STATE OF NEW YORK

DIVISION OF TAX APPEALS

In the Matter of the Petition	:	
of	:	
PHILIP MORRIS INCORPORATED	:	DETERMINATION DTA NO. 808403
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 June 1, 1982 through November 30, 1987.	:	

Petitioner, Philip Morris Incorporated, 120 Park Avenue, New York, New York 10017, 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 June 1, 1982 through November 30, 1987.

A hearing was held before Frank W. Barrie, Administrative Law Judge, at the offices of the Division of Tax Appeals, 500 Federal Street, Troy, New York, on October 10, 1991 at 9:15 A.M., with all briefs to be submitted by January 31, 1992. Petitioner's brief was filed on December 19, 1991. The Division of Taxation's answering brief was filed on January 16, 1992, and petitioner's reply brief on January 30, 1992. Petitioner appeared by Hunton & Williams (James W. Shea, Esq., and David A. Agosto, Esq., of counsel). The Division of Taxation appeared by William F. Collins, Esq. (Carroll R. Jenkins, Esq., of counsel).

ISSUES

I. Whether petitioner has established reasonable cause and the absence of willful neglect thereby justifying abatement of the penalties and interest imposed for late payment of sales and use taxes.

II. Whether the auditors made representations that penalties would be waived if tax and interest were paid so that the Division of Taxation is estopped from imposing penalties.

FINDINGS OF FACT

Philip Morris Incorporated ("Philip Morris"), a manufacturer of cigarettes, maintains its corporate headquarters in midtown Manhattan.

The Division of Taxation performed a sales and use tax audit of Philip Morris which took approximately 500 auditor hours for the period June 1, 1982 through November 30, 1987 ("current audit"). This audit followed a prior sales and use tax audit of petitioner for the period March 1, 1977 through May 31, 1982 ("prior audit") which took approximately 900 auditor hours. The current audit was commenced on February 15, 1985 and was completed in December 1988. The prior audit appears to have been completed by the late summer or early fall of 1983. The record does not disclose when it was commenced.

The Division of Taxation issued two statements of proposed audit adjustment dated December 16, 1988 against petitioner showing sales and use taxes due of $828,773.09, plus penalty and interest, for the period June 1, 1982 through May 31, 1987 and of $56,734.66, plus penalty and interest, for the period June 1, 1987 through November 30, 1987, respectively. By a signature of petitioner's assistant treasurer, Diane M. McAdams, dated January 12, 1989, on each of the statements of proposed audit adjustment, petitioner consented to the taxes shown due on the statements. However, petitioner added the following typed statement:

> "We agree with the taxes. However, we do not agree with the statutory interest & penalties. Please see attached letter."

The Division of Taxation issued three notices of determination and demands for payment of sales and use taxes due against petitioner dated December 30, 1988 which assessed sales and use taxes due of $573,434.27, plus penalty and interest, for the period June 1, 1982 through November 30, 1985, sales and use taxes due of $312,073.48, plus penalty and interest, for the period December 1, 1985 through November 30, 1987, and omnibus penalties of $9,930.20 for the period June 1, 1986 through November 30, 1986, respectively. The first two notices, which assessed taxes due, each included the following typed statement:

> "Your payment of $1,212,119.23 was received and applied against the tax due [shown on such notices]. The remaining portion of the payment will be applied to penalty and interest of the same [notices]."

