STATE OF NEW YORK

DIVISION OF TAX APPEALS

In the Matter of the Petition

of

KARAY RESTAURANT CORPORATION

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, 1990 through November 30, 1992.

In the Matter of the Petition

of

CHRISTOS KARAYIANNIS, AS OFFICER OF KARAY RESTAURANT CORPORATION

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, 1990 through November 30, 1992.

In the Matter of the Petition

of

JOHN KARAYIANNIS, AS OFFICER OF KARAY RESTAURANT CORPORATION

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, 1990 through November 30, 1992.

In the Matter of the Petition

of

PETER KARAYIANNIS, AS OFFICER OF KARAY RESTAURANT CORPORATION

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, 1990 through November 30, 1992.

DETERMINATION
DTA NOS. 814615, 814616, 814617 AND 814618

Petitioners, Karay Restaurant Corporation, 63-68 Austin Street, Rego Park, New York 11374, Christos Karayiannis, 23 Jackie Drive, Westbury, New York 11590-2807, John Karayiannis, 138 Stratford Avenue, Garden City, New York 11530-2737 and Peter Karayiannis, 32 Barnside Lane, Upper Brookville, New York 11546-2732, filed petitions for revision of determinations or for refund of sales and use taxes under Articles 28 and 29 of the Tax Law for the period June 1, 1990 through November 30, 1992.

A hearing was held before Thomas C. Sacca, Administrative Law Judge, at the offices of the Division of Tax Appeals, 500 Federal Street, Troy, New York, on October 29, 1996 at 1:15 P.M., with all briefs to be submitted by February 5, 1997, which date began the six-month period for the issuance of this determination. Petitioners appeared by John Sekkas, P.A. The Division of Taxation appeared by Steven U. Teitelbaum, Esq. (Vera R. Johnson, Esq., of counsel, at the hearing and Marvis A. Warren, Esq., of counsel, on the brief).

ISSUES

I. Whether the Division of Taxation's use of an observation test reasonably determined the sales tax liability of Karay Restaurant Corporation for the period June 1, 1990 through November 30, 1992.

II. Whether the penalties and that portion of interest exceeding the minimum amount prescribed by law should be cancelled.

FINDINGS OF FACT

1. Petitioner, Karay Restaurant Corporation d/b/a Shalimar Diner, operated a diner at 63-68 Austin Street, Rego Park, New York 11374. The diner was opened for business between the hours of 6:00 A.M. and 12:00 midnight seven days a week. Christos, John and Peter Karayiannis were the owners and officers of the corporation.

2. On March 17, 1994, following an audit of Karay Restaurant Corporation's ("Karay") available books and records, the Division of Taxation ("Division") issued a Notice of Determination for Payment of Sales and Use Taxes Due against Karay covering the period June 1, 1990 through November 30, 1992, for taxes due of $58,734.31, plus penalty and

interest. The penalty assessed to Karay included additional penalty pursuant to Tax Law § 1145(a)(1)(vi) for omitting more than 25 percent of the actual taxes found due in each of the quarterly periods.

3. On April 27, 1994, the Division issued notices of determination to Christos Karayiannis, John Karayiannis and Peter Karayiannis as officers of Karay for the same period and the same amount of taxes. Penalties assessed also included the additional penalty pursuant to Tax Law § 1145(a)(1)(vi) for omitting more than 25 percent of the actual taxes found due in each of the quarterly periods.

4. The Division began the audit by mailing to Karay a standard form audit appointment letter dated December 9, 1992. In addition to setting a date and time for the first meeting between petitioner Karay and the Division's auditor, this letter specifically requested that petitioner make available at the time of the first meeting all books and records pertaining to petitioner's sales tax liability for the period under review. The letter indicated that the period under review was June 1, 1990 through November 30, 1992. In the letter, the Division requested that the corporation make available for the auditor all journals, ledgers, sales invoices, purchase invoices, cash register tapes, federal income tax returns, exemption certificates, guest checks and bank statements maintained for the audit period. Accompanying the letter was a list of specific records requested by the Division. During the audit, the Division's auditor was not provided with a general ledger, sales invoices or guest checks.

