STATE OF NEW YORK

TAX APPEALS TRIBUNAL

In the Matter of the Petition	:	
of	:	
JAY'S DISTRIBUTORS, INC.	:	DECISION DTA NO. 824052
for Redetermination of a Deficiency or for Refund of Cigarette Tax under Article 20 of the Tax Law for the Period March 1, 2004 through December 31, 2006.	:	

Petitioner, Jay's Distributors, Inc., filed an exception to the determination of the Administrative Law Judge issued on July 3, 2013 and to the order of the Administrative Law Judge issued on November 27, 2013. Petitioner appeared by Michael Buxbaum, CPA. The Division of Taxation appeared by Amanda Hiller, Esq. (Michelle M. Helm, Esq., of counsel).

Petitioner filed a brief in support of its exception. The Division of Taxation filed a brief in opposition. Petitioner filed a reply brief. Oral argument was heard in Albany, New York on October 15, 2014.

After reviewing the entire record in this matter, the Tax Appeals Tribunal renders the following decision.

ISSUES

I. Whether the Division of Taxation properly determined petitioner's tobacco products tax liability for the audit period.

II. Whether the Division of Taxation has met its burden to prove that a fraud penalty pursuant to Tax Law § 481 (1) (a) (iv) is properly imposed herein, or, in lieu thereof, whether penalty and interest pursuant to Tax Law § 481 (1) (a) (i) and (ii) should be imposed.

III. Whether the Administrative Law Judge properly denied petitioner's motion to reopen the record.

IV. Whether petitioner was denied its right to an expedited hearing as provided in Tax Law § 2008 (2).

FINDINGS OF FACT

We find the facts as determined by the Administrative Law Judge, except for findings of fact 3, 4, 5, 7, 15, 20, 25, 26, 31, 34 and 35, which we have modified to more accurately reflect the record. We have also added additional findings of fact, numbered 36 through 42 herein. The Administrative Law Judge's findings of fact, the modified findings of fact and the additional findings of fact are set forth below.

1. Petitioner, Jay's Distributors, Inc. (Jay's), was at all times relevant herein a cigarette and tobacco wholesaler and tobacco distributor licensed in the State of New York. It operated from a warehouse located at 451-453 St. Paul's Avenue, Jersey City, New Jersey, along with two other companies, Vikisha, Inc. (Vikisha) and Jaydeen Corporation (Jaydeen). Petitioner sold cigarettes, tobacco products and accessories, food products, nonalcoholic beverages and sundries to convenience stores, delicatessens and other retail outlets primarily in the greater New York metropolitan area and Long Island. Some deliveries were made to New York customers with vans and small box trucks, and some customers picked up products at the warehouse in New Jersey.

2. During the period March 1, 2004 through December 31, 2006 (audit period), Kaushik Shah owned 100% of petitioner (70% through June 2004) and 100% of Vikisha. His spouse, Reshma Shah owned 100% of Jaydeen. Vikisha was a New Jersey wholesaler of cigarettes and cigar products that traded in New Jersey exclusively, and Jaydeen was a New Jersey corporation that was a wholesaler of soft drinks and candy in both New York and New Jersey.

3. To begin its tobacco products tax audit, the Division of Taxation (Division) sent a letter to petitioner, dated December 20, 2006, at the Jersey City address confirming the commencement of a field audit and setting forth all documents that were expected to be produced. The letter requested New York and New Jersey tobacco tax returns; work papers, summaries, and schedules used to prepare said returns; purchase and credit invoices; manufacturers' statements for returned products; ATF approval for destruction of product; check register/cash disbursements journals and/or EFT statements; exemption certificates; and customer invoices. Following a postponement of the first scheduled meeting, the Division sent a nearly identical letter, dated January 29, 2007, to petitioner's representative, scheduling a meeting on March 19, 2007. As a follow up to that first meeting, the Division sent a letter, dated May 15, 2007, to petitioner's representative requesting the production of certain additional items, including petitioner's general ledger.

4. In response to these requests, petitioner provided some records, but purchase invoices were missing and there were gaps in the sales invoice numbers. The auditor examined in detail the distributor of tobacco products returns (forms MT-203); tobacco tax return transcripts; monthly sales reports (printed); sales invoices; credit memoranda; purchase invoices; product listings; third-party information; New Jersey tobacco tax return transcripts; and a New Jersey Division of Taxation audit report.

5. The auditor found that the tobacco sales set forth on sales invoices matched the amounts on the monthly summary reports and that the totals from the monthly summary reports matched the MT-203 returns. However, the auditor was troubled by the complete commingling of inventory between Vikisha and petitioner, a fact that was conceded by petitioner. In addition, the auditor determined that the missing purchase invoices and, to a lesser extent, the gaps in sales

invoice numbers, prevented use of a detailed audit methodology. Alternative audit methods were therefore immediately considered.

6. The common practice of petitioner and Vikisha was to purchase tobacco products from outside suppliers and store them in the warehouse at 451-453 St. Paul's Avenue in Jersey City, New Jersey. The Division informed petitioner that it would be necessary for the Division to perform a total accountability audit that would examine the tobacco products purchased, sales and inventories of both petitioner and Vikisha, and the sales made from the companies' commingled inventory. Although not used frequently, this method had been employed by the Division in similar situations.

7. The Division made a request for computerized records during the audit, but was told it could not have them. It was later established at the hearing that, although petitioner maintained computerized records of sales and purchase invoices, petitioner decided not to produce them on audit because, according to petitioner, the records reflected only the combined totals for all of the companies in the group. Additionally, petitioner informed the auditor that it did not perform a physical inventory, even on an annual basis. Although this was later disputed by petitioner's president, Kaushik Shah, at the hearing, inventory figures were never produced.

