

STATE OF NEW YORK

DIVISION OF TAX APPEALS

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In the Matter of the Petition	:	
of	:	
<b>LIBERTY RESEARCH, INC./</b>	:	<b>DETERMINATION</b>
<b>FOOD &amp; DRUG RESEARCH LABORATORIES</b>	:	<b>DTA NO. 820547</b>
for Revision of a Determination or for Refund of	:	
of Sales and Use Taxes under Articles 28 and 29	:	
of the Tax Law for the Period March 1, 2000 through	:	
February 28, 2003.	:	

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Petitioner, Liberty Research, Inc./ Food & Drug Research Laboratories, 170 Route 17C, Waverly, New York 14892-0107, 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 March 1, 2000 through February 28, 2003.

A hearing was held before Dennis M. Galliher, Administrative Law Judge, at the offices of the Division of Tax Appeals, 641 Lexington Avenue, New York, New York on February 23, 2006 at 10:30 A.M., with all briefs to be submitted by July 8, 2006, which date commenced the six-month period for issuance of this determination (Tax Law § 2010[3]). Petitioners appeared by S. Buxbaum and Company, CPA's, LLP (Michael Buxbaum, CPA). The Division of Taxation appeared by Mark F. Volk, Esq. (Robert Maslyn, Esq., of counsel).

***ISSUE***

Whether the Division of Taxation's determination upon audit that petitioner owed additional sales tax, plus interest, was proper and should be sustained.

***FINDINGS OF FACT***

1. Petitioner, Liberty Research, Inc./ Food & Drug Research Laboratories (“Liberty”), conducts research into animal health products, and also breeds specific antibody defined animals to be used in its own research projects and to be sold to other research facilities for use in their research projects.

2. By a letter dated September 2, 2003, the Division of Taxation (“Division”) advised Liberty that a sales tax field audit of its business operations for the period spanning March 1, 2000 through February 28, 2003, would commence on September 23, 2003. This audit appointment letter advised Liberty that the auditor anticipated spending two consecutive days at Liberty’s premises, and that all of Liberty’s books and records pertaining to its sales and use tax liability for the audit period should be available for review on the audit appointment date. An attached Records Requested List specified a detailed listing of particular records which were to be available for the entire audit period, including sales tax returns, worksheets and canceled checks, Federal income tax returns, New York State corporation tax returns, general ledger, general journal and closing entries, sales invoices, exemption documents, chart of accounts, fixed asset purchase and sales invoices, expense purchase invoices, bank statements, canceled checks and deposit slips, cash receipts journal, sales journal, cash disbursements journal, purchase journal, financial statements and depreciation schedules. The letter further advised Liberty that additional records and information might be required during the course of the audit, and suggested that an owner, officer or employee with personal knowledge of the business operations should be available to meet with the auditor.

3. The initially scheduled audit appointment date of September 23, 2000 was changed, at petitioner’s request, to October 15, 2003. On October 15, 2000, the Division’s auditor arrived at

Liberty's premises to commence her audit. The auditor met with Liberty's Accounting and Office Manager, Joyce Terwilliger, and together they discussed the conduct of the audit. All of Liberty's accounting and financial records were maintained on premises. Specifically, all records for the three most recent years (in this instance, 2001, 2002 and 2003) were maintained in files located in Ms. Terwilliger's office, with the balance of Liberty's records maintained in files located in an office directly across the hall from Ms. Terwilliger's office. The audit was to focus on three areas, to wit, sales, fixed assets, and expenses.

#### Sales

4. On October 15, 2003, the auditor made an initial review of Liberty's sales records for the three-month test period spanning September 2002 through November 2002. Based upon such review, the auditor concluded that Liberty maintained an adequate and accurate accounting system with regard to sales, that all sales records were available, and that there were no changes during the audit period in Liberty's record keeping method for sales or in the personnel maintaining such records. The auditor concluded that such sales records were complete and adequate for the conduct of a detailed audit for the entire audit period. Further, the auditor concluded that none of Liberty's reported gross sales (\$10,159,745.00) were subject to sales tax because such sales resulted from Liberty's own research activities and from sales of animals to other research facilities. Accordingly, no further audit work was performed with regard to sales and no sales tax was determined to be due thereon. Although the auditor's conclusions were based upon a review of only three months of sales records (a test period), a Test Period Audit Method Election Form was not requested or signed because the auditor did not determine or assess any tax liability in the area of sales.