5. The restaurant had been in operation since 1974 and this was the fourth time it had been subject to audit. The corporation had been advised by the Division during the previous audit to maintain guest checks, but had continuously failed to do so. During the present audit, petitioners had been instructed by the auditor on at least three occasions to start saving guest checks, but the restaurant failed to save them.

6. Due to the lack of records and inadequate recordkeeping, especially the failure to maintain the guest checks used, the auditor decided to estimate sales on the basis of external indices. The auditor concluded that the lack of guest checks resulted in inadequate internal

control procedures in the business operation and rendered the records unusable to trace transactions back to the original source or forward to a final total.

7. The last audit the Division had performed of the restaurant involved the years just prior to the years at issue. Observation tests of the business's operations had been performed on July 13 and 16, 1990. These dates fell within the first quarter of the present audit. Adjustments were made to the amount determined of 11 1/2 percent because of the excessive heat on the observation days and of 3 1/3 percent for nontaxable sales, resulting in taxable sales per day of $3,309.00 and taxable sales per quarter of $301,119.00. The auditor compared this figure with the amount reported by the restaurant, $222,407.00, in the quarter in which he performed another observation test on June 9, 1993 and determined that there was a 26.13984 percent reduction in the taxable sales of the restaurant over the period between the August 31, 1990 quarter and the August 31, 1993 quarter. The observation test resulted in taxable sales for the quarter ended August 31, 1993 to be $230,048.00, but the auditor used the amount reported by the restaurant in determining the percentage reduction in taxable sales. By dividing the percentage reduction by the 12 quarters in the period of time between observation tests, the auditor determined that the taxable sales of each quarter were to be reduced by an average of 2.17832 percent. The auditor was able to spread the 26.13984 percent reduction in taxable sales over this period by reducing each quarter by 2.17832 percent. The audit resulted in additional taxable sales of $711,931.00 and additional tax due of $58,741.31.

8. During the audit Karay, by its representative, executed two consents extending the period of limitation for assessment of sales and use taxes under articles 28 and 29 of the Tax Law which collectively extended to September 20, 1994 the date by which the Division could assess tax due for the period June 1, 1990 through February 20, 1991.

At the hearing, the Division's representative conceded that, based upon Matter of Bleistein, (Tax Appeals Tribunal, July 27, 1995), the first three quarters of the notices of determination issued against the three officers should be cancelled, reducing the amounts of tax assessed by $14,064.52 and leaving the amount of tax due at $44,669.79. In Bleistein, the Tax Appeals

Tribunal held that the "only tax that can be assessed during the extended period is the tax of the taxpayer who signed the consent extending the period of limitations." As there was no consent extending the period of limitations for the officers, but only the corporation, assessments against the officers for the first three quarters were untimely.

CONCLUSIONS OF LAW

A. Every person required to collect tax must maintain and make available for audit upon request 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]). Failure to maintain and make available such records, or the maintenance of inadequate records, will result in the Division of Taxation's estimating tax due (Tax Law § 1138[a]). To determine the adequacy of a taxpayer's records, the Division of Taxation must first request and thoroughly examine the taxpayer's books and records for the entire period of the proposed assessment (Matter of Adamides v. Chu, 134 AD2d 776, 521 NYS2d 826, 828 lv denied 71 NY2d 806, 530 NYS2d 109; Matter of King Crab Rest. v. State Tax Commn., 134 AD2d 51, 522 NYS2d 978, 980). The purpose of such an examination is to determine whether the records are so insufficient as to make it "virtually impossible to verify taxable sales receipts and conduct a complete audit" (Matter of Chartair, Inc. v. State Tax Commn., 65 AD2d 44, 411 NYS2d 41, 43). When estimating sales tax due, the Division must adopt an audit method that will reasonably calculate the amount of taxes due (see, Matter of W.T. Grant Co. v. Joseph, 2 NY2d 196, 159 NYS2d 150, 157, cert denied 355 US 869, 2 L Ed 2d 75). Whether the audit method used was reasonably calculated to reflect the taxes due can only be determined based on information made available to the auditor before the assessment is issued (Matter of Queens Discount Appliances, Tax Appeals Tribunal, December 30, 1993; Matter of House of Audio of Lynbrook, Tax Appeals Tribunal, January 2, 1992). The burden rests with the taxpayer to show by clear and convincing evidence that the methodology was unreasonable or that the amount assessed was erroneous (Matter of Meskouris Bros. v. Chu, 139 AD2d 813, 526 NYS2d 679, 681; Matter of Surface Line Operators Fraternal Org. v. Tully, 85 AD2d 858, 446 NYS2d 451, 453).

