STATE OF NEW YORK

DIVISION OF TAX APPEALS

In the Matter of the Petition of SHOP RITE WINES & LIQUORS, INC. AND MRIDULA KHURANA, AS OFFICER for Revision of a Determination or for Refund of Sales and Use Taxes under Articles 28 and 29 of the Tax Law for the Period September 1, 1983 through February 28, 1986.	: : : : : :	DETERMINATION

Petitioners, Shop Rite Wines and Liquors, Inc. and Mridula Khurana, as officer, 2073 Second Avenue, New York, New York 10029, filed a petition for revision of a determination or for refund of sales and use taxes under Articles 28 and 29 of the Tax Law for the period September 1, 1983 through February 28, 1986 (File No. 806762).

A hearing was held before Jean Corigliano, Administrative Law Judge, at the offices of the Division of Tax Appeals, Two World Trade Center, New York, New York, on January 26, 1990 at 9:00 A.M., with all briefs to be submitted by May 18, 1990. Petitioners appeared by Robert J. Grant, P.A. The Division of Taxation appeared by William F. Collins, Esq. (Gary Palmer, Esq., of counsel).

ISSUES

I. Whether the Division of Taxation was warranted in employing a markup of purchases audit to determine sales tax due from Shop Rite Wines & Liquors, Inc.

II. Whether, if a markup audit was warranted, petitioners established any error in the audit methodology or results.

III. Whether, if additional sales tax is due, petitioners have established that the corporation had reasonable cause for its failure to accurately report and pay over all taxes due.

FINDINGS OF FACT

On December 10, 1986, the Division of Taxation ("Division") issued to petitioner Shop

Rite Wines & Liquors, Inc. ("Shop Rite") a Notice of Determination and Demand for Payment of Sales and Use Taxes Due for the period September 1, 1983 through February 28, 1986, assessing sales tax in the amount of $59,430.00 plus penalty and interest. On the same date, an identical notice was issued to petitioner Mridula Khurana, as officer of Shop Rite.

The issuance of the statutory notices followed an audit of Shop Rite's business operations for the period September 1, 1983 through February 28, 1986.

(a) By letter dated April 24, 1986, the Division scheduled an audit appointment for May 19, 1986. The letter stated:

> "All books and records pertaining to your Sales Tax liability for the period under audit should be available. This would include journals, ledgers, Sales invoices, purchase invoices, cash register tapes, exemption certificates and all Sales Tax records. Additional information may be required during the course of the audit, such as Federal Income Tax Returns."

(b) At petitioners' request, the initial audit appointment was postponed to June 16, 1986 at the Division's offices.

(c) On June 11, 1986, the auditor visited Shop Rite's business premises. Shop Rite is a retail liquor store located in a relatively high crime area in New York City. The auditor spoke briefly with Mr. Khurana asking him whether prices shown on bottles of liquor and wine included sales tax. Mr. Khurana stated that tax was included in all prices. Whether a sign indicating that prices included tax was visible on the premises is a matter of dispute between the parties. The auditor made a listing of some liquor prices at this time, but apparently did nothing with this information.

(d) On June 16, 1986, Shop Rite's representative delivered to the Division a box containing Shop Rite's books and records for the audit period. The representative did not discuss the audit with the Division at this time. The records provided consisted of a daybook, a cash receipts journal, a cash disbursements journal, a stack of purchase invoices, Federal income tax returns, and State sales tax returns. Cash register tapes were not provided.

(e) An analysis of Shop Rite's records disclosed discrepancies in three areas. Shop Rite's sales as shown on its Federal income tax return for the period August 31, 1984 through July 31, 1985 were higher than sales shown in its daybook for the same period. Bank deposits for the audit period were higher by $156,972.00 than cash receipts per the daybook. Purchases for the period August 15, 1983 through July 31, 1985 per the Federal return were $66,265.00 higher than purchases per the daybook. Because of these discrepancies and because Shop Rite did not provide a verifiable record of individual sales, such as cash register tapes, Shop Rite's records were deemed inadequate for audit.