### Fixed Asset Acquisitions

5. Continuing on October 15, 2003, the auditor conducted a detailed review of all of Liberty's asset acquisition records for the entire audit period. The auditor's review determined, as was the case with sales, that Liberty's system of record keeping for fixed assets was adequate and accurate, that all records of asset acquisitions were available, and that such records were complete and adequate for the conduct of a detailed review for the entire audit period. The auditor's review resulted in a finding that taxable assets in the amount of \$13,307.00 had been acquired upon which tax had not been paid. Accordingly, additional tax was therefore calculated as due in the amount of \$884.45.

### Expense Purchases

6. Also on October 15, 2003, and continuing thereafter on October 16, 17 and 28, 2003, the auditor conducted a review of Liberty's expense purchases. This review covered a test period spanning the year 2002.<sup>1</sup> The audit report in this matter recites, in much the same manner as for sales records and asset acquisition records, that expense purchase records were deemed to be adequate, to wit, that Liberty maintained an adequate and accurate accounting system with regard to expenses and that there were no changes during the audit period in Liberty's record keeping method for expenses or in the personnel maintaining such records. Expense invoices were filed in alphabetical order, were dated and legible, and no expense invoices were missing. The auditor utilized the year 2002 as the test period because "this period was representative of the business activity." In conducting her audit (i.e., when the auditor was physically present at petitioner's premises to review records), it is undisputed that the auditor asked Ms. Terwilliger

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<sup>1</sup> Although review of the audit workpapers pertaining to expense purchases reveals certain invoices bearing dates in 2001, it appears that the such purchases were included in Liberty's expense purchase records for 2002 on the basis that the invoices were paid in 2002.

for expense purchase records for 2002 only, stating “we can start with the most current year - 2002.” The auditor also noted, in her testimony, that “[I] had too much to review [on] that date [October 15, 2003] to ask for any other years.” The record reveals that the auditor did not request or move on to review expense purchase records for any other years or periods.

7. The auditor’s review of Liberty’s expense purchase invoices for 2002 revealed that Liberty was accruing tax on very few items, such as garbage bags and paper towels purchased from one vendor and was paying sales tax on very few items purchased, and that Liberty’s expense purchases fell into three categories (the taxable status of which is not in dispute), as follows:

- a) purchases of items used in the breeding of animals (taxable purchases);
- b) purchases of items used in research and development (nontaxable purchases); and
- c) purchases of items not allocable to either breeding or research, such as trash removal, cleaning and building maintenance (taxable purchases).

The auditor also understood that certain of the items purchased could be used in both breeding and in research and development (e.g., bedding to be used for animals being bred and sold and for animals used in Liberty’s own research and development), such that a given purchase invoice could fall into both categories “a” and “b” (above) and be considered partially taxable and partially nontaxable.

8. Notwithstanding the recitation of adequacy and completeness of records as set forth in her audit report, the auditor testified that Liberty’s expense purchase records were not adequate, specifically in that the same did not specify which of the expense purchases were fully or partially taxable and which were not taxable. She also explained that to the extent her audit report states such records were complete and adequate, the same results from her oversight in

failing to “uncheck” the computer generated paragraphs in the audit program software which state that records are complete and adequate, and to insert in their place narrative to explain any record keeping errors or inadequacies.

9. On October 16, 2003, while still in the process of reviewing expense purchase invoices for the year 2002, the auditor asked Ms. Terwilliger “how much of [the] business is for research and how much is for breeding.” Ms. Terwilliger advised the auditor that approximately 37 percent of Liberty’s sales income is from research and the rest is from breeding and selling animals to other research laboratories. The auditor’s log entry for October 17, 2003 notes that “[t]he taxpayer considers everything for research purposes,” apparently explaining why little tax was accrued or paid with respect to expense purchases. Liberty, for its part, admittedly did not specifically track or list which purchases were or were not taxable, in keeping with its belief that since none of its income from sales was subject to sales tax (as derived from its own research and development activities and from its sales of animals to other research facilities), then none of its expenses were likewise subject to sales tax.