8. To supplement the purchase records provided by petitioner, the auditor issued "third-party" letters to multiple suppliers to verify sales made to petitioner. However, it became immediately apparent to the auditor that the level of detail necessary to track individual brands of cigars and tobacco and the myriad of product offerings for three years would be impossible, and so it was decided to use a test period. At the suggestion of petitioner's representative, Stephen J. Bercovitch, Esq., the period chosen was the entire calendar year 2005, selected to fairly reflect petitioner's tobacco activity during the audit period. The lack of clear inventory records

demonstrating the flow of product through the warehouse weighed heavily in the decision to review a full year, as well.[1]

9. Responses from suppliers confirmed that the purchase records received from petitioner and Vikisha were not a complete set of records, even for the year 2005. Coupled with the lack of inventory records, the Division determined that there were insufficient records to perform a detailed audit. Therefore, even though the Division decided to use a test period audit methodology and apply the results to the entire audit period, it did not seek petitioner's consent to utilize said method since it was a component part of the estimated methodology.

10. When the audit began, petitioner was represented by Stephen J. Bercovitch, Esq., and Richard Lichtig, Esq. Subsequently, petitioner retained several other legal and professional representatives.

11. Mr. Bercovitch provided separate powers of attorney from both Vikisha and Jaydeen, appointing him as their representative with respect to tobacco products and sales and use tax for the period March 1, 2004 through December 31, 2006. In addition, Mr. Bercovitch provided Vikisha's available books and records. Subsequent representatives also agreed to submit powers of attorney on behalf of Vikisha and Jaydeen and understood the nature and scope of the Division's total accountability audit, including the commingled tobacco product inventories of petitioner and Vikisha.

12. The audit required four years and 566 man-hours to complete due to the scope of the examination required to fully ascertain petitioner's purchases, sales and inventory. Every item needed to be broken down by product type, brand and variation for the year 2005, and the

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[1] This must be differentiated from a mere snapshot of the contents of the warehouse, which the auditor assumed was a "constant," i.e., a relatively stable value.

resulting data collected and entered manually into spreadsheets and computer files. This task was long and involved and the Division was hampered by petitioner's failure to make its computerized records available. The Division was aware of petitioner's computerized records because all of its sales invoices were computer generated.

13. Petitioner executed numerous consents extending the period of limitations on assessment of tobacco taxes beginning in March of 2007 until September of 2009, the last of which permitted the Division to determine or assess additional tax for the entire audit period at any time on or before December 31, 2009.

14. Although the Division's review of all the tobacco products tax returns for the audit period revealed that each was filed and mathematically correct, and matched monthly summary reports and New York sales invoices, the Division discovered a large discrepancy between products purchased by Vikisha and petitioner and their sales.

15. The third-party requests for information on sales to Vikisha, Jaydeen and petitioner garnered responses from four companies that made sales to the companies: Altadis USA Inc.; NHA, Inc.; Cheyenne International, LLC; and Swisher International, Inc. A review of the sales of these companies to petitioner and Vikisha was compared to the purchase information provided to the Division and revealed that there were sales for which no purchase invoices were provided. These were designated "unaccounted for" purchases.

16. Additionally, the Division received responses from U.S. Smokeless Tobacco Brands, Inc., Corwood Sales Co., Inc., and Lane Limited that indicated that these companies made no sales to Vikisha, Jaydeen or petitioner during the audit period. There were several other unspecified vendors that did not respond to the Division's requests.

17. When the purchase records received from third parties and those provided by petitioner were compared with sales records provided by petitioner, it was determined that petitioner was making sales of products it never purchased. Since petitioner drew its product from the inventory commingled with that of Vikisha, it was concluded that Vikisha had purchased those products.

18. An example of petitioner selling product it had never purchased was discovered when the auditor looked at specific items purchased and sold during the test period. It was determined that petitioner sold various items produced by Captain Black: cans, packets and packs of little cigars, but provided no records substantiating a purchase of the goods. Lane Limited is a supplier of Captain Black products, but indicated no purchases by either Vikisha or petitioner during the audit period. Vikisha was purchasing the item elsewhere and depositing it into the commingled inventory at the Jersey City warehouse. Petitioner then drew the product from the commingled inventory and sold it.

19. Two other examples of product sold but not purchased occurred with Winchester little cigars, a product distributed by Lane Limited, and Rooster chew and Skoal chew, products distributed by U.S. Smokeless Tobacco. In both instances, the suppliers reported no sales to either Vikisha or petitioner in 2005, yet petitioner reported sales of each of these products during 2005, underscoring the confusion raised by the commingling of inventories between Vikisha and petitioner.

20. The third-party responses also made clear that both petitioner and Vikisha were purchasing far more product than they reported selling, and since petitioner never provided inventory reports to the Division, there was no way of determining what became of the excess product purchased but not reported sold. However, the auditor, who had extensive experience in tobacco and cigarette audits, determined that since tobacco is a perishable product, its shelf life

and time in inventory is limited. It was therefore assumed that such a product must have been sold.

21. The excess product issue was apparent to the Division when it reviewed purchase invoices provided by petitioner as well as sales records received from Klein Candy Company, located in Wilkes Barre, Pennsylvania. Looking at purchases by item and sales by item, the Division found several instances of excess inventory for which petitioner had not accounted. In one example, Vikisha and petitioner had purchased 158 boxes of Anthony & Cleopatra cigars but only sold a total of 78 boxes, with petitioner's sales accounting for only 12 boxes. Another instance was the purchase of 2,754 boxes of various types of Phillies little cigars in 2005 and combined sales of Vikisha and petitioner of only 14 boxes.

22. In another example involving the purchase of Copenhagen chewing tobacco, Vikisha and petitioner purchased 8,886 rolls of 10 tins and claimed to have sold 4 rolls, leaving 8,882 rolls of excess inventory.[2]

The Division also found instances where there were sales of certain brands of cigars and tobacco but no record of any purchases, indicating that these may have been attributable to some suppliers that had not responded to third-party requests for information or the existence of additional suppliers that were not disclosed to the Division.

23. Another example of missing records, and further evidence that complete books and records had not been provided to the Division, was the discovery of purchase information from a company called Santa Clara, Inc. (Santa Clara), which indicated purchases in the sum of $29,839.31 on June 20 and 21, 2005, but never reflected in purchase information received from

[2] The Division found that two additional rolls of Cougar or Red Seal Copenhagen chew were sold but not reflected on purchase records.

Vikisha or petitioner. Despite the fact that June was the only month of purchase records provided for Santa Clara, the Division did not assume more purchases from Santa Clara throughout the rest of 2005.

