STATE OF NEW YORK

TAX APPEALS TRIBUNAL

In the Matter of the Petition :

of :

33 VIRGINIA PLACE, INC. :

for Redetermination of a Deficiency or for Refund of Corporation Franchise Tax under Article 9-A of the Tax Law for the Period January 1, 2001 through December 31, 2002. :

In the Matter of the Petition :

of : DECISION
DTA Nos. 821181, 821182, 821183, 821290, 821291, & 821859

MARK SUPPLES AND AMY TAYLOR :

for Redetermination of a Deficiency or for Refund of Personal Income Tax under Article 22 of the Tax Law for the Period January 1, 2001 through December 31, 2003. :

In the Matter of the Petition :

of :

MATTHEW J. AND MELISSA A. CONROY :

for Redetermination of a Deficiency or for Refund of Personal Income Tax under Article 22 of the Tax Law for the Period January 1, 2002 through December 31, 2003. :

In the Matter of the Petitions	:
of	:
33 VIRGINIA PLACE, INC.	:
for Revision of Determinations or for Refund of Sales and Use Taxes under Articles 28 and 29 of the Tax Law for the Period March 1, 2001 through August 31, 2006.	:

In the Matter of the Petition	:
of	:
MARK SUPPLES	:
for Revision of a Determination or for Refund of Sales and Use Tax under Articles 28 and 29 of the Tax Law for the Period September 1, 2001 through November 30, 2003.	:

Petitioners, 33 Virginia Place, Inc., Mark Supples and Amy Taylor and Matthew J. and Melissa A. Conroy, filed an exception to the order of the Administrative Law Judge issued on July 22, 2010. Petitioners appeared by Amigone, Sanchez, Mattrey & Marshall, LLP (B.P. Oliverio, Esq., of counsel). The Division of Taxation appeared by Daniel Smirlock, Esq. (James Della Porta, Esq., of counsel). Petitioners' request for oral argument was denied.

Petitioners filed a brief in support of their exception. The Division of Taxation filed a brief in opposition. Petitioners filed a reply brief.

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

ISSUE

Whether petitioners are entitled to an award of costs pursuant to Tax Law § 3030.

FINDINGS OF FACT

We find the facts as determined by the Administrative Law Judge except for findings of fact "9" and "10," 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 33 Virginia Place, Inc. (petitioner or the Company) operates a bar and restaurant known as Mother's, which is located in the Allentown district of Buffalo, New York. Petitioner is a subchapter S corporation; its shareholders during the periods at issue were Mark Supples, Amy Taylor and Matthew Conroy. Mark Supples is the president of petitioner and is the general manager of Mother's.[1]

The Division of Taxation (Division) issued a Notice of Determination, dated December 1, 2004, to petitioner assessing additional sales and use taxes in the amount of $149,669.69, plus penalty and interest, for a total amount due of $256,924.22 for the period March 1, 2001 through November 30, 2003. The Division issued another Notice of Determination to petitioner assessing additional sales and use taxes in the amount of $318,815.93, plus penalty and interest for a total due of $536,589.45 for the period of December 1, 2003 through August 31, 2006.

The Division issued a Notice of Determination, dated December 27, 2004, to Mark Supples, which assessed tax in the amount of $127,688.20, plus penalty and interest, for a total amount due of $216,304.60 for the period September 1, 2001 through November 30, 2003. The

[1] "Petitioners" will refer to the Company and the individual petitioners collectively.

Notice of Determination advised Mr. Supples that it was being issued because he was an officer or responsible person of 33 Virginia Place, Inc.

The Division issued a Notice of Deficiency, dated March 30, 2006, to petitioner, which asserted a corporation franchise tax deficiency of $8,590.00 ($4,976.00 for 2001 and $3,614.00 for 2002), plus interest, for a total amount due of $11,082.95 for the years 2001 and 2002.

The Division issued a Notice of Deficiency, dated April 17, 2006, to Mark Supples and Amy Taylor, which asserted a personal income tax deficiency in the amount of $131,440.00 ($41,165.00 for 2001, $35,501.00 for 2002 and $54,774.00 for 2003), plus interest and penalty, for a total amount due of $172,260.75 for the years 2001, 2002 and 2003.