10. On October 28, 2003, the auditor finished reviewing the expense invoices for 2002, and had a “closing conference” (at Liberty’s premises) with Ms. Terwilliger. The auditor advised that breeding animals is not considered research, that the part of Liberty’s expense purchases relating thereto would therefore not be exempt from tax, and that the auditor would like to review her workpapers and then send them to Ms. Terwilliger for her review.

11. The auditor’s review of Liberty’s expense purchase invoices for the year 2002 revealed \$313,608.76 in total expense purchases, of which \$313,271.44 was considered subject to tax (at the rate of 7.5 percent), thus resulting in tax due on expense purchases for the year 2002 in the amount of \$23,495.69. This amount was reduced by tax paid (\$242.30), leaving

additional tax due for the year 2002 in the amount of \$23,253.39. From this, the auditor computed additional tax due on expense purchases for the entire audit period via a projection based on an error rate derived from the \$23,253.39 amount of additional tax determined due for the 2002 test period compared to gross sales for the year 2002 as follows:

a) Gross sales reported for the audit period:

PERIOD (Sales Tax Year)	GROSS SALES (GS)
03/01/00 - 02/28/01	\$3,106,378.00
03/01/01 - 02/28/02	\$3,388,507.00
03/01/02 - 02/28/03	\$3,664,860.00
TOTAL	\$10,159,745.00

b) Gross sales per sales tax year divided by 4 to arrive at quarterly gross sales, and thereafter quarterly gross sales divided by 3 to arrive a monthly gross sales:

PERIOD	GROSS SALES (GS)	÷ 4 =GS/QUARTER	÷ 3 =GS/MONTH
03/01/00 - 02/28/01	\$3,106,378.00	\$775,594.00	\$258,531.00
03/01/01 - 02/28/02	\$3,388,507.00	\$847,126.00	\$282,375.00
03/01/02 - 02/28/03	\$3,664,860.00	\$916,215.00	\$305,405.00

c) Gross sales for the year 2002 were computed, based on the foregoing calculations, to consist of:

– Gross sales for January and February, 2002 (\$282,375.00 x 2)	\$564,751.00
– Gross sales for March through May, 2002	\$916,215.00
– Gross sales for June through August, 2002	\$916,215.00
– Gross sales for September through November 2002	\$916,215.00
– Gross sales for December, 2002	<u>\$305,405.00</u>
– TOTAL (Base Amount)	<u>\$3,618,801.00</u>

d) The auditor divided additional tax due of \$23,253.39, as determined from her review of expenses for the year 2002, into gross sales (base amount) of \$3,618,801.00, to calculate an error rate of .006426.

e) The auditor multiplied gross sales per quarter by the error rate of .006426 to arrive at additional tax due for each of the sales tax quarterly periods within the audit period. By this method, the auditor calculated additional tax due in the amount of \$65,286.56 on expense purchases for the audit period.

12. The audit report states that “[a]dditional taxable expense purchases of \$870,487.46 were discovered . . . .” The workpapers in evidence do not show this figure, or explain how it was “discovered,” but rather reflect the calculation of tax due based upon application of the error rate against gross sales for the audit period, as described herein. It is possible that the auditor reviewed Liberty’s general ledger and discovered the amount of expense purchases for the audit period therein. However, the record reflects that the auditor reviewed expense purchases for only one year (2002), and made her calculations based thereon. Hence, it is equally likely that the auditor calculated expense purchases for the audit period through the simple expedient of dividing the amount of tax she found due as the result of her error rate projection (\$65,286.56) by the tax rate (7.5%) to arrive at expense purchases of \$870,487.46.

