STATE OF NEW YORK

TAX APPEALS TRIBUNAL

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In the Matter of the Petition

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of

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**BLACKHAT CHIMNEY**                      DECISION
**& FIREPLACE, INC.**           :            DTA NO. 824411

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 of June 1, 2006     :
through August 31, 2008.

_____:

       Petitioner, Blackhat Chimney & Fireplace, Inc., filed an exception to the determination of

the Administrative Law Judge issued on March 13, 2014. Petitioner appeared by Shelby Bakshi

& White (Justin S. White, Esq., of counsel). The Division of Taxation appeared by Amanda

Hiller, Esq. (Adam Roberts., Esq., of counsel).

       Petitioner filed a brief in support of its exception. The Division of Taxation filed a brief

in opposition. Petitioner did not file a reply brief. Oral argument was heard in Albany, New

York on October 15, 2014, which date began the six-month period for the issuance of this

decision.

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

following decision.

## *ISSUES*

    I. Whether the Division of Taxation properly issued a notice of determination assessing

sales and use taxes due for the period June 1, 2006 through August 31, 2008.

II. Whether petitioner has established that reasonable cause exists in order for penalties imposed to be abated.

### *FINDINGS OF FACT*

We find the facts as determined by the Administrative Law Judge, except for finding of fact 8, which has been modified to more clearly reflect the record. The Administrative Law Judge's findings of fact and the modified finding of fact are set forth below.

1. Petitioner, Blackhat Chimney & Fireplace, Inc., was a retail business making sales of fireplaces and fireplace equipment located in West Seneca, New York. Petitioner also engaged in contract work. Petitioner performed installations (which qualify as capital improvements) and repairs. Petitioner was owned 100% by Robert Kladke.

2. On October 1, 2008, the Division of Taxation (Division) began an audit of petitioner's sales and use taxes for the period June 1, 2006 through August 31, 2008.

3. The Division determined that petitioner's books and records were insufficient to conduct a detailed audit. Therefore, petitioner elected to have the Division utilize a test period audit methodology in order to determine its sales and use tax liability on its sales and recurring expense purchases.

4. The Division determined petitioner's taxable sales and purchases from the information available, including an analysis of materials used in capital improvements.

5. The agreed upon test period for the audit of sales was December 2006 and January 2008. For the audit of expenses, both for general expenses and for goods sold, the test period was the months of January through August of 2008.

6. To audit the sales, the auditor examined the gross sales in the journals that had been provided by petitioner. The auditor concluded that $152.09 was underreported for the two test months. This amount was used to calculate an error rate, which when multiplied against petitioner's reported gross sales, resulted in additional tax due on sales for the audit period of $2,010.53.

7. In reviewing the expenses, the auditor examined petitioner's tendered journal of purchases to determine if tax was properly paid, and he developed a list of exceptions based upon purchases for which he could not satisfy himself that the correct tax had ever been either paid or collected and remitted. For general expense purchases within the test period of January through August 2008, the auditor determined that only two purchases had been untaxed, which resulted in unpaid tax of $18.78. This amount was projected against a base of reported gross sales for the audit period because petitioner's actual report of these sales made them verifiable. This calculation resulted in additional unpaid tax due on purchases in the amount of $52.91.

8. By its audit of petitioner's goods sold, the Division sought to determine whether such goods were resold to customers or used by petitioner in performing capital improvements or repairs. This portion of the audit was performed using the same method as was used for expenses, except that petitioner's accountant provided documentation for an eleven-month period rather than the agreed upon eight-month test period. The auditor did not notice this at the time of his calculations. The audited tax due for the eight-month test period (January 2008 through August 2008) was $37,140.21, which was divided by gross sales for the eleven-month period (January 2008 through November 2008) of $1,450,650.00, resulting in an error rate of 2.5602%. This error rate was multiplied against petitioner's reported gross sales per quarter, which resulted

in additional tax due upon the cost of goods sold purchases in the amount of $104,197.13.[1]

Petitioner was given credit for tax already remitted in the amount of $58,526.71, which resulted

in additional tax due of $45,670.42 for goods sold.

9. The Division issued notice of determination L-033642756, dated April 26, 2010, to

Blackhat Chimney & Fireplace, Inc., asserting additional sales and use taxes due in the amount of

$47,733.86 plus penalties and interest. The auditor testified that penalties were imposed because

both additional sales and use taxes were determined to be due without any reasonable cause to

justify their abatement as well as the fact that petitioner continued its failure to maintain

complete and adequate records of each and every purchase and sale after being audited

previously on the same issue.

10. David Gross, an accountant with over 20 years experience, testified on behalf of

petitioner. Mr. Gross was brought in to the prior audit about halfway through, yet was involved

in this current audit throughout the process. He testified regarding the accounting system used by

petitioner in its sales tax compliance. Mr. Gross explained that petitioner uses a system called

Peachtree accounting system, which has certain limitations. He described that this particular

accounting program does not provide for the printing of individual invoices. Although he was

able to view certain financials and sales tax reports on the computer system, the detailed backup

documentation for the amounts was not available to be printed out.

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[1] Although the Division used eleven months rather than the agreed upon eight months in its calculation of the error rate on the cost of goods sold purchases, the inclusion of the additional months reduced the error rate and, thus, the additional tax asserted is lower (*see Matter of The Humphrey House*, Tax Appeals Tribunal, July 31, 1997). The Division is not seeking a higher tax liability, but rather, admits the computational error and that such error was in favor of petitioner.

11. Mr. Gross performed a series of calculations that were designed to estimate more accurately the sales tax liability of petitioner.  He explained that he took the total cost of goods sold for the audit period and multiplied that by approximately 60% for each year to come up with a taxable base.  He then subtracted out a credit for tax paid on costs of goods that were not used in capital improvement jobs.  Next, he subtracted out the tax paid and came up with an estimated figure.  Although admitting that his estimation process was not perfect, his goal was to get as close as possible to the correct sales tax liability.