Petitioner remitted $1,212,119.23 to the Division of Taxation by a check dated December 29, 1988, which appears to have been tendered on the same date. Apparently a day earlier, the Division of Taxation had provided petitioner with a "Summary of Additional Tax

and Interest Due" dated December 28, 1988, which showed a "tax total" of $885,507.75 ($828,773.09, for the period June 1, 1982 through May 31, 1987, plus $56,734.66 for the period June 1, 1987 through November 30, 1987) and an "interest total" of $326,611.48 ($321,937.16 for the period June 1, 1982 through May 31, 1987, plus $4,674.32 for the period June 1, 1987 through November 30, 1987). This summary, which showed no penalty due, explained the computation of interest as follows:

> "Minimum interest is computed on a simple basis at: 8.5% per annum until 8/12/81; 14% per annum until 2/28/82; 13.5% per annum until 2/28/83; 9.1% per annum until 8/31/83; and on a compounded basis at 9.1% per annum until 2/29/84; 10% per annum until 2/28/86; 7.9% until 2/28/87; 6% per annum until 2/28/88 and at 7.2 thereafter. Interest on this schedule is computed through 12/29/88. Full payment within ten (10) days of the date interest is computed to will avoid additional interest."

The "attached letter" referenced by petitioner on the statements, described in Finding of Fact "3", also dated January 12, 1989, was signed by Joseph A. Beggans, petitioner's "Director - State and Local Taxes", and directed to Paul Golas, "Group Chief, Tax Auditor III". In this letter, Mr. Beggans outlined the basis for petitioner's request that Mr. Golas should "find that penalties and punitive interest should not be assessed in this case."

Mr. Beggans testified that his motivation for making such request was as follows:

> "I believe that the auditors indicated that the penalties would have to be imposed as a result of a departmental policy, but that requesting the group chief -- having him -- request to him -- have the department[1] recommend that penalties not be imposed would be the end of the matter and the penalties would not be imposed."

Mr. Beggans testified that he spoke to the auditors, Steven Suskin and Edward Sandig, as well as Mr. Golas, the group chief, soon after petitioner's receipt of the statement of proposed audit adjustment dated December 16, 1988, which had imposed penalty and statutory interest. According to Mr. Beggans, he "believed that the letter to the group chief was going to be sufficient to take care of the penalty issue."

However, the auditor, Edward Sandig, testified that he did not "agree to waive penalty --

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[1] It appears that the witness mispoke and meant to say "group chief" instead of "department".

when the audit shows that more taxes is [sic] due the second time around than the first."

Prior Audit

A review of the narrative portion of the prior field audit report for the period March 1, 1977 through May 31, 1982 discloses that the auditor determined additional sales and use taxes due in the following areas:

(1) Furniture and fixed assets - "It was determined that furniture and fixtures of $2,125,070.11 were purchased without tax, for which the taxpayer was assessed $173,416.55 in tax."

(2) Leasehold improvements - "Leasehold improvements disallowed...refer to work done at the vendor's prior location at 100 Park Avenue, as tenants...assessed $190,471.03 in tax...."

(3) Recurring expenses - "Expense invoices other than cigarettes were reviewed for October 1979.... A .34 percentage of error was determined and applied to gross sales for the audit period. This resulted in expense purchases tax unpaid of $4,163,628.61 and tax due of $335,044.82."

(4) Cigarettes for employee use - "[T]he vendor was purchasing substantial quantities of cigarettes for employee use.... [O]ne carton of cigarettes per week was distributed to each employee.... This resulted in tax due of $74,505.52 for the period 3/1/77-3/31/81. Thereafter, the supplier charged Phillip Morris the proper tax."

(5) Cigarette samples - "The taxpayer accrued use tax on cigarette samples based on production cost [instead of]...the price at which items of the same kind of tangible personal property are offered for sale by him.... [T]he difference between wholesale price and product cost, multiplied by the number of cigarettes reported, was assessed. This resulted in tax of $65,388.32 for the audit period."

(6) Sales of used office furniture - Such sales "to employees for which no tax was charged amounted to sales of $95,494.64 and tax due of $7,649.57."

Philip Morris disagreed with the portion of the prior audit which determined tax due of $190,471.03 on leasehold improvements and $65,388.32 on cigarette samples. Subsequent to the assessment of such amounts, Flah's v. Tully (89 AD2d 729, 453 NYS2d 855), which concerned the taxability of a tenant's leasehold improvements, was decided by the Appellate Division in favor of the taxpayer. Consequently, the tax determined due of $190,471.03 on leasehold improvements was revised, and the only disagreed portion of the prior audit involved the tax due of $65,388.32 on cigarette samples.

