

STATE OF NEW YORK
TAX APPEALS TRIBUNAL

In the Matter of the Petition	:	
of	:	
FAMILY DELI OF BELLMORE, INC.	:	DECISION
	:	DTA No. 810719
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 March 1, 1987 through May 31, 1990.	:	

The Division of Taxation filed an exception to the determination of the Administrative Law Judge issued on July 20, 1995 with respect to the petition of Family Deli of Bellmore, Inc., c/o John Short, 24 Daniel Road South, North Massapequa, New York 11758. Petitioner appeared pro se by its president, John Short. The Division of Taxation appeared by Steven U. Teitelbaum, Esq. (John E. Matthews, Esq., of counsel).

The Division of Taxation filed a brief in support of its exception. Petitioner filed a brief in opposition. Oral argument was not requested.

The Tax Appeals Tribunal renders the following decision per curiam.

ISSUES

I. Whether the Division of Taxation appropriately relied on external indices as a method of determining petitioner's sales tax liability.

II. Whether, if petitioner is found to have underpaid its sales tax liability, such underpayment was due to reasonable cause and not willful neglect.

FINDINGS OF FACT

We find the facts as determined by the Administrative Law Judge except for findings of fact "4" and "5" which have been modified. We have also made an additional finding of fact. The Administrative Law Judge's findings of fact, the modified findings of fact and the additional finding of fact are set forth below.

Petitioner, Family Deli of Bellmore, Inc., owns and operates a delicatessen located at 2772 Sunrise Highway in Farmingdale, New York. The delicatessen sold cold cuts, salads, dairy and grocery products, prepared foods, sandwiches, beer and soda. It was open seven days a week, 7 A.M. to 10 P.M., and was located in a shopping center at the intersection of two major cross streets.

John Short, Jr. was the sole owner and president of petitioner. His brother, Brian Short, was the secretary of the corporation while their father, John Short, Sr., was the vice-president of and accountant for the corporation.

The Division of Taxation ("Division") initially contacted petitioner by telephone about performing a sales and use tax audit for the period March 1, 1987 through November 30, 1989. By letter, the auditor requested that petitioner have available all books and records. Subsequent thereto, the parties agreed to commence the audit after the end of the tax season, on approximately April 17, 1990. During April 1990, a new auditor advised petitioner that the original auditor was no longer with the Division and that he would be conducting the audit, which was to commence on May 8, 1990.

On May 2, 1990, the new auditor mailed an appointment letter to petitioner requesting that all books and records pertaining to petitioner's sales and use tax liability for the period under audit were to be available on the appointment date. The books and records were to include journals, ledgers, sales invoices, purchase invoices, cash register tapes, Federal income tax returns and exemption certificates. The appointment letter stated the audit period to be May 31, 1987 through May 31, 1990. Attached to the appointment letter was a document entitled "Checklist of Records to be Presented for Audit". The list of records to be presented on audit included the following:

General Ledger for audit period.

Cash Receipts Journal for audit period.

Cash Disbursements Journal for audit period.

Federal Income Tax Returns for audit period.

Sales Tax Returns and Worksheets for audit period.

Merchandise purchase invoices for period: 11/30/90 QUARTER ENDING.

Sales invoices for period: 11/30/90 QUARTER ENDING.

Expense purchase invoices for period: 11/30/90 QUARTER ENDING.

Fixed asset purchase/sales invoices for entire audit period.

Bank statements for all accounts for the audit period.

All exemption documents supporting nontaxable sales for audit period.

Latest NYS Withholding Tax Return and cancelled check.

Latest NYS WRS-2 return and NYS Corporation Tax Return.

General Journal or Closing Entries that affect sales, sales tax, merchandise purchases or fixed asset accounts.

On the evening of May 7, 1990, the auditor cancelled the audit appointment for the next day. No reason was given nor was there a discussion concerning a rescheduled date. On June 12, 1990, the auditor telephoned Mr. Short, Sr., to set up an appointment date to commence the audit on June 21, 1990. On June 18, 1990 the auditor's team leader telephoned Brian Short about executing an extension of time to audit the quarters ended May 31, 1987 through February 29, 1988. In response, petitioner demanded that the audit begin immediately and a meeting was scheduled for June 20, 1990. The extension of time to audit the quarters ended May 31, 1987 through February 29, 1988 was executed by petitioner and returned to the auditor. However, the extension was executed for seven days, extending the period to June 27, 1990, not the one-year extension requested by the Division.

