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 :

**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. :

---

DECISION
DTA NOS. 821181, 821182, 821183, 821290, 821291 and 821859

| | |
|---|---|
| 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. | : |

The Division of Taxation filed an exception to the determination of the Administrative Law Judge issued on November 13, 2008. Petitioners appeared by Amigone, Sanchez, Mattrey & Marshall, LLP (Vincent J. Sanchez and B.P. Oliverio, Esqs., of counsel). The Division of Taxation appeared by Daniel Smirlock, Esq. (James Della Porta, Esq., of counsel).

The Division of Taxation filed a brief in support of its exception. Petitioners filed a brief in opposition. The Division of Taxation filed a reply brief. Oral argument, at the request of the Division of Taxation, was heard on July 15, 2009 in Troy, New York.

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

## *ISSUE*

Whether the audit methodology utilized by the Division of Taxation in its audit of 33 Virginia Place, Inc. was reasonable or whether petitioners have shown error in either the audit methodology or the result.

## *FINDINGS OF FACT*

We find the facts as determined by the Administrative Law Judge. These facts are set forth below.

### *First Sales Tax Audit*

33 Virginia Place, Inc. (petitioner) 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.

This audit commenced as a result of the audit of another business wherein an improperly issued resale certificate from petitioner was found to have been issued for the purchase of furniture. On December 9, 2002, Mark Supples, on behalf of Mother's, issued a resale certificate to Jay's Furniture Products of Buffalo when Mother's purchased furniture. Mr. Supples indicated that the furniture purchased consisted of booths, which he believed to be a capital improvement. He stated that he did not read the resale certificate and that it was given to him by the vendor of the booths.

Mark Supples purchased Mother's in 1992. Mother's is open from 4:00 P.M. until 4:00 A.M. It serves its full menu (typically steak and seafood) until 3:00 A.M. Mother's accepts reservations on Thursdays, Fridays and Saturdays, and it is busiest at around 7:30 or 8:00 P.M. Mother's occupies the ground floor of a two-story building and the establishment is comprised of approximately 2,500 square feet, which includes 16 tables with seats for 58 diners, 16 bar stools at the bar and 6 additional bar stools against a side wall of the bar area. There is also an outdoor patio that is open during the summer months.

Mr. Supples described the City of Buffalo as "downtrodden," and that, in his opinion, approximately 50% of its population lives below the poverty line. Because there is little tourism in Buffalo, the success of the restaurant depends upon regular customers. Mr. Supples stated that the key to the success of Mother's is providing good value for the customers' dollar. To provide good value, Mother's provides larger portions than those of its competitors at a lower price. Mother's dinners include vegetables, rice, soup or salad, while dinners at its primary competitors, Buffalo Chophouse and Kennedy's Cove, include only rice. Credit card sales account for slightly more than 50% of Mother's sales.

Vincent J. Sanchez, a partner in the firm of Amigone, Sanchez, Mattrey & Marshall, LLP, the firm that represents petitioners in this proceeding, is a regular customer of Mother's (he dines at the restaurant at least once per week). Mr. Sanchez often dines there on Mondays, which he states, "[are] very slow. I mean, I've been there when I've been the only person in there and I've been there where there are a few people at the bar and maybe a table or two going." Mr. Sanchez stated that Mother's has a terrific reputation for food and price.

On January 29, 2004, the auditor contacted petitioner's owner, Mark Supples, and set up an appointment for February 18, 2004. An appointment letter, confirming the aforesaid date, was

sent to Mr. Supples. Attached to the letter was a Records Requested List, which set forth all of the books and records that were required to be made available for the audit. Pursuant to the appointment letter, the audit period was March 1, 2001 through November 30, 2003.

A few days prior to the scheduled appointment, Mr. Supples telephoned the auditor and requested that the audit be conducted at a storage facility in Williamsville, New York, where he stated that petitioner's records were located.

Along with the auditor's team leader, she met Mr. Supples at the storage facility. The auditor and team leader requested that they be permitted to take the records to their office, but Mr. Supples declined to allow them to take the records with them. The auditor and her team leader took an inventory of the records presented and reviewed them at the storage facility.

On February 27, 2004, a second letter was sent to Mr. Supples, which stated that a review of the records presented disclosed that not all of the records requested were made available, to wit: cash register tapes for the entire audit period; guest checks for the entire audit period; federal income tax returns for 2001, 2002 and 2003; bank statements for October and November 2003, merchandise and expense purchase invoices for 2001; sales sheets for March 2001 through December 2001, November 2002, January through May 2003 and August through November 2003; and fixed asset purchases for the entire audit period.

On March 15, 2004, Mr. Supples dropped off records to the auditors. At that time, he stated that he had no guest checks or register tapes for any portion of the audit period. He also stated that he made no cash purchases, except for miscellaneous small items and that any of these purchases would be listed on the daily sales sheets.

On March 25, 2004, another letter was sent by the auditor to Mark Supples. Enclosed with the letter was a copy of the Division's Technical Services Bureau memorandum (TSB-M-

85[5]S), which sets forth a vendor's responsibilities and the records that are required to be kept. At the hearing, petitioner's representatives stipulated, on the record, that petitioner failed to maintain the records that complied with the provisions of this memorandum.

According to the field audit record, an investigator employed by the Division went to Mother's in early April 2004 on a Friday evening. The investigator indicated that the bar was full (approximately 50 people) with mainly wine and alcohol sales and that there was seating for approximately 100 people with one-quarter of the tables full.

The auditor indicated that since there were no guest checks or cash register tapes for the audit period, she attempted to conduct a markup using petitioner's selling prices. She computed a markup for beer of 225% above cost (this markup pertained to canned and bottled beer since Mother's did not serve draught beer). The auditor gave Mr. Supples a bar fact sheet, which he agreed to prepare. However, the auditor concluded that a markup for wine and liquor could not be performed because wine was sold by the bottle and by the glass and liquor was sold in shots, mixed drinks and cocktails. As to food, the auditor stated that because there were a number of daily specials in addition to the regular menu items, register tapes and guest checks were needed to determine the quantity of items sold.

The auditor did not review petitioner's credit card sales. She determined that petitioner's net bank deposits (subtracting out sales tax paid on the sales tax returns) were approximately $170,000.00 greater than sales reported on the sales tax returns.

The auditor advised Mr. Supples, both orally and in writing, as to the records that he was required to maintain but at a meeting with Mr. Supples and a prior representative, he advised the auditor and her supervisor that he did not intend to keep such records.

To determine petitioner's markup percentages, the auditor utilized the 2002 edition of Restaurant Industry Operations Report by the National Restaurant Association and Deloitte & Touche. The auditor used the 2002 edition because the year 2002 was the one full year within the audit period. She indicated that she did not compare the data in the 2002 edition with any other editions of the report, including the 2001 and 2003 editions.

During direct examination, the auditor indicated that she used Exhibit C-10, Full Service Restaurants (Average Check Per Person $25 and Over), Statement of Income and Expenses - Amount Per Seat, to compute the markup percentage to be used in her audit. However, on cross examination, she corrected herself and stated that she used Exhibit C-12, Full Service Restaurants (Average Check Per Person $25 and Over), Statement of Income and Expenses - Amount Per Seat, to calculate the markup percentages. Using the median[1] figures in Exhibit C-12, the auditor calculated markup percentages for food and beverages of 181% and 185%, respectively, above cost.

The markup percentages were then applied to petitioner's purchases per its disbursements journal for food and beverages. Third-party verification was used to verify purchases and purchases did reconcile to petitioner's books. According to petitioner's disbursements journal, food purchases were approximately 62% and beverages were approximately 38% of total purchases. The disbursements journal contained only petitioner's purchases made by check; however, there were indications that some purchases of food and beverages had been made with cash. These purchases were noted on the sales summary sheets and consisted of smaller purchases made at supermarkets.