Current Audit

A review of the field audit report for the period June 1, 1982 through November 30, 1987 discloses only two sources for the total sales and use tax deficiency assessed of $885,507.75 ($573,434.27 for the period June 1, 1982 through November 30, 1985, plus $312,074.48 for the period December 1, 1985 through November 30, 1987). They were (1) recurring purchases where tax due of $626,052.78 was calculated and (2) fixtures and equipment where tax due of $259,454.97 was found due.

The basis for tax due on recurring purchases was described as follows:

> "Test of random items for the month of 4/85, for the account (060) general and administrative expenses, revealed $46,625.78 N/T/P [no tax paid] NYCNYS rate and $438.94 N/T/P NYC rate. These amounts over the amount tested of $618,204 resulted in error rates of .07542 and .00071, respectively."

Consequently, the Division of Taxation estimated that petitioner had additional taxable purchases/expenses of $7,625,152.00 and additional tax due thereon of $626,052.78.

The basis for tax due on fixtures and equipment was described as follows:

> "Furniture and fixture accounts (330, 320, 325) were analyzed in detail for the audit period resulting in additional taxable purchases of $193,672.62 or tax due of $15,977.99. For the years 6/1/82 to 12/31/85 various items were tested in the construction in progress account (380). For the years, 1986 and 1987, items over $5,000.00 were tested. This resulted in the following:

Year	Amount Tested	Amount N/T/P	Error Rate
6/82-12/82	$2,597,313	$188,846.07	.07271
1983	1,983,544	270,470.80	.13636
1984	3,842,570	374,360.61	.09742
1985	1,686,786	31,357.59	.01859
1986	1,004,855	173,866.30	.17303
1/87-11/87	866,371	96,643.40	.11155

> These above error rates were applied to their appropriate year total amount, less O/S aircraft and certain capital improvement jobs, resulting in total tax due of $243,476.98."

Tax due of $15,977.99 (furniture and fixtures accounts) plus $243,476.98 (construction in progress account) equals the tax due of $259,454.97 shown above for fixtures and equipment.

The field audit report for the current audit also discloses that petitioner's sales and purchase records were adequate for a detailed audit. Petitioner executed an audit election method agreement which permitted the Division of Taxation to use a random test of recurring

purchases and of items in the construction in progress account.

In addition, the auditors noted that (1) taxable sales were accepted as reported;[2] (2) petitioner maintained a sales tax accrual account and all recorded tax was properly reported; (3) purchases per records were in substantial agreement with purchases per Federal income tax returns; and (4) petitioner paid proper use tax on promotional items and cigarette samples.

Furthermore, petitioner's representative claims that $130,935.00 of the tax due of $259,454.97 on purchases of fixtures and equipment and $161,446.00 of the tax due of $626,052.78 on recurring purchases relate to items acquired during the period from June 1, 1982 through November 30, 1983, when the prior audit was pending.

It was not until January 1, 1989, after the current audit had been completed, that petitioner implemented a new accounts payable system that had the capacity to accumulate reports of invoices with no tax paid. Mr. Beggans explained the delay in implementation as follows in his letter to Mr. Golas (as referenced earlier in Finding of Fact "6"):

> "During 1985 and 1986 a new system was being developed internally which was constantly delayed and eventually scraped [sic] in the later part of 1986. With a personnel change in the head of that department, a new package system was purchased and became operational in 1987. Since we were already in the current audit period we chose to make no change in our sales tax reporting method of self accrued items until it was complete."

In this letter, Mr. Beggans also explained that "by far the largest invoices for which no tax was paid was from Jarret Woodworking" which was not the result of any bad faith on the part of petitioner:

> "The largest item in the previous audit was furniture and fixtures purchased for our then new world headquarters building.[3] In this category one firm, Pilot

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[2]The field audit report noted that all of petitioner's sales were wholesale sales, except a small amount of employee sales.