13. The auditor sent her workpapers to Ms. Terwilliger on November 4, 2003 for review. The workpapers provided the calculations and resulting amount of tax as set forth above. From this point in time and forward, it is apparent that Liberty disagreed with the auditor’s conclusion as to the taxability of expenses, and had become focused on determining and pursuing its appeal rights. Entries in the auditor’s log summarize a number of telephone calls between the auditor and Ms. Terwilliger. Relevant portions of these entries are set forth as follows:

-12/12/03: (in response to Ms. Terwilliger's call to inquire about appeal procedures)

I called Joyce [Terwilliger] and explained to her I sent her only workpapers, not assessment. In order for them to appeal, I have to assess. I told her, I had reviewed only one year of expenses, and in order for me to assess I need to have a Test Period Method election agreement signed, or I need to go back and review the rest of the audit period. I also told her the workpapers are not final and they are open for discussion. She said she is going to talk to her boss and get back with me.

-01/14/04:

Called Joyce and asked her if she had heard anything about the audit from her boss. She said the only thing she knows is that they want to appeal the finding. I told her, in this case I am going to assess, and then, they will file for the hearing. I also told her I am going to need Test Method Election Form signed and mailed back to me. She said she will sign the form, because they feel year of 2002 is representative and their expenses are pretty much the same for each year. She said she doesn't think it is necessary for me to go back and review more expenses.

-01/15/04:

I had prepared the workpapers, AU-346, test period method election form and mailed them to Joyce.

14. The balance of the telephone calls between the auditor and Ms. Terwilliger do not reflect a lack of cooperation between the two, but rather a mutual understanding that the auditor would issue an assessment (a Notice of Determination) so as to confer upon Liberty the ability to pursue an appeal. It is undisputed that Liberty did not sign a Test Period Method Election Form (AU-346). It is also undisputed that the auditor did not request or specify a date to return to Liberty's premises to review the balance of expense purchases records, did not otherwise make additional requests or efforts to review such records (e.g., by requesting that the same be brought to the auditor's office), and was not precluded from completing her review of such records prior to the issuance of the assessment contested herein. The only allocation of taxable versus nontaxable expense purchases proposed at this time was the 63 percent taxable (breeding) and 37

percent nontaxable (research) allocation, based on the approximate percentage of income from sales of animals bred by Liberty for sale versus income from research, as noted by Ms. Terwilliger on October 16, 2003 in response to the auditor's question (*see* Finding of Fact "9").

15. As a result of its audit, the Division issued to Liberty a Notice of Determination, dated March 1, 2004, assessing additional tax due for the period March 1, 2000 through February 28, 2003 in the amount of \$66,171.01, plus interest. The amount assessed consisted of tax found due on asset acquisitions (\$884.85) plus tax found due on expense purchases (\$65,286.56).

16. Liberty challenged the assessment and, pursuant to a Conciliation Order dated May 20, 2005 (CMS No. 202031), the amount of tax due was reduced to \$50,718.05, plus interest. The record includes no workpapers detailing the calculation of the reduction, but rather only includes a one-page document entitled Sales Tax Audit Adjustment Worksheet which sets forth the dollar amount of tax and interest due for each of the sales tax quarterly periods within the audit period. Testimony at hearing indicated that the reduction was in recognition that a portion of the expense purchases were used in Liberty's research activities and therefore were not properly subject to tax. It does not appear that any reduction was afforded with respect to the tax assessed on asset acquisitions (\$884.85), and thus the reduced amount of tax assessed on expense purchases would be \$49,833.20 (\$50,718.05 minus \$884.85).<sup>2</sup>

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<sup>2</sup> At hearing, the Division stated that the conference reduction was premised on acceptance and application of the allocation based on Liberty's sales (63% from sales of animals bred for sale and 37% from research activities). In its brief, the Division again states that the reduction was based upon the Division's acceptance of the allocation of expense purchases provided by Ms. Terwilliger. It is not readily apparent from a review of the documents in the record (specifically comparing the audit workpapers with the Sales Tax Audit Adjustment Worksheet) that the reduction ties to a 63% taxable/37% nontaxable allocation of expenses, nor do such documents otherwise allow for a calculation which would confirm that the reduction afforded pursuant to the Conciliation Order was based on such an allocation. The testimony at hearing indicated that the nonallocable (i.e., fully taxable) expense purchases such as trash removal, cleaning, and maintenance were (appropriately) not included in the dollar amount of expense purchases being allocated, such that only the remaining "mixed use" expenses were allocated as described on the 63%/37% taxable to nontaxable basis. Unfortunately, the documents in the record do not allow for verification of the mathematical calculations supporting this statement.

