STATE OF NEW YORK

DIVISION OF TAX APPEALS

In the Matter of the Petition	:	
of	:	
MICHAEL J. MACLEOD	:	DETERMINATION DTA NO. 820992
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, 1999 through August 31, 2000.	:	

Petitioner, Michael J. MacLeod, P.O. Box 606, Florida, New York 10921, 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, 1999 through August 31, 2000.

A hearing was held before Arthur S. Bray, Administrative Law Judge, at the offices of the Division of Tax Appeals, Riverfront Professional Tower, 500 Federal Street, Troy, New York, on October 18, 2006 at 10:30 A.M. with all briefs to be submitted by February 26, 2007, which date began the six-month period for the issuance of this determination. Petitioner appeared by Vanacore DeBenedictus DiGovanni & Weddell (Thomas R. DiGovanni, CPA). The Division of Taxation appeared by Daniel Smirlock, Esq. (Michael J. Hall).

ISSUE

Whether the audit methodology was reasonably calculated to determine the sales and use taxes due.

FINDINGS OF FACT

1. During the period in issue, petitioner, Michael J. MacLeod, was the president and sole shareholder of MJM Studios of New York, Inc. ("MJM"). MJM engaged in the manufacturing

of fiberglass reinforced concrete in order to create facades, marquees and signs for major construction projects. The corporation's offices were located in New Jersey.

2. On August 13, 2003, the Division of Taxation ("Division") sent a letter to Mr. MacLeod stating that MJM's sales and use tax records had been scheduled for a field audit on September 29, 2003. The letter further stated that the audit period was June 1, 1999 through May 31, 2003 and that "[a]ll books and records pertaining to the sales and use tax liability, for the audit period, must be available on the appointment date."[1] In an attached records request list the Division specifically requested all exemption documents supporting nontaxable sales for the entire audit period including capital improvement certificates.

3. In a letter that was received by the Division on August 27, 2003, Mr. MacLeod responded that his company was in bankruptcy and he did not have any records. Mr. MacLeod also pointed out that the attorney handling his affairs was Leonard Walcyz, Esq. MJM referred the auditor to the bankruptcy attorney who, in turn, referred the auditor to the trustee of the bankruptcy proceeding. It was the auditor's understanding that the trustee was in possession of MJM's records. The auditor called and left a voice message for the trustee but the trustee never returned the call.

4. On January 8, 2004, the auditor sent a letter to petitioner stating that due to the lack of availability of records, he would be issuing an estimated assessment based upon bank deposits. It was explained that the deposits were adjusted to reflect sales made outside of New York State. The letter concluded with a request that petitioner provide the records needed to perform the audit.

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[1] On February 9, 2004, petitioner executed a consent extending the statute of limitations for assessment of sales and use taxes for the period June 1, 1999 through August 31, 2001 to any time on or before September 20, 2004.

5. On February 3, 2004, petitioner responded that the records were still in the possession of the bankruptcy trustee in Newark, New Jersey.

6. On May 11, 2004, the auditor sent another letter to petitioner explaining that the Division had not received the records that it had requested and that it was not the Division's responsibility to obtain the records from the bankruptcy trustee. Accordingly, petitioner was asked to provide the Division with the records which were in the custody of the trustee. The Division noted, among other things, that it would be issuing an assessment based upon the records it had.

7. On August 13, 2004, petitioner's representative advised the Division that the bankruptcy court lost most of petitioner's records. In response, the auditor again requested capital improvement certificates or exempt organization certificates from the customers.

8. On November 24, 2004, the counsel to the bankruptcy trustee advised petitioner by letter that he could not authorize the release of the documents since the case was not closed. He did not think that there would be a problem releasing the books and records when the case was closed and the trustee's office had reviewed the materials.

9. On or about February 24, 2006, the bankruptcy trustee for MJM filed a notice of intent to abandon the documents it had in storage which were related to MJM's operations. If no objections were filed with the Bankruptcy Court, the destruction would take place on or about March 20, 2006. There is no evidence in the record that, at this juncture, an effort was made to secure the documents.

10. The auditor discussed the lack of records with his supervisor and section head and they decided to subpoena the bank records of MJM from Warwick Savings Bank. The bank records were considered highly reliable because they were from a disinterested third party. The

bankruptcy trustee was not subpoenaed because the Division questioned whether the subpoena would be honored outside of New York State.

11. In order to calculate the amount of tax due, the Division utilized MJM's bank records and proceeded upon the premise that all sales were deposited in the bank and that the bank deposits represented sales. On the basis of the New York State franchise tax returns, the Division determined the percentage of MJM's total sales which were New York sales. This percentage was multiplied by the bank deposits to calculate sales in New York. The sales in New York were then multiplied by the tax rate to determine the amount of tax due.