[3]However, as noted in Finding of Fact "8", in the prior audit it was determined that furniture and fixtures of $2,125,070.11 were purchased without tax. Recurring expenses on which tax was not paid totalled $4,163,628.61, a larger amount.

> Woodworking, represented over 75% of the not tax paid invoices. As a result of the audit we contacted Pilot and informed them to collect sales tax on all future billings.... During the current audit, only one invoice with no tax paid for approximately $10,000 appears for Pilot and that sum was paid in December 1982 prior to the completion of the previous audit. Subsequent to this, our people became dissatisfied with Pilot and switched contractors for the furniture and fixtures from Pilot to Jarret Woodworking. Also at this time, the two individuals responsible for the construction accounting who were aware of the sales tax problem, left the Company. As a result the Tax department was not informed of the switch from Pilot to Jarret nor was Jarret notified that they must bill sales tax. As far as we were concerned, since by the end of 1983 most of the building was already occupied and we had notified Pilot of their sales tax responsibility, we felt we had taken care of the largest part of the audit changes discovered during the previous audit. However, during the current audit by far the largest invoices for which no tax was paid was from Jarret Woodworking."

Joseph A. Beggans testified that it was his "day-to-day responsibility [as petitioner's 'Director - State and Local Taxes'] to ensure that taxes are timely filed and paid." Mr. Beggans' staff consists of 16 employees[4] in five different locations: New York City; Westchester; Chicago, Illinois; and Milwaukee and Madison, Wisconsin. Five of the 16 have supervisory responsibilities.

Mr. Beggans' tax department is a distinct unit from petitioner's accounts payable department. Mr. Beggans described his relationship to accounts payable as follows:

> "[W]e were to receive copies of invoices that the Accounts Payable determined were of an unusual nature and taxes should be paid on it. The procedure with regard to the Accounts Payable was an informal procedure."

Since fixed asset invoices as well as recurring expenses were handled through the accounts payable department, this informal procedure for determining what taxes were to be paid applied to both areas audited as noted in Finding of Fact "10".

Mr. Beggans explained in his letter to Mr. Golas that petitioner was not able to "update its reporting methods [for recurring expenses and purchases of fixed assets and furniture] because of the explosive growth of the Company and the shortage of personnel...." This "explosive" growth is reflected in the following approximate sales figures:

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[4]However, it is not known whether the staff size was the same during the audit period.

	New York Sales	Total Sales	Consolidated sales of petitioner and affiliated corporations
1977	$180,000,000	$2,100,000,000	$ 5,200,000,000
1981	280,000,000	3,700,000,000	10,700,000,000
1987	570,000,000	9,000,000,000	27,700,000,000

During the current audit period, petitioner purchased a scoreboard for use in Yankee Stadium for $4,000,000.00 which was reported and a tax of $330,000.00 paid. In addition, tax of $395,125.00 was paid on the purchase of a company jet for $5,450,000.00. Sales tax also appears to have been properly collected and remitted on a timely basis on sales at petitioner's company store. During the current audit period, petitioner paid a total of approximately $19,000,000.00 in sales and use taxes to the State.

SUMMARY OF THE PARTIES' POSITIONS

Petitioner argues that sales and use taxes assessed amounted to only 4.4% of its total sales and use tax liability:

> "When coupled with the Petitioner's exemplary compliance record, detailed books and records and extraordinary circumstances concerning the explosive growth of the Petitioner's business and the construction of its headquarters building, this discrepancy is clearly de minimis and not due to bad faith or willful neglect."

Furthermore, petitioner contends that it relied on representations that "penalties imposed pursuant to a so-called departmental policy would be waived." Consequently, it paid tax and interest of $1,212,119.23 to close out the current audit.