Petitioner had recently been involved in a sales and use tax audit for prior years involving the same auditor. It was the opinion of the officers of petitioner that the prior audit took too long and that some of the auditor's behavior was inappropriate. They were also concerned that several months had passed since the initial contact of the original auditor and the audit had not even started. According to petitioner's witnesses, the officers placed three conditions on the

signing of the consent extending the period of limitation for the period March 1, 1987 through February 29, 1988: the auditor would do a complete audit of all the books and records; the auditor would report to the officers as to the status of the audit; and the auditor would complete the audit within three months. According to the Division's witnesses, no conditions were agreed to. In addition, the only written evidence of these conditions is on a request letter for an extension of time to assess. The conditions on the letter are, for the most part, illegible. Assuming that the conditions would be met, Brian Short executed the consent extending the period of limitation to September 20, 1990.

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

On June 20, 1990, the auditor met with John Short, Sr., in the latter's office. Available for review were petitioner's sales tax returns and related worksheets, Federal and State income tax returns and related worksheets, depreciation schedules, cash register tapes, purchase journal, general ledger and journal entry sheets, cancelled checks and monthly bank statements, all for the entire audit period. The auditor determined, however, that the books and records were inadequate because the business operation did not utilize guest checks and the cash register produced cash register tapes that could only provide total sales, taxable sales and nontaxable sales but had no description of the item being sold. The business's "z" tapes indicated, among other things, the amount of sales tax collected. The auditor stated that upon seeing the register tapes, he had a strong suspicion that an observation test would be necessary (tr., pp. 325-326). It was the auditor's conclusion that, based on the information that was available, there was no way to accurately verify that petitioner was collecting the proper amount of sales tax other than by conducting an observation test (tr., pp. 30, 129, 185, 223, 285, 430).¹

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

On July 11, 1990, the auditor left a second Checklist of Records to be Presented for Audit with Mr. John Short, Sr. The checklist was identical to the checklist mailed to petitioner on May 2, 1990 except that the requested period for the merchandise purchase invoices, the sales invoices and the expense purchase invoices had been changed to "3/1/87-5/31/90". The auditor's contact sheet indicates that on July 10,

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We modified this finding by deleting the Administrative Law Judge's last sentence and adding the last two sentences to such paragraph in order to more accurately reflect the record.

1990 and July 11, 1990, the auditor reviewed the cash register tapes and other records in preparation for the observation test. The auditor looked at everything that was presented to him (tr., p. 90). The auditor examined register tapes to confirm the amount of gross sales reported by petitioner (tr., p. 129). Purchases were analyzed and petitioner's categorization of purchases was accepted (tr., p. 93). The auditor testified that all of petitioner's register tapes were not looked at because once it was determined that the tapes did not specify what was being sold, it would be pointless to do an in-depth analysis of such tapes for purposes of verifying whether the proper amount of sales tax was being collected (tr., p. 207).

On the morning of August 16, 1990, the auditor arrived at petitioner's business operation to conduct an observation test. None of the officers of the corporation had been previously advised that the auditor would be conducting such a test. The auditor was advised by petitioner that an observation test would not be allowed. Following several telephone calls between the auditor and petitioner's officers concerning the need to do an observation test and the expiration of the waiver on September 20, 1990, the auditor wrote Mr. John Short, Sr., on September 4, 1990 stating that since the auditor was not allowed to observe the operation, further analysis of the business's records would be necessary. The letter requested that at the next appointment on or before September 10, 1990, petitioner should have available all cash register tapes for the audit period and all other information previously requested. New consents extending the period of limitations for assessment beyond September 20, 1990 were also enclosed. The auditor never received a response (tr., pp. 107, 109, 191, 192).²

John Short, Jr., and John Short, Sr., testified that quarterly meetings were held among the three officers in order to: determine gross sales in comparison to the cash register tapes; determine converted taxable sales; control employee error; watch for employee theft; track competition; and, maintain quality control.

To maintain internal controls, various operations manuals were used and worksheets were completed on a quarterly basis. In the area of converted prepared foods, six different categories were used. The first category was provisions. The operations manual called for preslicing sandwich meats in quarter pound lots in the morning. Since this quarter pound amount is placed in each sandwich, it was possible to determine how much of the provisions bill was going into sandwiches. The total number of sandwiches sold was multiplied by the

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We modified this finding by deleting the Administrative Law Judge's last sentence of the first paragraph and adding the last four sentences to such paragraph and the last sentence of the second paragraph in order to more accurately reflect the record.

average price of a sandwich to arrive at a gross figure for sandwiches prepared.