(f) The Division obtained information regarding Shop Rite's wine and liquor purchases from Shop Rite's suppliers. These third-party suppliers reported total purchases by Shop Rite of $2,163,938.00. This amount was $339,471.00 higher than the amount shown in Shop Rite's cash disbursements journal.

(g) The auditor performed a test period markup audit. Purchase invoices made available for the month of February 1986 provided the cost of wine and liquor to Shop Rite. Selling prices of the items shown on the purchase invoices were obtained from Mrs. Khurana (the wife of petitioner Mridula Khurana) and an unrelated employee. They indicated that some items were sold with tax included in the price and some were not, and the auditor adjusted the selling prices accordingly. The auditor calculated a wine markup of 24.49 percent, a liquor markup of 39.02 percent and a combined markup of 28.33 percent. The combined markup was applied to total purchases per third-party verification to calculate audited taxable sales of $2,776,982.00. Reported taxable sales were subtracted from audited taxable sales to determine additional taxable sales of $720,360.00 with a tax due on that amount of $59,430.00.

Following a conciliation conference, the Division agreed to reduce the tax assessment to $37,277.46. This reduction resulted from several adjustments to purchases. Purchases were reduced by $7,500.00 to correct an error made by the Gallo Company in its report of Shop Rite's purchases. Purchases were increased by $48,935.00, representing inventory purchased by Shop Rite from prior owners of the retail store. A two percent allowance for breakage and theft reduced purchases by $44,107.00. Net inventory on hand at the end of the audit period reduced purchases by $137,000.00. These adjustments resulted in total purchases of $2,024,266.00.

Shop Rite's representative pointed out that the cost of liquor was higher in June 1986 than it had been in February 1986. Since the auditor applied June prices to February costs, the calculated markups were too high. Using purchase invoices from June 1986 the auditor calculated a reduced markup of 23.92 percent. This markup was applied to purchases to obtain total taxable sales of $2,508,470.00. Additional taxable sales were determined to be $451,848.00, with a tax due on that amount of $37,277.46. The Division issued notices of assessment review to petitioners, assessing sales tax in the amount of $37,277.40 plus penalty and interest.

The adjustments made after the conciliation conference were based primarily on representations made by petitioners' representative in a letter to the Division.

Shop Rite used one cash register to record sales. The register produced a single tape both sides of which were used to record sales. When the tape was exhausted, it was discarded. Receipts were not ordinarily provided to the customer. If one was requested, it was prepared on a slip of paper.

Shop Rite's books and records were maintained by its accountant. Petitioners did not explain the methods by which records of sales and purchases were kept. They acknowledged that the accountant was not informed of cash purchases, causing some discrepancy in the records.

For the year ended July 31, 1986, Shop Rite reported an end of year inventory of $166,475.00 on its Federal return. This return was not available to the Division at the time of the audit.

SUMMARY OF THE PARTIES' POSITIONS

Petitioners' representative recalculated Shop Rite's taxable sales, based upon the Division's audit figures and information provided to him by Mr. Khurana.

(a) Audited taxable sales for the test period were reduced by eight and one-quarter percent to eliminate the sales tax which petitioners claim was included in the price of all items sold. A combined liquor and wine markup percentage of 13.69 percent was then calculated.

(b) Mr. Khurana testified that a large percentage of the items sold were discounted. Shop

Rite is located in a poor neighborhood with other liquor stores very close by. To compete, discounts were given on bulk purchases and customers were allowed to pay less than the listed price if they threatened to purchase elsewhere unless given a discount. Petitioners estimated that approximately 25 percent of Shop Rite's sales were in bulk with a markup of 5 percent, and 15 percent of its sales were discounted at the time of sale with a markup of 10 percent. Petitioners calculated a combined markup on all of its sales of 10.94 percent.

(c) Petitioners calculated purchases per audit of $2,207,088.00.[1] This amount was reduced by $166,000.00, representing purchases remaining in inventory per Shop Rite's 1985 Federal return. Purchases were further reduced by 5 percent as an allowance for theft and breakage. These adjustments resulted in purchases of $1,939,034.00.