The Division issued a Notice of Deficiency, dated April 17, 2006, to Matthew J. Conroy and Melissa A. Conroy, which asserted a personal income tax deficiency in the amount of $9,922.00 ($3,902.00 for 2002 and $6,020.00 for 2003), plus interest and penalty, for a total amount due of $12,625.63 for the years 2002 and 2003.

The basis for the Division's notices was two sales tax audits of petitioner's business, a corporation franchise tax assessment issued to the Company and personal income tax assessments to the individual petitioners, all flowing from the results of the sales tax audits. As to the first sales tax audit, after a proper request for books and records, and a production of some records (more fully set forth in the determination of the administrative law judge), a determination was made by the Division that petitioner failed to maintain records that were required of petitioner as a vendor.[2] In an attempt to verify sales, since there were no guest checks

[2] At the hearing, petitioners stipulated to the fact that they failed to maintain records as required.

or cash register tapes for the audit period, the Division attempted to use petitioner's selling prices to determine a markup of items sold. As to wine, liquor and food, there were too many menu variables and information not provided to the Division for a markup to be done reliably. Thus, the Division turned to the 2002 edition of the Restaurant Industry Operations Report by the National Restaurant Association and Deloitte & Touche (2002 Report). The auditor chose an exhibit for Full Service Restaurants (Average Check Per Person $25 and Over), Statement of Income and Expenses - Amount Per Seat. Using the median figures in the exhibit, the auditor calculated markup percentages for food and beverages at 181% and 185%, respectively, above cost. Third-party verification was used to verify purchases per petitioner's books, and the markup percentages were then applied to petitioner's purchases from its own disbursements journal. Additional tax due was calculated to be $140,369.88 on sales of food and beverages; additional tax on fixed asset acquisitions in the amount of $9,299.79 (not in dispute) was added to this amount, for a total tax due by petitioner of $149,669.69, for the period March 1, 2001 through November 30, 2003.

The Division's auditor could not articulate her reasoning for using the figures in this schedule to compute the markup, as opposed to other schedules in the publication, and never considered using the total sales per seat amount, a component of the schedule used, in computing the tax due. Had the auditor used the median sales per seat of $10,887.00, the Division would have computed taxable sales of $2,612,880.00 (compared to petitioner's reported sales for the same period of $3,714,329.00); however, based upon the markup percentage calculated by the Division, petitioner's sales were estimated to be $1.7 million over that which it reported, and $2.9 million over the per seat amount set forth in the same schedule used by the Division.

Although another schedule of the 2002 Report allowed a calculation to be made that considered the number of times a seat turned over in the restaurant, the Division ignored the information that calculated the number of seat turns per day and amount of profit per seat.

The second sales tax audit, performed by a different auditor, spanned the period December 1, 2003 through August 31, 2006. Again, the Division made a proper request for records and received some records, but too insufficient to determine whether petitioner had properly reported its sales. The auditor made a determination to use the 2006/2007 edition of the Restaurant Industry Operations Report by the National Restaurant Association and Deloitte & Touche LLP (2006/2007 Report) in order to compute petitioner's markup on items sold. The auditor chose a different schedule from the report than was used in the prior audit. This time the exhibit entitled Statement of Income and Expenses - Ratio to Total Sales for Full Service Restaurants (Average Check Per Person $25 and Over), with sales of $2 million and over was used. Using the median ratios of cost to total sales from this schedule, the auditor arrived at a 315% markup for food and 336% markup for beverages, which were applied to petitioner's purchases from its general ledger. This calculation resulted in additional taxable sales of $3,797,508.69, with tax due thereon in the amount of $318,815.94.

The auditor handling the second audit was aware that the markup percentages that he calculated (315% for food and 336% for beverages) were different from the percentages calculated in the prior audit (281% for food and 285% for beverages), but attributed the difference to the fact that different indices from different exhibits of the two reports were used. He could not recall, however, whether the other exhibits in the report were examined and why they were not used.