To analyze dairy goods, eggs were used because they were purchased in bulk and the number used in an egg sandwich is known, resulting in the number of egg sandwiches made. This was cross-checked with the paper goods order which indicated the amount of sheets of 12 x 15 dry wax which was purchased within a quarter. One sheet was used to wrap one egg sandwich.

In dairy, the purchase of butter was analyzed. The business knew it obtained 24 buttered rolls or bagels out of each package of butter, so it multiplied packages of butter times 24, yielding the number of rolls or bagels sold. This was also cross-checked with the paper order as the business purchased pop-up dry wax specifically to wrap rolls and bagels.

The amount of cups of coffee sold in a quarter was arrived at by multiplying the number of packs used times the number of cups obtained per pack, eight. This was also cross-checked with the amount of styrofoam coffee cups purchased within the quarter.

The amounts of soup and salads that were sold in a quarter were determined by reviewing the number of bowls and number of quarter-pound cups purchased during that particular time period.

For each of the six areas - provisions, dairy goods, grocery goods, soup, salads and bagels - petitioner multiplied the amount of goods sold times the average retail selling price to arrive at the gross sales for each area. The items which were always taxable - beer, soda, cigarettes, candy -utilized the same computation of amount purchased per the invoices times the average retail selling price to determine gross sales. Total gross taxable sales were determined by adding the total converted, prepared foods and the total always taxable. This figure was compared to the taxable sales figure on the cash register tape and the higher of the two was used as taxable sales on the sales and use tax return. In addition, the amount of sales tax due per the taxable sales computed was compared to the sales tax collected on petitioner's "z" tape to insure the proper payment of sales tax was being paid to the Department of Taxation and Finance.

Mr. John Short, Sr., developed the accounting system used by petitioner. Its purpose was to account for the cash that came into the business, to maintain purchase control over the products bought for resale or consumption and to maintain control over the bank reconciliation procedures for money deposited. These controls were maintained in an operations manual kept for review by the officers of the business operation.

After deciding that the records were inadequate to perform a complete audit and being refused an opportunity to do an observation test, the auditor decided to pursue other external indices to determine petitioner's sales tax liability. There are three areas of the overall audit that arrived at the amount at issue.

The first area reviewed by the auditor was taxable purchases. He used the business's records, listing the purchases by category. From this list he extracted those items which are always taxable when sold to customers, a total of \$285,234.00, and compared that to total purchases of \$1,005,231.00. This yielded a taxable purchase ratio of 28.37 percent.

The next area involved an erroneous overcollection of sales tax on a nontaxable item. On one of the occasions that petitioner would not allow an observation test, two auditors entered the business premises and purchased lunch for a total of \$9.15. The clerk in the delicatessen charged sales tax on a bottle of Veryfine apple juice, a nontaxable item. The erroneous collection on the \$.80 item divided by the total sale of \$9.15 yielded an error rate of 8.74 percent.

The final area involved the determination of a percentage of converted prepared foods to total gross sales. The auditor reviewed four delicatessen observation test audits performed in Nassau County to make the determination. The four delicatessens were chosen because they had similar hours, gross sales, locations, items sold (product mix), audit periods and traffic patterns. In addition, they were closest in time to the audit at issue. Some relevant information relating to the four delis is as follows:

<u>Delis</u>	<u>Audit Period</u>	<u>Audited Gross Sales</u>	<u>Length of Audit Period</u>	<u>Annual Gross Sales</u>	<u>Overall Taxable Ratio</u>
Deli #1	6/1/84 - 2/28/87	\$1,077,971.00	2.75 years	\$391,989.00	74.9%
Deli #2	6/1/83 - 11/30/86	\$1,768,771.00	3.5 years	\$505,363.00	53.6%
Deli #3	3/1/85 - 11/30/87	\$1,990,249.00	2.75 years	\$723,726.00	57.7%
Deli #4	3/1/85 - 2/28/88	\$1,255,818.00	3.0 years	\$418,606.00	48.9%
Family Deli	3/1/87 - 5/31/90	\$1,801,659.00	3.25 years	\$554,356.00	---

The average annual gross sales for Delis #1-4 was \$509,921.00. All the Delis on the list were located in shopping centers except Deli #1. The average of taxable prepared foods of Delis #1-4 was 45.6%.