---

[1] Median means that one-half of the restaurants surveyed had higher markup percentages and one-half had lower markup percentages than the median number.

The 185% beverage markup was applied to beer, liquor and wine purchases of $741,808.29, which resulted in audited beer, wine and liquor sales of $2,114,153.63 for the audit period. The 181% food markup was applied to food purchases of $1,189,681.05, which resulted in audited food sales of $3,343,003.75. Total audited sales were, therefore, determined to be $5,457,157.38. After subtracting reported sales of $3,714,329.00, additional taxable sales were found to be $1,742,828.38, with tax due thereon (computed at 8%) of $140,369.88. The error percentage in terms of underreporting of sales was approximately 46%.

The auditor also performed a detailed audit of petitioner's fixed asset acquisitions. Some of the invoices indicated that petitioner had paid cash for some of the items purchased. For the audit period, it was determined that petitioner made purchases totaling $118,653.34 and had paid tax of $181.83. Accordingly, tax was found to be due on purchases totaling $118,470.71, with additional tax due thereon of $9,299.79. Petitioner indicated that this amount was not in dispute.

In May 2003, Mother's closed for 10 or 11 days for remodeling. Mr. Supples indicated that some of the items used in the remodeling were purchased with cash. At the time, he obtained a loan in the amount of $70,000.00 from M& T Bank and also used additional moneys from his personal funds (his bank account, his wife's bank account, stock sales and his weekly check from the restaurant).

As a result of this audit, total additional tax due was determined to be $149,669.67, which consisted of $140,369.88 due on sales of food and beverages and $9,299.79 due on fixed assets acquired without payment of sales tax.

On December 1, 2004, the Division issued a Notice of Determination 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.

Previously, on June 3, 2004, petitioner, by its former representative, and again on August 18, 2004, by Mark Supples, petitioner's owner, and the Division executed consents extending the period of limitation for assessment of sales and use taxes whereby it was agreed that taxes for the period March 1, 2001 through November 30, 2003 could be assessed at any time on or before December 20, 2004.

On December 27, 2004, the Division issued a Notice of Determination 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 Notice of Determination advised Mr. Supples that it was being issued because he was an officer or responsible person of 33 Virginia Place, Inc.

During cross examination, the auditor, when asked why she used the figures set forth in Exhibit C-12 of the Restaurant Industry Operations Report, as opposed to any of the other schedules set forth in Section C - Full Service Restaurants (Average Check Per Person $25 and Over) stated as follows:

> It just seemed to be an average of - - some of the other schedules, exhibits; we didn't have that type of information pertaining exactly to that category, so this seemed as though it was just an average.

When asked why she did not use the total per seat sales figure of $10,887.00 set forth in Exhibit C-12 to compute petitioner's sales by multiplying this figure by the amount of seats in Mother's, the auditor's response was: "I don't know."

The Restaurant Industry Operations Report, 2002 edition, on the first page thereof, states, in relevant part, as follows:

> Almost 800 questionnaires were received from restaurant operators, and 660 were used as the basis for this report. This unique study of the operating results of restaurants in 2001 . . . .

* * *

> This data is not intended to be standards or goals for individual restaurants, nor is this report an attempt by the National Restaurant Association or Deloitte & Touche to set or adjust industry prices or operating ratios. Rather, the data and related worksheet at the back of the report are intended to be used as management tools to help you compare your restaurant's performance with that of similar restaurants.

On page 15 of the Report, under "Explanatory notes," it is stated:

> Readers should be aware that the operators who participated in this study are not identical with those who participated in prior years' studies. This makes comparisons with previous data difficult, because reporting ratios can be vastly different.

The Report, in section C pertaining to full service restaurants with an average check per person of $25 and over, indicated that it represented the characteristics of the 102 respondents in this category. More than three-quarters (83.3%) of the respondents represented independent restaurants and 53.9% were the sole occupant of their location. More than three-quarters (80.4%) of the respondents were located within a metropolitan area and restaurants with American menu themes represented 41.2% of the sample.

Section C of the Report contains 20 exhibits pertaining to full service restaurants with an average check per person of $25 and over. Exhibits C-9 through C-19 set forth data relating to statements of income and expenses. In particular, Exhibit C-9 contains data relating to amount per square foot while Exhibits C-10, C-12, C-14, C-16 and C-18 and Exhibits C-11, C-13, C-15, C-17 and C-19 contain figures or percentages pertaining to amounts per seat and ratio to total sales, respectively.

The New York State Department of Taxation and Finance's Indirect Audit Methods Trainer's Manual, issued May 2001, sets forth a hierarchy of indirect audit methods. Upon cross

examination, the auditor indicated that she never reviewed the manual before deciding which audit method to employ.

According to the manual, the strongest case, as the case goes through the appeals process, is a markup test, using either some of the vendor's records or third-party information to arrive at audit findings. The next strongest method is an observation test. Following the observation test is the use of a prior audit. According to the manual: "The last, and least accurate would be the use of external indices. These are industry averages throughout the country or region." The manual further states that "[s]omewhere in between the use of a prior audit and the use of external indices would be the District Office index. This is better than the external indices in that the results of the data collected is localized." Finally, the manual states, in bold print: "**Major point to stress: The more you use the vendor's records, the stronger the case will be**."

The auditor's supervisor, the sales tax section head of the Buffalo District Office, supervised this audit. He stated that petitioner's markup per its books was approximately 92% to 93% above cost which, in his opinion, was a low markup based on his audit experience. As a result of the use of the 2002 edition of the Restaurant Industry Operations Report, the markup calculated for petitioner was 181% above cost for food and 185% above cost for beverages, which the section head stated was reasonable based on his audit experience.

Because petitioner made cash purchases and a cash disbursements journal was not provided, the section head could not be certain that the purchase records were complete. He stated that a markup test based on petitioner's records was not performed because, due to the fact that there were many daily specials offered, he had no idea what was being sold and at what price. As a result thereof, the section head directed the auditor to use the 2002 Restaurant Industry Operations Report and he also determined which exhibit within the report to use to

determine petitioner's markup percentage. He never compared the 2002 edition with the 2001 or 2003 editions to determine if the results varied markedly.

The section head made the decision to assess penalties in this matter based on an almost 50% understatement of gross receipts and, in addition, on the fact that required records were not kept by petitioner.

The section head also made the decision to refer the audit results to the personal income tax and corporation franchise tax sections for possible assertions of income tax and franchise tax deficiencies.

On cross examination, the section head stated that Exhibit C-12 of the 2002 Restaurant Industry Operations Report, which was the exhibit used by the auditor to determine petitioner's markup, indicates that the median per seat total sales was $10,887.00. Multiplying this per seat figure by the total seats in petitioner's restaurant (approximately 80 including the bar stools) equals $870,960.00. Multiplying this amount by 3 (total years in the audit period) equals $2,612,880.00. For the audit period, petitioner reported sales of $3,714,329.00; however, based upon the markup percentage determined by the auditor using Exhibit C-12, the Division increased petitioner's sales by approximately $1.7 million, resulting in audited sales that were approximately $2.9 million over the per seat amount set forth in Exhibit C-12.

In Exhibit C-2, Average Daily Seat Turnover for Full Service Restaurants (Average Check Per Person $25 and Over), the same category as Exhibit C-12, which was used to calculate petitioner's markup percentage, the median average daily seat turnover was 0.9, or less than one turn per day. The section head admitted that the results of the audit would require substantially more than one turn per day to achieve the level of sales computed by the Division.

In Exhibit C-8, Statement of Income and Expenses for Full Service Restaurants (Average Check Per Person $25 and Over), the median profit before income taxes is $200.00 per seat. Pursuant to the results of the audit, the additional $1.7 million, divided by 3 (the years in the audit period), divided by the seats in petitioner's restaurant (approximately 80), results in a profit per seat of more than $7,000.00.