Upon referral from the Sales Tax Audit Bureau, the Division advised petitioner that its corporation franchise tax returns for the years 2001 through 2003 had been selected for audit. The Division explained to Mr. Supples that, as a result of the sales tax audit findings, there would be franchise tax and personal income tax deficiencies asserted by the Division. Since January and February 2001 were outside the sales tax audit period, those months were estimated. To compute the additional franchise tax due from petitioner, the auditor used additional gross receipts from the results of the first sales tax audit and applied it to the years at issue. The result was franchise tax due on the entire net income base for 2001 in the amount of $4,976.00. For 2002, the franchise tax due on the same entire net income base was $3,614.00.[3]

As to the personal income tax ramifications that flowed through from the sales tax audits, the Division asserted the following additional liabilities:

a. For 2001, Mark Supples was the owner of 100% of the shares of petitioner. Thus, the additional gross receipts computed for 2001 in the amount of $594,611.00 were attributed to him, resulting in additional tax due of $41,165.00 after payments for which he received credit.

b. For 2002, Mark Supples was a 45% shareholder, Amy Taylor (Mark Supples's wife) was a 45% shareholder and Matthew Conroy was a 10% shareholder. Thus the additional gross receipts in the amount of $556,011.00 were attributed to them in accordance with their percentage of ownership. For Mark Supples and Amy Taylor, who filed a joint return, the resulting tax due for tax year 2002 was $35,501.00. For Matthew Conroy, who filed jointly with his wife Melissa A. Conroy, the resulting personal income tax was $3,902.00 for the 2002 tax

[3] After a change in the Tax Law that eliminated the differential between the franchise tax rate and the personal income tax rate, no franchise tax deficiency was asserted for the 2003 tax year.

year.

c. For 2003, as with 2002, Mark Supples was a 45% shareholder, Amy Taylor was a 45% shareholder and Matthew Conroy was a 10% shareholder. Thus, the additional gross receipts in the amount of $772,868.00 were attributed to them in accordance with their percentage of ownership. For Mark Supples and Amy Taylor, who filed a joint return, the resulting tax due for tax year 2003 was $54,774.00. For Matthew Conroy, who filed jointly with his wife Melissa A. Conroy, the resulting personal income tax was $6,020.00 for the 2003 tax year.

A hearing before an administrative law judge was held on January 9 and 10, 2008, at which time petitioners provided testimony and documents explaining what they believed were the deficiencies in the audit by the Division. In addition, petitioners put forth the testimony and analysis of Dave Gross, a certified sales tax specialist, who, among other observations, performed an analysis based on table turnover rates. Mr. Gross concluded, based upon his table turnover analysis and the amount of profit that would have to have been generated if the Division's audit results were accurate, that the Division's calculation of markup percentages based upon the select information used from the 2002 Restaurant Industry Operations Report for the first audit period and the 2006/2007 Restaurant Industry Operations Report for the second audit period, were not consistent with the other exhibits within the reports, which were ignored by the Division during the performance of the audits.

Additionally, Brendan McCafferty, an attorney specializing in sales and use taxation, reviewed the work performed by David Gross and determined that his assumptions and premises were reasonable. When he reviewed the audit materials pertaining to the second sales tax audit,

he saw no evidence that the Division considered the results of the first audit. Further, Mr. McCafferty offered the opinion that observation tests are frequently used by the Division in food service or cash-type businesses and, in his opinion, an observation test would have been useful in determining whether the Division's assessments were reasonable in this case. Mr. McCafferty reviewed the reports and stated that, in his opinion, they were not the most reasonable studies to use because their express purpose was to be used as a benchmark in the industry for comparing management operations and to provide an informational resource. Particularly with respect to the second audit, Mr. McCafferty noted that the auditor selected the incorrect category for petitioner because he used the median ratios of cost to total sales for restaurants with sales over $2,000,000.00, when petitioner's total sales for the nearly three-year period were $4,766,594.00, or less than $2,000,000.00 per year. In addition, when comparing the audit results with the table turn analysis performed by David Gross, Mr. McCafferty stated that in order to generate the sales as assessed, it was necessary for petitioner to achieve a seat turnover of 4 to 4.5 turns per day, which he deemed unreasonably high.