24. The Division reviewed the purchases determined from petitioner's records and third-party information, subtracted out the sales that were reported in both New Jersey and New York, and determined that the remainder was excess inventory for which petitioner was unable to account. For the test period of 2005, the Division took the excess inventory and applied an average price (determined from purchase prices of the individual items) to find the value of average unaccounted inventory.

25. The State of New Jersey performed a tobacco products audit of Vikisha in 2007 for the audit period October 2002 through September 2006. A review of the New Jersey Division of Taxation's audit report indicates that the New Jersey auditor examined a three-month sample of the sales records of both Vikisha and petitioner. It does not appear from the audit report that the New Jersey auditor reviewed any purchase records. The New Jersey audit found no additional tax due, accepting New Jersey sales as reported on Vikisha's tobacco tax returns. On audit, the Division reasoned that all product purchases that exceeded the total of New Jersey and New York reported sales were excess inventory that must have been imported or sold in New York in part because New Jersey had already accepted the product sales reported to it.

26. From its comparison of purchases and sales by Vikisha and petitioner by product category for the test year 2005, the Division was able to identify unaccounted for product in the

sum of $893,481.37, based on actual purchase prices. This figure was divided by 12 to establish an average monthly figure, $74,456.37, and subsequently projected over the entire audit period.[3]

Likewise, the Division totaled all unreported tobacco purchases by petitioner and Vikisha in 2005 from Altadis, Cheyenne International, National Honey Almond, Santa Clara, Swedish Match and Swisher, which was found to be $1,974,454.76. This sum was divided by 12 to reach the average unreported purchases per month, or $164,537.90.

The Division added the average monthly figures for unaccounted for product and unreported purchases to arrive at a total monthly wholesale price of $238,994.68,[4] to which the tax rate of 37% was applied to arrive at a monthly tax due of $88,428.03, yielding total tax due for the audit period of $3,006,553.02. The Division issued a notice of determination to petitioner, dated December 28, 2009, asserting additional tax due of $3,006,553.02, plus penalty and interest.

27. In its review of Vikisha's records, the Division discovered that, during the audit period, Vikisha made substantial sales and purchases of tobacco products to Klein Candy, a Pennsylvania distributor. As an example, Vikisha reported total tobacco product sales of $821,085.94 in November 2004. Of this amount, $710,085.94, 86.51%, was sold to Klein Candy. In the same month, Klein reported sales to Vikisha of $739,889.21.

28. In 2005, the test period, Klein Candy sold Vikisha $3,836,159.89 of tobacco products and Vikisha sold $1,636,536.22 of product back to Klein. In addition, the Division noted Vikisha's sales of $2,188,929.00 of product in 2005 to One Stop Wholesale Distributors, Inc.

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[3] The Division's audit workpapers detailing such unaccounted for product also provide some detail for 2005 "accounted for" sales. Such information indicates that Vikisha accounted for 183,464 units of tobacco products sold in 2005, while petitioner accounted for 49,210 units.

[4] The unreported tobacco purchases from the six companies were not included in the analysis of purchases and sales that yielded the unaccounted for inventory because the detail of products purchased on the invoices could not be obtained by the Division.

(One Stop), a Pennsylvania distributor wholly-owned by Kaushik Shah, president and owner of petitioner. One Stop shares the same address in Wilkes-Barre, Pennsylvania, with Klein Candy.

29. Underlying invoices examined by the Division indicated that the prices charged by both distributors for the same product were identical. An example was the sale by Vikisha to Klein Candy of Dutch Master coronas on March 10, 2005 for $24.99 a box. On March 11, 2005, Klein Candy sold the same product back to Vikisha for the same price. Further, since Vikisha and petitioner commingled their inventories, the product sales and purchases between Vikisha, Klein Candy and One Stop could be ascribed to either Vikisha or petitioner.

30. Since the typical flow of tobacco products to market originates with a manufacturer selling to distributors and in turn to retailers and finally customers, intercompany transactions between distributors for identical prices was an aberration not observed by the Division prior to this particular audit.

31. The Division discovered several instances during the audit period where Klein Candy paid a related company, Jaydeen Corporation, for tobacco products purchased from Vikisha, even though Jaydeen was not licensed to sell tobacco products and was a New Jersey corporation that operated as a wholesaler of candy, gum, soft drinks and other non-tobacco products. The sales invoices for such tobacco products sold by Vikisha to Klein Candy were issued by Vikisha.

32. Although petitioner understood that its purchases, and thus its purchase records, were critical to substantiate its tobacco products returns and also central to the Division's audit methodology, it did not produce additional purchase records to challenge the Division's findings, despite claiming that such records existed.

33. By letter, dated December 6, 2007, during the audit of petitioner herein, Mr. Robert Eisman, an Associate Attorney with the Division's Office of Tax Enforcement, informed

petitioner's attorney, Mr. Scott Lippert, that Jay's Distributors was being investigated for fraud and that it was in violation of the New York Tax Law for not maintaining its tobacco products in a secure and separate warehouse facility. Mr. Eisman demanded that petitioner comply with the directive of the Tax Law as soon as possible.

34. Petitioner paid an average of approximately $28,000.00 in tax per month with its tobacco tax returns during the audit period.

35. Based on the substantial underpayment of tax, petitioner's failure to produce all books and records requested, petitioner's failure to comply with the Tax Law and regulations, particularly the requirement to maintain a separate and secure warehouse for its tobacco products, petitioner's practice of importing and selling inventory from another company, billing practices that disregarded the actual vendor of its product and the unexplained circular transactions between Vikisha and Klein Candy, the Division asserted fraud penalty in the December 28, 2009 notice of determination.

36. At the hearing in this matter, petitioner's accountant, who has served in that capacity since 1985, testified that there were transactions between petitioner, Vikisha and Jaydeen over the years. He specifically referenced an entry in petitioner's 2004 general ledger, dated December 31, 2004, showing a $750,000.00 sale of tobacco products to Vikisha. He explained the entry as follows: "[W]hen we were doing the final accounting for 2004, we realized that purchases is [sic] higher than sales and this $750,000.00 was tobacco product used by Vikisha which was purchased through Jay's Distributors. That is why we put this entry on the books."