12. On the basis of the forgoing audit, the Division issued a Notice of Determination to petitioner, dated June 25, 2004 (Assessment no. L-023959610-9), which assessed sales and use taxes in the amount of $193,232.66, plus interest in the amount of $128,449.14 and penalty in the amount of $57,969.23 for a balance due of $379,651.03. The notice further explained that the Division's records indicated that petitioner was a responsible officer or person of MJM.

13. Petitioner requested a conference in the Bureau of Conciliation and Mediation Services ("BCMS"). In the course of proceedings before BCMS, the auditor was given the opportunity to review workpapers maintained by petitioner's accountant and, as a result, a Conciliation Order was issued which reduced the amount of tax assessed to $121,492.82.

14. At the hearing, petitioner offered portions of a contract pertaining to work performed by MJM at John F. Kennedy International Airport. On the basis of this contract and materials offered at the conciliation conference the Division has agreed to the following adjustments:

Quarter Ending	Tax Originally Assessed	Tax Per BCMS Order	Tax Currently Sought
08/31/99	$7,600.36	$4,778.64	$4,778.64
11/30/99	27,602.47	17,354.74	17,354.74
02/29/00	26,433.85	16,619.98	16,619.98
05/31/00	47,856.59	30,089.28	1,689.86[2]
08/31/00	83,739.39	52,650.18	2,956.91

15. In the course of auditing construction companies, the auditor would usually visit construction sites if records were available. Here, the auditor never visited petitioner's place of business or construction sites. He did not realize that the place of business was only three miles from the office.

SUMMARY OF THE PARTIES' POSITIONS

16. The Division maintains that the notice should be sustained because the Division had the right to presume that all of MJM's New York receipts were subject to sales tax, the Division employed a reasonable method and petitioner has not proven that the method used was erroneous.

17. In response to the Division, petitioner's representative notes that he tried but was unable to produce the documents which the auditor chose to review. It is maintained that the auditor should have examined each job to determine if capital improvement work was undertaken since the work itself was the only evidence available. Petitioner's representative believes that some steps should have been taken to determine whether petitioner was involved in

[2] It appears that the Division's brief contains a typographical error (***Compare*** Division's brief p. 4 ***with*** the Division's exhibits "S" and "T" and the transcript at page 63).

a taxable engagement. It is submitted that a ruling in favor of the Division would confirm the helpless state of taxpayers if for some reason they do not have the correct paperwork available.

CONCLUSIONS OF LAW

A. Tax Law § 1105(a) imposes a sales tax on the receipts from every "retail sale" of tangible personal property except as otherwise provided in Article 28 of the Tax Law. Tax Law § 1138(a)(1) provides, in relevant part, that if a sales tax return is not filed, "or if a return when filed is incorrect or insufficient, the amount of tax due shall be determined [by the Division of Taxation] from such information as may be available. If necessary, the tax may be estimated on the basis of external indices. . . ." When acting pursuant to section 1138(a)(1), the Division is required to select a method reasonably calculated to reflect the tax due. The burden then rests upon the taxpayer to demonstrate that the method of the audit or the amount of the assessment was erroneous (***see, Matter of Your Own Choice, Inc.,*** Tax Appeals Tribunal, February 20, 2003).

B. The standard for reviewing a sales tax audit where external indices were employed was set forth in ***Matter of Your Own Choice, Inc***. (***supra***), as follows:

> To determine the adequacy of a taxpayer's records, the Division must first request ***(Matter of Christ Cella, Inc. v. State Tax Commn.***, [102 AD2d 352, 477 NYS2d 858] ***supra***) and thoroughly examine (***Matter of King Crab Rest. v. Chu***, 134 AD2d 51, 522 NYS2d 978) 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, ***lv denied*** 71 NY2d 806, 530 NYS2d 109). The purpose of the examination is to determine, through verification drawn independently from within these records (***Matter of Giordano v. State Tax Commn.***, 145 AD2d 726, 535 NYS2d 255; ***Matter of Urban Liqs. v. State Tax Commn.***, 90 AD2d 576, 456 NYS2d 138; ***Matter of Meyer v. State Tax Commn.***, 61 AD2d 223, 402 NYS2d 74, ***lv denied*** 44 NY2d 645, 406 NYS2d 1025; ***see also***, ***Matter of Hennekens v. State Tax Commn.***, 114 AD2d 599, 494 NYS2d 208), that they are, in fact, so insufficient that it is "virtually impossible [for the Division of Taxation] to verify taxable sales receipts and conduct a complete audit" (***Matter of Chartair, Inc. v. State Tax Commn.***, 65 AD2d 44, 411 NYS2d 41, 43; ***Matter of Christ Cella, Inc.***

v. State Tax Commn., ***supra***), "from which the exact amount of tax due can be determined" (***Matter of Mohawk Airlines v. Tully***, 75 AD2d 249, 429 NYS2d 759, 760).

