STATE OF NEW YORK

TAX APPEALS TRIBUNAL

In the Matter of the Petition	:	
of	:	
YOUR OWN CHOICE, INC.	:	DECISION DTA NO. 817104
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, 1993 through November 30, 1997.	:	

Petitioner Your Own Choice, Inc., 687 Broadway, Brooklyn, New York 11206 and the Division of Taxation each filed exceptions to the determination of the Administrative Law Judge issued on April 25, 2002. Petitioner appeared by Franklin D. Pacheco, CPA. The Division of Taxation appeared by Barbara G. Billet, Esq. (Jennifer A. Murphy, Esq., of counsel).

The Division of Taxation filed a brief in support of its exception and in opposition to the exception filed by petitioner. Petitioner filed a brief in support of its exception and a brief in opposition to the exception filed by the Division of Taxation. Both parties filed reply briefs. Neither petitioner nor the Division of Taxation requested oral argument.

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

ISSUES

I. Whether petitioner's books and records were adequate to allow the Division of Taxation to accurately calculate petitioner's sales tax liability.

II. Whether the indirect audit method utilized by the Division of Taxation was reasonably calculated to determine sales tax due.

III. Whether the Division of Taxation effectively extended the audit period to include the period from September 1, 1996 to November 30, 1997.

FINDINGS OF FACT

We find the facts as determined by the Administrative Law Judge except for finding of fact "14" which has been modified. The Administrative Law Judge's findings of fact and the modified finding of fact are set forth below.

Petitioner, Your Own Choice, Inc., was incorporated in New York State in 1987. During the period at issue, Mohammed Alam was its president and sole shareholder. During this period he operated petitioner as a grocery/convenience store at 687 Broadway, Brooklyn, New York. Petitioner made nontaxable sales of food and Lottery tickets and taxable sales of beer, soda, candy, cigarettes and photo processing services.

The Division of Taxation ("Division") commenced a sales tax audit of petitioner's business operation, and on October 4, 1996, an appointment letter was mailed to petitioner by Chae Kuo, the Division's sales tax auditor, which letter stated in part:

> Your New York State tax records for the tax(es) listed above have been scheduled for a field audit at your office on **November 4, 1996 at 9:30 am**.
>
> All books and records pertaining to your sales and use tax liability, for the period under audit, must be available on the appointment date. This includes financial statements, journals, ledgers, sales invoices, purchase invoices, cash register tapes, sales and use tax returns, federal income tax returns, and exemption certificates.

The letter stated the tax type to be "Sales and Use Tax" and identified the audit period as "09/01/93-08/31/96." Attached to the letter was a check list of records to be presented for audit.

The check list restated the items listed in the letter and requested the following additional records: cash disbursements journal, cash receipts journal, general ledger, expense purchase invoices, fixed asset purchase invoices, bank statements, canceled checks and deposit slips.

Among the records made available by petitioner to the Division were copies of sales tax returns, Federal income tax returns, New York State franchise tax reports and bank statements. Among the records requested in the appointment letter or the attached check list, but which were not furnished to the Division by petitioner, were the general ledger, cash receipts journal, sales invoices, cash register tapes and canceled checks. At the outset of the audit and again on November 27, 1996, Mr. Kuo met with petitioner's representative. No source records of sales such as cash register tapes or sales invoices were made available to the Division. Purchase invoices were incomplete, especially in the area of taxable beverages. The auditor was informed by Mr. Pacheco, petitioner's accountant, that petitioner's reported gross sales were computed, in part, by applying a mark-up rate to the purchase records, and, in part, by relying on bank deposit information. Some of petitioner's purchases were cash purchases, which served to reduce the amount of cash deposited in the bank at the end of the day.

Petitioner's representative conceded on the record that petitioner's books and records needed to verify taxable sales were insufficient for purposes of performing a detailed audit.

The auditor started to do an observation test, but was instructed by his supervisor, Mr. Dolan, to discontinue the observation test when it became apparent that petitioner's two cash registers did not generate totals or produce register tapes. Another reason for discontinuing the

observation test was that despite being informed that petitioner had abandoned its film processing activities, the auditor's assistant noticed that customers were coming in during the observation test seeking to drop off film for developing or to pick up finished photos.

A mark-up audit was considered and rejected by the Division because of the lack of adequate purchase invoices.

