STATE OF NEW YORK

TAX APPEALS TRIBUNAL

In the Matter of the Petition	:	
of	:	
BAGEL BOSS EAST, INC. AND JERRY ROSNER AND MICHAEL FICCO, AS OFFICERS	:	DECISION DTA No. 812215
	:	
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, 1987 through November 30, 1990.	:	

Petitioners Bagel Boss East, Inc. and Jerry Rosner and Michael Ficco, as Officers, 555 Montauk Highway, Bayshore, New York 11706, filed an exception to the determination of the Administrative Law Judge issued on April 27, 1995. Petitioners appeared by Morris D. Weintraub, Esq. The Division of Taxation appeared by Steven U. Teitelbaum, Esq. (John E. Matthews, Esq., of counsel).

Petitioners filed a brief on exception. The Division of Taxation's letter of July 28, 1995 declining to file a brief in opposition began the six-month period for the issuance of this decision. Petitioners' request for oral argument was denied.

Commissioner Koenig delivered the decision of the Tax Appeals Tribunal. Commissioners Dugan and DeWitt concur.

ISSUES

I. Whether petitioners provided the Division of Taxation with books and records adequate for the purpose of verifying petitioners' reported taxable sales for the audit period.

II. Whether the one-day observation test conducted by the Division of Taxation was a reasonable method of determining the taxable sales of the business operated by petitioners.

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 Bagel Boss East, Inc. ("Bagel Boss") a Notice of Determination and Demand for Payment of Sales and Use Taxes Due dated December 18, 1991 assessing sales tax duefor the period September 1, 1987 through November 30, 1990 in the amount of $69,704.36, plus penalty and interest. A second notice of determination, also dated December 18, 1991, was issued to Bagel Boss assessing a penalty of $6,970.44. Identical notices of determination were issued to petitioners Michael Ficco and Jerry Rosner, as officers of Bagel Boss.

The assessments were issued as a result of a field audit of the business operations of Bagel Boss. During the audit period, Bagel Boss operated a wholesale bagel bakery and a retail store which sold deli items, bagels, coffee and other beverages, milk, eggs and some prepackaged foods (e.g., lox, bacon and processed cheese). There was a cooking area in the store with a grill and deep fryer. Tables and chairs were provided for consumption of food and drink on the premises.

In 1983, Bagel Boss began doing business in a strip mall located on Montauk Highway. Before 1986, there were two anchor stores located on opposite ends of the mall, Gimbel's Department Store and a Grand Union supermarket. Bagel Boss was located in the middle of the mall with approximately 12 small retail stores around it. Both of the anchor stores closed before the end of 1986. On Halloween evening 1986, a fire began in the vacant Gimbel's store and swept through the mall destroying seven stores in all. After the fire, only four or five stores remained operating, including Bagel Boss.

Ownership of the strip mall changed about 12 to 18 months after the fire. In the spring of 1988, the mall owners began renovation of the mall, including the stores and parking area. Bagel

Boss acquired a new facade in the summer of 1989. In September 1990, renovations were begun on the interior of Bagel Boss; they were completed by April 1991.

The field audit of Bagel Boss began in September 1990. The auditor visited Bagel Boss's premises for the first time on September 27, 1990. Shortly thereafter, the auditor contacted Bagel Boss's accountant, Arthur I. Siegel, to set up an appointment to discuss the audit. Because Mr. Siegel was recovering from surgery, the first audit appointment was not scheduled until February 20, 1991. A letter was sent to Bagel Boss by the auditor to confirm that appointment. The letter, dated January 18, 1991, states, in part:

> "Please have available all books and records pertaining to your sales tax liability for the period under audit. This would include journals, ledgers, sales invoices, purchase invoices, cash register tapes, exemption certificates, and all sales tax records."

The audit period was identified in the letter as September 1, 1987 through November 30, 1990.