Although not used in the audit, the auditor had available a list of 34 delicatessens located in Suffolk County that had been audited by the Suffolk County District Office. The delicatessens had an average overall taxable ratio of 53.87 percent. In addition, the auditor had testified that it was his experience that delicatessens generally have overall taxable ratios of between 60 and 70 percent.

The auditor first arrived at an audited taxable percentage by adding together the three components of the audit:

Converted prepared foods	45.6 %
Erroneous collections	8.74%
Always taxable sales	<u>28.37%</u>
Audited taxable percentage	82.71%

The audited taxable percentage was multiplied by the gross sales reported of \$1,801,659.00 to arrive at audited taxable sales of \$1,490,152.16. The auditor then subtracted taxable sales reported of \$572,626.00 to compute additional taxable sales of \$917,526.16 to which was applied the tax rate of 8 percent to determine additional tax due of \$73,402.09. Penalties were assessed based upon the tax omission's being greater than 25% of audited tax due for the audit period.

On September 17, 1990, the Division issued to petitioner, Family Deli of Bellmore, Inc., a Notice of Determination and Demand for Payment of Sales and Use Taxes Due for the period March 1, 1987 through May 31, 1990 assessing a liability of \$73,402.09, plus penalty and interest. On the same date, the Division issued to petitioner an additional Notice of

Determination and Demand for Payment of Sales and Use Taxes Due for the same period assessing a penalty liability in the amount of \$7,340.22, pursuant to Tax Law § 1145(a)(1)(vi).

During the initial hearing date of April 29, 1993, petitioner's representative questioned the auditor concerning the four audits used to compute petitioner's tax liability. The auditor was not familiar with the audits other than that information contained in his workpapers. During the time between the first and second hearing dates, the auditor reviewed the files relating to the four audits. On the second hearing date, the auditor testified by direct examination as to the details surrounding the four audits.

We find the following additional finding of fact.

When asked on cross examination whether the items being sold were being rung up properly as taxable or nontaxable, John Short, Sr. responded that without actually being there it was impossible to know (tr., p. 589).

OPINION

In the determination below, the Administrative Law Judge held that although the auditor made a proper request for petitioner's books and records, he did not thoroughly examine those records in order to determine whether they were sufficient to allow a complete audit to be performed. The Administrative Law Judge held that because of this failure, the auditor was not justified in resorting to the use of external indices to estimate sales tax liability. Based on these holdings, the Administrative Law Judge cancelled the notices of determination.

Although his holding was dispositive of the petition, in accordance with our directives in Matter of Bleistein (Tax Appeals Tribunal, August 11, 1994), the Administrative Law Judge proceeded to address the remaining issues raised by the parties.

The Administrative Law Judge held that because petitioner's cash register receipts did not show the specific nature of individual transactions, the Division would have been entitled to resort to the use of external indices to estimate petitioner's taxable sales. With some modification, the Administrative Law Judge found that the Division's methodology for estimating petitioner's taxable sales was reasonable. He found that the Division was not estopped from relying on the consent to extend the statute of limitations for assessment because

there was no evidence presented to establish that the Division made an explicit promise to petitioner that petitioner's conditions would be met in conducting the audit. Additionally, the Administrative Law Judge held that the notices of determination in question were not issued for the sole purpose of procuring an extension of time. Next, the Administrative Law Judge held that penalties would have been waived based upon petitioner's extensive recordkeeping efforts and its timely filing of sales tax returns during the audit period. Finally, the Administrative Law Judge held that the auditor's subsequent testimony on redirect examination concerning questions posed to him on cross-examination (which he could not answer with any detail) was admissible. The Administrative Law Judge stated that petitioner's objections would go to the weight to be given the testimony.

On exception, the Division asserts that it was proper to determine petitioner's tax liability by the use of external indices because petitioner did not maintain records detailing individual sales. The Division contends that "[t]he only source documents which could allow the auditor to accurately and independently verify those sales reported as taxable were detailed sales invoices or detailed register tapes" (Division's brief, p. 4). The Division also takes exception to the Administrative Law Judge's holding that penalties should be waived.

In response, petitioner urges the Tax Appeals Tribunal to affirm the determination of the Administrative Law Judge insofar as the Administrative Law Judge cancelled the notices of determination based on the auditor's failure to review petitioner's books and records prior to resorting to external indices to estimate its tax liability.