17. Ms. Terwilliger explained that Liberty's expense records were maintained in a manner such that the purchase invoice from the vendor was the first document, beneath and to which the original purchase order and any other documents involved were stapled. According to Ms. Terwilliger, the original purchase orders list the name of the vendor, the product purchased, the date needed (i.e., the delivery required date), and the purpose for which the product was to be utilized, such as breeding, maintenance, surgeries, and the like. She admitted that many items purchased by Liberty (e.g., bedding material for the animals) are used in both breeding and in research and development, without specific distinction or tracking. She noted that the purchase orders show that some items go to "barriers," which are breeding facilities, and some go to research areas, and also stated her belief that she could have explained how and where most, if not all, of the purchased items were used (i.e., either in research or in breeding, or split between the two [for which an allocation would have been appropriate]). It appears the auditor did not, as part of her audit activities, undertake a review of the underlying purchase orders and other documents either on her own or in concert with Ms. Terwilliger.

18. At the hearing, Liberty conceded that the amount of tax assessed on fixed asset acquisitions (\$884.53) was proper and is not contested or at issue herein.

#### ***CONCLUSIONS OF LAW***

A. The only area in which tax was assessed and remains at issue in this matter is upon Liberty's expense purchases, with such tax calculation based on an examination of Liberty's purchase invoices for a portion of the audit period (the year 2002) followed by a projection of tax due based upon the results of such examination. It is well established and undisputed by the parties that the Division may, in appropriate circumstances, resort to such test period and

projection auditing methods in arriving at its determination of tax due. However, in *Matter of Chartair v. State Tax Commn.* (65 AD2d 44, 411 NYS2d 41), the Court stated:

Although there is statutory authority for the use of a “test period” to determine the amount of tax due when a filed return is incorrect or insufficient (Tax Law § 1138, subd. [a]), resort to this method of computing tax liability must be founded upon an insufficiency of record keeping which makes it virtually impossible to verify taxable sales receipts and conduct a complete audit [citations omitted]. However, if records are available from which the exact amount of tax can be determined, the estimate procedures adopted by the respondent become arbitrary and capricious and lack a rational basis [citation omitted]. (*Id.*, 411 NYS2d at 43.)

B. Because the statutory and decisional authority allowing for a taxpayer’s sales tax liability to be calculated by estimate procedures rests upon a finding that the taxpayer’s books and records are inadequate to conduct a complete audit, the Division is required to first request (*Matter of Christ Cella v. State Tax Commn.*, 102 AD2d 352, 477 NYS2d 858, 859) and thoroughly examine (*Matter of King Crab Rest. V. State Tax Commn.*, 134 AD2d 51, 522 NYS2d 978, 979-980) 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), in order to determine from verification drawn independently from within these records whether they are sufficient to support a complete audit (*Matter of Meyer v. State Tax Commn.*, 61 AD2d 223, 402 NYS2d 74, 76, *lv denied* 44 NY2d 645, 406 NYUS2d 1025). If the Division’s examination establishes that the taxpayer’s records are adequate and complete, the taxpayer is entitled to have its assessment calculated based upon a detailed audit of those records (*Matter of James G. Kennedy & Co. v. Chu*, 125 AD2d 773, 509 NYS2d 199). In contrast, when a taxpayer’s records are incomplete and unreliable for determining sales, the Division may resort to a test-period audit using external indices (*Matter of Skiadas v. State Tax Commn.*, 95 AD2d 971, 464 NYS2d 304, 305).

While the absence of adequate and complete records allows the Division to proceed with indirect auditing methods (*id.*), the maintenance of adequate and complete records rightfully entitles a taxpayer to have such records used in the conduct of an audit. The Division cannot simply ignore a taxpayer's records and use an indirect method of estimating tax due if the taxpayer's records are readily available and provide an adequate basis on which to determine the amount of tax due (*Matter of Christ Cella, Inc. v. State Tax Commn., supra.*; *Matter of Chartair, Incl. v. State Tax Commn., supra.*). At the same time, a taxpayer who maintains and makes available complete and adequate records may nonetheless consent to the Division's use of indirect auditing methodologies, including test period and projection methods. The reasons for making such a consent are various, and may include a taxpayer's desire to limit the amount of time, cost and personnel required to be devoted to the retrieval and presentation of records necessary for the conduct of a full and detailed audit examination. Whatever the reasons for such a consent, the Division specifically provides for the objective memorialization of such a consent by requiring a taxpayer to execute a Test Period Audit Method Election Form (AU-346).