37. As part of its license application in 2002, petitioner provided the Division with an accurate diagram of its St. Paul's Avenue warehouse. The diagram showed that petitioner and

Vikisha were sharing warehouse space and indicated a single storage space for tobacco products (designated in the diagram as "Cigars").

38. The petition in this matter was filed on or about December 13, 2010. Petitioner did not expressly reference fraud penalty in the petition, but did make the general assertion that "reasonable cause exists for the elimination of all penalties." The conciliation order dated December 3, 2010, attached to the petition, contains no reference to fraud penalty. The notice of determination dated December 28, 2009, also attached to the petition, likewise contains no reference to fraud penalty.

39. The Division filed its answer to the petition on or about February 16, 2011. The answer contains no specific reference to fraud penalty, but only a general statement that "no reasonable cause exists for the abatement of penalties properly imposed."

40. The fraud issue was discussed during the first prehearing conference call held in this matter on January 11, 2012. At that time, the Administrative Law Judge consented to a Division request to file an amended answer. The Administrative Law Judge received the Division's amended answer on or about February 2, 2012. The amended answer affirmatively stated that the notice of determination at issue asserted fraud penalty under Tax Law § 481 (1) (a) (iv). The amended answer also asserted, in the alternative and in the event that fraud penalty is not sustained, "interest and penalties under Tax Law § 481 and any other applicable provision."

41. A second prehearing conference was held on February 2, 2012. The Administrative Law Judge sent a letter to the parties, dated February 3, 2012, summarizing the conference in relevant part, as follows:

> "I received Ms. Helm's Amended Answer on February 2, 2012. Since that was the first instance in this matter where the Division alleged fraud penalty, I am considering February 2, 2012 as the date the time begins to run on the expedited

> hearing provided for in Tax Law section 2008 (2) (iii). Since Mr. Buxbaum requested time to examine documents which the Division will be sending to him this week, the statutory time period for my determination is tolled. . . . Our next prehearing conference will be April 5, 2012 at 11:30 A.M. At that time, I will again entertain requests from either party for an adjournment of the expedited hearing, which would be scheduled within seven days if no such request is made."

42. At the April 5, 2012 prehearing conference, both parties requested that the hearing in this matter be scheduled for August 2012. The hearing was held on August 15, 2012.

THE DETERMINATION OF THE ADMINISTRATIVE LAW JUDGE

The Administrative Law Judge determined first that the correct standard by which to evaluate the Division's audit methodology in a tobacco products tax matter is the standard established for sales tax audits. Next, the Administrative Law Judge found that the subject audit met the sales tax audit standards. Specifically, the Administrative Law Judge found that the Division requested records; the records provided were inadequate; and, accordingly, the use of a test period method was appropriate. The Administrative Law Judge further concluded that the audit method was rooted in petitioner's own records and therefore reasonably calculated to reflect tobacco products tax due. Noting the commingling of inventory and the auditor's credible testimony that tobacco product was perishable and thus unlikely to remain in the warehouse for long, the Administrative Law Judge determined that the Division reasonably presumed that all audited purchases by petitioner and Vikisha in excess of reported sales by the same entities were sold by petitioner in New York. Finally, the Administrative Law Judge found that petitioner did not prove error in either the audit method or result, and thus, sustained the assessment of tax.

After noting the standards for determining whether a taxpayer may be subject to a civil fraud penalty, the Administrative Law Judge sustained the Division's imposition of such penalty herein, citing the following factors: petitioner's commingling of its inventory with Vikisha; the circular transactions between Vikisha, Klein Candy and One Stop, described by the

Administrative Law Judge as transactions with no apparent legitimate business purpose; petitioner's poor record keeping; and petitioner's substantial underreporting of its tobacco products tax liability.

The determination also dismissed petitioner's assertions that the Division did not properly plead an alternative penalty in lieu of the fraud penalty and that the Division failed to heed a subpoena issued in this matter. Neither of these issues has been raised on exception.

THE ORDER OF THE ADMINISTRATIVE LAW JUDGE

Following the issuance of the determination, petitioner timely filed a motion to reopen the record pursuant to the Rules of Practice and Procedure of the Tax Appeals Tribunal (20 NYCRR 3000.16). By its motion, petitioner sought to introduce into the record certain documents that it claimed were newly discovered evidence. Specifically, petitioner offered an Inspector General's report, dated May 2013, concerning the Petroleum, Alcohol, and Tobacco Bureau of the Tax Department, and its involvement with certain cigarette operations. Petitioner also offered Vikisha's Federal tax returns for the years 2004, 2005 and 2006. Additionally, the motion alleged certain "fraud, misrepresentation or other misconduct" by the Division as a basis for reopening the record. Petitioner's motion also asserted, as a basis for reopening the record, issues regarding the pleading of fraud penalty; prior notice of witnesses and documents to be presented at the hearing; the Division's asserted failure to make available petitioner's full criminal investigation file; and a failure to comply with petitioner's Freedom of Information requests.

On November 27, 2013, the Administrative Law Judge issued an order denying the motion. The Administrative Law Judge found that the Vikisha tax returns did not constitute newly discovered evidence, noting that petitioner offered no explanation as to why such evidence could not have been discovered in time to produce it at the hearing. Additionally, the

Administrative Law Judge concluded that petitioner had not established the relevance of the tax returns. The Administrative Law Judge also deemed the Inspector General's report to be irrelevant to the instant matter. The Administrative Law Judge found no evidence in the record of fraud, misrepresentation or other misconduct by the Division. The Administrative Law Judge dismissed all other issues raised in the motion as matters that should have been argued at the hearing or on exception.

ARGUMENTS ON EXCEPTION

With respect to the audit, petitioner contends, as it did before the Administrative Law Judge, that the Division's failure to inspect its 2004 and 2006 records violates established audit standards and requires cancellation of the assessment. Petitioner further contends that its records were complete and that such records should have been used to compute its liability on audit. Additionally, petitioner asserts that the audit improperly reviewed the purchases of Vikisha and improperly attributed such purchases to petitioner.

Petitioner also continues to assert that the Division failed to prove that fraud penalty was properly imposed. Petitioner contends that it cooperated with the Division during the audit and that the record lacks any evidence of fraudulent intent on petitioner's part. Additionally, petitioner contends that the requirement for a tobacco products distributor to maintain a separate and secure warehouse is inapplicable to it because it is located in New Jersey and subject to the laws of that state.

