than it had been in February 1986. Since the auditor applied June prices to February costs, the calculated markups were too high. Using purchase invoices from June 1986, the auditor calculated a reduced markup of 23.92 percent. This markup was applied to purchases to obtain total taxable sales of \$2,508,470.00. Additional taxable sales were determined to be \$451,848.00, with a tax due on that amount of \$37,277.46. The Division issued notices of assessment review to petitioners, assessing sales tax in the amount of \$37,277.40 plus penalty and interest.

¹The Administrative Law Judge's finding of fact "2(g)" read as follows:

The auditor performed a test period markup audit. Purchase invoices made available for the month of February 1986 provided the cost of wine and liquor to Shop Rite. Selling prices of the items shown on the purchase invoices were obtained from Mrs. Khurana (the wife of petitioner Mridula Khurana) and an unrelated employee. They indicated that some items were sold with tax included in the price and some were not, and the auditor adjusted the selling prices accordingly. The auditor calculated a wine markup of 24.49 percent, a liquor markup of 39.02 percent and a combined markup of 28.33 percent. The combined markup was applied to total purchases per third-party verification to calculate audited taxable sales of \$2,776,982.00. Reported taxable sales were subtracted from audited taxable sales to determine additional taxable sales of \$720,360.00 with a tax due on that amount of \$59,430.00."

We modified the fact to clarify that the auditor subtracted sales tax from the price of items where it was appropriate.

The adjustments made after the conciliation conference were based primarily on representations made by petitioners' representative in a letter to the Division.

Shop Rite used one cash register to record sales. The register produced a single tape both sides of which were used to record sales. When the tape was exhausted, it was discarded. Receipts were not ordinarily provided to the customer. If one was requested, it was prepared on a slip of paper.

Shop Rite's books and records were maintained by its accountant. Petitioners did not explain the methods by which records of sales and purchases were kept. They acknowledged that the accountant was not informed of cash purchases which caused some discrepancy in the records.

For the year ended July 31, 1986, Shop Rite reported an end of year inventory of \$166,475.00 on its Federal return. This return was not available to the Division at the time of the audit.

We find in addition to the facts found by the Administrative Law Judge that petitioners suffered a 7% loss of inventory due to theft and breakage during the audit period.

OPINION

The Administrative Law Judge found that petitioners' books and records were inadequate, and that resort to an estimate audit was appropriate. Moreover, the Administrative Law Judge found that petitioners failed to sustain their burden to show by clear and convincing evidence that the markup audit or the percentage allowed for breakage and theft of petitioners' products was erroneous.

With respect to the markup audit, the Administrative Law Judge determined that petitioners were obligated to prove that the Division's calculations resulted in an overstatement of taxable sales. Yet, the Administrative Law Judge found that petitioners did no more than estimate their taxable sales. The Administrative Law Judge further stated that although Mr. Khurana's testimony did support a conclusion that some adjustment to the percentage for

breakage and theft was reasonable, such testimony was not sufficient to show that such percentage amounted to 5% of inventory.

In their exception, petitioners argue that sales tax was included twice by the auditor in his calculations. Petitioners contend that the auditor included the sales tax when calculating the markup percentage, and then tax was applied against the total sales number calculated by the auditor. Furthermore, petitioners argue that because their liquor store is located in East Harlem, a high crime area, as well as the fact that breakage is a big problem for petitioners, it is unconscionable under the circumstances to limit theft and breakage to 2% of inventory.

In response, the Division asserts that petitioners have failed to substantiate the claims underlying their tax computation.

We affirm, in part, and reverse in part, the determination of the Administrative Law Judge.

The Division's right to resort to a markup audit to estimate taxes arises from the taxpayer's failure to maintain records adequate to determine that tax has been charged on all taxable items (Matter of Licata v. Chu, 64 NY2d 873, 487 NYS2d 552). Thus, estimates by the Division of a taxpayer's liability are acceptable on the principle that "where the taxpayer's own failure to maintain proper records prevents exactness in determination of sales tax liability, exactness 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).

The rule in these types of cases is that the petitioner has the burden to prove by clear and convincing evidence, that the method of audit used or the amount of tax assessed was erroneous (Matter of Meskouris Bros. v. Chu, 139 AD2d 813, 526 NYS2d 679, 681; Matter of Surface Line Operators Fraternal Org. v. Tully, 85 AD2d 858, 446 NYS2d 451, 453). A taxpayer cannot successfully challenge the Division's determination of taxable sales merely by offering its own estimate of its tax liability (Matter of Meskouris Bros. v. Chu, supra).