### *THE DETERMINATION OF THE ADMINISTRATIVE LAW JUDGE*

The Administrative Law Judge found that petitioner and the Division agreed to use a test period audit methodology.  While the Division included an additional three months in the test period for goods sold, the Administrative Law Judge determined this error to be inconsequential because it lowered the error rate and audited tax liability.  Regarding petitioner's challenge to the Division's projection of goods sold, the Administrative Law Judge found that petitioner's records were inadequate because, as admitted by petitioner, its system did not track individual transactions.  As such, the Administrative Law Judge found that petitioner failed to establish that the estimated audit was either erroneous or unreasonable, and sustained the assessment.

With regard to penalties, the Administrative Law Judge determined that petitioner had failed to demonstrate any basis for abatement, and thus the penalties were sustained.

### *ARGUMENTS ON EXCEPTION*

In its exception, petitioner challenges the audit methodology utilized by the Division.  It argues that the audit resulted in an erroneous error rate because it included three months outside of the selected test period.  Petitioner contends that utilizing this data violated its due process

rights because the Division went outside the agreed scope of the audit. Additionally, petitioner argues that there was no reason to project cost of goods sold from gross sales because the auditor was provided with records. For these reasons, petitioner argues that the estimated audit methodology was erroneous and should be modified.

Regarding penalties, petitioner contends that the Administrative Law Judge did not fully consider the record. It cites to the auditor's testimony at the hearing for its position that the Division imposed penalties upon a false premise (i.e., that petitioner did not alter its tax reporting methods from its first audit to the current audit). Petitioner argues that this is not a case of willful neglect because it changed its reporting methods, and submitted sales and use tax returns that substantially complied with its liability. As the record fails to establish willful neglect, petitioner argues that penalties should be abated in this matter.

The Division argues that the determination should be affirmed. It notes that the inclusion of the additional three months into the test period inured to petitioner's benefit because this mistake substantially reduced the error rate. Regarding the projection of goods sold, the Division argues that petitioner's record keeping was inadequate because it failed to associate particular purchases with the actual use of the purchased good. The Division also contends that petitioner's proposed alternative audit does not establish that the methodology employed herein was unreasonable or erroneous. It also notes that, as petitioner failed to maintain adequate records, it bears the burden of inaccuracies resulting from the audit.

Regarding penalties, the Division argues that petitioner failed to establish the requisite reasonable cause and absence of willful neglect. Accordingly, it argues that the determination be affirmed and the notice sustained.

## *OPINION*

We affirm the determination of the Administrative Law Judge.

Tax Law § 1138 provides, in relevant part, that if a sales tax return was 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 . . ." (Tax Law § 1138 [a] [1]).

Generally, the use of an estimated audit method is premised on a taxpayer's inadequate record keeping (*see e.g. Matter of Coram Diner*, Tax Appeals Tribunal, March 12, 2015).  Here, the record shows that petitioner failed to maintain adequate records as required (*see* Tax Law § 1135).  Specifically, petitioner's records failed to identify which items that it purchased were used in its services (e.g., installations and repairs) and which items were sold at retail.  Such failure justified the Division's use of an external index (*see e.g. Matter of AGDN, Inc.*, Tax Appeals Tribunal, February 6, 1997).

The Division's use of a test period audit method in this instance was also authorized by petitioner's consent (*see* Finding of Fact 3; *Matter of Wallach v Tax Appeals Trib.*, 206 AD2d 696 [1994], *lv denied* 85 NY2d 805 [1995]).

Having thus determined that the Division properly used a test period audit method, it became petitioner's burden to prove error in either the method or the result (*see e.g. Matter of 33 Virginia Place*, December 23, 2009).

Petitioner failed to show that either the audit method or resulting liability was erroneous or unreasonable.  The Administrative Law Judge correctly determined that the inclusion of the additional three months was inconsequential because it did not materially impact the audit

calculation but for reducing petitioner's estimated tax liability. Additionally, petitioner's challenge to estimating the liability must fail because, as stated above, its records were insufficient to establish the ultimate utilization of the goods. Further, the Administrative Law Judge properly determined that an alternative methodology alone is insufficient to establish that an audit is erroneous or unreasonable (*Matter of Meskouris Bros. v Chu*, 139 AD2d 813 [1988]; *Matter of Surface Line Operators Fraternal Org. v Tully*, 85 AD2d 858 [1981]).

Regarding penalties imposed under Tax Law § 1145 (a) (1) (i), it is well-established that the taxpayer seeking the abatement of penalties faces an "onerous" task (*Matter of Philip Morris, Inc.*, Tax Appeals Tribunal, April 29, 1993). To do so, the taxpayer must establish that the failure to pay sales and use tax "was due to reasonable cause and not willful neglect" (Tax Law § 1145 [a] [1] [iii]; 20 NYCRR 536.5 [b]). In reviewing the record, it appears that petitioner's failure to track the end use of its purchases resulted in the failure to remit the proper amount of tax due. The record lacks any evidence establishing a reasonable cause for this failure, or sufficient grounds for abatement. Accordingly, the Administrative Law Judge properly sustained penalties.

Accordingly, it is ORDERED, ADJUDGED and DECREED that:

1. The exception of Blackhat Chimney & Fireplace, Inc., is denied;

2. The determination of the Administrative Law Judge is affirmed;

3. The petition of Blackhat Chimney & Fireplace, Inc., is denied; and

4.  The notice of determination, dated April 26, 2010, is sustained.

DATED: Albany, New York
      April 9, 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