Petitioner continues to contest the Administrative Law Judge's order declining to reopen the record for the purpose of receiving additional evidence.

As it did in its motion to reopen the record, petitioner asserts that it was denied its right to an expedited hearing pursuant to Tax Law § 2008 (2) (a).

Also, as it did in its motion to reopen the record, petitioner contends that the Division's representative engaged in professional misconduct in the present matter by failing to provide certain documents and by making certain statements to petitioner's representative.

The Division contends that petitioner failed to provide adequate books and records upon request and that such failure authorized it to estimate petitioner's tobacco products tax liability using a test period and records received from various third party suppliers. The Division further asserts that the audit method and result were reasonable and that petitioner has failed to establish any errors therein.

The Division also contends that it properly imposed fraud penalty against petitioner and cites various factors in the record that it claims support the imposition of such penalty.

Additionally, in lieu of fraud, the Division asserts that negligence penalty and interest pursuant to Tax Law § 481 (1) (a) (i) and (ii) should be imposed.

Finally, the Division contends that the Administrative Law Judge properly denied petitioner's motion to reopen the record; that petitioner was not denied any substantive appeal rights by the lack of an expedited hearing in this matter; and that its representative did not engage in any professional misconduct.

OPINION

Tax Law § 471-b imposes a tobacco products tax on all tobacco products possessed in New York State by any person for sale. During the period at issue, the tax was imposed at the rate of 37% of the wholesale price of the tobacco product (***see*** Tax Law former § 471-b [1]). Tobacco products are defined as "[a]ny cigar, including a little cigar, or tobacco, other than cigarettes, intended for consumption by smoking, chewing, or as snuff" (Tax Law § 470 [2]).

The distributor is liable for payment of the tax on tobacco products that he "imports or causes to be imported into the state . . . and [must] pay the tax on tobacco products sold, shipped

or delivered by him to any person in the state" (Tax Law § 471-b [2]). Petitioner was such a distributor of tobacco products during the period at issue (***see*** Tax Law § 470 [12]).

Tax Law § 473-a requires every distributor of tobacco products to file a monthly return showing the quantity and wholesale price of all tobacco products imported or caused to be imported, and all tobacco products sold, shipped or delivered into New York State during the prior month. If the Division determines that such return is "incorrect or insufficient," it "shall determine the amount of tax due" (***see*** Tax Law § 478).

As noted, tobacco tax liability for a distributor, such as petitioner, is premised on the wholesale price of tobacco products sold, shipped or delivered in New York State (***see*** Tax Law former § 471-b [1]). Pursuant to its regulations, the Division "may determine the wholesale price of any tobacco product based upon such evidence as may be presented by any person with an interest therein or such information as may be otherwise available" (20 NYCRR 89.2 [b] [2]). The Division may also require any distributor of tobacco products "to submit a schedule containing the description, trade/brand name and wholesale price of every tobacco product imported or caused to be imported into this State for sale, manufactured in this State or sold, shipped or delivered to any person within the State by such distributor . . . ." (***id.***).

We agree with the Administrative Law Judge's conclusion that the correct standard by which to evaluate the Division's estimated audit method and result herein is the well-established sales tax audit standard. We have previously noted that the tobacco products tax "functions much like the sales tax imposed by Article 28 in that it applies only once as goods move from manufacturer to wholesaler to retailer to consumer" (***Matter of J.C. Newman Cigar Company***, Tax Appeals Tribunal, November 6, 2008). Indeed, similar to the sales tax, and in contrast to personal income and corporate franchise taxes, the tobacco products tax imposes a tax on

"verifiable receipts as evidenced by books and records" (***see Matter of R & J Automotive***, Tax Appeals Tribunal, June 15, 1989).

Accordingly, as developed in the sales tax case law, the Division's proper use of an estimated method in a tobacco products tax audit begins with an explicit request for the taxpayer's books and records (***Matter of Christ Cella, Inc. v State Tax Commn.***, [102 AD2d 352 [1984]) for the entire period of the assessment (***Matter of Adamides v Chu***, 134 AD2d 776 [1987], ***lv denied*** 71 NY2d 806 [1988]). The Division must then make a thorough review of such records (***Matter of King Crab Rest. v Chu***, 134 AD2d 51 [1987]). If such review indicates that the records are so insufficient that it is virtually impossible for the Division to verify, in this case, petitioner's sales of tobacco products in New York and the wholesale price of such tobacco products, and thus conduct a complete audit from which the exact amount of tax due can be determined, then the Division may resort to the use of external indices to estimate tax (***see Matter of Chartair, Inc. v State Tax Commn.***, 65 AD2d 44 [1978]).

Pursuant to the foregoing principles, we find that the Division properly resorted to the use of an indirect audit method to estimate petitioner's tobacco products tax liability in the present matter. In response to the Division's clear requests for records (***see*** Findings of Fact 3 and 7), petitioner failed to provide any of its electronic records of sales or purchases[5] and also failed to provide its general ledger. The absence of such records prevented the Division from verifying the completeness of the paper purchase and sales invoices that were made available and thus prevented the Division from verifying the accuracy of petitioner's tobacco products returns as filed. Additionally, the Division's detailed review of the 2005 purchase invoices that were

[5] We give little weight to petitioner's rationale for not providing the electronic records as requested (***see*** Finding of Fact 7). The utility or relevance of taxpayer records to the conduct of an audit is a decision to be made, in the first instance, by the auditor.

provided and the Division's use of third party information to verify such purchase invoices indicated that the 2005 purchase invoices provided on audit were incomplete (***see*** Finding of Fact 9). We note that the Division may use third party information to verify purchase records even where a taxpayer produces ostensibly complete records (***see Matter of Morano's Jewelers of Fifth Ave., Inc.***, Tax Appeals Tribunal, January 2, 1992). We note further that the Division's decision to audit Vikisha's purchases and sales of tobacco products as part of its audit of petitioner was reasonable, given these entities' common ownership, common record keeping and commingled inventory.