On cross examination, the section head conceded that the markup computed per the Restaurant Industry Operations Report ignored the number of seat turns per day and amount of profit per seat. On direct examination, the section head indicated that the hours of operation for Mother's was 4:00 P.M. until 4:00 A.M and, when asked why an observation test was not performed for Mother's, he stated that an observation test is not normally performed when an establishment is "open to the middle of the night."

***Second Sales Tax Audit***

A second sales tax audit of petitioner was performed for the period December 1, 2003 through August 31, 2006. While the section head was the same for the second audit, a different auditor conducted the audit.

By letter dated October 10, 2006, petitioner was advised that its sales and use tax records were scheduled for audit. Attached to the letter was a Records Requested List, which set forth all of the records required to perform the audit. Pursuant to the letter, the auditor received some guest checks, which were in a box separated on a per day basis. Petitioner began keeping the guest checks in January 2005. The guest checks were prenumbered but were not in sequential order. Some end-of-day register tapes were available for the period January 25, 2006 through August 31, 2006, although some tapes were missing.

By a letter dated November 21, 2006 to Mark Supples, petitioner was advised that the following records were missing and needed for review:

> End of day register cash out tapes were available from 1/25/06 - 8/31/06 however [*sic*] there are numerous tapes missing during this period. The missing tapes will need to be presented for review by the date below. See included transcript.
>
> End of day register cash out tapes or guest checks were not provided prior to 1/25/06 please [*sic*] provide these records for review.
>
> Cash register journal tapes for the entire period were not made available.

On January 30, 2007, another letter was sent to Mark Supples, which requested the same records previously requested in the November 21, 2006 letter. In addition, this letter also asked for daily cash out sheets for the months of December 2003 and February 2006.

Guest checks were provided for petitioner's credit card sales only; guest checks for cash sales were not made available to the auditor. The guest checks were not sequentially numbered; they were not in books but were loose. In addition, Z tapes (end-of-day register tapes that list all daily transactions) were missing for many Fridays and Saturdays. Based upon the records presented, the auditor could not determine what petitioner's sales were for any given day.

For the audit period, petitioner's book markup was approximately 90%, which, based upon the auditor's experience, was "a little bit low." The auditor determined that he could not perform a food markup because he could not verify what was being sold and in what portions since he did not have the daily specials menu for all of the days in the audit period.

The auditor stated that he considered an observation test, but "the way it was set up, it didn't lend itself to an observation." This was because Mother's had two small registers behind the counters that had small displays and "we would have had to basically sit right next to the register behind the counter, which was quite small, and watch the register in order to see that

everything was being rung in." The credit card machine was located at one end of the bar and to perform an observation would have caused "major disruption in the business."

The auditor decided to use the 2006/2007 edition of the Restaurant Industry Operations Report by the National Restaurant Association and Deloitte & Touche LLP. In computing petitioner's markup, the auditor used Exhibit C-16, Statement of Income and Expenses - Ratio to Total Sales for Full Service Restaurants (Average Check Per Person $25 and Over). The auditor utilized the median ratios of cost to total sales for restaurants with sales of $2,000,000.00 and over (the auditor stated that while the heading at the top of the page states $2,000 and over, it actually is $2,000 times 1,000 which equals $2,000,000.00) which, using this exhibit, were 31.7% for food and 29.8% for beverages. The auditor then divided 100 by the 31.7 to arrive at a 315% markup for food and divided 100 by the 29.8 to arrive at a 336% markup for beverages. These markup percentages were applied to petitioner's purchases for food and beverages, which the auditor obtained from general ledger reports supplied by petitioner's accountant.

Based on these markup percentages, audited taxable sales were determined to be $8,564,102.69. Petitioner reported gross sales on its returns filed for the audit period in the amount of $4,766,594.00; therefore, additional taxable sales were $3,797,508.69, with tax due thereon in the amount of $318,815.94. Penalties were imposed by the auditor because of "gross understatement of tax" and because petitioner, despite being advised during the prior audit as to what records were required to be kept, failed to keep such records.

On May 31, 2007, the Division issued a Notice of Determination to petitioner, which assessed additional sales and use tax in the amount of $318,815.93, plus penalty and interest, for a total amount due of $536,589.45 for the period December 1, 2003 through August 31, 2006.

The audit was conducted at the restaurant, which the auditor visited four or five times. An investigator employed by the Division visited Mother's with another employee of the Division on February 15, 2007 and prepared a report that stated, among other things, that:

> It was estimated that the food traffic was primarily by Credit Card, and that the Servers were using a bank. This will be a very difficult inside observation for several reasons. The locations to scrutinize are each of two cash registers, the credit card station, and the kitchen/wait station. With five servers, each moving quite rapidly, identifying their activities will be difficult.

The auditor did not perform a markup using petitioner's records because he did not have sufficient information regarding sales. Upon cross examination, the auditor stated that he was somewhat familiar with the prior audit and the method of computing the markup in the prior audit. When asked whether he had read the 2006/2007 edition of the Restaurant Industry Operations Report, the auditor replied that he had not read the entire publication. The auditor stated that he had not read page 15 of the publication, entitled "Introduction To Analysis of Data and Explanatory Notes," where it stated that more than 1,370 restaurants throughout the United States responded to the survey and, after a careful review for accuracy and completeness, 996 were used for the report. Page 15, under "Explanatory Notes," stated, in part, as follows:

> Readers should be aware that the operators who participated in this study are not identical with those who participated in prior years' studies. This makes comparisons with previous data difficult, because reporting ratios can be vastly different. However, comparisons of the information in past reports may be useful in identifying certain financial trends.

The auditor 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 he attributed that difference to the fact that different indices (or exhibits) were used. However, he stated that he thought that the use of Exhibit C-16 from the

2006/2007 edition of the Restaurant Industry Operations Report "was more representative of the taxpayer's business." The auditor stated that he did not realize that the category (exhibit) that he selected from the report was going to result in a higher markup percentage than was computed in the prior audit.

The auditor, when asked during cross examination why he selected Exhibit C-16 rather than any of the other exhibits contained in Section C of the Report, stated that he did not remember which of the other exhibits were examined and why these other exhibits were not used.

During cross examination, Exhibit C-11 from the 2006/2007 edition of the Restaurant Industry Operations Report was introduced into evidence by petitioners. This exhibit was the 2006/2007 equivalent of Exhibit C-12 of the Restaurant Industry Operations Report from the 2002 edition that was used in the first audit. If Exhibit C-11 from the 2006/2007 edition had been used in the second audit, the markup percentages would have been 297% for food and 289% for beverages, as opposed to the 315% for food and 336% for beverages derived from Exhibit C-16.

Petitioners also introduced into evidence Exhibit C-18 from the 2006/2007 edition of the Restaurant Industry Operations Report. Use of this exhibit, entitled "Full Service Restaurants (Average Check Per Person $25 and Over), Statement of Income and Expenses - Ratio to Total Sales," would have yielded still different markup percentages, to wit, 294% for food and 313% for beverages.

On cross examination, the auditor was asked if he would agree that if his markup was reasonable, that it should also require reasonable seat turns per day and the auditor responded: "I would think so." When asked if, during his audit, he had noticed in the Restaurant Industry

Operations Report a schedule relating to daily seat turnover, he replied: "I just saw it now. I don't remember if I reviewed it, you know, which schedules I actually reviewed."

The auditor also agreed, during cross examination, that because Mother's credit card sales were verifiable by audit, any additional sales determined on audit (in this instance, $3,797,508.69) would have to have been cash sales.

***Corporation Franchise Tax and Personal Income Tax Audits***

A letter dated March 3, 2005 was sent by the Division to petitioner advising it that its corporation franchise tax returns for the years 2001 through 2003 had been selected for audit based upon a referral from the Sales Tax Audit Bureau.

