STATE OF NEW YORK

DIVISION OF TAX APPEALS

In the Matter of the Petition	:	
of	:	
JOHN SMYTHE	:	DETERMINATION DTA No. 822160
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 December 1, 1997 through February 28, 1999.	:	

Petitioner, John Smythe, 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 December 1, 1997 through February 28, 1999.

A hearing was held before Joseph W. Pinto, Jr., Administrative Law Judge, at the offices of the Division of Tax Appeals, 500 Federal Street, Troy, New York, on October 13, 2009 at 10:30 A.M., with all briefs to be submitted by March 2, 2010, which date began the six-month period for the issuance of this determination. Petitioners appeared by Hodgson Russ LLP (Timothy P. Noonan, Esq., of counsel). The Division of Taxation appeared by Daniel Smirlock, Esq. (Anita K. Luckina, Esq., of counsel).

ISSUES

I. Whether the Division was warranted in resorting to an indirect audit methodology in this matter.

II. If the Division was correct in utilizing an indirect audit methodology, whether it had a rational basis and was reasonably calculated to determine sales tax due from Showtime

Entertainment, Inc., and John Smythe, as officer, for the period December 1, 1997 through February 28, 1999.

III. Whether petitioner has demonstrated reasonable cause for the abatement of the penalty asserted.

FINDINGS OF FACT

Petitioner submitted 42 proposed findings of fact which have been incorporated into the findings below, except proposed findings 19, 24 and 25 to the extent they quoted the transcript at length; finding 22 to the extent it quoted the audit report; findings 27, 29 and 30, which were not relevant; and finding 41 to the extent that the table is irrelevant.

1. Petitioner, John Smythe, was the president and part owner of Showtime Entertainment, Inc. (Showtime) during the period December 1, 1997 through March 20, 1999.[1] Mr. Smythe had a background in the industry, working for the 25 years immediately preceding the hearing in the nightclub business.

2. From December 1, 1997 through February 28, 1999 (the audit period), Showtime operated a nightclub called Maxine's. Maxine's had opened in 1994 as a restaurant that was open six days a week for lunch and dinner and originally employed approximately 10 to 12 people. However, after six to eight months of slow sales, Showtime decided to alter its business operations at Maxine's.

3. During the first months of operation, especially on Friday and Saturday evenings, it was noticed that some patrons had begun dancing to the restaurant's background music on a small dance floor after finishing their meals. The management at Maxine's, including Mr. Smythe,

[1]This date is cited because it was the day after payment was due on a note from petitioner to Michael Gentile, the default on which resulted in all of petitioner's shares of stock in Showtime being transferred to Mr. Gentile.

decided to create more room for dancing, removing tables from the main dining area and bringing in bands and DJ's to provide more suitable music, and the restaurant began a slow transition to a nightclub.

4. Less than a year after opening as a restaurant in 1994, Maxine's was operating exclusively as a nightclub, ceasing its lunch and dinner offerings. It opened only two nights a week, Friday and Saturday, employed six or seven people, served a complimentary buffet (it sold no food) and only sold beer and liquor. The nightclub Maxine's operated on one floor of the premises, which contained one bar, two cash registers and the dance floor.

5. At first, the nightclub operation proved more successful than the restaurant, but business began to decline after a few years. Management tried to reverse this trend by opening on Thursdays beginning in August of 1998 and the Wednesday before Thanksgiving. However, despite its efforts, Maxine's was not able to appreciably improve business, and 1998 proved to be a poor year financially.

6. Cash flow problems ensued, and Showtime was unable to submit payment with its sales and use tax returns filed for the period December 1, 1997 through November 30, 1998.

7. At some point in late 1998, Mr. Smythe was contacted by an attorney representing individuals who were interested in purchasing the business. One of the interested buyers, Mr. Michael Gentile, was anxious to have the sale consummated quickly so that he could begin renovations to accommodate his new business. Serious negotiations began for the purchase of petitioner's stock in Showtime in December 1998.

8. The purchasers insisted that the sale of petitioner's stock in Showtime be structured as a "defaulted loan" transaction, whereby Mr. Gentile would loan Showtime $144, 000.00, which was guaranteed by petitioner and collateralized with his shares of stock in the corporation. Upon

default, petitioner's shares of stock were transferred to Mr. Gentile. In fact, petitioner received and kept the loan proceeds, which had been diminished by a percentage of Showtime's outstanding debts, including a sales tax liability for the period December 1, 1997 through November 30, 1998. There was an understanding between the parties to the loan agreement that Mr. Gentile would assume responsibility for these debts. Mr. Gentile informed petitioner that it was his intention to purchase the shares of other shareholders in separate transactions.