Petitioner contended that the Division's failure to review the 2004 and 2006 invoices that were made available violated the well established sales tax audit rule that the Division must thoroughly review a taxpayer's records for the entire audit period before making a determination as to their adequacy (***see Matter of King Crab Rest. v Chu***). We disagree. In this case, petitioner's failure to make its general ledger and its electronic records available rendered its production of records incomplete and therefore insufficient for the purpose of verifying its purchases and sales. Accordingly, the Division's failure to review the 2004 and 2006 invoices was, under the specific facts herein, rendered moot.

Having found that the Division's use of an estimated audit method was proper, we must next determine, consistent with sales tax audit principles, whether the method utilized by the Division in the present matter was reasonably calculated to determine petitioner's tobacco products tax liability (***see Matter of W.T. Grant Co. v Joseph***, 2 NY2d 196 [1957], ***cert denied*** 355 US 869 [1957]). We conclude that it was. The test period, as well as the use of third party supplier information, are both well established as reasonable audit techniques (***see e.g. Matter of Continental Arms Corp. v State Tax Commn.***, 72 NY2d 976 [1988]; ***Matter of Lima***, Tax Appeals Tribunal, April 19, 2007).

Furthermore, and specific to the present matter, we find that the Division's audit decision to deem all unaccounted for purchases by both petitioner and Vikisha to have been sold in New York and thus taxable to petitioner was reasonable. Petitioner and Vikisha had common ownership, shared the same warehouse and drew product from the same commingled inventory. Moreover, the audit revealed that petitioner sold product purchased by Vikisha (***see*** Findings of Fact 17 and 18). Additionally, the existence of transactions between petitioner and Vikisha during the audit period was confirmed by the testimony of petitioner's accountant. Further, by his testimony regarding the $750,000.00 adjustment to account for petitioner's sale of tobacco products to Vikisha in 2004, petitioner's accountant revealed that transfers between the two entities were not necessarily well (or contemporaneously) documented (***see*** Finding of Fact 36).

Additionally, given lack of any inventory records and the perishability of tobacco products (***see*** Finding of Fact 20), it was plainly reasonable for the Division to presume, for audit purposes, that all purchases of tobacco product were sold and none went into inventory.

We note that the factual finding regarding the perishability of tobacco products was premised on the testimony of the auditor, an excise tax auditor with extensive experience in tobacco and cigarette audits. We note further that the Administrative Law Judge found the auditor's testimony on this point to be credible, a finding to which we defer (***see Matter of Spallina***, Tax Appeals Tribunal, February 27, 1992).

Since the audit method was reasonable, petitioner had the burden of proof to show, by clear and convincing evidence, that the result of the audit was unreasonably inaccurate or that the amount of tax assessed was erroneous (***see Matter of Your Own Choice, Inc.,*** Tax Appeals Tribunal, February 20, 2003).

Upon review of the record, we find that petitioner has failed to meet this burden. Petitioner's objections to the audit method focus on the inclusion of Vikisha's purchases in the

audit determination of unaccounted for purchases and the audit presumption that all unaccounted for purchases were sold by petitioner in New York. As discussed above, we find the inclusion of Vikisha's purchases and the presumption that all unaccounted for product was sold in New York to be reasonable. We note that petitioner offered no evidence to show that any of the unaccounted for purchases were sold in New Jersey or placed in inventory.

Petitioner also contends that, by its audit, the Division misapplied Tax Law § 471-b (1), which provides for a presumption that all tobacco products within the state are subject to tax until the contrary is established and that the burden of proof to show that such products are nontaxable is on the person in possession. Petitioner reasons that since the products in question were purchased in New Jersey, the presumption does not apply.

Petitioner's reasoning is flawed. As discussed, the audit reasonably presumed that all unaccounted for purchases were sold by petitioner in New York and therefore taxable to petitioner. As also discussed, pursuant to case law, petitioner has the burden to prove error in the audit method and results. Furthermore, petitioner had the burden of proof at the hearing in this matter (20 NYCRR 3000.15 [d] [5]).

The notice of determination issued to petitioner asserted fraud penalty pursuant to Tax Law § 481 (1) (a) (iv). Such penalty is properly imposed where "the failure to pay any tax within the time required by or pursuant to this article is due to fraud." The standard for the imposition of the fraud penalty is as follows:

> "The issue of whether a taxpayer wilfully failed to file returns and timely pay tax was with the intent to evade payment of tax presents a question of fact to be determined upon consideration of the entire record (***see Matter of Drebin v. Tax Appeals Tribunal,*** 249 AD2d 716 [1988]). The burden of demonstrating this falls upon the Division (***see Matter of Sona Appliances,*** Tax Appeals Tribunal, March 16, 2000). Fraud is not defined in [the] Tax Law . . . . However, a finding of fraud requires the Division to show 'clear, definite and unmistakable evidence of every element of fraud, including willful, knowledgeable and intentional wrongful acts or omissions constituting false representation, resulting in deliberate

> nonpayment or underpayment of taxes due and owing' (***see Matter of Sona Appliances***). In order to establish fraudulent intent, petitioners must have acted deliberately, knowingly and with the specific intent to violate the Tax Law (***see Matter of Cousins Serv. Sta.***, Tax Appeals Tribunal, August 11, 1988).
>
> The [Tax Law] penalty provisions are modeled after Federal penalty provisions and, thus, Federal statutes and case law may properly provide guidance in ascertaining whether the requisite intent for fraud has been established (***see Matter of Uncle Jim's Donut & Dairy Store,*** Tax Appeals Tribunal, October 5, 1989). Since direct proof of a taxpayer's intent is rarely available, fraud may be proved by circumstantial evidence, including the taxpayer's course of conduct (***Intersimone v. Commissioner***, T.C. Memo 1987-290, 53 TCM 1073 [1987]; ***Korecky v. Commissioner,*** 781 F2d 1566 [1986], 86-1 USTC ¶ 9232). Relevant factors held to be significant include consistent and substantial understatement of tax, the amount of the deficiency itself, the existence of a pattern of repeated deficiencies and the taxpayer's entire course of conduct (***see Merritt v. Commissioner***, 301 F2d 484 [1962], 62-1 USTC ¶ 9408; ***Bradbury v. Commissioner***, T.C. Memo 1996-182, 71 TCM 2775 [1996]; ***Webb v. Commissioner***, 394 F2d 366 [1968], 68-1 USTC ¶ 9341; ***see also Matter of AAA Sign Co.***, Tax Appeals Tribunal, June 22, 1989).
>
> The burden rests with the Division to prove by clear and convincing evidence that petitioners, with willful intent, were in violation of the tax laws (***see Matter of Cardinal Motors***, State Tax Commn., July 8, 1983, ***confirmed Cardinale v. Chu*** 111 AD2d 458 [1985]). Fraud must be established with affirmative evidence and may not be presumed (***see Intersimone v. Commissioner***, ***supra***). Therefore, mere suspicion of fraud from the surrounding circumstances is not enough (***see Goldberg v. Commissioner,*** 239 F2d 316 [1956], 57-1 USTC ¶ 9261)." (***Matter of What a Difference Cleaning***, Tax Appeals Tribunal, May 15, 2008.)