B. The record in this case clearly shows that petitioners failed to maintain and make available upon the Division's clear and unequivocal requests records sufficient to verify their sales for the period under review. Indeed, despite several requests to petitioners by the Division during this and prior audits to maintain guest checks, petitioners failed to produce any checks or other sales source documentation prior to the issuance of the statutory notice. Without guest checks, the Division could not verify the accuracy of the register tapes (see, Korba v. State Tax Commn., 84 AD2d 655, 444 NYS2d 312, lv denied, 56 NY2d 502, 450 NYS2d 1023). The Division was therefore authorized under Tax Law § 1138(a) to estimate petitioners' sales tax liability.

C. Petitioners allege that the audit methodology used by the Division to determine the tax due was not reasonable. It is the taxpayer who bears the burden of proving by clear and convincing evidence that the audit methodology was unreasonable (Matter of Surface Line Operators Fraternal Org. v. Tully, supra; Matter of MNS Cards & Gifts, Inc., Tax Appeals Tribunal, May 7, 1992). The method employed by the Division to determine petitioners' sales tax liability was rational and reasonable. As noted previously, the reasonableness of the audit method can only be determined based on information made available to the auditor before the issuance of the statutory notice (see, Matter of Queens Discount Appliances, supra). In this case, before the issuance of the notice, petitioners failed to produce any source documentation of their sales in response to the Division's requests. Additionally, petitioners' representative advised the Division that petitioners had no guest checks, and petitioners failed to begin to maintain guest checks notwithstanding several directives by the auditor to do so. The use of observation audits has been upheld on numerous occasions as a reasonable method of estimating taxable sales (Vebol Edibles, Inc. v. Tax Appeals Tribunal, 162 AD2d 765, 557 NYS2d 678, appeal denied, 77 NY2d 803, 567 NYS2d 643; Club Marakesh v. State Tax Commn., 151 AD2d 908, 542 NYS2d 881, appeal denied, 74 NY2d 616, 550 NYS2d 276; Meskouris Brothers, Inc., supra). Moreover, the use of information gleaned from a prior audit, which is also an issue in dispute in this case, has been sustained by the Tax Appeals Tribunal in

several cases (see, Matter of Burbacki, Tax Appeals Tribunal, February 9, 1995, Matter of C & L Systems, Tax Appeals Tribunal, August 11, 1994). Accordingly, while the audit method employed herein may not be "immune from attack" (Matter of Meskouris Bros. v. Chu, supra), considering the broad latitude historically given the Division in its choice of audit method (see, Matter of Grecian Square v. New York State Tax Commn., 119 AD2d 948, 501 NYS2d 219, 221), it must be concluded that the method selected was reasonably calculated to reflect tax due (W.T. Grant Co. v. Joseph, supra).

D. Because the audit method selected was reasonable, it was incumbent upon petitioners to establish by clear and convincing evidence that the tax assessed herein was erroneous (see, Matter of Meskouris Bros. v. Chu, supra). For the reasons that follow, it is concluded that petitioners have failed to meet their burden.

Petitioners' arguments, in summary, are that the use of the observation tests was unreasonable, its sales were negatively affected when a large department store closed in the vicinity of the diner and the adjustments made to the results of the observation test done in July 1990 should also be done to the observation done in June 1993.

Petitioners' first argument is rejected. As noted previously, the corporation was required by law to keep records sufficient to verify all of its taxable sales (see, 20 NYCRR 533.2[a][1]). Petitioners did not introduce any documentary evidence to support their claim that the use of the observation test to estimate additional sales tax due was unreasonable. The Division utilized data obtained from observations of the restaurant premises conducted at the beginning of the audit period for purposes of a prior audit. The Division may determine tax due for one period based upon data projected from the audit of a different period (Matter of Markowitz v. State Tax Commn., 54 AD2d 1023, 388 NYS2d 176, affd, 44 NY2d 684, 405 NYS2d 454). The use of the data from the earlier audit is most compelling here because the two days of observation fell within the present audit period. The data from these earlier observations are directly related to the audit period at issue herein.