Bagel Boss provided the auditor with copies of sales tax returns and Federal income tax returns, a cash receipts journal, a check disbursements journal, payroll records, a general ledger (in the form of ledger sheets prepared by Mr. Siegel), cancelled checks and monthly bank statements. The auditor reviewed the records to determine how Bagel Boss prepared its sales tax returns. Bagel Boss used two cash registers which produced tapes which recorded receipts in four categories: taxable sales, nontaxable sales, sales tax collected and total sales. Each day, totals from each of these categories were taken from the register tapes and entered into a daily journal which served as a cash receipts journal. Mr. Siegel posted the amounts entered in the daily journal to ledger sheets on a monthly basis. The figures in the general ledger were then used to prepare sales tax returns. The auditor worked on the premises of Bagel Boss when she reviewed the books and records on February 20, 1991.

The auditor verified that sales recorded in the daily journals reconciled with sales reported on sales tax returns. Also, there was no significant difference between reported Federal gross receipts and gross sales as shown in Bagel Boss's books and records. Nonetheless, the auditor determined that the books and records were inadequate for the purpose of verifying Bagel Boss's

reported taxable sales. The auditor gave two reasons for this conclusion. First, Bagel Boss did not retain the cash register tapes that were used to prepare its records of daily sales so the postings in the daily journals could not be verified. Second, the tapes produced by Bagel Boss's registers did not identify the individual items sold; therefore, the auditors could not use the tapes to determine whether Bagel Boss was collecting sales tax on all taxable items.

To determine Bagel Boss's taxable sales for the audit period, the Division conducted a one-day observation test. The auditor visited the premises on March 6, 1991 to acquaint herself with the layout of the store and to decide how many auditors would be needed for the test. The observation test was conducted on Thursday, April 11, 1992 from 6:00 A.M. to 9:00 P.M. (the posted hours of operation). It was conducted in two shifts with two auditors on each shift. There were two registers in the store; one was used for deli sales and the other for the bagel counter. One auditor was stationed at each register. The auditor testified that the store was very busy on the day of the observation test with about six clerks handling sales. She also stated that it was difficult to keep track of the taxable sales being made by the clerks. Since there were many fewer nontaxable sales than taxable sales, the auditors recorded only the nontaxable sales. Using pencil and paper, the auditors kept track of each nontaxable item sold and multiplied the item sold by the posted selling price to determine the amount of sales in the nontaxable sales category. Total sales figures were taken from each of the two registers. The auditor subtracted nontaxable sales per the observation test from total sales as shown on the register tapes to determine taxable sales for the day.

Petitioners complained to the auditor that the observation test was unfair because it did not reflect the nature of Bagel Boss's business prior to the renovations. Petitioners told the auditor that the deli business, which sells taxable prepared foods, was greatly expanded by the renovation. They also said that the date of the observation test was the day after the start of a "Grand Opening" promotional campaign which caused Bagel Boss to be particularly busy on the observation day.

To address some of petitioners' claims, the auditor eliminated sales from the deli counter register from the test. Nontaxable sales at the bagel counter register (register number 1 in the auditor's workpapers), as counted by the auditors, amounted to $868.00. Total sales per the register reading was $1,914.71. By subtracting nontaxable sales from total sales, the auditor determined taxable sales for the test day of $1,046.70.

The auditor computed taxable sales for the audit period essentially by projecting the results of the test day. This entailed several different computations. Recognizing that inflation would cause sales figures to be higher in later years than in earlier years, the auditor reduced audited taxable sales on the test day ($1,046.70) by 5% to estimate audited taxable sales for an average day in April 1990 of $994.36. This figure was reduced by 5% to determine audited taxable sales for an average day in April 1989 of $944.64. This figure was reduced by 5% to determine audited taxable sales for an average day in April 1988 of $897.41.

The auditor then set out to calculate a ratio which would allow her to compare audited taxable sales with taxable sales as shown in the daily journals. First, she transcribed daily figures from the daily journals for the month of April of 1988, 1989 and 1990. Since the day of the observation test was a Thursday, the auditor then selected Thursday sales in April of each year to use as a point of comparison. She computed average Thursday taxable sales as shown in the daily journals of $183.96 for 1988, $186.13 for April 1989 and 186.70 for April 1990. She then computed a margin of error comparing audited taxable sales (see, finding of fact below) with taxable sales according to Bagel Boss's records. This resulted in margins of error of 3.8783 for 1988, 4.0752 for 1989 and 4.3243 for 1990.