On November 13, 2008, Administrative Law Judge Brian L. Friedman addressed the underlying matter and issued his determination. He summarized the issues as follows:

> In the present matter, it is conceded that for each of the two sales tax audits conducted, petitioner did not maintain and, upon request by the Division, did not provide sufficient books and records to the Division's auditors to enable the auditors to perform a detailed audit. Accordingly, there is no dispute that for each of the sales tax audits at issue, the Division was within its rights to resort to external indices to determine whether, for each of the periods, petitioner owed additional sales and use taxes. What is at issue, however, is whether the external indices selected, the 2002 edition of the Restaurant Industry Operations Report in the first audit and the 2006/2007 edition of the Restaurant Industry Operations Report in the second audit were reasonable audit methodologies or whether the results derived therefrom were erroneous.

Administrative Law Judge Friedman cancelled all assessments other than the tax assessed on petitioner's fixed asset acquisitions in the amount of $9,299.79 (plus applicable penalty and interest). He concluded as follows:

> In summary, it is undisputed that Mother's did not maintain and, therefore, produce for audit, the books and records necessary to perform a detailed audit. Case law holds that, as a general proposition, any imprecision in the results of an audit arising by reason of a taxpayer's own failure to maintain adequate and accurate records of all of its sales as required by Tax Law § 1135(a)(1) must be borne by that taxpayer (***Matter of Meyer v. State Tax Commn.***; ***Matter of Markowitz v. State Tax Commn.***).
>
> What resulted from the two sales tax audits at issue in this matter is far more than imprecision, however. Both auditors chose to utilize data contained in a Restaurant Industry Operations Report by the National Restaurant Association and Deloitte & Touche LLP. The first auditor used the 2002 edition; the second auditor used the 2006/2007 edition. While prior Tax Appeals Tribunal decisions have sustained the use of this Report, it must be pointed out that in a number of these cases, the only data utilized was a rent factor. Obviously, the editors of the Report have provided sufficient warning as to its year-to-year reliability and its use for anything more than a management tool. . . . Since these auditors nevertheless chose the Report as a means by which to compute sales tax liability, they must be sufficiently familiar with the Report to be able to respond meaningfully to inquiries regarding its use (***see Matter of Fokos Lounge***) and, clearly, such familiarity was lacking herein.
>
> The auditors could not explain why this particular report was chosen, and they did not sufficiently familiarize themselves with the contents so as to be certain that the chosen data was applicable to petitioner's business. Each auditor attempted to calculate a markup percentage which was applied to petitioner's purchases. Neither auditor bothered to check the reasonableness of their markup percentage by comparing the resulting audited taxable sales with other data which was set forth in the same section of the report that was utilized in computing the markup percentage.
>
> Petitioner, while clearly negligent in its record keeping, was most diligent in analyzing the audit results in both sales tax audits. Its witnesses, most notably, David E. Gross and Brendan McCafferty, visited the business premises, reviewed the reports used by the auditors and performed independent analyses of the data contained in the reports which, in total, leads to the conclusion that the methods selected were not reasonably calculated to reflect tax due. By clear and convincing

> evidence, petitioner has shown that the results of both sales tax audits were erroneous and, clearly and unequivocally, that the audit methods employed were unreasonable.