(d) Petitioners applied their calculated markup of 10.94 percent to adjusted purchases of $1,939,034.00 to calculate total sales for the audit period of $2,151,164.00. Reported sales of $2,056,619.00 were subtracted from this figure to obtain additional taxable sales of $94,545.00 with a tax due on this amount of $7,799.96.

Mr. Khurana testified that theft was a continual problem in the liquor store. He also claimed that many cartons of liquor and wine were delivered with broken bottles. New York law allows a retailer to claim a credit from the manufacturer for bottles delivered broken; however, Mr. Khurana stated that his suppliers required that returns be made within 24 hours of delivery and often he was unable to inspect purchases in that short a period of time. It is petitioners' position that the Division did not allow a reasonable allowance for theft and breakage. Petitioners introduced into evidence an article from Beverage Media, an industry publication, which describes the difficulties retail liquor stores encounter with shoplifting and other forms of theft. According to the article, the average loss of inventory attributed to

[1]The Division calculated purchases of $2,163,938.00 based upon third-party verification received from Shop Rite's suppliers. This amount was later reduced by $7,500.00. The record does not show the source of petitioners' calculation of purchases, which is in fact larger than the amount determined by the Division.

shoplifting is seven percent.

Petitioners contend that Shop Rite's books and records were reliable and adequate for the purpose of verifying sales. They claim that the discrepancy between bank deposits and the daybook resulted from the owner's practice of depositing his own money in the corporation's account when the corporation was short of cash. Petitioners acknowledge that their records failed to record cash purchases, but they claim this was an oversight resulting from a lack of communication between Mr. Khurana and Shop Rite's accountant. This error has now been corrected.

Petitioners ask for an abatement of penalty on the ground that any errors in reporting tax due were inadvertent and not done with the intention of avoiding the tax. They point out that a second audit of Shop Rite disclosed only a very minimal amount of additional tax due.

CONCLUSIONS OF LAW

A. Every person required to collect tax must maintain records sufficient to verify all transactions, in a manner suitable to determine the correct amount of tax due (Tax Law § 1135[a]; 20 NYCRR 533.2[a]). Among the records required to be maintained are "records of every sale" and the tax due on that sale (Tax Law § 1135[a]; see, Matter of Goldner v. State Tax Commn., 70 AD2d 978, 418 NYS2d 477, lv denied 48 NY2d 608, 423 NYS2d 1025).

Petitioners contend that Shop Rite's records were accurate and reliable, but it is obvious that those records did not satisfy the requirements of section 1135(a) and hence were not suitable for audit purposes. Specifically, Shop Rite did not maintain records of each individual sale and the tax charged on that sale. Cash register tapes were employed but discarded. Moreover, the records that were provided contained some inconsistencies which cast doubt on their reliability. The Division cannot be asked to conduct an audit by relying entirely on general ledgers which cannot be independently verified and the word of the taxpayer to explain any discrepancies (Matter of Giordano v. State Tax Commn., 145 AD2d 726, 535 NYS2d 255, 257; Matter of Ronnie's Suburban Inn, Tax Appeals Tribunal, May 11, 1989).

B. Inasmuch as Shop Rite's books and records were inadequate for the purpose of verifying its reported taxable sales, the Division was required to determine the sales tax due based upon the information that was available to it and to resort to external indices if necessary (Tax Law § 1138[a][1]; Matter of Grant v. Joseph, 2 NY2d 196, 204, 159 NYS2d 150, 157). The burden was then upon petitioners to prove by clear and convincing evidence that the audit method or the amount of tax assessed was erroneous (Matter of Surface Line Organizers Fraternal Org., 85 AD2d 858, 859, 446 NYS2d 451).

C. Petitioners do not claim that the use of the test period markup audit was impermissible; however, they have pointed out what they perceive to be errors in the audit computations. Petitioners' representative prepared a test period markup audit of Shop Rite's taxable sales calculating a maximum sales tax liability for the audit period of $7,799.96. Petitioners' calculations will be considered in detail later. First, however, it is necessary to discuss the weight given to petitioners' evidence.