The error rates for each calendar year were applied to reported taxable sales for the four sales tax quarters most closely corresponding to the calendar year to determine additional taxable sales for each quarter. This resulted in additional taxable sales for the audit period of $929,391.00, with a tax due on that amount of $69,704.36.

Petitioners claimed that their business was particularly busy on the day of the observation test because there was an advertisement in the local Pennysaver offering free bagels and muffins

as well as price specials from April 10th through April 24th. The advertisement was placed in evidence. It offers: special prices on three kinds of deli meats sold by the pound; one-half dozen bagels or bialys free with the purchase of a dozen at regular price; and one free muffin with the purchase of three others.

The auditor testified that she did not believe any adjustment to the audit results was warranted because of the promotional special. The coupons were all for nontaxable items and any sales made with a coupon would have been counted as nontaxable sales by the auditors as part of the observation test. Thus, an increase in sales resulting from the coupons would not have caused an increase in audited taxable sales. Also, the auditor testified that Bagel Boss seemed no more busy on the day of the observation than it had seemed to her on her prior visits to the premises. She also claimed to have seen few customers using the coupons.

The auditor offered to perform a second observation test, but petitioners declined the offer. Mr. Ficco testified that petitioners believed that their business was growing and that a second test would be no more representative of Bagel Boss's business during the audit period than the first test had been.

Both on audit and at hearing, petitioners maintained that their business had changed so significantly from the audit period to the day of the observation test that the test results could not be valid. Mr. Ficco, vice-president of Bagel Boss, testified about the effect of the fire and the renovations on Bagel Boss's business. He stated that the retail business significantly decreased after the fire and especially after construction began in the parking lot of the mall, approximately the spring of 1989 through the fall of 1990. He testified that Bagel Boss attempted to compensate for the lost revenue by increasing its wholesale bagel bakery business. He also testified that the business struggled financially through this period because the wholesale business is significantly less profitable than the retail business.

Photographs of the area outside of Bagel Boss show piles of dirt, torn up sidewalks, and an unpaved parking area. According to Mr. Ficco's testimony, the worst of these conditions existed for a couple of months in the summer of 1989.

Mr. Ficco described the operation of the Bagel Boss retail store before and after the renovations. Before the renovations, there was a grill on the left side of the front of the store where hot food was prepared, primarily eggs and other breakfast foods. Towards the right of the store, there was a bagel display counter and dairy cases containing milk, eggs, soda, juice, carbonated juice drinks and prepackaged foods. One cash register was located on the deli counter and a second was located at the bagel counter. As part of the renovations, petitioners removed the dairy cases and installed large walk-in coolers. They also removed the grill and put in a complete deli department. The seating area was increased from about 20 to 39.

Mr. Ficco testified that new employees are provided with a list of taxable items and are required to familiarize themselves with that list. They are then instructed to collect sales tax in accordance with the list. He and his co-owner, Jerry Rosner, are on the premises during business hours and monitor their employees using a one-way mirror and a video camera.

Bagel Boss's accountant, Arthur I. Siegal, testified concerning the recordkeeping practices of Bagel Boss and its financial difficulties. He stated that the business was not profitable during the audit period and operated at a loss or close to it. He also stated that Bagel Boss had undergone audits by the Internal Revenue Service in 1985 and 1989. The 1989 audit was a detailed audit, and the Internal Revenue Service made no changes to the amounts of income reported.

To establish that the nature of the business changed during the audit period and after from one that emphasized wholesale sales to one that emphasized retail sales, Mr. Siegel provided a breakdown of Bagel Boss's total sales, wholesale sales and taxable sales taken from records he maintained. Using his figures, and subtracting wholesale sales from total sales results in calculated retail sales for the same periods as follows:[1]

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[1]Bagel Boss changed its Federal income tax reporting period from a fiscal year to a calendar year in 1987. Only the last month of 1987 was included in the sales tax audit period.