C. In this case, the audit was commenced by the mailing of an audit appointment letter and an attached list of records required for audit, which together set forth specifically the records petitioner needed to have available for review by the Division's auditor. Hence, in the first instance the Division, by this letter and list, made a clear and unequivocal request for petitioner's records. However, it is undisputed that the auditor did, in fact, resort to a test period and projection method of audit for the purpose of determining petitioner's expense purchases and the amount of tax due thereon. Thus, the initial question presented is whether petitioner maintained complete and adequate books and records, as specified, had the same available for the auditor's review, and provided the same to the auditor for such review during the course of

the audit. If Liberty failed to maintain or make available such books and records, then the Division was clearly entitled to resort to test period and projection auditing techniques. In contrast, if Liberty maintained complete books and records of its expense purchases and made the same available to the auditor, then the auditor was not entitled to resort to test period and projection auditing and the assessment must be eliminated to the extent it is based thereon, unless Liberty consented to the use of such an audit methodology. In this latter regard, it is undisputed that Liberty did not execute a Test Period Audit Method Election Form which specifically reflects a taxpayer's consent and authorization allowing the Division to utilize such a test period method audit.

D. The Division alleges that Liberty did not maintain or make available adequate records with regard to its expense purchases, specifically in that petitioner only provided such records to the auditor for one year (2002), as opposed to the full audit period. The Division goes on to argue that the expense purchase records provided for 2002 were themselves inadequate, in that they allegedly did not distinguish between purchases used in taxable versus nontaxable aspects of Liberty's business. While it is literally true that Liberty only supplied its expense purchase records for the year 2002, the fact is that Liberty only supplied its expense purchase records for such year because that is precisely what the auditor requested and specifically stated she would be able to review during the time she allotted herself to be at Liberty's premises (*see*, Finding of Fact "6").<sup>3</sup> In fact, all of Liberty's expense purchase records were readily available, in major part (for 2001, 2002 and 2003) in Ms. Terwilliger's office and in minor part (for 2000) in an office located directly across the hall from Ms. Terwilliger's office, with none of Liberty's

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<sup>3</sup> The record is unclear as to the extent of the expense purchase records supplied, with the auditor referring to purchase invoices, while Ms. Terwilliger referred to such invoices together with the attached (stapled) underlying purchase orders (*see*, Finding of Fact "17").

records stored off site (*see*, Finding of Fact “3”). These conclusions are born out by the auditor’s written notes (log and audit report) and her testimony, which together indicate that the year 2002 was the only period for which expense purchase records were specifically requested during the field audit portion of the audit, as well as by Ms. Terwilliger’s testimony regarding where Liberty’s records were kept. At no point is there any sense that expense purchase records for the full audit period were not maintained by Liberty, or were not available for review upon request. Liberty never, in fact, refused to supply any expense purchase records requested by the auditor.<sup>4</sup>

E. The Division’s audit appointment letter, not unreasonably, specified and required the availability of a very large and all inclusive group of records. Still, there must be a practical distinction drawn between the large amount of records specified in an audit appointment letter (which gives a taxpayer notice of those records which should be available for the Division to review upon audit) and those records requested for presentation by an auditor during the actual conduct of an audit. Simply because an auditor does not request or review certain records, either for a given portion of an audit period or at all, does not lead to a conclusion that such records were not available or would not have been made available. There is no sense, from the tenor of the testimony, that petitioner refused or was unable to provide the auditor with any of its records, and there is no serious question that all of petitioner’s expense purchase documents were