Administrative Law Judge Friedman's determination was appealed to the Tax Appeals Tribunal, and on December 23, 2009, the Tribunal issued its decision. After first setting forth the standards for conducting a sales and use tax audit, the Tribunal affirmed the conclusions of the administrative law as follows:

> There is a distinction to be made between determining whether or not it was rational for the Division to use particular external indices, such as the 2002 and 2006/2007 Reports, as the basis for its audit and whether the audit methodology resulting from the use of these Reports was reasonably calculated to reflect taxes due. We find that in this case, it was rational for each auditor to rely on the Restaurant Industry Operations Report as the basis for calculating petitioners' sales and use tax liability, notwithstanding each auditor's inability to testify as to the quality of the data contained in the report.
>
> That being said, however, the manner in which these indices were used resulted in audit methodologies that cannot be said to have been reasonably calculated to reflect petitioners' tax liability.
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> * * *
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> Had the Division used the median portion of Exhibit C-12 appropriately in calculating petitioners' taxable sales, it would have estimated petitioners' tax liability for the period by calculating the sales price of food and beverages sold "per seat," based on the number of seats in petitioners' restaurant. As pointed out by the Administrative Law Judge, this calculation, if performed, would have shown that audited sales were significantly lower than sales actually reported by petitioners, and resulted in no additional tax due by petitioners. In fact, even if the auditor had considered petitioners' business to be in the upper quartile of Exhibit C-12 instead of in the median range, a "per seat" analysis would still have shown petitioners' taxable sales to have been lower than what it had previously reported.
>
> Rather, what the Division did was to extract numbers from Exhibit C-12 of the report and use those numbers in a manner for which they were not intended. Whatever information was used to compile the cost of beverages and food and the sales of beverages and food contained in Exhibit C-12 of the report was necessarily modified by the number of seats in the restaurants that contributed to their cost and sales figures.

Ignoring this component of Exhibit C-12, the Division used the Restaurant Report to create its own external index, which it identified as a "markup percentage." The term "markup percentage" is not contained in Exhibit C-12.

The Division is correct that its auditors are not required to explain the basis of the data underlying the external indices used, nor the method in which the data was formulated. We believe, however, that this does not give the Division carte blanche to simply extract convenient numbers from an index and use them in a manner for which they were never intended to be used. Having chosen to use the median portion of Exhibit C-12 of the 2002 Report, the Division should have used it for the purposes for which it was intended, and not randomly selected numbers from the exhibit that supported an increased tax liability for petitioners. While there is no question that petitioners' lack of records opened the door for the Division to use an external index to estimate petitioners' taxable sales, it must be pointed out that a lack of records does not equate to a presumption that taxable sales have been underreported.

While it is advisable to do so, auditors are not required by law to confirm the reasonableness of the results of their chosen methodology. However, the failure to do so here proved fatal to the Division's choice of audit methodology. The choices of exhibits were the Division's to make and, having made them, the Division is responsible for the outcome.

* * *

While the Division is not under an obligation to use an external index in such a way as to minimize petitioners' tax liability, as stated above, the index chosen must be "reasonably calculated to reflect the taxes due" (***see, Matter of W.T. Grant Co. v. Joseph, supra***). Had consideration been given to other exhibits in that Report, it would have appeared obvious that petitioners may not have underreported sales in any respect. With no articulated basis having been provided for using one exhibit over another, and given the divergent range of results depending on the choice of exhibits within the same external index, we find that, in this instance, the use of Exhibit C-16 of the Report by the auditor to calculate petitioners' taxable sales was not "reasonably calculated to reflect the taxes due" by petitioners.

We modify finding of fact "9" of the Administrative Law Judge's order to read as follows:

Petitioners' January 19, 2010 application for costs seeks an award of costs in the amount of $126,024.74, consisting specifically of the following items:

a. $18,822.50 for expert witnesses
(i) Sales Tax Solutions and Consulting ($5,255.00 at $75.00 to $100.00 per hour)
(ii) Brendan McCafferty ($13,567.50 at $225.00 per hour)

b. $97,556.00 for attorneys fees
(i) Amigone, Sanchez, Mattrey & Marshall, LLP ($53,707.50 at $175.00 per hour)
(ii) Hodgson Russ LLP ($43,848.50 at $100.00 to $625.00 per hour)[4]

c. $3,271.24 for disbursements
(i) Amigone, Sanchez, Mattrey & Marshall, LLP ($2,059.50)
(ii) Hodgson Russ LLP ($1,211.74)

d. $6,375.00 for legal fees and disbursements associated with this application
(i) Amigone, Sanchez, Mattrey & Marshall, LLP legal fees ($6,300.00 at $175.00 per hour)
(ii) Amigone, Sanchez, Mattrey & Marshall, LLP disbursements ($75.00)[5]