In contrast, the Division of Taxation argues that petitioner failed to demonstrate "a reasonable effort for a party with its experience and knowledge in business and taxation to ensure that tax on its fixed assets and expense purchases were timely ascertained, reported and paid." The Division further contends that petitioner's estoppel argument is without merit because the auditors never "promised to abate penalties in this matter and then reneged on that promise."

CONCLUSIONS OF LAW

A. Tax Law § 1145(a)(1)(i) provides for the imposition of penalty upon persons who fail

to timely file a return or timely pay any tax under Articles 28 and 29. Statutory interest is imposed for such failure by Tax Law § 1145(a)(1)(ii). Under Tax Law § 1145(a)(1)(iii), such penalty and interest in excess of the minimum may be waived if "such failure or delay was due to reasonable cause and not due to willful neglect...."

B. In MCI Telecommunications Corp. (Tax Appeals Tribunal, January 16, 1992), the Tribunal emphasized that the very nature of this statutory framework for the imposition of penalties places a substantial burden upon the taxpayer of establishing reasonable cause for the abatement of penalties:

> "By first requiring the imposition of penalties (rather than merely allowing then at the Commissioner's discretion), the Legislature evidenced its intent that filing returns and paying tax according to a particular timetable be treated as a largely unavoidable obligation [citation omitted]."

C. Petitioner has argued that it has established that penalties should be abated on the basis of 20 NYCRR 536.5(c)(5) which provides the following grounds for reasonable cause for delay in payment of taxes, as well as examples:

> "(5) Any other cause for delinquency which would appear to a person of ordinary prudence and intelligence as a reasonable cause for delay and which clearly indicates an absence of willful neglect may be determined to be reasonable cause. Ignorance of the law, however, will not be considered as a basis for reasonable cause.
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> Example 5: A manufacturer with production facilities throughout New York State has established an accrual accounting system to record purchases subject to use tax. The manufacturer, as the result of his first sales and use tax audit, owes additional use tax because of occasional misclassification of office supplies and equipment and because of local tax errors on transfers of supplies and equipment between different facilities. After a review of a written statement, submitted by the taxpayer, containing all of the facts alleged as a basis for reasonable cause, it was determined that the taxpayer had made reasonable efforts to account for its use tax liabilities, that the understatement of tax was unintentional and that the manufacturer had otherwise substantially complied with the law. The audit findings established that willful neglect did not occur and reasonable cause existed. Therefore, penalty and interest in excess of the statutory minimum will be waived.
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> Example 6: A vendor who operates a large restaurant business has an accounting system which is devised in such a way that the tax to be remitted each quarter is based on the accumulated taxable sales. An overcollection test was performed on the guest checks which disclosed occasional miscalculation of tax by vendor's staff which resulted in an understatement of the tax due and paid. The taxpayer submitted a written statement containing all of the facts alleged as a basis for reasonable cause. The understatement of the tax due was not considered substantial taking into account the size of the operation, volume of sales and an

> otherwise sound accounting system. The audit findings established that willful neglect did not occur and that reasonable cause existed. Therefore, the penalty and interest in excess of the statutory minimum will be waived."

D. The Tax Appeals Tribunal in G & R Machinery & Equipment Co. (May 24, 1990) reviewed the examples noted above in analyzing whether there is a "de minimis rule upon which to base a finding of reasonable cause." The Tribunal noted that in example 5, "the understatement of tax was unintentional and that the manufacturer had otherwise substantially complied with the law" [emphasis in Tribunal's decision]. Similarly, the Tribunal observed that in example 6, "[t]he understatement of the tax due was not considered substantial taking into account the size of the operation, volume of sales and an otherwise sound accounting system" [emphasis in Tribunal's decision].