Petitioner filed its franchise tax returns on a calendar year basis. A letter was sent to petitioner scheduling an appointment for March 22, 2005; however, petitioner did not appear. Mark Supples telephoned the auditor on March 23, 2005, and when asked if he wished to schedule another appointment, he indicated that he did not wish to since he disagreed with the sales tax audit findings and intended to contest such findings. The auditor 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. The auditor further explained that since the months of January and February 2001 were outside the sales tax audit period, the additional income attributable to these months would have to be estimated unless Mr. Supples wished to provide the auditor with actual sales figures. Mr. Supples stated that he did not wish to do that and told the auditor to go ahead and bill him. Petitioner's previous representative asked that the matter be placed on hold pending a decision from the Division's Bureau of Conciliation and Mediation Services (BCMS) regarding the sales tax assessments. The auditor stated that the case would be placed on hold if a waiver extending the statute of limitations was executed.

Accordingly, on May 25, 2005, consents were executed whereby it was agreed that franchise taxes due from petitioner for the period January 1 through December 31, 2001 could be determined or assessed at any time on or before September 15, 2006 and personal income taxes due from Mark Supples and Amy Taylor for the period January 1, 2001 through December 31, 2002 and due from Matthew J. and Melissa A. Conroy for the period January 1, 2002 through December 31, 2002 could be determined or assessed at any time on or before September 15, 2006.

To compute the additional franchise tax due from petitioner, the auditor used the additional gross receipts from the results of the first sales tax audit and applied it to the years at issue. For the months of January and February 2001, which were not part of the sales tax audit, the auditor utilized the audited sales for the period March 1, 2001 through December 31, 2001, divided the results by 10 (to get an average monthly sales figure) and then multiplied the monthly figure by 12 to get a yearly total for 2001. For the month of December 2003, which was not a part of the first sales tax audit, a similar method was used by taking audited sales for January 1, 2003 through November 30, 2003, dividing the results by 11 (to get an average monthly sales figure) and then multiplying the monthly figure by 12 to arrive at a yearly total for 2003.

Pursuant to the first sales tax audit of petitioner, the total audited sales were $5,457,157.38 (***see***, finding of fact above) which, on a yearly basis, were as follows: $1,482,935.00 for March 1 through December 31, 2001; $1,824,665.00 for 2002; and $2,149,557.00 for January 1 through November 30, 2003. Using the method set forth above to estimate the months that were not part of the sales tax audit (January and February 2001 and December 2003), the auditor determined the following:

| Year | Audited Gross Receipts | Gross Sales Reported | Additional Gross Receipts |
|---|---|---|---|
| 2001 | $1,779,522.00 | $1,184,911.00 | $594,611.00 |
| 2002 | $1,824,665.00 | $1,268,654.00 | $556,011.00 |
| 2003 | $2,344,971.00 | $1,572,103.00 | $772,868.00 |

Federal taxable income per audit was computed as follows:

| Year | Federal Taxable Income Reported | Additional Gross Receipts | Federal Taxable Income Per Audit |
|---|---|---|---|
| 2001 | $20,562.00 | $594,611.00 | $615,173.00 |
| 2002 | $37,423.00 | $556,011.00 | $593,434.00 |
| 2003 | $125,265.00 | $772,868.00 | $894,133.00 |

For 2001, the franchise tax due on the entire net income base was determined to be $5,076.00. Petitioner had previously paid the sum of $100.00; therefore, the balance due for 2001 was $4,976.00. For 2002, the franchise tax due on the entire net income base was determined to be $3,858.00. Petitioner had previously paid the sum of $244.00: therefore, the balance due for 2002 was $3,614.00.

On March 30, 2006, the Division issued a Notice of Deficiency 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.

Since petitioner is an S corporation and the franchise tax rate was higher than the personal income tax rate for 2001 and 2002, deficiencies of corporation franchise tax were asserted for those years. Due to a change in the law, which eliminated the differential between the franchise tax rate and the personal income tax rate, the tax flowed through to the corporate shareholders, so all that was due on the S corporation's return for the year 2003 was the minimum tax of $225.00,

which had already been paid by petitioner. Therefore, no corporation franchise tax deficiency was asserted against petitioner for the 2003 tax year.

For the year 2001, Mark Supples was the owner of 100% of the shares of petitioner. Therefore, the additional gross receipts of $594,611.00 (***see***, finding of fact above) were attributable to him, thereby increasing his New York State adjusted gross income to $781,193.00 which, after the standard deduction, resulted in New York State taxable income of $767,793.00, with tax due thereon of $52,741.00. Mr. Supples had previously paid the sum of $11,429.00 (penalty of $147.00 had also been paid), leaving a balance of $41,165.00. No adjustments for other expenses or deductions were made because Mr. Supples did not provide any information to the auditor.

For the year 2002, Mark Supples was a 45% shareholder of petitioner. Amy Taylor, the wife of Mark Supples, was also a 45% shareholder and Matthew Conroy was a 10% shareholder. Therefore, the additional gross receipts of $556,011.00 (***see***, finding of fact above) were attributable as follows: $250,205.00 to Mark Supples; $250,205.00 to Amy Taylor; and $55,601.00 to Matthew Conroy.

Since Mark Supples and Amy Taylor filed a joint return, the $500,410.00 was added to their adjusted gross income for the year. Accordingly, after the subtraction of the standard deduction, their New York State taxable income was $658,656.00, with tax due thereon of $45,118.00. After credit for tax previously paid of $9,617.00 (penalty of $250.00 had also been paid), tax due for the 2002 year was $35,501.00.

For 2003, as was the case for 2002, Mark Supples and Amy Taylor were each owners of 45% of the shares of petitioner while Matthew Conroy owned 10% of the shares. Therefore, the

additional gross receipts of $772,868.00 (***see***, finding of fact above) were attributable as follows: $347,791.00 to Mark Supples; $347,791.00 to Amy Taylor; and $77,287.00 to Matthew Conroy.

Since Mark Supples and Amy Taylor filed a joint return, the $695,582.00 was added to their adjusted gross income for the year. Accordingly, after the subtraction of the standard deduction, their New York State taxable income was $986,394.00, with tax due thereon of $75,952.00. After credit for tax previously paid of $21,178.00 (penalty of $267.00 had also been paid), tax due for the 2003 year was $54,774.00.

As a result of Matthew Conroy's 10% ownership of petitioner's stock in 2002, $55,601.00 was added to the adjusted gross income of Matthew J. Conroy and Melissa A. Conroy, his wife, with whom he filed a joint return. After subtraction of the standard deduction, their New York State taxable income was $93,203.00, with tax due thereon of $5,708.00. Since the Conroys had previously paid tax in the amount of $1,806.00, the balance due for the 2002 tax year was $3,902.00.

For 2003, as a result of Matthew Conroy's 10% stock ownership of petitioner, $77,287.00 was added to the adjusted gross income of Matthew J. Conroy and Melissa A. Conroy, his wife, with whom he filed a joint return. After subtraction of the standard deduction and one exemption, their New York State taxable income was $123,459.00, with tax due thereon of $8,283.00. After an adjustment due to a reduction in their New York State child and dependent care credit as a result of the increased income, the balance due for 2003 was $6,020.00.

On April 17, 2006, the Division issued a Notice of Deficiency 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.

On April 17, 2006, the Division issued a Notice of Deficiency 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.

During cross examination, when posed with the question of whether he asked or requested that the auditors conduct an observation of the business to determine the sales, Mark Supples indicated that during both the first and second sales tax audits, he "begged them to do it." He stated:

> I went so far as to offer to pay the auditors to sit at my bar during any night of their choice, sit in front of the registers, sit in front of the credit card machine, sit in my kitchen. I would pay double time to the auditors to do this, to disprove their ridiculous claims. I made that offer every single time we met.