Upon review of the record, we find that, while there are some facts present that support the imposition of fraud penalty, on balance, the record falls short of the "clear, definite and unmistakable" evidentiary standard necessary to sustain a fraud penalty (***see Matter of Sona Appliances***).

As evidence of fraud, the Administrative Law Judge cited petitioner's failure to maintain adequate books and records and its commingling of inventory in violation of Tax Law § 480 (1) (d). The failure to maintain accurate records is well established as a "badge" of fraud (***see Niedringhaus v Commissioner***., 99 TC 202 [1992]). With respect to the commingling of

inventory, we agree with the Administrative Law Judge's finding that petitioner failed to maintain a secure separate warehouse facility as required under Tax Law § 480 (1) (d). We reject petitioner's contention that it was not subject to this requirement because it was located in New Jersey. As an entity authorized as a distributor of tobacco products in New York, petitioner was and is required to comply with all laws and regulations pertaining to its status as such a distributor. As evidence of fraud, however, the significance of this factor is tempered by the lack of any apparent effort at concealing the shared warehouse and the resulting commingling of inventory between petitioner and Vikisha (***cf. Garavaglia v C.I.R.***, TC Memo 2011-228 [2011] [a taxpayer's efforts to conceal and mislead taxing authorities weighed in favor of a finding of fraud]). Specifically, petitioner provided the Division with an accurate diagram of its warehouse as part of a licensing application in 2002 that indicated the commingling of inventory; its representative acknowledged the commingling during the audit; and its president and accountant acknowledged the commingling of inventory at the hearing.

Additionally, we disagree with the Administrative Law Judge's conclusion that the circular transactions between Vikisha and Klein Candy (***see*** Findings of Fact 27 through 29) support a finding that petitioner committed fraud in its underpayment of tobacco products tax. We appreciate that these transactions were, in the Division's experience, highly unusual and contrary to the typical flow of tobacco products to market (***see*** Finding of Fact 30), and thus suspect. We find, however, that there is insufficient evidence in the record to conclude that these transactions were fraudulent. Indeed, in its brief, the Division merely asserts that these transactions "appeared to lack any legitimate business purpose." This claim amounts to a suspicion of fraud. Such a suspicion may not prove fraudulent intent (***see Goldberg v Commissioner***).

The Administrative Law Judge also noted petitioner's underreporting of its tobacco products tax liability as a factor in support of fraud. The continuous and substantial

underreporting of tax liability is strong evidence of fraud (***Merritt v Commissioner.***, 301 F2d 484 [5th Cir. 1962]), but only where the Division affirmatively proves such understatement (***see Matter of Cousins Serv. Sta.***). In our view, the Division has not met this burden in the present matter.

We see two shortcomings in the audit that compel this conclusion. First, and most significantly, the audit presumes that all unaccounted for purchases were sold in New York by petitioner and none were sold by Vikisha outside New York. The record, however, lacks any evidence supporting this presumption. Indeed, the record suggests that Vikisha sold significantly more tobacco products than petitioner. Specifically, the Division's workpaper detailing 2005 purchases and sales by petitioner and Vikisha indicates that Vikisha's accounted for sales for that year exceeded petitioner's by an approximate 3 to 1 margin (***see*** Finding of Fact 26). Contrary to the Division's reasoning on audit, the "no change" result of the New Jersey audit lends little affirmative support to its audit presumption, as the New Jersey audit did not examine purchases by either Vikisha or petitioner (***see*** Finding of Fact 25). As discussed, the Division's audit rests entirely on a finding of additional, unaccounted for purchases.

A second shortcoming in the Division's audit is the lack of evidence of purchases made by petitioner and Vikisha for most of the relevant period. The majority of the assessment is an estimate based on a test period projection. The Division performed a detailed audit of petitioner's and Vikisha's purchase records for 2005, but did not review any purchase records for the other 22 months of the audit period.

We note that our decision herein thus finds the same evidence sufficient to sustain an assessment of tax in the first instance, but insufficient to affirmatively prove the same assessment in the fraud penalty context. We note further that this is not an inconsistency, but simply a shifting of the burden of proof (***see Matter of Cousins Serv. Sta.***).

In its brief, the Division asserts that petitioner's president, Mr. Shah, gave false testimony at the hearing and that such alleged false testimony supports the imposition of fraud penalty. As noted previously, we generally defer to the Administrative Law Judge's credibility judgements (***see Matter of Spallina***). As the Administrative Law Judge made no finding regarding Mr. Shah's credibility and did not cite his testimony as a factor in support of his finding of fraud, we dismiss this assertion.

Also in its brief, the Division cites evidence in the record of unreported sales by petitioner in New York that occurred subsequent to the audit period. The Division contends that such evidence supports the imposition of fraud penalty. The Administrative Law Judge did not make a finding of fact with respect to such evidence and we defer to his decision in that regard. We note further that, generally, fraudulent intent must exist at the time the taxpayer files the return and not some later date (***see Holmes v C.I.R.***, TC Memo 2012-251 [2012]).

Additionally, the Division notes checks from Klein Candy payable to Jaydeen for invoices that included tobacco products (***see*** Finding of Fact 31). The Division notes that Jaydeen was not licensed to sell tobacco products. We disagree with the Division that these facts indicate fraud because the checks were prepared by Klein Candy, a third party. Moreover, we note that the invoices for tobacco products were issued (apparently correctly) by Vikisha. The impropriety complained of by the Division thus appears to be the fault of Klein Candy and not petitioner or Vikisha.