There is no question that a test period markup audit is a reasonable basis for determining a taxpayer's sales tax liability in the absence of verifiable books and records (see, Matter of Licata v. Chu, 64 NY2d 873, 487 NYS2d 552; Sakran v. State Tax Commn., 73 AD2d 989, 423 NYS2d 567). Since the Division had a reasonable basis for its calculations, petitioners were obligated to prove their contention that the Division's calculations resulted in an overstatement of taxable sales. Here, petitioners did no more than estimate their taxable sales. In fact, petitioners' position regarding the percentage of items sold at a discount and the amount of inventory lost to theft and breakage was a matter of pure speculation. The case law firmly establishes that a taxpayer cannot successfully challenge the Division's determination of taxable sales merely by offering its own estimate of its tax liability (see, e.g., Matter of Licata v. Chu, supra; Matter of Giordano v. State Tax Commn., supra; Matter of Albanese Ready Mix, Tax Appeals Tribunal, June 15, 1989). Also, in weighing petitioners' evidence, it was noted that petitioners' calculations show purchases of $2,207,088.00 and sales of $2,151,164.00, resulting in a net loss before deductions for any expenses except purchases of inventory. This outcome is not consistent with Shop Rite's Federal income tax returns. Under all of these circumstances, no weight could be given to petitioners' own calculation of Shop Rite's sales tax liability.

D. Petitioners' claims for individual adjustments to the audit will be considered next.

First, petitioners claim that sales tax was included in the selling price of all items and that the auditor failed to take this into account. In fact, the auditor reduced the selling price of many items to eliminate sales tax included in the selling price, and petitioners' calculation of a markup of 13.69 percent failed to take the auditor's reductions into account. The auditor testified that his conclusions, regarding which items included tax and which did not, were based on information supplied by Mrs. Khurana and a Shop Rite employee. Petitioners presented no direct evidence contradicting this testimony. In light of this, Mr. Khurana's testimony that all items included tax is deemed insufficient to show an error in the auditor's calculations.

Petitioners next contend that they were entitled to reductions in selling prices because many items were sold at a discounted price. Mr. Khurana's testimony in this regard was not incredible, but it was merely anecdotal. It did not support petitioners' claim that 25 percent of its purchases were sold at a 5 percent markup and 15 percent of its purchases were sold at a markup of 10 percent.

On the basis of Shop Rite's 1985 Federal income tax return, petitioners request a reduction in purchases of $166,000.00, representing purchases remaining in inventory. At the conciliation conference, purchases were reduced by $137,000.00 to allow for year end inventory, based upon representations made by petitioners' representative at that time. Shop Rite's 1983 Federal income tax return shows year end inventory of $135,670.00, and its 1984 return shows year end inventory of $137,254.00. Shop Rite's 1985 Federal return includes five months not within the audit period. Weighing these facts together, it is found that an allowance of $137,000.00 was reasonable, and petitioners have not shown that this amount should be increased.

Finally, petitioners argue that they are entitled to a five percent reduction in purchases for theft and breakage. This is in place of the two percent allowance agreed to by the Division at the conciliation conference. Again, Mr. Khurana's testimony was adequate to support a conclusion that some adjustment for breakage and theft was reasonable. It was not sufficient to show that losses to inventory from breakage and theft amounted to five percent of inventory. Accordingly, the two percent allowance provided for at the conciliation conference is deemed to be adequate.

E. Penalties imposed under the authority of Tax Law § 1145(a)(1)(ii) for failure to accurately report and pay over all sales taxes due may be canceled upon a showing that the taxpayer's failure to comply with the Tax Law was due to reasonable cause and was not due to willful neglect (see, Tax Law § 1145[a][1][iii]). Petitioners offered no evidence which demonstrated reasonable cause for Shop Rite's failure to comply with the Tax Law.

F. The petition of Shop Rite Wines and Liquor, Inc. and Mridula Khurana, as officer, is denied, and the notices of determination and demands for payment of sales and use taxes due issued on December 10, 1986, as revised by the notices of assessment review, are sustained.

DATED: Troy, New York

ADMINISTRATIVE LAW JUDGE