The Division attempted to reach a reasonable result in estimating the amount of sales tax due. Adjustments were made to reflect decreases in the restaurant's business over the entire audit period. In addition, the Division made an adjustment for large sales occurring on the observation days in July 1990 resulting from unusually hot and humid weather conditions on those days. Adjustments were also made for nontaxable sales. Petitioners claimed that these adjustments should have also been applied to the observation conducted on June 9, 1993, but produced no evidence to support this claim. In addition, the auditor testified that the weather on June 9, 1993 was rainy and humid rather than unusually hot, so that an adjustment for unusually large sales was not warranted.

Petitioners also failed to offer any documentary evidence in support of their claim that the closing of a large department store caused a decrease in sales. Furthermore, a map introduced by the Division into the record of this matter indicated that the restaurant was approximately four blocks away from the department store. The map also indicated that a large thoroughfare, Queens Boulevard, separated the restaurant and the department store, casting doubt on petitioners' claim that the restaurant attracted customers from the department store.

As petitioners offered no evidence in support of their claims, they have failed to meet their burden of establishing by clear and convincing evidence that the tax determined to be due was erroneous.

E. Section 1145(a)(1)(vi) of the Tax Law authorizes the imposition of penalty upon a taxpayer for its omission from the total amount of sales and use taxes required to be shown on a return an amount which is in excess of 25 percent of the amount of such taxes required to be shown on the return. The commissioner may abate all penalty, pursuant to section 1145(a)(1)(iii), when it is determined that such omission was due to reasonable cause and not due to willful neglect. Petitioners bear the burden of establishing that there was reasonable cause, and not willful neglect, for the failure to report and pay the taxes in question (Matter of F & W Oldsmobile, Inc. v. State Tax Commn., 106 AD2d 792, 484 NYS2d 188; Matter of East End Student Transportation Corp., Tax Appeals Tribunal, March 26, 1992). Here, the record is

devoid of any facts which establish reasonable cause for petitioners' failure to pay the tax due. Thus, there is no basis to abate the penalty without such grounds.

In fact, the record establishes that petitioners were guilty of willful neglect in their reporting of sales and use taxes. The business failed to maintain adequate records for purposes of verifying taxable sales. Penalties cannot be waived where a taxpayer's failure to maintain accurate records resulted in underreporting of sales and use tax due (Matter of Rosemellia, Tax Appeals Tribunal, March 12, 1992; Matter of Lima Florists, Tax Appeals Tribunal, December 15, 1988). Karay has been subject to sales and use tax audits four times since it began operation in 1974. Where the taxpayer has been subject to prior audits and took no steps to correct its record keeping or reporting methods, penalties are not to be cancelled (S.H.B. Supermarkets v. Chu, 135 AD2d 1048, 522 NYS2d 985; Matter of Mustafa, Tax Appeals Tribunal, December 27, 1991). Petitioners were advised during the preceding audit and the instant audit to maintain guest checks, yet they ignored this instruction after that audit and during the current one.

A substantial discrepancy between the sales tax reported on the returns and the sales tax found to be due is sufficient to sustain the penalties assessed (S.H.B. Supermarkets v. Chu, supra). During the instant audit period, petitioners reported taxable sales of $2,004,089.00 and the Division on audit determined taxable sales to be $2,716,020.00, a deficiency of $711,931.00.

Petitioners were aware of their record-keeping requirements by virtue of the three prior audits. They ignored the instructions to maintain guest checks given to them during the prior audit and during the instant audit. Their failure to maintain accurate records, failure to maintain guest checks and the large deficiency resulting from the current audit are all evidence of willful neglect and dictate against the waiver of the penalties herein.

F. The petitions of Karay Restaurant Corporation, Christos Karayiannis, John Karayiannis and Peter Karayiannis are denied, and the notices of determination dated March 17,1994 and April 27, 1994, except as modified (see, Finding of Fact "8"), are sustained.

DATED: Troy, New York
June 19, 1997

ADMINISTRATIVE LAW JUDGE