9. Prior to execution of the "defaulted loan" transaction, Mr. Gentile took physical possession of the premises following a New Year's Eve party at Maxine's on December 31, 1998. Petitioner handed the keys to the building to him in the early hours of January 1, 1999 and left the premises. All business records, including register tapes and reconciliations prepared by the bookkeeper, remained at Maxine's and petitioner never entered the premises again.

10. The "defaulted loan" transaction was memorialized in three documents: a loan agreement, a pledge agreement and an Assignment of Lease, all of which were executed on January 22, 1999. The loan agreement required Showtime to pay back the loan received from Mr. Gentile on or before March 19, 1999. Thus, when Showtime failed to make the payment, Mr. Gentile acquired petitioner's stock in the corporation on March 20, 1999, as well as Showtime's interest in its lease for the premises at 602 Broad Hollow Road, Melville, New York.

11. Prior to the documentation of the "defaulted loan" transaction being executed on January 22, 1999, Mr. Gentile began significant renovations of the premises, reopening in February 1999 as an upscale gentlemen's club that offered topless dancing, a full-service, fine dining restaurant, cigar bar, and V.I.P lounge.

12. On or about March 2, 1999, a corporate certificate of assumed name, Gossip, was filed by Showtime with the New York State Secretary of State, indicating that Michael Gentile was the

vice president of Showtime. However, print advertisements for Gossip began appearing in February 1999. In those advertisements, it stated that Gossip was open six days a week from afternoon to 4:00 A.M. Subsequently, Gossip was open seven days a week.

13. John Smythe never owned or operated exotic dancing or topless clubs and has never been associated with the adult entertainment industry in any way.

14. The Division commenced a field audit of Showtime with the mailing of an appointment letter to the corporation on or about March 9, 2000 that requested all books and records of the corporation pertaining to the corporation's sales and use tax liability for the period June 1, 1997 through February 29, 2000, including its financial statements, journals, ledgers, sales invoices, purchase invoices, cash register tapes, sales and use tax returns, federal income tax returns and exemption certificates.

15. The auditor assigned to the matter, Mr. Robert Lawrence, made a field visit to Gossip, unbeknownst to Showtime, on March 8, 2000. Mr. Lawrence noted that the establishment was an upscale gentlemen's club located in an upscale commercial area. He observed that the establishment had two bars and six cash registers and appeared to charge a "cover" or admission charge at night. There was valet parking available and a clientele that appeared to be mostly businessmen. Mr. Lawrence did observe some food present but did not believe there was a menu. Besides dancing, he also noted that the entertainers provided various other private, personalized services for patrons that were compensated with scrip, which patrons purchased from the establishment.

16. Showtime's accountant, Harvey H. Mendelsohn, CPA, responded to the appointment letter and provided a power of attorney executed by Mr. Gentile, in his capacity as president of Showtime, dated July 25, 2000. The power authorized Mr. Mendelsohn to represent Showtime in

the audit for the years 1999 and 2000 only, even though this prevented him from discussing the portion of the audit period from December 1, 1997 through December 31, 1998. Since it was signed by Mr. Gentile in his capacity as president, the auditor surmised that he was a person responsible for the collection and payment of sales and use taxes on behalf of Showtime.

17. Mr. Mendelsohn produced bank reconciliations, bank statements, a trial balance and some detail of purchases from the trial balance. No source documentation was provided. The auditor reviewed the books and records produced but concluded that, without more, the records were inadequate to perform a detailed audit of Showtime's records and it was decided to perform an indirect audit.

18. In an effort to use Showtime's available books and records, the auditor reviewed Showtime's taxable receipts per the company's bank records and compared them to its taxable sales as reported on its sales tax returns filed for the period March 1, 1999 through February 29, 2000. The auditor also compared Showtime's purchase figures gleaned from the trial balance with information received from third-party vendors. When contacting third-party vendors, the auditor requested purchase information for the period September 1, 1997 through February 29, 2000 for Showtime Entertainment, Inc. T/A Maxine's. Some vendors responded with information that covered the period prior to January 1, 1999, the date Showtime stopped operating as Maxine's, and one vendor, DiCarlo Distributor Inc. (DiCarlo Food Service) wrote back and informed the auditor that it only knew the trade name as Gossip and not Maxine's. The food bill from DiCarlo's for the months of April, May and June of 1999 totaled $14,550.85.