Noting that petitioner's annual rent for its business premises was readily apparent on the face of its Federal income tax returns for each fiscal year falling within the audit period, the Division consulted a publication entitled "Cost of Doing Business - Corporations" for fiscal year July 1987 to June 1988 and published by the Dun & Bradstreet Corporation. This publication is a self-described "guide to selected operating expenses for corporations" which covered 191 lines of business. The tables within the publication set forth the average amount spent by corporations for 11 selected operating expenses, including rent paid on business property, for each of the 191 business lines, expressed as a percentage of business receipts reported by a representative sample of all corporate Federal income tax returns filed for 1987. The table chosen by the auditor included a group of business lines headed "Retail Trade," which group includes the business line "Food Stores." This table reveals that food stores doing business in the corporate form, on average, pay as rent an amount that is equal to 1.73 percent of their business receipts.

Based on the office experience of the auditors, the ratio of taxable sales to gross sales of a convenience store or corner grocery store can be as high as 70 or 80 percent, while that of a supermarket can range from about 29 percent to 38 percent.

The Division, in the course of its audit, assumed a taxable ratio of 29.7 percent for petitioner, and it is assumed further that petitioner's rent was 1.73 percent of its reported gross

sales. Using these figures, the Division compiled a test computation of petitioner's additional taxable sales for the audit period of $1,839,915.88 and additional sales tax due thereon in the sum of $151,793.06.

The Division then substituted 10 percent for the 1.73 percent rent factor and repeated the tax computation as follows:

4 qtrs. ending	reported gross sls	rent paid	rent factor	audited gross sls	taxable %	audited taxable sls	reported taxable sls	additional taxable sls	additional sls tax due
8/94	$189,272	$27,188	.1	$271,880	.297	$80,748	$19,346	$61,402	$5,065.69
8/95	224,243	28,174	.1	281,740	.297	83,677	24,703	58,974	4,865.34
8/96	246,931	27,328	.1	273,280	.297	81,164	25,217	55,947	4,615.64
8/97	234,886	27,328	.1	273,280	.297	81,164	51,227	29,937	2,469.82
10/97	39,147	4,555	.1	45,550	.297	13,528	8,538	4,990	411.70
Total	$934,479	$114,573		$1,145,730		$340,281	$129,031	$211,250	$17,428.19

The reasons given by the Division for its adoption of the 10 percent rent factor in place of 1.73 percent from the Dun & Bradstreet study was out of consideration of a number of factors bearing on the volume of petitioner's business, including its location in a commercial neighborhood with plenty of competition that served to reduce traffic in the store and the Division's inability to rule out that petitioner's gross sales included Lottery commissions.

In December of 1997 the Division learned that petitioner's assets were to be sold in a bulk sale. By letter dated December 31, 1997, the auditor informed petitioner's representative that the Division was updating the audit period to "10/97." No request for records for the updated period was included in this letter.

On February 23, 1998, the Division issued a notice of determination to petitioner assessing additional sales tax due in the sum of $17,428.24 plus penalty and interest for the period from

September 1, 1993 to November 30, 1997. Petitioner, by its representative, timely filed a request for a conciliation conference with the Bureau of Conciliation and Mediation Services. The conference was held on December 2, 1998 and a conciliation order was issued on February 9, 1999 sustaining the notice of determination.

We modify finding of fact "14" of the Administrative Law Judge's determination to read as follows:

> On May 10, 1999, petitioner filed a petition for a hearing with the Division of Tax Appeals. A hearing was held before Administrative Law Judge Gary R. Palmer on June 26, 2001. At the hearing, petitioner's president, Mr. Mohammed Alam, testified that in the winter he closed his store between 5:00 and 6:00 P.M., and in the summer he closed the store between 6:00 and 7:00 P.M. The audit questionnaire, completed by Mr. Pacheco, states that closing time is 8:00 P.M. and that the store was open for business from Monday through Saturday and was closed on Sundays. Mr. Alam further testified that no more than 15 to 20 percent of the merchandise sold at petitioner's store consisted of taxable items. The Division examined petitioner's filed sales tax returns and determined that the ratio of reported taxable sales to reported gross sales for the sales tax quarters ending August 31, 1995, November 30, 1995, February 29, 1996, May 31, 1996 and August 31, 1996 were, respectively, 11 percent, 8.9 percent, 9.2 percent, 9.3 percent and 13 percent. The Division's initial appointment letter was mailed to petitioner on October 4, 1996. The taxable ratios for the four quarters ending November 30, 1996, February 28, 1997, May 31, 1997 and August 31, 1997 are, respectively, 26 percent, 15 percent, 25 percent and 24 percent.[1]

Petitioner sold New York Lottery tickets during the years at issue on which it received a commission of six percent of its on-line and instant ticket sales. During calendar year 1995 petitioner's total Lottery sales were $971,100.00 and during 1996 such sales totaled $820,567.00. Petitioner's Lottery sales were not included in its gross sales reported on its quarterly sales tax

[1]We have modified this fact by adding the first two sentences in order to more clearly set forth the record.

returns. It is not clear from the record whether petitioner's reported gross sales included the Lottery commissions it earned.