We modify finding of fact "10" of the Administrative Law Judge's order to read as follows:

> Accompanying petitioners' application for costs were detailed itemized statements of each of the attorneys and expert witnesses listed above. These records set forth the actual time expended and the rate at which their fees and other expenses were computed. None of the items indicated special circumstances or factors.
>
> A review of these records reveals that State Tax Solutions and Consulting charged petitioners for roughly 53.5 hours of professional services. Brendan McCafferty, Esq. charged petitioners 60 total hours, 55 hours of legal services and 5 hours attending the hearing and providing testimony. Amigone, Sanchez, Mattrey, & Marshall, LLP charged petitioners approximately 306 hours for legal services on the underlying matter. Hodgson Russ LLP charged petitioners for

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[4] Hodgson Russ charged petitioners at varying rates depending upon which individual conducted the work. The rates are as follows: Paul R. Comeau ($595.00/hr), Mark S. Klein ($400.00-$450.00/hr), Timothy P. Noonan ($250.00-$325.00/hr), Christopher L. Doyle ($310.00-$350.00/hr), Christian J. Soller ($190.00/hr), Jack Trachtenberg ($250.00/hr), Joseph N. Endres ($160.00-$180.00/hr), Stephen W. Kelkenberg ($185.00/hr), and Susan M. Malyszka ($100.00/hr).

[5] We have modified finding of fact "9" to more precisely identify the costs sought by petitioners.

approximately 200 hours of legal services.[6]

Also accompanying petitioners' application for costs were the following:

a) The affidavit of Mark Supples, as president of 33 Virginia Place, Inc. and a 45% shareholder, set forth the following information:

i. A listing of the costs for which petitioners are seeking reimbursement.
ii. A statement that the Company's net worth at the time the proceeding was commenced was less than $7 million.
iii. A statement that the most recent Balance Sheet and Statement of Profit & Loss of the Company showed a book value of $12,000.00 as of December 31, 2009.
iv. A statement that at the time the proceeding was commenced, the Company had fewer than 50 full time and part time employees.
v. A statement that at the time the proceeding was filed, his net worth was substantially less than $2 million, and although it has increased, it still remains so.
vi. A statement that the joint net worth of Mark Supples and his wife, Amy Taylor, is substantially less than $2 million as evidenced by an attached joint financial statement.

b) The affidavit of Amy Taylor, an officer of 33 Virginia Place, Inc. and a 45% shareholder, set forth the following information:

i. A statement that at the time the proceeding was filed, her net worth was substantially less than $2 million, and although it has increased, it still remains so.
ii. A statement that the joint net worth of Amy Taylor, and her husband, Mark Supples, is substantially less than $2 million as evidenced by an attached joint financial statement.

c) The affidavit of Matthew J. Conroy, stating that at the time the proceeding was filed, his net worth was less than $2 million. Attached to his affidavit was a personal financial statement, dated January 11, 2010, showing that his total net worth was less than $2 million at that time.

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[6] We have modified finding of fact "10" to more precisely identify the costs sought by petitioners.

d) The affidavit of Melissa A. Conroy, stating that at the time the proceeding was filed, her net worth was less than $2 million. Attached to her affidavit was a personal financial statement, dated January 11, 2010, showing that her total net worth was less than $2 million at that time.

We make the following additional finding of fact:

> Each of the submitted financial statements appears to be self-prepared, signed and certified by the respective petitioners.[7]

THE ORDER OF THE ADMINISTRATIVE LAW JUDGE

The Administrative Law Judge determined that the question of whether the Division's position was substantially justified turned on whether the Division justifiably estimated petitioners' tax liability and, if so, whether its resorting to external indices was proper.