In our case, petitioners argue that the audit was improper because the auditor included sales tax when he calculated the markup percentage, and then he applied sales tax to the total sales number. We cannot agree.

According to the auditor's testimony and his worksheets submitted at hearing, it is clear that the auditor did not apply sales tax twice. The auditor "backed out" the sales tax on the items that were found to have the sales tax included in its shelf price, prior to his calculating the markup percentage on petitioners' sales. Only when the auditor finally calculated total sales did he apply the sales tax. Therefore, we find that petitioners' claim that sales tax was included twice in the markup audit is unfounded.

Next, petitioners contend that a 2% allowance for breakage and theft is too low a percentage based on the location of their liquor store. The Division argues that the percentage used by the auditor was reasonable and should be sustained.

The auditor testified at the hearing that he applied a 2% allowance for theft and breakage based on his prior two liquor store audits (Tr., p. 39). When the auditor was asked again on redirect by the Division's attorney about the waste allowance, the auditor testified that he thought the audit guidelines applicable to liquor stores allowed an average of 2% for waste (Tr., p. 48). Later, on a second redirect examination by the Division's attorney, the auditor testified that he used a 2% figure that was based on "other auditor experience" (Tr., p. 53).

We recognize that "the Audit Division is not responsible for demonstrating the propriety of the assessment, including the basis for its audit" (Matter of Blodnick v. New York State Tax Commn., 124 AD2d 437, 507 NYS2d 536, 538), that "[c]onsiderable latitude is given an auditor's method of estimating sales under such circumstances as exist in this case" (Matter of Grecian Sq. v. New York State Tax Commn., 119 AD2d 948, 501 NYS2d 219, 221), and that petitioner bears the burden to prove the audit methodology unreasonable (Matter of Surface Line Operators Fraternal Org. v. Tully, supra); however, there is a limit on these principles (Matter of Fashana, Tax Appeals Tribunal, September 21, 1989). This limitation is that the record must

contain sufficient evidence to allow the trier of fact to determine whether the audit had a rational basis (Matter of Grecian Sq. v. State Tax Commn., *supra*; Matter of Fashana, *supra*; Matter of Savino, Tax Appeals Tribunal, September 22, 1988). On the record before us, it is not possible to determine the source of the 2% allowance. If the source of such a figure is not known, a petitioner's burden of proof to show its use unreasonable is insurmountable. In other cases where we found the record did not contain sufficient evidence to determine the source of an audit factor, we concluded that the appropriate remedy was to remand the matter for further testimony to describe the basis of the audit (Matter of Fashana, *supra*; Matter of Savino, *supra*).

However, in the instant case, we conclude that a remand would not be appropriate because the issue of the source of the 2% allowance has already been exhaustively addressed. At the hearing, the auditor testified on direct examination, cross examination, and then again on redirect examination as to the basis for the percentage used by him in his audit calculations. It is clear that he did not know the source of the percentage.

Thus, it is obvious, based on the auditor's testimony, that there exists no rational basis for the use of a 2% figure for theft and breakage. On the other hand, petitioners did introduce evidence at the hearing to substantiate their claim that 2% was too low a percentage. In addition to testimony, petitioners submitted an article from the Beverage Media, an industry magazine, which explains the problems of shoplifting for liquor retailers. The article stated that the average nationwide loss in package liquor stores to theft alone was 7% of inventory. The article was from the June 1988 volume of the magazine. Weighing the evidence submitted by petitioners, versus the lack of any evidence by the Division to support the 2% allowance, we conclude that petitioners sustained their burden of proof in establishing that the auditor should have utilized a 7% figure for theft and breakage in his audit calculations (*cf.*, Matter of Licata v. Chu, *supra*, 487 NYS2d 552, 553).

Accordingly, it is ORDERED, ADJUDGED and DECREED that:

1. The exception of petitioners, Shop Rite Wines & Liquors, Inc. and Mridula Khurana, as officer, is granted to the extent that the percentage allowed for theft and breakage is increased to 7%, and in all other respects denied;

2. The determination of the Administrative Law Judge is reversed to the extent indicated in paragraph "1" above, and in all other respects is affirmed;

3. The petition of Shop Rite Wines & Liquors, Inc. and Mridula Khurana, as officer, is granted to the extent indicated in paragraph "1" above, and in all other respects denied; and

4. The Division of Taxation is directed to modify the notices of determination issued on December 10, 1986, as revised by the Notices of Assessment Review, in accordance with paragraph "1" above but such notices are otherwise sustained.

DATED: Troy, New York
February 22, 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