We reverse the determination of the Administrative Law Judge.

The Division may use an indirect audit methodology in a sales tax audit where the taxpayer's records are so insufficient it is "virtually impossible to verify taxable sales receipts and conduct a complete audit" (Matter of Chartair, Inc. v. State Tax Commn., 65 AD2d 44, 411 NYS2d 41, 43). To determine the sufficiency of the taxpayer's records, the Division must thoroughly examine such (Matter of King Crab Rest. v. Chu, 134 AD2d 51, 522 NYS2d 978), for it is their inadequacy which justifies the use of an indirect audit methodology (Matter of

Chartair, Inc. v. State Tax Commn., supra). In the determination below, the Administrative Law Judge found that upon seeing that the register tapes did not designate the items sold, the auditor did not review any other records and determined that petitioner's sales records were inadequate. Accordingly, the Administrative Law Judge cancelled the assessment. In its exception, the Division argues that the auditor was justified in relying on external indices because a complete audit could not be performed. We agree with the Division.

Based on our review of the record, we find that the auditor did review the records prior to making the final determination that petitioner's books and records were inadequate for purposes of verifying taxable sales receipts and conducting a complete audit. While it is true that upon seeing the register tapes, the auditor was inclined toward using an indirect audit methodology, his suspicions were confirmed after examination of the remaining records. The auditor's testimony coupled with the audit file submitted into evidence shows that petitioner's records were examined in accepting petitioner's gross receipt amounts and categorization of purchases, etc. The problem that the auditor encountered was that there was no way the auditor could independently verify petitioner's taxable receipts. In fact, Mr. Short, Sr. attested to this conclusion when he stated that there was no way to determine if items being sold were properly being rung up as taxable or nontaxable without physically being there. Accordingly, it was proper for the auditor to resort to use of an indirect audit methodology (see, Matter of Licata v. Chu, 64 NY2d 873, 487 NYS2d 552).

After cancelling the assessment herein, the Administrative Law Judge concluded that had the auditor reviewed all the records prior to determining they were inadequate for purposes of conducting a complete audit, the auditor would have been justified in resorting to an indirect audit methodology because the records were indeed inadequate. The Administrative Law Judge then held that the audit methodology utilized was, for the most part, reasonable and modified the assessment accordingly. Specifically, the Administrative Law Judge removed the erroneous over-collection rate of 8.74 percent in computing the taxable ratio and held that the overall taxable ratio of delis #2-4 (53%) would be used in computing petitioner's tax liability

(Determination, conclusion of law "G"). Since the Division did not take an exception to these modifications, the assessment should be modified accordingly.

Next, the Division takes exception to that portion of the Administrative Law Judge's determination waiving all penalty. We agree with the Division that petitioner has not established reasonable cause which would justify abatement of penalties. In the determination, the Administrative Law Judge stated that:

"Petitioner went through great lengths to maintain complete and extensive records in an effort to ascertain its proper sales tax liability. These books and records were made available to the Division. The auditor accepted both the gross sales and purchases as reported by petitioner. The books and records reconciled with the Federal income tax returns and the sales and use tax returns. In addition, petitioner timely filed its sales and use tax returns and paid all sales tax when due during the audit period. As a result, all penalties should be waived" (Determination, conclusion of law "J").

We disagree with this conclusion and hold that petitioner has not established reasonable cause. While petitioner's recordkeeping and internal control system was quite elaborate for its purposes, petitioner's records were insufficient for purposes of verifying petitioner's taxable sales receipts. Due to the auditor's inability to perform an observation test in an attempt to verify petitioner's taxable receipts, the auditor was forced to use the indirect audit methodology resulting in the assessment. Petitioner must now bear the consequences. Accordingly, the imposition of penalties is sustained.

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 Family Deli of Bellmore, Inc. is granted to the extent that the notices of determination are modified pursuant to conclusion of law "G" of the Administrative Law Judge's determination, but in all other respects is denied; and

4. The notices of determination dated September 17, 1990 are modified in accordance with paragraph "3" herein, but are otherwise sustained.

DATED: Troy, New York
April 3, 1997

/s/Donald C. DeWitt

Donald C. DeWitt
President

/s/Carroll R. Jenkins

Carroll R. Jenkins
Commissioner

/s/Joseph W. Pinto, Jr.

Joseph W. Pinto, Jr.
Commissioner