The Administrative Law Judge found that the Division had proper grounds to estimate petitioners' tax liability because petitioners failed to maintain sales tax records as required by the tax law. The Administrative Law Judge also held that the Division's failure to employ common sense checking in the audit calculation, which proved fatal to the Notices of Deficiency, did not obviate its justification in using external indicies. The Administrative Law Judge noted that there was no evidence that the Division issued the notices for the purposes of harassment or embarrassment, or that its position was inconsistent with similar cases. The Administrative Law Judge concluded that petitioners were not the prevailing party pursuant to Tax Law § 3030 because the Division established substantial justification for issuance of the determination.

ARGUMENTS ON EXCEPTION

On exception, petitioners argue that the Administrative Law Judge erred in holding that

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[7] We note that the financial statements of Matthew and Melissa Conroy claim a joint 15% interest in 33 Virginia Place. Combined with the percentages held by Mark Supples and Amy Taylor, 45% each respectively, this calculates to 105% total ownership in the corporation.

the Division possessed substantial justification when it issued the notices. Petitioners state that the cancellation of the notices was based entirely upon analyzing the information available to the Division prior to the issuance. Accordingly, petitioners contend that the order was premised upon an error of fact. Additionally, petitioners argue that a reversal is required because no substantial justification can be found where an audit produces results that are "arbitrary and patently" unreasonable. Petitioners cite Penal Law § 15.05 and suggest that the Division's conduct more closely resembles criminal recklessness rather than reasonable justification.

Petitioners also present several arguments that they should be treated as the prevailing party. They argue that, while federal law may guide the decision in cost matters, it does not necessarily control. Petitioners argue that Tribunal decisions and basic principles of fairness should be applied and strongly support a finding in their favor.

The Division argues that substantial justification existed at the time the notices were issued. The Division contends that justification existed because petitioners' failure to maintain records and cooperate with the audit forced an estimation. The Division also argues that it had legal support for its audit methodology and that its mechanics were consistent with prior cases. The Division further supports the finding of substantial justification with mathematics and observations drawn from the record below.

The Division argues that costs should not be granted because of petitioners' active refusal to cooperate on audit. It states that external indicies were used because petitioners refused to comply with their legal obligation to keep guest check records even for a short mark-up period. The Division claims that this willful refusal to maintain source records supports a finding of substantial justification and provides equitable grounds for the denial of costs.

OPINION

We affirm the order of the Administrative Law Judge.

As stated by the Court of Appeals:

> Tax Law § 3030 was enacted to provide taxpayers with additional rights and equitable relief under the Taxpayer Bill of Rights Act of 1997 (Governor's Program Bill Mem, Bill Jacket, L 1997, ch 577). Section 3030 permits a discretionary award of attorneys' fees to the prevailing party in a proceeding in which the Commissioner is a party and which involves the determination, collection or refund of any tax (Tax Law § 3030[a]). A prevailing party is not entitled to recovery attorneys' fees if the Commissioner satisfies his burden of proving, by a preponderance of the evidence, that his position was substantially justified (Tax Law § 3030[c][5][B]) (***City of New York v. State of New York***, 94 NY2d 577, 598 [2000]).

The Legislature modeled Tax Law § 3030 after Internal Revenue Code § 7430 (***see*** Legislative Mem, McKinney's Session Laws of NY, at 2549). Therefore, it is appropriate to use both New York and Federal jurisprudence as guidance in applying this statute (***see Matter of Levin v. Gallman***, 42 NY2d 32 [1977]; ***see also Matter of Ilter Senser***, May 6, 1988).

The Division must establish that its position was substantially justified (***see*** Tax Law § 3030 [b][5][B][ii]). This standard requires that the Division show a reasonable basis in both law and fact (***see Powers v. Commissioner***, 100 TC 457 [1993]; ***see also Pierce v. Underwood***, 487 US 552 [1988]). While the cancellation of a notice may be considered (***Heasley v. Commissioner***, 967 F2d 116 [1992]), this determination must also consider "all the facts and circumstances surrounding the [case]," not solely the final outcome (***Phillips v. Commissioner***, 851 F2d 1492, 1499 [1988]). The Division has met its burden when it has shown that the issuance of the notices were "justified to the degree that could satisfy a reasonable person" (***Pierce v. Underwood***, ***supra*** at 565).