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<sup>4</sup> The conclusion that Liberty maintained all of its purchase records is strengthened by the auditor’s conclusions and findings with respect to Liberty’s record keeping system as a whole. In conducting her audit, the auditor examined Liberty’s records in three areas, namely sales, asset acquisitions and expense purchases. First, the auditor requested and reviewed sales records for a specific three month test period, and concluded based thereon that petitioner had complete and adequate sales records maintained systematically for the entire audit period (*see*, Finding of Fact “4”). In turn, the auditor requested and reviewed petitioner’s asset acquisition records in detail for the full audit period, concluding that petitioner had complete and adequate records of such acquisitions maintained systematically for the entire audit period (*see*, Finding of Fact “5”). Finally, the auditor requested and reviewed expense purchase records specifically for a test period of one year, 2002, and concluded from such review that petitioner had complete and adequate records of its expense purchases, maintained systematically, and that there were no records of purchases missing for such period (*see*, Finding of Fact “6”, *et seq.*) In fact, no insufficiency or incompleteness in any aspect of Liberty’s record keeping was noted in the audit report.

maintained, not only for the year 2002, but for the balance of the audit period as well, and would have been, upon request, provided to the auditor for review. From such a review, the auditor could have determined, at a minimum and without resort to a projection from her test period, the actual dollar amount of expense purchases for the entire audit period and the amount of tax which would be due thereon absent substantiation of nontaxability by Liberty. While the purchase invoices reviewed by the auditor may not have distinguished on their faces the uses to which the purchased items were put (i.e., taxable or nontaxable as the case may have been), there is no indication that petitioner did not have all of its expense purchase invoices for the entire audit period. The only alleged inadequacy in Liberty's records concerned whether Liberty could substantiate which, if any, of its expense purchases were not taxable. This situation is different from a finding of general record keeping inadequacy or insufficiency. In sum, the Division could thus have calculated in the first instance the actual tax due, without resort to the use of a test period and projection relying on sales as a function of expense purchases. Accordingly, since there has been no demonstrated inadequacy in Liberty's records sufficient to support the Division's resort to test period and projection auditing to determine tax due, the same must be rejected unless it can be shown that Liberty consented to the use of such an audit methodology.

F. Turning to the question of consent, the Division does not dispute that its policy, in the face of the availability of complete and adequate records, is that a signed Test Period Method Election Form must be obtained before resort to test period auditing methodologies may be undertaken. In fact, this policy, concededly set forth in the Division's own audit manual, was clearly known to the auditor and was articulated by the auditor to Liberty (*see*, Finding of Fact "13"). This policy of obtaining a signed consent seems well advised, for it protects both the taxpayer and the Division. Most specifically, from the Division's perspective, the policy

provides a clear and indisputable means of establishing a taxpayer's consent to the use of test period and projection auditing, even in the face of complete and adequate records, thus avoiding any later claim that a taxpayer never consented. The benefit of such an objective policy standard is brought into clear focus in this case. Unfortunately, since the policy was not followed, its benefit may not be claimed herein.

G. Without a signed test period election form, the only remaining question is whether Liberty nonetheless consented to the Division's resort to a test period and projection audit method. A taxpayer may certainly waive its right to a full books and records audit review. However, such a waiver must be clear, knowing and unequivocal. Without such a waiver, and in the face of complete books and records, it must be shown that the auditor was precluded or otherwise thwarted in her attempts to review the relevant records. Thus, at a minimum, the Division's auditor in this case was required to specifically attempt to review petitioner's expense purchase records for the balance of the audit period. Such an attempt and subsequent rejection simply have not been established by the facts. There is no evidence that the auditor actually attempted to return and review the balance of the purchase records by sending a letter to petitioner or otherwise attempting to specify and secure a date to do so, such that petitioner's refusal thereafter to permit the auditor to return and review the balance of the records would support the auditor's resort to test period and projection auditing. Ms. Terwilliger's comments to the auditor that Liberty would sign the test period election form because the year 2002 was "representative," Liberty's expenses were "pretty much the same for each year," and Liberty "did not think it was necessary for the auditor to go back and review more expenses" (*see*, Finding of Fact "13") did not, under the circumstances of this case, clearly constitute a refusal to make records available in response to a specific request from the auditor. To conclude that such