For the week of Friday, November 9 through Thursday, November 15, 2007, Mark Supples kept a record of his total sales with tax ($40,687.01), charge sales without tips ($25,092.55), total food without tax ($19,108.25), number of customers who dined (963), and average amount of check per person including tax ($32.20).

David E. Gross, is a certified sales tax specialist, a CMI (Certified Member of the Institute of the Institute of Professionals in Taxation), which is a designation of achievement, knowledge and distinction in sales and use tax. He has provided services to numerous clients, from Fortune 500 to family owned operations for approximately 15 years. He possesses a Bachelor of Science Degree in accounting from Medaille College and also attended the University of Buffalo School of Management. Mr. Gross currently is the owner of Sales Tax Solutions of North Tonawanda, New York, which represents companies and clients in state sales and use tax audits. He was formerly employed: as a senior tax accountant at Lumsden & McCormick, LLP of Buffalo, New

York; as a senior sales tax accountant at Allegis Group, Inc. of Baltimore, Maryland; as a sales tax consultant at Freed Maxick & Battaglia, CPA of Buffalo, New York; as a senior accountant at Sodexho Marriott Services of Williamsville, New York; and as a sales and property tax supervisor and sales tax analyst at Delaware North Companies, Inc. of Buffalo, New York.

Mr. Gross reviewed the operating records of Mother's and opined that the sales tax assessments were considerably high for a restaurant of the type and size of Mother's. He performed a food cost analysis for the year 2006 for the restaurant after reviewing the Division's assessments by taking a full year of purchases, targeting approximately 20 or so menu items and calculating a cost percentage per unit.

Mr. Gross also performed a cost markup comparison for each of the two audit periods. He utilized petitioner's costs (purchases) which, as noted in the audit report for the first audit, reconciled to petitioner's books. For the first audit period, petitioner's liquor purchases were $741,808.29 and its food purchases were $1,189,681.05 (total purchases were $1,931,489.34). Sales reported for the period were in the amount of $3,719,518.00. Using the auditor's calculations and utilizing the markup percentages, per the 2002 edition of the Restaurant Industry Operations Report of 285% for liquor and 281% for food, petitioner would have liquor sales of $2,114,413.93 and food sales of $3,341,800.70, or total sales of $5,455,214.63. If the Division's audit results are correct, petitioner underreported its sales by $1,735,696.63. Petitioner's bank deposits for this audit period were $3,890,460.99, which amount was greater than reported sales by $170,942.99, which Mr. Gross indicated was likely the sales tax collected (petitioner had reported tax due in the amount of $297,466.00 for the audit period).

According to a cost markup comparison for the second audit period, petitioner's liquor purchases were $1,018,250.21 and its food purchases were $1,632,629.20 (total purchases were

$2,650,879.41). Sales reported for the period were in the amount of $4,766,594.00. Using the auditor's calculations and utilizing the markup percentages, per the 2006/2007 edition of the Restaurant Industry Operations Report of 336% for liquor and 315% for food, petitioner would have liquor sales of $3,421,320.71 and food sales of $5,142,781.98, or total sales of $8,564,102.69. If the Division's audit results are correct, petitioner underreported its sales by $3,797,508.69. Petitioner's bank deposits for the audit period were $5,150,404.00, which amount was greater than reported sales by $383,810.00, which Mr. Gross indicated was likely the sales tax collected (petitioner had reported sales tax due in the amount of $397,162.11 for the audit period).

For the first audit period, December 1, 2001 through November 30, 2003, Mr. Gross examined the number of table turns. According to the figures reported by petitioner, the turning rate would have been approximately 1.9, while if the Division's audit figures were used, the turn rate would have been approximately 3.6, or nearly twice as much as petitioner's figures. Mr. Gross observed the operation of Mother's and stated that based upon his experience, it is not physically possible for this restaurant to turn each seat more than three times per night. Exhibit C-2 of the 2002 edition of the Restaurant Industry Operations Report indicates that the median turn rate of a steak and seafood restaurant is 0.9 while the upper quartile turn rate is 1.4.

For the second audit period, the Division's audit results indicate that petitioner's sales were $8,564,102.69. Per the 2006/2007 edition of the Restaurant Industry Operations Report, the median turn rate for steak and seafood restaurants is 0.7 and the upper quartile is 1.0. Therefore, Mr. Gross stated that to achieve the sales that the Division asserts were made by petitioner, a seat turn rate of more than four times the average would have been required.

Mr. Gross performed a turnover rate analysis for each audit period. In performing his analysis, he used a $25.00 average sale per meal and a $5.00 average sale per drink. The number of seats used in the analysis were 58, consisting of 13 tables with 4 seats and 3 tables with 2 seats. Noting that the restaurant was open seven days per week, his analysis assumed, after discussions with Mark Supples, that the prime dinner hours were Monday through Saturday from 5:00 P.M. to 10:00 P.M. and Sunday from 3:00 P.M. to 10:00 P.M. To calculate the turnover time, Mr. Gross used the five hour dining period for Mondays through Saturdays and the seven hour period for Sundays. For the first audit period, his analysis concluded as follows:

> Based on the average meal sale plus the average drink sale, and the number of tables, Mother's restaurant would have to turn a table of two over every 65 minutes in order to produce the sales as indicated by the New York State audit. This estimate is nearly double the calculated meal time of 90 minutes. This would indicate Mother's is turning over each seat at an average rate of 2.8 times a day which is .9 more than Mother's calculation.

For the second audit period, Mr. Gross's analysis concluded:

> Based on the average meal sale plus the average drink sale, and the number of tables, Mother's restaurant would have to turn a table of two over every 40 minutes in order to produce the sales as indicated by the New York State audit. This estimate is nearly double the average meal time of 60 to 75 minutes. This would indicate that Mother's is turning over each seat at an average rate of 4.3 times a day.

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 use of selected exhibits (markup percentages) within 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 that were ignored by the Division during the performance of the audits.

Mr. Gross also noted that on the first page of Section C - Full Service Restaurants (Average Check Per Person $25 and Over), the 2006/2007 Restaurant Industry Operations Report, under "Highlights," it states that median food sales are $8,595.00 per seat and the median beverage sales are $3,174.00 per seat, or roughly $11,769.00 in total sales per seat. Using his calculations of approximately 2 turns per seat per day on a yearly basis, the result would be $23,538.00 per seat times 58 seats times 3 years, or $4,095,612.00 in sales. For the second audit period, petitioner reported sales of $4,766,594.00. Using the Division's audit findings of sales of $8,564,102.69, dividing by 3 years, then dividing by 58 seats, results in median sales per seat of $49,218.00, more than 4 times the median sales per the 2006/2007 Restaurant Industry Operations Report.

Brendan McCafferty holds a Bachelor's Degree from St. John Fisher College, a Master's Degree from Rochester Institute of Technology and a law degree from the University of Buffalo. He worked as a financial auditor for Price Waterhouse and then worked for a smaller CPA firm as an auditor. Upon completion of law school, Mr. McCafferty practiced with the law firm of Damon & Morey with a specialty in tax. Thereafter, he entered into a consulting practice specializing in multistate taxation, primarily sales and use tax. He also worked as a consultant to Ernst & Young and Deloitte & Touche. In total, Mr. McCafferty worked as a tax accountant and consultant for approximately 20 years.

Mr. McCafferty reviewed the work performed by David E. 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. For the first audit, the Division used markup percentages obtained from the 2002 edition of Restaurant Industry Operations Report by Deloitte & Touche, which were 281% for food and

285% for liquor. In the second audit, the Division used markup percentages from the 2006/2007 Restaurant Industry Operations Report, which were 315% for food and 336% for liquor.

Mr. McCafferty stated 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.