	Total Sales	Wholesale Sales	Taxable Sales	Retail Sales
1988	$716,216.64	$398,126.57	$ 66,856.21	$318,090.07
1989	703,935.70	290,420.01	70,061.82	413,515.69
1990	608,247.58	88,145.55	76,421.47	520,102.03
1991	724,357.94	66,244.77	179,790.91	658,113.17

Sales, as transcribed by the auditor from the accountant's worksheets, are substantially the same as the figures testified to by Mr. Siegel. The auditor's transcription shows nontaxable sales during the audit period as follows:

1988	$251,163.86
1989	343,453.87
1990	443,680.56

Petitioners placed in evidence wholesale invoices, bank statements, checkbook stubs and the daily journals for the audit period. Mr. Ficco testified that he threw out the cash register tapes after posting the totals to the daily journals.

OPINION

In the determination below, the Administrative Law Judge reviewed the recordkeeping requirements for those persons required to collect sales and use taxes under the Tax Law along with the requirements imposed on the Division under said law in determining the amount of tax due when a return filed is either incorrect or insufficient.

The Administrative Law Judge rejected petitioners' claim that they provided adequate books and records to the Division which would have permitted the Division to verify Bagel Boss's taxable sales, holding that:

> "[t]he cash register tapes which were purportedly the source of the figures entered in the daily journals were destroyed. Moreover, the tapes did not individually identify the items sold; therefore, they could not serve to determine whether petitioners were accurately collecting tax on all taxable items (see, Matter of Licata v. Chu, 64 NY2d 873, 487 NYS2d 552)" (Determination, conclusion of law "B").

The Administrative Law Judge also: (1) held that since the accuracy of the journals could not be verified, the Division did not have to accept the daily journals as being a truthful record of daily sales; (2) rejected petitioners' reliance on Matter of King Crab Rest. v. Chu (134 AD2d 51, 522 NYS2d 978, 980) since in that case the auditor failed to review the guest checks which were

presented for audit whereas, in the case at hand, petitioners had no register tapes for the auditor to check to verify the accuracy of the sales tax returns as filed; (3) held that the Division was warranted in using an indirect audit method, a one-day observation test, to determine taxable sales; and (4) held "[f]urthermore, petitioners have not established that the nature of their business changed so significantly after the audit period that the results of the observation test had to be arbitrary and unreasonable" (Determination, conclusion of law "C").

The Administrative Law Judge, after reviewing the procedures used by the auditors during the one-day observation test which determined that taxable sales were approximately 55% of all retail sales as compared to the 15% and 21% reported by Bagel Boss during the audit period, held that petitioners failed to present evidence to explain this discrepancy.

The Administrative Law Judge also rejected petitioners' claim that retail sales decreased during the audit period due to mall construction and held that even with the renovation of the store itself:

> "the nature of the business did not change so dramatically as to render the observation test unreasonable. Where verifiable records of taxable sales are not maintained, the Division is only required to select a reasonable audit method, not one that is exact (Matter of Markowitz v. State Tax Commn., 54 AD2d 1023, 388 NYS2d 176, affd 44 NY2d 684, 405 NYS2d 454)" (Determination, conclusion of law "C").

The Administrative Law Judge further held that reasonable attempts (elimination of sales recorded on the deli register from its calculations and a reduction in sales of 5% per year to adjust for inflation) in considering petitioners' business operational changes were made by the Division during the audit. Further, even though petitioners established that renovations took place in both the mall and the parking area after a fire destroyed a portion of the mall, the Administrative Law Judge held that petitioners "have not established that their taxable sales decreased during the audit period as a result of those events. They could not do so since their own records show an increase in both taxable and nontaxable sales during the audit period" (Determination, conclusion of law "C").

On exception, petitioners claim disagreements with and make requests for additions to, as well as varied assertions relating to, the findings of fact as found by the Administrative Law Judge.

Petitioners also argue that:

> "[n]otwithstanding the auditor's verification and reconciliation of sales and determination of the auditable condition of all available books and records, the auditor inconsistently determined that the books and records were inadequate for purposes of verifying Bagel Boss's reported taxable sales" (Petitioners' Brief in Support, p. 3).