On May 30, 2001 the Division caused to be served on petitioner's representative, by certified mail, a Notice to Admit pursuant to 20 NYCRR 3000.6(b)(2) and CPLR 3123. The schedule attached to the Notice to Admit set forth 15 purported statements of fact that petitioner was asked to admit, deny or explain why such statements could not be admitted or denied. The Division's cover letter to Mr. Pacheco, dated May 25, 2001, stated, "[p]lease be advised that if you do not respond within 20 days after service of request, then all matters in request shall be deemed admitted." No response was made on petitioner's behalf within the 20-day period or thereafter.

THE DETERMINATION OF THE ADMINISTRATIVE LAW JUDGE

In his determination, the Administrative Law Judge noted that in order for the Division to use an indirect audit methodology, it must first establish that the taxpayer's books and records were so deficient as to render it virtually impossible to determine the taxpayer's liability solely from those books and records. The Division must first request and then thoroughly examine the taxpayer's books and records for the entire audit period. The Administrative Law Judge concluded that the Division made a clear and unequivocal request for source documents bearing on petitioner's sales. After petitioner failed to produce such records for the Division's review, the Administrative Law Judge found that it was reasonable for the auditor to conclude that petitioner's books and records were insufficient to verify its taxable sales for the audit period.

The Administrative Law Judge noted that petitioner's representative conceded the inadequacy of petitioner's books and records. Therefore, the Administrative Law Judge found that it was proper for the Division to resort to external indices to calculate petitioner's tax liability.

The Administrative Law Judge determined that petitioner failed to meet its burden of proof to show that either the audit method used, which was a rent factor adjusted in petitioner's favor by the Division, or the amount of tax assessed was erroneous.

The Administrative Law Judge rejected petitioner's arguments that the audit method selected was imprecise, finding that it was petitioner's failure to maintain adequate records of its sales that was the cause of any imprecision in the amount of tax assessed.

However, the Administrative Law Judge found that in its appointment letter dated October 4, 1996, the Division stated the audit period to be "09/01/93-08/31/96." Although the Division later extended the audit period until November 1997, the auditor failed to request petitioner's records for examination for any period after August 31, 1996. Based on this, the Administrative Law Judge concluded that the Division's resort to external indices to estimate petitioner's sales tax liability for the period after August 31, 1996 violated the rule stated in ***Matter of Christ Cella, Inc. v. State Tax Commn.*** (102 AD2d 352, 477 NYS2d 858) and the Administrative Law Judge canceled all tax, penalty and interest for any period subsequent to August 31, 1996.

ARGUMENTS ON EXCEPTION

On exception, petitioner argues that the books and records of petitioner were adequate for the Division to have relied on them in conducting a complete audit of petitioner's sales tax liability. Petitioner asserts that except for cash register tapes and sales receipts, records requested were provided to the auditors for their review. Petitioner argues that before the Division decided to use external indices to calculate petitioner's tax liability, it had to examine petitioner's records thoroughly. Petitioner maintains that the Division did not follow this procedure and, as a result, it

should be precluded from estimating petitioner's tax liability based on external indices. Further, petitioner argues that a second observation test of petitioner's business should have been conducted rather than resorting to the use of a rent factor to estimate petitioner's tax liability.

The Division argues, in support of its exception, that the Administrative Law Judge erroneously concluded that the Division did not make an adequate request for petitioner's books and records for the period of the extended audit (beyond August 31, 1996). The Division maintains that clear verbal requests were made for such records for the period September 1, 1996 to November 30, 1997 but no records were ever provided by petitioner. The Division bases its position on the fact that it served a Notice to Admit on petitioner containing a request that petitioner admit that certain of its records had been requested for the entire audit period. The Division introduced proof that such Notice was received by petitioner. As petitioner did not respond to this Notice, the Division asserts that petitioner is deemed to have admitted that such a request for books and records was made. The Division further argues that petitioner's representative indicated at the hearing that petitioner's records were inadequate and that it was not contesting the Division's right to estimate petitioner's sales tax liability for the entire audit period. Additionally, the Division maintains that at the hearing, the auditor demonstrated by his testimony that he made an adequate verbal request for the subject records.