Mr. McCafferty reviewed the Division's Indirect Audit Methods Trainer's Manual (***see***, finding of fact above). In the section pertaining to external indices on page 4-3 thereof, it states: "The last method we can use if there is nothing else are external indices." This section also sets forth some of the more well known examples of published data, which include: Risk Management Association f/k/a Robert Morris Associates (RMA); Troy's Almanac of Business Ratios; and Dun & Bradstreet. Mr. McCafferty stated that the RMA study is from a consortium of creditors, banks and other lenders that compile information from businesses that have applied for loans. The information is typically broken out by size of business, by type of business and by standard industrial code (SIC), which identifies the specific business. Mr. McCaffferty indicated that the SIC code, as it pertains to restaurants, is broken down into the various types of restaurants, which can be further broken down by the size and geographical location (by region) of the restaurants.

Mr. McCafferty indicated that the financial information provided in the RMA report is based on a credit application, which is usually backed up by audit and financial statements of the business. Usually an external CPA firm has input into the financial information, as opposed to the Restaurant Industry Operations Report, which contains information that was basically self-prepared by the members of the industry itself, i.e., voluntary information provided for that particular survey.

The Dun & Bradstreet service is similar to the RMA study in that it provides information used by creditors and, like the RMA study, is sortable by business category. The Troy's Almanac of Business Ratios is a compilation that is primarily derived from federal income tax returns.

Mr. McCafferty reviewed the Deloitte & Touche Restaurant Industry Operations Report and stated that, in his opinion, it was not the most reasonable study to use because its express purpose is that it is to be used as a benchmark in the industry for comparing management operations and to provide an informational resource. Moreover, the source of the information was voluntary information provided by members of the restaurant management association.

Particularly with respect to the second audit, Mr. McCafferty opined that the auditor selected the incorrect category for petitioner since 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. 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 Mother's to achieve a seat turnover of 4 to 4.5 turns per day, which is not reasonable. Based on industry standards, turnover is substantially lower than that. Even with respect to the first audit period, Mr. Gross's analysis revealed that, to generate the sales as assessed, a turnover rate of 2.8 per evening was required, which Mr. McCafferty stated was not reasonable for this restaurant.

***THE DETERMINATION OF THE ADMINISTRATIVE LAW JUDGE***

In his determination, the Administrative Law Judge noted that the propriety of the sales tax assessments and the personal income tax and corporate franchise tax deficiencies depended on whether the sales tax audits and results derived therefrom were upheld.

The Administrative Law Judge cited applicable provisions of the Tax Law that provide for the imposition of a sales tax on the receipts from every retail sale of tangible personal property, and which permit the Division to estimate tax on the basis of external indices, if necessary. The Administrative Law Judge noted applicable case law, which provides that the Division must first request and examine a taxpayer's records for the audit period, and then, if the records are incomplete or inadequate to allow the Division to conduct a complete audit, the Division may resort to external indices to estimate tax.

The Administrative Law Judge observed that when estimating the tax, the Division must choose a methodology that is reasonably calculated to reflect the tax due, but it need not be exact. The taxpayer bears the burden of proving, by clear and convincing evidence, that the assessment is erroneous or the audit methodology is unreasonable.

The Administrative Law Judge found that the parties had conceded that, although requested to do so by the Division, petitioner did not supply books and records sufficient to enable the Division to perform a detailed audit of petitioner's sales and use tax liability. The Division was entitled, therefore, to resort to external indices to determine whether petitioner owed additional sales and use tax.

The Administrative Law Judge found that the issue for resolution was whether the external indices selected for each audit had a rational basis, were reasonably calculated to reflect the tax due and whether the results derived therefrom were erroneous.

The Administrative Law Judge agreed with the Division that the incomplete menu information available, coupled with the lack of guest checks and register tapes, was insufficient to allow the Division to perform a food markup test utilizing petitioner's selling prices.

Similarly, there was insufficient information available to allow a beverage markup test using petitioner's selling prices.

The Administrative Law Judge found that neither the auditors nor their section head were able to adequately describe the rationale behind the selection of the particular exhibit of the Restaurant Industry Operations Report used to conduct the audit. Further, there was not even a cursory examination of the other exhibits within the section of the report used to ascertain whether the audit results were reasonable. The Administrative Law Judge found that these facts, coupled with the independent evidence presented by petitioner's witnesses, led him to determine that petitioner had proven by clear and convincing evidence that the sales tax assessments at issue were erroneous and that the audit methodology was arbitrary and patently unreasonable.

The Administrative Law Judge reviewed the testimony of the auditor for the first audit and found that she was confused as to why Exhibit C-12 of the Restaurant Industry Operations Report was used rather than another exhibit. The Administrative Law Judge observed that Exhibit C-12 was an "amount per seat" analysis, yet the auditor did not know why she did not use the numbers therein to compute total sales per seat. The Administrative Law Judge concluded that "Clearly, Exhibit C-12 was not utilized in the manner for which the data was presented."

Likewise, the Administrative Law Judge found that the auditor's section head was aware that the numbers present in Exhibit C-12 represented the cost of food and beverage and the sales of food and beverage per seat, but he never multiplied the numbers therein by the number of seats in petitioner's restaurant to see if the calculations were reasonable. The Administrative Law Judge noted that such calculation, when performed, produced a sales amount for the years of the audit significantly lower than the sales reported by petitioner for that period.

As for the second audit, the Administrative Law Judge noted that the auditor was somewhat familiar with the first audit and the method used to calculate markup. However, using a different year of the Restaurant Industry Operations Report, the auditor chose a different exhibit than had been used in the first audit. The Administrative Law Judge found that the auditor offered no rational basis for his utilization of this exhibit and that this auditor also failed to take any steps to determine if his calculations were reasonable.

The Administrative Law Judge noted that when a taxpayer fails to keep adequate and accurate records, any imprecision in the results of an audit must be borne by the taxpayer. He found, however, that the results of these audits were far more than imprecise. The Administrative Law Judge noted that the use of the Report has been sustained by the Tribunal in prior cases. However, since the auditors chose the Report as a means by which to compute sales tax liability, they must be sufficiently familiar with the Report to respond meaningfully to inquiries regarding its use, and clearly, such familiarity was lacking herein. The Administrative Law Judge found that neither auditor could explain why the particular report was chosen; they did not familiarize themselves with the contents to be certain that the chosen data was applicable to petitioner's business; nor did they bother to check the reasonableness of their calculated mark-up percentage by comparing the audited taxable sales with other data contained in the report.

Accordingly, except for so much of the tax that was assessed on petitioner's fixed asset acquisitions, plus penalty and interest thereon, the Administrative Law Judge cancelled all the notices of determination and notices of deficiency at issue.

## *ARGUMENTS ON EXCEPTION*

In support of its exception, the Division argues that their request for records and petitioner's responses to those requests are relevant to the reasonableness of the audit methods.

The Division asserts that petitioner's willful refusal to comply with the law relevant to record keeping, even subsequent to the period of the first audit, precluded the Division from performing a detailed audit or a weighted markup of petitioner's purchases. Based on case law, the Division argues that when the taxpayer's failure to maintain records prevents exactness, exactness in determining tax is not required. The Division asserts that this principle applies with more force when a taxpayer refuses to maintain records during an audit that could be used to provide a more exact estimate of tax due.

The Division argues that to confuse lack of precision with unreasonableness would be to reward petitioner for its non-cooperation on audit.

The Division cited case law indicating that an auditor's method of estimating sales should be given considerable latitude. The Division argues that in this case, since petitioner deliberately limited the information available to the Division, the audit method was reasonable.

The Division pointed to case law that has upheld the use of a markup audit employing data contained in an industry publication to estimate a taxpayer's sales. Therefore, the Division asserts that the use of the Restaurant Industry Operations Report was reasonable. Further, the Division points out that the source of the data in the publication is identified and it is based on a survey of hundreds of restaurants. The Division disagrees with the Administrative Law Judge's conclusion that the Division had to be familiar with every page of the publication and cited case law holding that the Division was not under an obligation to understand and explain the compilation of the chart and how it specifically related to petitioner. Further, the Division argues that it was not obligated to explain why it chose to use one exhibit in the report instead of another, as the applicability of the data is self-evident. Also, the Division maintains that it was not obligated to confirm the accuracy of the markup computations. The Division asserts that the

markup percentages used were consistent with auditors' experience auditing more than 50 restaurants and taverns in the Buffalo area.