19. The auditor's workpapers indicated responses from two of the largest suppliers of alcoholic beverages to Long Island businesses, to wit: Charmer Industries, Inc., and Peerless Importers, Inc. From September 1, 1997 to December 31, 1998, the workpapers show that

Charmer made sales to Showtime, operating as Maxine's, of $62,570.00, while for the period January 1, 1999 to February 29, 2000, Charmer made sales of $157,370.00 to Showtime when it was operating as Gossip. The sales pattern was the same for Peerless. From January 1, 1998 to December 31, 1998, Peerless made sales to Showtime T/A Maxine's of $14,772.00, while for the period January 1, 1999 to February 29, 2000, it made sales to Showtime T/A Gossip of $44,081.00. Thus, Showtime's overall purchases of alcohol from the two main suppliers for Long Island businesses almost tripled after Mr. Gentile took over the company in January 1999. In addition, the workpapers disclosed that Showtime T/A Gossip purchased from two other liquor distributors after January 1, 1999: "LI Bev" and "ISEM Way."

20. Generally, the auditor found that the markup percentage disclosed by Gossip's purchases and sales information was a bit low in his experience with gentlemen's clubs, but he did not think it would have been worthwhile to pursue it because he did not have much information on admission charges or the food operations. He assumed food was given away at happy hours.

21. After comparing the bank deposits to the sales tax returns and the purchases on the trial balance with the third-party information, the auditor concluded that sales of approximately one million dollars per year were acceptable, based on his experience with audits of "a few" gentlemen's clubs. Mr. Lawrence then made the decision that the sales and use tax returns filed on behalf of Showtime T/A Gossip for the period March 1, 1999 through February 29, 2000 should be accepted as filed with no changes.

22. The auditor claimed he was not aware that there was a change in the business operation of Showtime during the audit period until the BCMS conference in 2005 and assumed during the audit that the two businesses were the same. In his testimony before the Division of Tax Appeals in the ***Matter of Showtime Entertainment, Inc.*** (Division of Tax Appeals, February 8, 2007), the

auditor testified that no one ever told him of a change in business operation. He further testified that there was no closing conference because for "the period that Mr. Mendelsohn was power of attorney there was no tax." [2]

Therefore, having accepted the returns filed for Gossip, he chose to project the sales figures for the accepted quarters back to the corresponding quarters beginning on December 1, 1997 and ending February 28, 1999. Tax was calculated based on these sales figures, credit was given for tax reported for those quarters and the difference was the additional tax due in the sum of $68,409.02.

23. The auditor did not review expense purchases or fixed asset purchases, concluding that they were not material to the audit. However, in other entries in the audit report, the auditor noted definitively that there were no assets acquired or disposed of during the audit period. In testimony at hearing, Mr. Lawrence noted that Showtime had not filed a corporate income tax return, and no general ledger was provided, two documents which would have shown what assets were acquired and disposed of.

24. During the course of the audit, Mr. Lawrence received information about the sale of the business to Mr. Gentile. Specifically, he was aware that Mr. Gentile had foreclosed on a personal loan and taken over Showtime from its prior owners, one of which was Mr. Smythe.

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[2]Official notice is being taken of the record of another matter before the Division of Tax Appeals pursuant to State Administrative Procedure Act § 306(4) which provides that "official notice may be taken of all facts of which judicial notice could be taken and of other facts within the specialized knowledge of the agency." Courts of the State of New York may take judicial notice of their own record of the proceeding of the case before them, the records of cases involving one or more of the same parties or the records of cases involving totally different parties (***Berger v. Dynamic Imports, Inc.***, 51 Misc 2d 988, 274 NYS2d 537; 57 NY Jur 2d, Evidence and Witnesses, § 47). The record of the proceeding before the Division of Tax Appeals of which official notice is being taken is ***Matter of Showtime Entertainment, Inc***, NYS Division of Tax Appeals, February 8, 2007, a copy of which was duly served on petitioner. (***Matter of Kolovinas***, Tax Appeals Tribunal, December 28, 1990.)