In G & R Machinery & Equipment Co., the Division of Taxation determined additional taxable sales on disallowed exempt sales within an 11-month test period of $33,380.00 when gross sales were $1,163,954.00. An error rate of 2.87 was then applied to gross sales for the entire audit period (of 2 years and 9 months) resulting in tax due of $7,595.00. Noting that "petitioner provided documentation for 136 of the 150 [tax-exempt] transactions in question", and that "[t]he forklift sale [for which the company had relied, in good faith, upon letters from its customer that the sale should be treated as tax exempt] accounted for nearly one-half of the dollar amount of the 14 remaining sales at issue," the Tribunal concluded that "the understatement of tax was not intentional and that petitioner substantially complied with the law." However, it is observed that penalties were not abated on the flea market sales and recurring purchases of the taxpayer in G & R Machinery & Equipment Co., even though additional taxes determined due for such categories were extremely small amounts of $1,612.00 and $260.00, respectively.

E. The circumstances in the matter at hand are quite distinguishable from those in G & R Machinery & Equipment Co., where the Tribunal determined that the taxpayer substantially complied in its accounting of tax-exempt sales so that penalty should not be imposed on additional tax found due in such category. The fact that in a prior audit Philip Morris was

assessed additional tax on its recurring purchases and purchases of fixed assets and furniture is of prime importance. Petitioner was made aware of tax due on recurring expenses and purchases of fixed assets and furniture in the course of the prior audit. Its failure to remit tax during the current audit period on a timely basis for such categories because of difficulties relating to its increased business, turnover of staff and/or poorly-designed software was not due to a reasonable cause (cf., Rochester Gas and Electric Corporation, Tax Appeals Tribunal, January 4, 1991). An "explosion" in business or turnover in staff cannot justify petitioner's failure to implement adequate accounting procedures in its accounts payable department (cf., MCI Telecommunications Corp., Tax Appeals Tribunal, January 16, 1992). Furthermore, good faith does not establish reasonable cause (see, Auerbach v. State Tax Commission, 142 AD2d 390, 536 NYS2d 557). Consequently, petitioner's timely payment of tax on its purchase of the scoreboard for use in Yankee Stadium, its payment of tax on its purchase of a corporate jet and the other examples of its tax compliance in the record do not establish reasonable cause for its failure herein.

F. In addition, petitioner's estoppel argument is without merit. Unlike the situation in Kayton Specialty Shop, Inc. (Tax Appeals Tribunal, January 17, 1991), the auditor did not agree that penalties and statutory interest would be waived if tax and minimum interest were paid. Rather, as noted in Finding of Fact "6", petitioner was advised to seek approval of such waiver by outlining its reasonable cause for delay in payment to the auditor's group chief. In Kayton, the Division of Taxation "never denied petitioner's assertions that petitioner was told that penalty and additional interest would be waived if the tax asserted and minimum interest was paid promptly." But even if the auditor in the matter at hand had assured petitioner that penalty and statutory interest would be waived, it was not reasonable for petitioner to rely on such oral assurance when at the same time it was advised to send a letter to get such approval.

Furthermore, as noted in Finding of Fact "7", the auditor denied making any assurance that penalty would be waived, and Mr. Beggans' testimony on this point was somewhat equivocal. Mr. Beggans' testimony, "I believe that the auditors indicated", is not the same as a

straightforward, "the auditors assured me...." In sum, petitioner has not established such assurance and has failed to make "a showing of exceptional facts" which would require the application of estoppel to avoid a manifest injustice (Matter of Harry's Exxon Service Station, Tax Appeals Tribunal, December 6, 1988, citing Matter of Sheppard-Pollack, Inc. v. Tully, 64 AD2d 296, 298; Matter of Turner Construction Co. v. State Tax Commn., 57 AD2d 201, 203).

G. The petition of Philip Morris Incorporated is denied, and the notices of determination and demands for payment of sales and use taxes due dated December 30, 1988 are sustained.

DATED: Troy, New York
July 23, 1992

/s/ Frank W. Barrie
ADMINISTRATIVE LAW JUDGE