The Division opposes petitioner's exception and argues that the Administrative Law Judge correctly determined that the Division was justified in using external indices to estimate petitioner's sales tax liability because petitioner's records were insufficient to allow a determination of the correct tax due. The Division asserts that its assessment methodology was reasonable, and that petitioner has failed to meet its burden of proof to establish that either the

methodology employed was incorrect or that the amount of additional tax asserted due was inaccurate.

Petitioner, in reply, argues that the Division's methodology was inaccurate and that petitioner had never seen the Notice to Admit prior to its introduction at the hearing. Therefore, all statements contained therein should be disregarded.

OPINION

Petitioner has argued on exception that despite its lack of register tapes or sales invoices, it presented sufficient books and records to the Division's auditor to allow an accurate determination of sales tax liability using these records. We disagree. To determine the adequacy of a taxpayer's records, the Division must first request ***(Matter of Christ Cella, Inc. v. State Tax Commn.***, ***supra***) and thoroughly examine (***Matter of King Crab Rest. v. Chu***, 134 AD2d 51, 522 NYS2d 978) the taxpayer's books and records for the entire period of the proposed assessment (***Matter of Adamides v. Chu***, 134 AD2d 776, 521 NYS2d 826, ***lv denied*** 71 NY2d 806, 530 NYS2d 109). The purpose of the examination is to determine, through verification drawn independently from within these records (***Matter of Giordano v. State Tax Commn.***, 145 AD2d 726, 535 NYS2d 255; ***Matter of Urban Liqs. v. State Tax Commn.***, 90 AD2d 576, 456 NYS2d 138; ***Matter of Meyer v. State Tax Commn.***, 61 AD2d 223, 402 NYS2d 74, ***lv denied*** 44 NY2d 645, 406 NYS2d 1025; ***see also***, ***Matter of Hennekens v. State Tax Commn.***, 114 AD2d 599, 494 NYS2d 208), that they are, in fact, so insufficient that it is "virtually impossible [for the Division of Taxation] to verify taxable sales receipts and conduct a complete audit" (***Matter of Chartair, Inc. v. State Tax Commn.***, 65 AD2d 44, 411 NYS2d 41, 43; ***Matter of Christ Cella, Inc. v. State Tax Commn.***, ***supra***), "from

which the exact amount of tax due can be determined" (***Matter of Mohawk Airlines v. Tully***, 75 AD2d 249, 429 NYS2d 759, 760).

Where the Division follows this procedure, thereby demonstrating that the records are incomplete or inaccurate, the Division may resort to external indices to estimate tax (***Matter of Urban Liqs. v. State Tax Commn.***, ***supra***). The estimate methodology utilized must be reasonably calculated to reflect taxes due (***Matter of W.T. Grant Co. v. Joseph***, 2 NY2d 196, 159 NYS2d 150, ***cert denied*** 355 US 869, 2 L Ed 2d 75), but exactness in the outcome of the audit method is not required (***Matter of Markowitz v. State Tax Commn.***, 54 AD2d 1023, 388 NYS2d 176, ***affd*** 44 NY2d 684, 405 NYS2d 454; ***Matter of Cinelli***, Tax Appeals Tribunal, September 14, 1989). The taxpayer bears the burden of proving with clear and convincing evidence that the assessment is erroneous (***Matter of Scarpulla v. State Tax Commn.***, 120 AD2d 842, 502 NYS2d 113) or that the audit methodology is unreasonable (***Matter of Surface Line Operators Fraternal Org. v. Tully***, 85 AD2d 858, 446 NYS2d 451; ***Matter of Cousins Serv. Station***, Tax Appeals Tribunal, August 11, 1988). In addition, "[c]onsiderable 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, 221).

It is quite clear from the record that the Division reviewed the records presented by petitioner and correctly concluded that they were not adequate to do a complete audit since there were no source documents; i.e., sales invoices, complete purchase invoices or cash register tapes, submitted by petitioner (***see***, ***Matter of Vebol Edibles v. State of New York Tax Appeals Tribunal***, 162 AD2d 765, 557 NYS2d 678, ***lv denied*** 77 NY2d 803, 567 NYS2d 643; ***Matter of Club Marakesh v. Tax Commn. of State of New York***, 151 AD2d 908, 542 NYS2d 881, ***lv denied*** 74

NY2d 616, 550 NYS2d 276). Under these circumstances, it was not possible for the Division to verify taxable sales and receipts (and conversely nontaxable sales and receipts) and conduct a complete audit.