The Division asserts that the Administrative Law Judge has sought to impose a standard on the Division that is contrary to case law, in that it has never been required to corroborate the reliability of the method of estimation used. The Division noted case law that provides that while a different audit methodology might produce a more precise result, that does not render the use of an otherwise acceptable method unreasonable. The Division further argues that case law has held that a taxpayer cannot meet its burden to prove that the Division's audit methodology is unreasonable by substituting its own estimate of tax liability in place of the Division's estimate. Thus, the Division argues against accepting petitioners' table turn-over analysis.

Petitioners argue, in opposition, that they do not contest the Division's right to resort to external indices to estimate the tax in connection with the operation of petitioners' restaurant. Rather, petitioners maintain that the Division's chosen methodology was not reasonably calculated to determine the correct tax and, therefore, the Division was not entitled to a presumption of the correctness of the assessment. Petitioners assert that sufficient information existed to allow the Division to conduct a mark up of the taxpayer's food sales. Despite the testimony of the auditors that a mark up would involve too many assumptions, petitioners argue that a mark-up test could have been conducted. The auditors testified that the purchases had been reconciled with third-party vendors and menus were available. Instead, the Division used the Restaurant Industry Operations Report as an external index, which was the least favored methodology prescribed in the Division's Indirect Audit Methods training manual.

Further, petitioners maintain that the Division could have done an observation test, as requested by petitioners. Petitioners posit that the short visits by Division personnel to

petitioners' restaurant provided nothing but anecdotal evidence and were not bona fide observation tests.

Petitioners argue that in the case of the second audit, the auditor should have familiarized himself with what had been done in the first audit. Instead, the Division chose, in both audits, to use the Restaurant Industry Operations Report, which, as the Administrative Law Judge concluded, was not reasonably calculated to reflect the tax due from petitioners.

Petitioners contest the audit methodology not because of its imprecision, but because the results were unreasonably inaccurate.

Petitioners believe that the Administrative Law Judge properly disregarded the claims of the Division's witnesses that their experience conducting audits in the Buffalo area supported the estimated sales.

Petitioners do not challenge the use of external indices by the Division, but the exhibits used by the Division, the manner of their use and the results obtained. Petitioners argue that nothing in the Restaurant Industry Operations Report or the corporation's records ties in with the Division's estimates and assessments.

In reply, the Division argues that its methodology was reasonable because the Division had a good faith reason for believing that the taxpayers may owe the tax projected by the audit method. The Division states that it chose the categories in the publication that most closely aligned with the operation of petitioners' restaurant. While the Division produced at hearing all relevant pages of the publication it used, it was under no obligation to explain the compilation of data in the publication or how it specifically related to petitioners' business.

The Division also posits that case law does not recognize a hierarchy of audit methods, and asserts that audit guidelines are not mandatory and do not have the force and effect of law. The

Division explained at the hearing why it did not use other methods of estimating petitioners' tax and continued to disagree with petitioners that a weighted markup could have been conducted based on the records available.

The Division argues that it need not prove that the restaurant had cash receipts equal to the sales estimated on audit less credit card receipts. The Division maintains that cash purchases were testified to and cash sales were observed by the Division's investigator.

The Division argues that even if petitioners' table turn-over analysis was relevant, it is of doubtful probative value. The Division believes that petitioners' markup computations are "comically flawed" (Division's reply brief, p. 28).

***OPINION***

The standard for conducting an audit of sales and use tax has been stated often by this Tribunal. In order to determine the adequacy of a taxpayer's records, the Division must first request ***(Matter of Christ Cella, Inc. v. State Tax Commn.***, 102 AD2d 352 [1984]) and then thoroughly examine (***Matter of King Crab Rest. v. Chu***, 134 AD2d 51 [1987]) the taxpayer's books and records for the entire period of the proposed assessment (***see***, ***Matter of Adamides v. Chu***, 134 AD2d 776 [1987], ***lv denied*** 71 NY2d 806 [1988]). 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 [1988]; ***Matter of Hennekens v. State Tax Commn.***, 114 AD2d 599 [1985]; ***Matter of Urban Liqs. v. State Tax Commn.***, 90 AD2d 576 [1982]; ***Matter of Meyer v. State Tax Commn.***, 61 AD2d 223 [1978], ***lv denied*** 44 NY2d 645 [1978]), 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 [1978]; ***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 [1980]).

Where the Division follows this procedure, thereby demonstrating that the records are incomplete or inaccurate, the Division may then resort to external indices to estimate tax (***see***, ***Matter of Urban Liqs. v. State Tax Commn.***, ***supra***). Examples of such external indices are provided in Tax Law § 1138(a)(1), which provides, in pertinent part, as follows: "If a return required by this article is not filed, or if a return when filed is incorrect or insufficient, the amount of tax due shall be determined by the commissioner from such information as may be available. If necessary, the tax may be estimated on the basis of external indices, such as stock on hand, purchases, rental paid, number of rooms, location, scale of rents or charges, comparable rents or charges, type of accommodations and service, number of employees or other factors."

The estimation methodology utilized by the Division must be reasonably calculated to reflect taxes due (***Matter of W.T. Grant Co. v. Joseph***, 2 NY2d 196 [1957], ***cert denied*** 355 US 869 [1957]), but exactness in the outcome of the audit method is not required (***see***, ***Matter of Markowitz v. State Tax Commn.***, 54 AD2d 1023 [1976], ***affd*** 44 NY2d 684 [1978]; ***see also***, ***Matter of Cinelli***, Tax Appeals Tribunal, September 14, 1989).

There is no question that for each of the two sales tax audits conducted, the Division properly requested petitioners' records for review. However, petitioners did not present books and records sufficient to allow the Division's auditors to perform a detailed audit. Absent guest checks and invoices for the audit periods, the Division was unable to verify reported sales by cross-checking with source documents. We conclude, and petitioners do not dispute, that for each of the sales tax audits at issue, the Division was entitled to resort to external indices to determine petitioners' sales and use tax liability.

Petitioners argue that the Division should have conducted an observation test or a mark-up test rather than resorting to the industry indices contained in the Restaurant Industry Operations Reports. However, the Division explained that although it would have preferred to conduct a weighted mark up of petitioners' selling prices, it did not have adequate menu and pricing information available to it. Further, the Division's auditors testified that an observation test would not be appropriate given the nature of petitioners' business.

Eliminating the feasibility of such alternate estimation methodologies is not a mandatory prerequisite to selecting indices such as the Restaurant Industry Operations Reports for use in estimating tax liability. The Division is correct that although its Indirect Audit Methods training manual might prescribe a hierarchy of methods to be employed in conducting an estimated audit, the Division has the latitude to choose the method it feels best accomplishes its goal of reasonably estimating petitioners' tax liability.

The issue to be determined is whether the use of the external indices selected, the 2002 edition of the Restaurant Industry Operations Report in the first audit (hereinafter "2002 Report") and the 2006/2007 edition of the Restaurant Industry Operations Report in the second audit (hereinafter "2006/2007 Report") were reasonable; whether the audit methodologies resulting from the use of these Reports were reasonably calculated to reflect taxes due; and whether the results derived therefrom were erroneous. In this regard, 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 [1986]) or that the audit methodology is unreasonable (***see***, ***Matter of Surface Line Operators Fraternal Org. v. Tully***, 85 AD2d 858 [1981]; ***see also***, ***Matter of Cousins Serv. Sta.***, Tax Appeals Tribunal, August 11, 1988).