25. In an effort to learn more about the officers of the corporation for purposes of assessing the responsible parties, on August 22, 2000, the auditor requested that an investigator obtain information on the prior owners. The investigator submitted his report on August 30, 2000, providing the names and addresses of Showtime's old and new owners. The report contained petitioner's name, social security number, date of birth, address and telephone number.

26. Although this information was received more than six months before the auditor issued a statement of proposed audit change, form AU-346, on March 2, 2001, Mr. Lawrence never tried to contact Mr. Smythe, testifying that it seemed "pointless" to him to do so since the "conclusions [concerning the audit] had been made."

27. The auditor's log did not contain any mention of an attempt to contact petitioner at any time between March 2000 and January 2002. However, contrary to this evidence and his sworn testimony, Mr. Lawrence wrote in his audit report, dated January 15, 2002, that "[s]everal attempts were made to contact the previous owners to no avail."

28. Petitioner was never informed by Mr. Mendelsohn or Mr. Gentile that Showtime was being audited for the period in issue. He never received any correspondence from the Division during the audit and, thus, never participated in any part of the audit.

29. Although Showtime was requested to sign waivers extending the period for assessment, Mr. Mendelsohn informed Mr. Lawrence that he would not do so. The Division, in its brief, has conceded that the Notice of Determination issued to petitioner for the period December 1, 1997 through February 28, 1998 was not timely issued and, as a result, should be canceled.

30. On May 3, 2001, the Division issued to petitioner a Notice of Determination, L-019348032-5, which asserted additional sales tax due of $68,409.02 plus penalty and interest

for the period December 1, 1997 through February 29, 1999, stating that petitioner was liable for this tax as a "Officer/Responsible person of: Showtime Entertainment Inc."

31. Showtime had a previous outstanding sales tax liability for the period December 1, 1997 through November 30, 1998 that was the result of tax returns filed without payments for the same quarters. Petitioner was advised to submit a tax amnesty application for this period even though he had long since left the corporation and despite the fact that Mr. Gentile had assumed the debt as part of the sale of the corporation in 1999. On March 12, 2003, petitioner sent a check for $29,192.87 to the Division with his application. Subsequently, he sought payment from Mr. Gentile in a lawsuit, but the debt proved uncollectible.

32. Throughout the amnesty process petitioner was unaware of the Division's audit of Showtime and the liability emanating therefrom, thinking that his amnesty payment would resolve his tax issues for the period.

33. On August 11, 2004, the Division seized petitioner's automobile and ultimately sold it on May 15, 2007 for $22,500.00, which netted $15,491.91 after costs and fees. This amount was applied to petitioner's outstanding liability resulting from the instant audit.

34. Thereafter, the Division issued a tax compliance levy to Citibank North America indicating a balance due pursuant to the warrant of $182,641.69. Petitioner's bank account was frozen, and a check with petitioner's funds was issued on July 13, 2007 by Citibank to the Commissioner of Taxation and Finance in the sum of $182,641.69.

35. The funds acquired by the Division from the seizure of petitioner's car and the funds from Citibank were applied to the liability assessed stemming from the Notice of Determination issued in this case. However, the amounts collected exceeded petitioner's liability and the

Division issued petitioner a refund check in the sum of $13,072.45, representing the overpayment of $12,945.23 and interest of $127.22.

36. On November 9, 2007, petitioner submitted a refund claim in the sum of $232,641.69[3] to the Division, which was denied by letter dated December 7, 2007, and further explained in a letter dated January 29, 2008. The Division explained that petitioner had exhausted his appeal rights because he did not protest the Conciliation Order issued on March 25, 2005 within the prescribed 90 days.

37. Showtime T/A Maxine's bank statements for the period February 28, 1998 through February 26, 1999 indicated deposits of $304,368.60. Assuming these deposits reflected sales, at a rate of 8.25%, Maxine's would have had a tax liability of $25,110.42. In fact, on the sales tax returns filed during this period, Showtime reported sales of $274,085.00 and $22,612.01 in tax.

SUMMARY OF PETITIONER'S POSITION

38. Petitioner contends that the Division did not properly request the books and records from Showtime for the period prior to January 1, 1999 because the auditor never contacted the owners for that period of time and chose to deal with a representative who was only authorized to represent the company for 1999 and 2000.