Petitioners further argue that despite producing detailed and voluminous evidence relating to the business operations before and during the one-day field audit, "the one-day field audit which was done during such special conditions rendered a distorted view of business sales and any additional tax assessment therefrom would be manifestly unfair" (Petitioners' Brief in Support, p. 3).

Petitioners' argument relative to the $929,391.00 in additional taxable sales is that the auditor ignored the credible evidence submitted and:

> "arrived at such figure by applying a 10.42% factor as a margin of error to observed taxable sales to the reported taxable sales during the audit period. However, $929,391.00 in additional taxable sales, as computed at 10.42%, would result in an incredible $8,919,299.00 in total sales! Clearly, such an extrapolation by the auditor is a distortion and not reflective of the actual business conditions during the audit period" (Petitioners' Brief in Support, p. 4).

Petitioners also argue that at the time of the one-day audit: (1) the premises had just reopened; (2) the premises was reconfigured after being damaged by fire; (3) extensive advertising and promotions were taking place; (4) the Jewish holiday of Passover had just ended; (5) new taxable items were being sold; and (6) a new deli counter was installed, and because of these extraordinary business conditions, the auditor's computations were distorted.

Petitioners also argue that Bagel Boss had complete purchase records which could have been used as an audit basis and since the auditor chose to ignore said records, the one-day field audit rendered a distorted and warped result.

Finally, petitioners argue that the testimony of its principals and accountant reinforce the improbability of the auditor's computations.

The Division did not submit a brief on exception but instead relies on its post-hearing brief and argues the determination of the Administrative Law Judge should be affirmed for the reasons stated therein.

With the exception of petitioners' argument relating to the auditor applying a 10.42% factor as a margin of error, which argument we will address below, petitioners have not raised any issues on exception that were not raised before the Administrative Law Judge. The Administrative Law Judge correctly analyzed and weighed all the evidence presented in this case, accurately found the facts as established by the record and correctly decided the relevant issues. We uphold the determination of the Administrative Law Judge for the reasons stated therein.

As noted above, petitioners' argument relative to the $929,391.00 in additional taxable sales is that the auditor ignored the credible evidence submitted and "arrived at such figure by applying a 10.42% factor as a margin of error to observed taxable sales to the reported taxable sales during the audit period" (Petitioners' Brief in Support, p. 4). We find that the record and evidence before us does not support such an argument.

As noted in Exhibit "E" (Audit Report), Schedule "A" (Summary of Tax Due) and as found by the Administrative Law Judge, a margin of error of 3.8783 was applied to reported taxable sales for the periods ending November 1987, February 1988, May 1988 and August 1988; a margin of error of 4.0752 was applied to reported taxable sales for the periods ending November 1988, February 1989, May 1989 and August 1989; and a margin of error of 4.3243 was applied to reported taxable sales for the periods ending November 1989, February 1990, May 1990, August 1990 and November 1990, the result being additional taxable sales for the 13 periods in the amount of $929,391.00. Petitioners did not except to these findings of the Administrative

Law Judge,[2] nor do petitioners point to anything in the record in support of their contention that a 10.42% factor was applied. Therefore, we find no merit to petitioners' argument.

As stated above, we uphold the determination of the Administrative Law Judge for the reasons stated therein.

Accordingly, it is ORDERED, ADJUDGED and DECREED that:

1. The exception of petitioners Bagel Boss East, Inc. and Jerry Rosner and Michael Ficco, as officers, is denied;

2. The determination of the Administrative Law Judge is affirmed;

3. The petition of Bagel Boss East, Inc. and Jerry Rosner and Michael Ficco, as officers, is denied; and

4. The notices of determination and demands for payment of sales and use taxes due dated December 18, 1991 are sustained.

DATED: Troy, New York
January 25, 1996

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

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

/s/Donald C. DeWitt
Donald C. DeWitt
Commissioner

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[2]Petitioners' exception does note disagreement with findings of fact "12" and "13" of the determination to the extent that they object to the audit methodology, but the exception does not contain any objection to the percentages applied as found by the Administrative Law Judge.