In ***Matter of Basileo*** (Tax Appeals Tribunal, May 9, 1991), the Tribunal stated:

> While it is true that 'considerable 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), certain limitations have been placed on this principle. It is necessary that the record contain sufficient evidence to allow the trier of fact to determine whether the audit has a rational basis (***Matter of Grecian Sq. v. New York State Tax Commn.***, ***supra***) and, further, that the record contain specific information identifying the external index employed by the Division in estimating the taxpayer's liability (***Matter of Fashana***, Tax Appeals Tribunal, September 21, 1989).
>
> * * * *
>
> [t]he Division must at hearing, through witnesses or documents, be able to respond meaningfully to inquiries regarding the nature of the audit performed. Such information is necessary in order to provide petitioner with an opportunity to meet its burden of proving such methodology unreasonable (***Matter of Fokos Lounge***, Tax Appeals Tribunal, March 7, 1991).

The Administrative Law Judge concluded that the auditors in both audits failed to meet this standard in that they "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 petitioners' business. Each auditor attempted to calculate a markup percentage that was applied to petitioners' purchases. Neither auditor bothered to check the reasonableness of their markup percentage by comparing the resulting audited taxable sales with other data that was set forth in the same section of the report that was utilized in computing the markup percentage."

In ***Matter of Bitable on Broadway*** (Tax Appeals Tribunal, January 23, 1992), the Tribunal considered whether an Administrative Law Judge had properly cancelled an assessment based on the inability of the Division to adequately explain the basis of its audit. The Tribunal stated the following:

> In his determination below, the Administrative Law Judge dismissed the assessments issued against petitioner because the auditor did not understand how the information set forth in the NRA report was compiled. In conclusion of law "B", the Administrative Law Judge wrote: "Petitioner contends that the National

> Restaurant Association report does not take into consideration the type, size or location of a particular restaurant and that the Division of Taxation cannot employ this or other similar reports or surveys without fully understanding how the information was compiled or how such information can, if at all, be correlated to a specific business. I must agree with petitioner's contentions.
>
> The above-quoted phrase misinterprets the law . . . . The auditor at hearing testified that he utilized the NRA report. The report was clearly identified and was subject to examination by petitioner. We do not agree with the Administrative Law Judge's statement that the Division had the further obligation to understand and explain the compilation of the chart and how it specifically related to petitioner. The purpose of requiring the Division to identify the report utilized in this type of audit (***see, Matter of Fokos Lounge, supra; Matter of Fashana, supra***) is to provide a petitioner with access to the source of the chart and, thus, with the ability to introduce evidence challenging the soundness or applicability of the report. In other words, it ensures that a petitioner has the opportunity to sustain his burden of proof. In our view, to require that the Division explain the derivation of a report prepared by a third party would accomplish nothing except to introduce another level of questions as to whether the Division's description was accurate. We conclude that the Administrative Law Judge erred in finding the audit methodology unreasonable based on the inability of the auditor to explain the compilation of the NRA report. We stress the difference between the instant case and those cases where the audit methodology is based on facts that are peculiarly within the knowledge of the Division, e.g., audits of similar establishments, where the Division has the obligation to describe these facts in response to the petitioner's inquiries at hearing (***see***, ***Matter of Basileo***, Tax Appeals Tribunal, May 9, 1991).

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.

In the first audit, the Division decided to use the median category of Exhibit C-12 from the 2002 Report to calculate petitioners' taxable sales for the audit period. Despite the fact that the exhibit was entitled "Full Service Restaurants (Average Check Per Person $25 and Over) Statement of Income and Expenses - Amount per Seat," the auditor ignored the nature of the exhibit. Neither the auditor nor her supervisor could explain why, having chosen to use Exhibit C-12, no "per seat" calculation was made. Yet, this title cannot be considered superfluous verbiage. The only conclusion that can be drawn from reviewing Exhibit C-12 is that its data is presented solely for the purpose of making calculations on a "per seat" basis.

The Administrative Law Judge pointed out that in Section C of the 2002 report, there are 20 exhibits pertaining to full service restaurants with an average check per person of $25 and over. Five of these exhibits contain figures or percentages pertaining to amounts per seat.

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.

We find, as did the Administrative Law Judge, that the extraction of the cost of beverages and food and the sales of beverages and food from Exhibit C-12 by the first auditor in order to create a markup percentage, and the application of that percentage to petitioners' purchase records to estimate taxable sales, was an unreasonable audit methodology. Having chosen to use the data contained in Exhibit C-12 to calculate tax liability on other than a "per seat" basis resulted in an erroneous assessment. As a result, we affirm the Administrative Law Judge's cancellation of the assessments resulting from the first audit, other than the tax assessed on petitioners' fixed asset acquisitions, $9,299.79 (***see***, finding of fact above), plus applicable penalty and interest.

In the second audit, as with the first audit, petitioners failed to provide adequate records to enable the Division to perform a detailed audit after a request by the Division for such records was made. As with the first audit, the auditor accepted petitioners' purchase records for the audit period. For the second audit, however, although the Division chose to use the 2006/2007 Report (a later edition of the 2002 Report), the auditor chose to use a different exhibit (C-16) than had been used in the first audit. The second auditor then applied the percentages of the cost of beverages and cost of food to total sales from Exhibit C-16 to petitioners' purchase records to calculate petitioners' taxable sales.

Petitioners offered their own analyses consisting of cost markup and seat-turns at the hearing. However, petitioners cannot invalidate the Division's audit by offering their own "estimate" of tax liability as a substitute for the Division's (***see***, ***Matter of Albanese Ready Mix***, Tax Appeals Tribunal, June 15, 1989; ***see also***, ***Matter of Sol Wahba, Inc. v. New York State Tax Commn***., 127 AD2d 943 [1987]).

We are presented here with two successive audits of the same taxpayer, each based on a different compilation of data contained in separate editions of the same external index. The

exhibit chosen for use in the first audit, if employed as intended, would have indicated that petitioner had not underreported its taxable sales. The second auditor, using Exhibit C-16, marked up petitioners' purchases to an even higher level than the first auditor did, and found a greater level of underreported sales than did the first auditor.

There is no indication in the record that petitioners' business operation changed radically from one audit period to the next. Yet in this case, the Division failed to articulate why different exhibits would be used in each audit to calculate petitioners' tax liability. Further, the Division failed to consider whether either of the exhibits used in the audits were reasonably calculated to determine petitioners' tax liability. Petitioners successfully demonstrated that the use of a different exhibit in the 2006/2007 Report would yield a vastly different picture of petitioners' tax liability.[2]

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.

Accordingly, it is ORDERED, ADJUDGED and DECREED that:

---

[2] We note that had the successor exhibit (C-11) been used to calculate petitioners' taxable sales on a "per seat" basis, the calculation would show that petitioners had not underreported their sales.

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

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

3. The petitions of 33 Virginia Place, Inc. and Mark Supples are granted to the extent indicated in conclusion of law "I" of the Administrative Law Judge's determination and the Division of Taxation is directed to modify the Notice of Determination dated December 1, 2004 issued to 33 Virginia Place, Inc. and the Notice of Determination dated December 27, 2004 issued to Mark Supples in accordance therewith;

4. The petitions of 33 Virginia Place, Inc. with respect to the second sales tax audit and the corporation franchise tax audit are granted;

5. The Notice of Determination issued May 31, 2007 and the Notice of Deficiency dated March 30, 2006 issued to 33 Virginia Place, Inc. are cancelled;

6. The petition of Mark Supples and Amy Taylor and the petition of Matthew J. Conroy and Melissa A. Conroy are granted; and

7. The Notices of Deficiency dated April 17, 2006 are cancelled.

DATED:Troy, New York
December 23, 2009

/s/ Charles H. Nesbitt
Charles H. Nesbitt
President

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