The Division presented evidence that the method it chose to determine petitioner's tax liability was based on verifiable information available and the type of business engaged in by petitioner. The Division made several modifications to its methodology in order to take account of the nature and size of petitioner's business. These modifications resulted in a lower estimate of petitioner's tax liability. Therefore, the Administrative Law Judge properly concluded that the Division was authorized to resort to an external index to estimate petitioners' tax liability and that the methodology employed was reasonable. Petitioner has offered no evidence below, and no argument on exception, that demonstrates that the Administrative Law Judge's determination is incorrect.

At some point during the audit, the Division determined that the audit period should be extended beyond August 31, 1996. Just as it was required to do for the original audit period, the Division was required to make an adequate demand for petitioner's books and records for the extended audit period. Here, there is no disagreement that a written demand was not made for production of petitioner's records for this extended audit period. The Division maintains that it made an oral request for petitioner's books and records for that period. However, we find no evidence in the record which substantiates this. The sole basis on which the Division premises its claim that an adequate request for petitioner's books and records was made is that such a claim was deemed to have been made due to petitioner's failure to respond to the Division's Notice to Admit. The Rules of Practice and Procedure of the Tax Appeals Tribunal provide that a party

may serve on any other party a written request for admission of the truth of any matter set forth in the request (***see***, 20 NYCRR 3000.6[b]). The request is to pertain to "matters as to which the party requesting the admission reasonably believes there can be no substantial dispute at the hearing and which are within the knowledge of the adverse party". The party to whom the request is directed is deemed to admit each of the matters as to which an admission was properly requested unless such party responds to the request within 20 days either denying the matters requested to be admitted or explaining why such matters cannot be fairly admitted. An Administrative Law Judge may allow a party to amend or withdraw any admission on such terms as may be just.

The admission deemed to have been made by petitioner is the following:

> During the sales tax audit of petitioner for the period at issue, the Division of Taxation and Finance (Division) requested but did not receive the following records: a.) general ledger; b.) cash receipts journal; c.) sales invoices, and d.) exemption certificates (Exhibit "E").

In the present case, petitioner made no response to the Notice to Admit nor did it make a motion to withdraw or amend its deemed admission. Therefore, petitioner must be deemed to have admitted each of the matters contained within the Division's request, including the statement set forth above.

However, even with such a deemed admission, the record is insufficient to allow a conclusion that the Division made an adequate request for petitioner to produce its books and records for the extended audit period such that the failure to produce such requested records would allow the Division to proceed to estimate petitioner's sales tax liability using external indices.

We note, as did the Administrative Law Judge, that the first evidence of the Division's intention to extend the audit period was the Division's letter to petitioner's representative of December 31, 1997. Shortly thereafter, in February 1998, the Division issued a notice of

determination to petitioner which contained a determination of additional sales tax due for the original audit period as well as for the extended audit period.

Prior to the computation of additional tax due for the extended audit period, it was necessary for the Division to have made an adequate request for books and records for that period. From the statement contained in the Notice to Admit, such request was simply made "[d]uring the sales tax audit." Further, it is clear from the testimony of the Division's auditor that the basis on which he concluded that petitioner's records were inadequate to allow a calculation of sales and use tax liability for the original period of the audit was due to the absence of cash register tapes and incomplete purchase orders. Neither of these items was included in the records deemed to have been requested by the Division, although such records were specifically requested for the original audit period.

As a result, we agree with the Administrative Law Judge that the Division did not make an adequate request for the books and records of petitioner prior to determining that an estimation of tax liability for the period of the extended audit was appropriate.

We find that the Administrative Law Judge completely and adequately addressed the issues presented to him and we see no reason to modify them in any respect. As a result, we affirm the determination of the Administrative Law Judge.

Accordingly, it is ORDERED, ADJUDGED and DECREED that:

1. The exception of the Division of Taxation is denied;

2. The exception of Your Own Choice, Inc. is denied;

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

4. The petition of Your Own Choice, Inc. is granted to the extent stated in Conclusion of Law "D" of the Administrative Law Judge's determination, but in all other respects is denied; and

5. The Notice of Determination dated February 23, 1998, as modified in accordance with paragraph "4" above, is sustained.

DATED: Troy, New York
February 20, 2003

/s/Donald C. DeWitt
Donald C. DeWitt
President

/s/Carroll R. Jenkins
Carroll R. Jenkins
Commissioner