39. Petitioner contends that the Division's audit methodology lacked a rational basis because the auditor used sales and bank deposits from one business to estimate taxes of another, completely different business. Further, petitioner argues that the Division acted irrationally and unreasonably in failing to allow an adjustment for information received after completion of the

[3]The refund claim amount represents the $182,641.69 seized from the Citibank account and the retail value of the automobile, $50,975.00, which petitioner believes he should recover. Petitioner subtracted the $12,945.23 he received as a refund from the Division for the overpayment.

audit that would have properly reflected the difference in operations between Maxine's and Gossip.

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. A "retail sale" is "a sale of tangible personal property to any person for any purpose, other than . . . for resale as such . . ." (Tax Law § 1101[b][4][i]). Tax Law § 1138(a)(1) provides, in relevant part, that if a sales tax return was not filed, "or if a return when filed was 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].) 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 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***. 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. New York State Tax Commn.***, 119 AD2d 948, 501 NYS2d 219, 221).

C. Whether or not the Division made a proper request for books and records and then thoroughly examined them is the quintessential issue that presents itself for resolution in this matter. These two requirements, often taken for granted, must be executed in a meaningful manner if the Division is to be allowed the opportunity to estimate a taxpayer's tax liability with external indices or "such information as may be available." After careful consideration of all the facts and circumstances it is determined that no such request was made for the quarters in the audit period that began prior to 1999.

The appointment letter sent to Showtime Entertainment, Inc., on March 9, 2000 was very straightforward in its request for the production of all books and records of the company pertaining to its sales tax liability for the period December 1, 1997 through February 29, 2000. However, when the corporation's representative responded he disclosed that he was authorized

to represent the corporation only for the years 1999 and 2000, leaving the five quarters that began prior to January 1, 1999 without a representative and the possibility of defending against an estimated audit, a fact of which the auditor was keenly aware.

Nonetheless, the auditor's response when presented with this circumstance was indifference. He did not question Mr. Mendelsohn's period of representation or make any inquiry with regard to the period that was unrepresented. He did not question why Mr. Mendelson's representation began on January 1, 1999 when he knew Showtime Entertainment, Inc., had been filing returns long before that date. Despite his testimony to the contrary, the auditor knew or should have known at this very early stage of the audit that there had been a transfer of ownership in Showtime. Failing to investigate such a glaring discrepancy was an error in judgment that effectively foreclosed petitioner from defending himself on audit.

With complete disregard for this unusual circumstance, the auditor proceeded with an examination of books and records provided by Mr. Mendelsohn for the period March 1, 1999 through February 29, 2000. Finding these to be inadequate, he resorted to an audit methodology that he deemed reasonable for a cash business like Gossip, using Gossip's bank statements, third-party purchase records, a trial balance and sales tax returns. Based on his experience with "a few" audits of gentlemen's clubs, he deemed the sales reported acceptable and recommended no change in taxable sales and no additional tax liability. However, in comparing the sales reported for the five quarters that began prior to March 1, 1999, he noted far fewer sales. Having no records or representative to question with regard to this discrepancy, his solution was to ascribe the corresponding higher sales for the same quarters in the later years to the earlier quarters. Again, the auditor's reaction to a major discrepancy, which he could not discuss with Mr. Mendelsohn, was to assume no changes in the corporation, its business operations or any other

logical basis for the radical change in sales reported. Building on his approach begun with ignoring Mr. Mendelsohn's truncated representation, the auditor chose to ignore a second signal that something significant had changed at Showtime. The auditor was quick to jump to the conclusion that, because Showtime operated a cash business, it must have omitted sales in the prior periods - - a seemingly incongruous conclusion given his rapid acceptance of the sales stated for the quarters after January 1999, which were based, in part, on his audits of "a few" gentlemen's clubs.

The auditor admitted that sometime during the audit, he did become aware of the change in ownership of Showtime through a stock transfer, when Mr. Gentile "foreclosed on a personal loan" and took over the business from Mr. Smythe and another co-owner. He noted in his audit report that this was a bulk sale but not a retail sale for sales tax purposes and, in the very next line, added that several attempts had been made to contact the prior owners without success. The report was written in January of 2002 and at least by this point in time the auditor appears to have realized that contacting the responsible persons for the period prior to January 1999 would have been the prudent course of action.