Accordingly, pursuant to the foregoing discussion, we find that the Division has not proven by clear and convincing evidence that petitioner's underpayment of tobacco tax determined due herein was the result of fraud. We thus conclude that the penalty imposed pursuant to Tax Law § 481 (1) (a) (iv) must be canceled.

Our finding with respect to fraud notwithstanding, we find that the Division has affirmatively established that penalty and interest pursuant to Tax Law 481 § (1) (a) (i) and (ii) are properly imposed herein.

Where, as here, the Division gives notice in its answer to the taxpayer of its intention to assert a late payment penalty as an alternative to a fraud penalty, doing so shifts the burden to the Division to prove petitioner's willful neglect (***Matter of General Building Appliance Corp.***, Tax Appeals Tribunal, July 14, 2005).

In ***Matter of General Building Appliance Corp***., we followed federal guidance in defining willful neglect as a "conscious, intentional failure or reckless indifference" (***United States v Boyle***, 469 US 241, 245 [1985]), a "designed" failure (***Orient Investment & Fin. Co. v Commissioner***, 166 F2d 601, 602 [1948] and a "voluntary" failure (***Vaughn v United States***, 536 F Supp 498, 504 [1982]) to pay the taxes due.

In our view, the record clearly establishes that petitioner's underpayment of tobacco products tax was, in significant part, the result of willful neglect pursuant to the standards outlined above. The record plainly shows that petitioner's record keeping was deficient. Its electronic records did not segregate the related companies. It did not maintain all of its purchase invoices. Transfers between petitioner and Vikisha were not well documented. Additionally, as discussed, petitioner failed to maintain a separate and secure warehouse as required under Tax Law § 480 (1) (d) and such failure facilitated petitioner's sale of product purchased by Vikisha.

Addressing now the Administrative Law Judge's order denying petitioner's motion to reopen the record, our Rules of Practice and Procedure (20 NYCRR 3000.0 et seq.) provide the following grounds for vacating a determination rendered by an administrative law judge:

> (1) newly discovered evidence which, if introduced into the record, would probably have produced a different result and which could not have been

> discovered with the exercise of reasonable diligence in time to be offered into the record of the proceeding, or
>
> (2) fraud, misrepresentation, or other misconduct of an opposing party (20 NYCRR 3000.16 [a] [1], [2]).

Consistent with the principle articulated in ***Evans v Monaghan*** (306 NY 312 [1954]), we have interpreted the foregoing regulation to mean that "it is appropriate to reopen an administrative hearing where one party offers important, newly discovered evidence which due diligence would not have uncovered in time to be used at the previous hearing" (***Matter of Reeves***, Tax Appeals Tribunal, September 2, 2004). "Newly discovered evidence" means evidence that was in existence but hidden at the time of hearing (***see Matter of Frenette***, Tax Appeals Tribunal, February 1, 2001 citing ***Matter of Commercial Structures v City of Syracuse*** (97 AD2d 965 [1983]).

We affirm the order of the Administrative Law Judge. We find that the Administrative Law Judge properly declined to reopen the record for the purpose of receiving either the Vikisha tax returns or the Inspector General's report. We note that neither of these items constitute newly discovered evidence as defined above. We also agree with the Administrative Law Judge's finding that these items lacked relevance to the issues herein. Additionally, we concur with the Administrative Law Judge's conclusion that there is no evidence in the record of fraud, misrepresentation or other misconduct by the Division to support a reopening of the record. Moreover, we agree with the Administrative Law Judge's finding that the other issues raised in petitioner's motion were not proper grounds to reopen the record.

We next address petitioner's claim that it was denied its right to an expedited hearing. Tax Law § 2008 (2) (a) provides that, where a statutory notice asserts fraud penalty, "[a]n expedited hearing must be scheduled within ten business days of receipt of the petition." Here, the petition was filed on or about December 13, 2010 and the hearing was held on August 15, 2012.

Tax Law § 2008 (2) (b) requires a showing of "good cause" for any delay in the expedited hearing process and further provides that an administrative law judge or this Tribunal "must render a default determination or decision against the dilatory party for any unwarranted delay."

As the record shows, both parties contributed significantly to the length of time between the filing of the petition and the hearing (***see*** Findings of Fact 38 through 42). Indeed, in our view, both parties plainly sought to avoid an expedited hearing process. Accordingly, it is unnecessary to discuss whether the various prehearing delays herein were justified by good cause or were unwarranted, for under the present circumstances, the relief provided by the statute, that is, a default determination or decision, is inappropriate.

Additionally, although not asserted by petitioner on exception, we acknowledge that the determination in this matter and this decision have not been issued in accordance with the time limits set forth in Tax Law § 2008 (2) (b). As neither party is responsible for this failure, a default determination or decision is similarly inappropriate.

We note further that, the present matter notwithstanding, the Division of Tax Appeals and this Tribunal will make every effort to comply with the expedited hearing process set forth in Tax Law § 2008 in the future.

Finally, we note that we find no evidence of professional misconduct by the Division's representative as petitioner claims.

Accordingly, it is ORDERED, ADJUDGED, and DECREED that:

1. The exception of petitioner, Jay's Distributors, Inc., is granted to the extent provided below, but is otherwise denied;

(a) Fraud penalty under Tax Law § 481 (1) (a) (iv) as asserted in the notice of determination, dated December 28, 2009, is canceled; and

(b) Penalty and interest under Tax Law § 481 (1) (a) (i) and (ii) shall be imposed in lieu of such fraud penalty;

2. The determination of the Administrative Law Judge is modified to the extent indicated in paragraph 1 above, but is otherwise affirmed;

3. The petition of Jay's Distributors, Inc., is granted to the extent indicated in paragraph 1 above, but is otherwise denied; and

4. The notice of determination, dated December 28, 2009, as modified to the extent indicated in paragraph 1 above, is sustained.

DATED: Albany, New York
April 15, 2015

/s/ Roberta Moseley Nero
Roberta Moseley Nero
President

/s/ Charles H. Nesbitt
Charles H. Nesbitt
Commissioner

/s/ James H. Tully, Jr.
James H. Tully, Jr.
Commissioner