Where the Division follows this procedure, thereby demonstrating that the records are incomplete or inaccurate, the Division may resort to external indices to estimate tax (***Matter of Urban Liqs. v. State Tax Commn.***, ***supra***). The estimate methodology utilized must be reasonably calculated to reflect taxes due (***Matter of W.T. Grant Co. v. Joseph***, 2 NY2d 196, 159 NYS2d 150, ***cert denied*** 355 US 869, 2 L Ed 2d 75), but exactness in the outcome of the audit method is not required (***Matter of Markowitz v. State Tax Commn.***, 54 AD2d 1023, 388 NYS2d 176, ***affd*** 44 NY2d 684, 405 NYS2d 454; ***Matter of Cinelli***, Tax Appeals Tribunal, September 14, 1989). The taxpayer bears the burden of proving with clear and convincing evidence that the assessment is erroneous (***Matter of Scarpulla v. State Tax Commn.***, 120 AD2d 842, 502 NYS2d 113) or that the audit methodology is unreasonable (***Matter of Surface Line Operators Fraternal Org. v. Tully***, 85 AD2d 858, 446 NYS2d 451; ***Matter of Cousins Serv. Station***, Tax Appeals Tribunal, August 11, 1988). In addition, "[c]onsiderable latitude is given an auditor's method of estimating sales under such circumstances as exist in [each] case" (***Matter of Grecian Sq. v. Tax Commn.***, 119 AD2d 948, 501 NYS2d 219, 221).

C. In this matter, the Division made repeated requests for books and records. In response, petitioner explained that he was unable to present any documents because they were in the possession of the bankruptcy trustee. The Division then attempted, without success, to obtain the records from the bankruptcy trustee. At some juncture, the bankruptcy proceeding was closed and the records were lost. The lack of the records made it impossible to verify taxable sales through a complete audit from which the exact amount of tax due could have been determined. Accordingly, it was proper for the Division to resort to the use of external indices.

D. As set forth above, it was incumbent upon the Division to select an audit method that was reasonably calculated to determine the amount of taxes due (***see, Matter of Your Own Choice, Inc., supra***). Here, petitioner's representative has not raised any issue with respect to the use of the bank records to calculate sales. Rather, it is petitioner's position that once it was

shown that petitioner was not able to produce records, the auditor should have taken other steps to determine what kind of work was done and whether it was subject to sales tax.

E. There are at least two difficulties with the argument presented by petitioner's representative. First, as pointed out by the Division, there is a presumption that receipts are subject to tax (Tax Law § 1132[c]; ***see, e.g., Matter of Petak v. Tax Appeals Tribunal***, 217 AD2d 807, 629 NYS2d 547), and the burden of proof is upon the taxpayer to show that a transaction is not taxable (***id***). If petitioner's argument were accepted, it would improperly place the burden of proof upon the Division.

Second, petitioner's argument appears to be based on the faulty premise that by merely observing an item that is or has been constructed one can invariably determine if it is a capital improvement within the meaning of Tax Law § 1101(b)(9). The term capital improvement is defined by Tax Law § 1101(b)(9)(i) as an addition or alteration to real property which:

> (A) Substantially adds to the value of the real property or appreciably prolongs the useful life of the real property; and
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> (B) Becomes part of the real property or is permanently affixed to the real property so that removal would cause material damage to the property or article itself; and
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> (C) Is intended to become a permanent installation.

Thus, in order to conclude that the facades constructed by petitioner were capital improvements, one would need evidence that the facades added to the value of the property, were permanently affixed to the property and were intended to become a permanent installation. Assuming without deciding that merely observing the construction sites would provide the information needed to satisfy the first criteria, it is clear that an observation would not necessarily provide sufficient information to conclude that removal would cause material damage to the

property or that the installation was intended to be permanent. Therefore, a simple observation would not have been sufficient to satisfy the criteria of a capital improvement and show that the sales were not subject to sales tax.

F. The petition of Michael J. MacLeod is denied and the Notice of Determination, as modified per Finding of Fact "14," is sustained together with such penalties and interest as are lawfully due.

DATED: Troy, New York
August 9, 2007

/s/ Arthur S. Bray
ADMINISTRATIVE LAW JUDGE