In fact, no attempts were ever made to contact petitioner, much to his detriment. The auditor admitted under oath that he never tried to contact Mr. Smythe because it seemed "pointless" since the "conclusions had been made." This decision was made with full knowledge of Mr. Smythe's address, telephone number, social security number and date of birth. Further, it is not clear what the auditor meant when he said, "the conclusions had been made." He had already made third-party vendor inquiries using Maxine's as Showtime's trade name. He had the sales tax returns. We now know that the bank records were available and that both Maxine's and Gossip used the same bank account, and it will never be known what other records could have

been produced or located by Mr. Smythe in March 2000 if he had been contacted when the original request for records was issued by the Division, given that there were register tapes and daily sales reconciliations maintained by Maxine's bookkeeper.

The auditor also stated that he was unaware and never informed that the business operation had changed after the ownership was transferred. However, this was a curious statement to make given the facts that presented themselves to him during the audit. First, when he requested records from third-party suppliers in July 2000, he chose to use the prior business name, Maxine's, and not Gossip, even though he knew Maxine's had been out of business for a year and a half. In addition, the responses he received from the two largest liquor suppliers on Long Island indicated that sales to Gossip were three times those to Maxine's, yet the only possible reason he could think of for this discrepancy was that Maxine's may have been buying its liquor elsewhere with cash and thus underreporting its sales.

The Division chose the course of least resistance, finding a lack of sufficient books and records and implementing an indirect audit methodology against a taxpayer that was unrepresented and that the Division knew (and made sure) could not raise a defense. Even Mr. Lawrence acknowledged this in his testimony in the corporate case when asked if there had been a concluding conference at the end of the audit, and his response was that there had not been one because the period for which Mr. Mendelsohn was the representative had no additional tax due. That statement underscores the Division's recognition that the corporation had no representation for the audit period prior to January 1, 1999 and would never be afforded an opportunity to present books and records until after a notice of determination had been issued, if ever. Further, by refusing to inform the prior owners and officers, who were certainly going to receive notices of determination, the Division guaranteed that its audit methodology and the results therefrom

would go unchallenged until a BCMS conference or a hearing in the Division of Tax Appeals. Additionally, this also ensured that petitioner would likely face insurmountable problems with the preservation of evidence.

The Division's actions on audit prevented Mr. Smythe from ever defending himself in a *meaningful* manner. He credibly testified about the radically different operations of Maxine's, its short hours of operation, its bookkeeping procedures and the daily records kept to document those procedures and the preparation of its sales and use tax returns by its accountant, Mr. Steve Lawrence. Mr. Smythe credibly testified that these business records were left at Maxine's on December 31, 1998 for the benefit of the new owners. Any chance of producing those records, locating them or the individuals connected with their preparation was lost or became a remote possibility when the Division chose not to contact him.

D. Because the Division deliberately chose not to contact persons it knew had knowledge of Showtime T/A Maxine's during the period prior to January 1999, it cannot be said that it made a specific request for Showtime Entertainment, Inc.'s records for the entire audit period. As in ***Matter of Todaro*** (Tax Appeals Tribunal, July 25, 1991), the Division did not conduct the audit in a manner that provided petitioner with a meaningful opportunity to produce his books and records for a sales tax audit and was therefore inconsistent with the principles underlying the decision in ***Matter of Christ Cella***, where a weak and casual request for books and records was insufficient to justify a resort to an estimated audit.

Further, the Division violated the spirit and intent of the law when it knowingly excluded the prior owners from participating in the audit and assuring that their interests and those of the corporation would not be meaningfully represented. In ***Matter of Chartair, Inc. v. State Tax Commn.***, the court stated:

> The honest and conscientious taxpayer who maintains comprehensive records as required has a right to expect that they will be used in any audit to determine his ultimate tax liability.

Choosing not to contact petitioner, even though aware of his address and telephone number over six months before the statement of proposed audit changes was issued, and effectively preventing Showtime from producing any records for the audit period for all quarters that began prior to January 1999, was a violation of ***Todaro*** and ***Chartair***. It is of no moment that petitioner did not produce a comprehensive set of books and records at hearing, since the hearing occurred over nine years after the audit was originally performed.

It is the overwhelming number of indicators that dictates the outcome reached herein. The Division clearly chose not to involve the former owners despite the information they might have provided. The Division saw the large discrepancies in sales for the audit period herein; it knew there had been a transfer of ownership in January 1999; it knew the person with whom they were dealing on behalf of Showtime, Mr. Mendelsohn, did not represent his client for the audit quarters which began prior to January 1999 and that he was not concerned with any deficiencies assessed therefor.