an exchange may result in a waiver by a taxpayer pursuant to which the Division may resort to test period and projection audit methodology leaves readily apparent the difficulty and the potential for abuse sought to be eliminated by the policy of requiring a signed audit method election form. The type of colloquy apparently engaged in here simply does not reflect either a clear request to review records at a specific date, time and place, or an answer which was a clear denial or affirmative refusal to allow further audit review of records. Finally, Ms. Terwilliger's statement to the auditor that petitioner "will sign the election form" is irrelevant since the form, in fact, was never signed. In sum, the auditor clearly articulated the Division's policy (i.e., sign the election form or I'll have to come back and review the balance of the records), but then did not fulfill the policy either by obtaining the signed election form or by setting a specific date and time to finish reviewing petitioner's records only to be refused thereafter in her attempt to conduct such a review. The Division's claim that Liberty "stopped cooperating" and "didn't provide records" is more accurately characterized as a situation where Liberty provided the auditor with what she requested during her time at petitioner's premises, and thereafter was never afforded a specific request for a time and date to finish a records review.

H. As detailed earlier, if the Division had not resorted to a test period and projection to determine the amount of tax due on petitioner's expense purchases, but rather had at least reviewed petitioner's expense purchase records for the entire audit period, the Division could then have calculated total expense purchases for the audit period. If upon review of such expense purchase records, including the underlying attached purchase orders, the auditor was unable to determine which of such purchases were taxable, the Division could then have either estimated that a certain percentage of such purchases were taxable or, pursuant to Tax Law § 1132(c)(1), held all of such expense purchases to be taxable subject, in either instance, to

Liberty's right to substantiate the nontaxability of any or all of such expense purchases.

Liberty's failure to specify the taxable or nontaxable status of an expense purchase invoice on its face, at most, leaves all of such expense purchases potentially subject to tax upon initial audit review. However, it does not establish that a determination of full or partial taxability or nontaxability could not have been made by review of the purchase invoices in concert with the balance of accompanying documentation allegedly maintained, including the original underlying purchase orders (*see*, Finding of Fact "17").<sup>5</sup> In any event, it is unnecessary to resolve the question of which expense purchases were taxable for any part of the audit period other than the year 2002 since, as discussed above, the Division erroneously resorted to a test period and projection to calculate the dollar amount of expense purchases and tax due thereon notwithstanding that complete records of such expense purchases in total existed for the entire audit period.

I. Based on the foregoing, the portion of the assessment covering periods other than the year 2002 must be cancelled. With respect to the period for which expense purchases were reviewed in detail (2002), the Division calculated tax due on nearly all of such purchases (*see*, Finding of Fact "11"). In turn, petitioner did not present any specific evidence (e.g., purchase orders or other information) at hearing to substantiate which of such purchases were nontaxable for the year 2002. Thus, the additional tax calculated as due for such year must therefore stand as validly assessed. However, as the result of the conciliation conference and subsequent Conciliation Order, the amount of tax assessed was reduced to reflect the Division's acceptance that a portion of petitioner's expense purchases were nontaxable. Accordingly, the Division's

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<sup>5</sup> On this record, it is not possible to know if the determination of taxable and nontaxable purchases could have been made based on the purchase orders underlying the purchase invoices since the auditor did not speak thereto or even look at any such records except, possibly, for 2002.

audit result for the year 2002 must be adjusted and reduced, consistent with the basis and result determined at the conciliation conference.<sup>6</sup>

J. The petition of Liberty Research, Inc./ Food & Drug Research Laboratories is hereby granted to the extent indicated in Conclusion of Law "I", but is otherwise denied, and the Notice of Determination dated March 1, 2004, as reduced accordingly, is sustained.

DATED: Troy, New York  
January 4, 2007

/s/ Dennis M. Galliher  
ADMINISTRATIVE LAW JUDGE

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<sup>6</sup> As noted, while confirming workpapers supporting the conciliation conference reduction are not in the record, it appears that the nonallocable (i.e., fully taxable) expense purchases for the year 2002 (e.g., cleaning, maintenance, plowing, and the like) were removed from total purchases and that an allocation between taxable and non taxable expense purchases, on the basis of 63% taxable/37 % nontaxable, was then made with regard to the remaining amount of expense purchases.