We conclude that the Division proved substantial legal justification for the issuance of the

notices. It is well-settled that, upon a proper request for sales tax records and a review determining that such records are inadequate (***see e.g. Matter of Giordano v. State Tax Commn.***, 145 AD2d 726 [1988]), the Division may estimate a taxpayer's liability using external indicies (***see*** Tax Law § 1138[a][1]; ***Matter of Urban Liqs. v. State Tax Commn.***, 90 AD2d 576 [1982]). In our prior decision (***Matter of 33 Virginia Place***, Tax Appeals Tribunal, December 23, 2009), we held that the Division was legally entitled to utilize external indicies in estimating petitioners' tax liability. The parties did not dispute that the Division issued proper records requests and that petitioners failed to provide records sufficient to determine the proper amount of tax due. Accordingly, we hold that the Division has presented the requisite legal justification for issuing the subject notices.

We also conclude that the facts of this case support the finding that the Division was substantially justified in issuing the subject notices. Herein, petitioners operated a popular business in Buffalo. Petitioners did not maintain guest checks or invoices to substantiate their sales, and willfully declined to do so even after notifications by the Division. Indeed, petitioners refused to maintain records for even a short audit period, as requested by the Division. In light of the entire record, petitioners' actions are entitled to the strongest negative inference. Their conduct not only violated Tax Law § 1135(a) and Tax Law §1817(j), but provided the Division with the latitude to estimate their tax liability. Accordingly, we find that the facts substantially justify the issuance of the notices against petitioners.

We reject petitioners' contention that the order below and our December 23, 2009 decision are inconsistent. From their arguments, it appears that petitioners misapprehended our decision in this matter. Therein, we found that the Division failed to meet the threshold burden

of showing a rational basis because its auditors could not explain how they used the subject external indicies (***see Matter of Fashana***, Tax Appeals Tribunal, September 21, 1989 [record must contain "sufficient evidence to determine whether a rational basis existed for the audit computations"]). This evidentiary failure was sufficient to cancel the notices at the hearing, but did not invalidate any of the foregoing bases for the notices at the time of issuance. Moreover, in our decision, we neither found the conduct of the Division criminal, nor condoned petitioners' dereliction of their legal responsibilities. Contrary to petitioners' argument, basic principles of fairness do not stand in their favor. This is especially true considering petitioners' willful and wanton disregard for their statutory obligation to maintain books and records.

We also reject petitioners' argument that costs should be awarded on equitable grounds. The Legislature intended Tax Law § 3030 to serve as an equitable remedy protecting taxpayers against abuses of discretion by the Division. The record shows that the Division possessed substantial justification for issuing the notices. It also shows that petitioners not only failed to maintain records, but that they willfully refused to do so for even a short test period, which caused the Division to seek an alternative audit methodology. Such conduct by petitioners bars equitable recovery (***see e.g. Hykto v. Hennessey***, 62 AD3d 1081 [2009]). Accordingly, petitioners' application for costs are also denied on these grounds.

We conclude that petitioners are not the prevailing party within the meaning of Tax Law § 3030 because the Division presented substantial justification for the issuance of the subject notices. Accordingly, petitioners motion for costs was properly denied.

The issue of whether the costs and fees sought by petitioners are reasonable is rendered moot by virtue of the foregoing discussion.

Accordingly, it is ORDERED, ADJUDGED and DECREED that:

1. The exception of 33 Virginia Place, Inc., Mark Supples and Amy Taylor and Matthew J. and Melissa A. Conroy is denied;

2. The order of the Administrative Law Judge is sustained; and

3. The application for costs of 33 Virginia Place, Inc., Mark Supples and Amy Taylor and Matthew J. and Melissa A. Conroy is dismissed with prejudice.

DATED: Troy, New York
March 31, 2011

/s/ James H. Tully, Jr.
James H. Tully, Jr.
President

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

/s/ Charles H. Nesbitt
Charles H. Nesbitt
Commissioner