The Division's response to all these factors was deliberate, irrational and calculated to prevent petitioner from participating in the audit, challenging the assumptions made to his detriment and otherwise defending himself and Showtime for the audit period in issue. It refused to contact petitioner because to do so was "pointless" because the Division had already decided how it wanted the case to be resolved. It did not care to find out if any books and records were available for the periods for which it had estimated additional tax due. The Division did not even conduct a closing conference because it knew Mr. Mendelsohn was happy with the audit results, which only affected the quarters for which his client was not liable.

E. Because it is determined that a meaningful, clear and specific request for records was never made, it is not possible to determine what books and records petitioner would have produced at hearing had the Division made a demand of him for specific books and records at the time of the audit. Without knowledge of the books and records that would have been produced, it is not possible to determine the adequacy of those records. Therefore, without a sufficient basis to make a finding that the records were inadequate, the resort to external indices is deemed to have been arbitrary and capricious. (***Matter of Todaro***.) In language that is applicable to this case, the Tax Appeals Tribunal stated:

> [I]n the present case, since a specific demand for records was never made to petitioners, no response was generated. Any effort on our part, or the Administrative Law Judge's, to determine the adequacy of petitioner's records is in essence speculation of what petitioners would have provided if they had been asked to produce records at the time of the audit. Such speculation places petitioners in the untenable position of proving, some eight years after the audit was conducted, that they could have produced records that could have satisfied a request by the Division that has never been made or defined. We conclude that such a burden would eviscerate the right of taxpayers who maintain comprehensive records to have such records utilized to determine their tax liability. (Citation omitted.)

The logic of this position is fundamental and deeply rooted in case precedent. In ***Matter of Antonio Martinez*** (State Tax Commission, April 28, 1986),[4] where the Division had applied an estimated audit methodology to a business operated during the audit period by two different owners during the 42-month audit period but never examined the books and records of the prior owner who had operated the business for 22 months, the Tax Commission stated:

> Since the Audit Divsion did not examine the books and records of [the prior owner] it is not known whether said books and records were adequate or inadequate. Inasmuch as it has not been established that [the prior owner's] books and records

[4]As decisions of a body of coordinate jurisdiction, the State Tax Commission decisions are not binding precedent, but are entitled to respectful consideration (***see Matter of Cruikshank's Estate***, 169 Misc 514, 8 NYS2d 279). ***(Matter of Racal Corporation***, Tax Appeals Tribunal, May 13, 1993.)

> were adequate, the Audit Division cannot use external indices to determine if any tax is due from [the prior owner] during the period of her ownership of the business.

In ***Matter of Negat***, (Tax Appeals Tribunal, April 9, 1992), the Division relied on the statements of the taxpayer's bookkeeper to determine that a prior owner (Negat) operated the same business as the new owner. However, there was nothing in the record to indicate that the bookkeeper had any knowledge of the prior owner's business operations or that the audit supervisor had any reason to believe him. In fact, the bookkeeper did not have knowledge of the prior business and the Division did not perform any investigation of its own. It merely assumed that because the two businesses operated restaurants in the same location, they were identical. The Tribunal found no rational basis to assume the two businesses were similar. It stated:

> Accordingly, the audit methodology employed in this case consisted only of the undescribed experience of the bookkeepeer and the auditor's comparison of two unknown entities. Although "[c]onsiderable latitude is given an auditor's method of estimating sales under such circumstances as exist in the case," there must still be a rational basis underlying the audit (citation omitted) and we conclude that none exists here.

F. Petitioner has requested a refund partially based on a valuation of his automobile that differs from the value as determined by the proceeds of an auction less costs. This specifically raises an issue with respect to the operations of the Tax Compliance Division, which this forum has no jurisdiction to review. Therefore, the Division of Tax Appeals does not have the authority to modify the valuations and the refund claims may only be granted consistent with the value established by the auction less costs and subsequently applied to satisfy the Notice of Determination.

H. The petition of John Smythe is granted to the extent that the Notice of Determination issued on May 3, 2001 is canceled, and petitioner is to be refunded the amounts seized from his

bank account, less the refund previously issued, and the amount netted from the sale of his automobile (***see*** Conclusion of Law F).

DATED: Troy, New York
August 26, 2010

/s/ Joseph W. Pinto, Jr.
ADMINISTRATIVE LAW JUDGE