

STATE OF NEW YORK
TAX APPEALS TRIBUNAL

In the Matter of the Petition :
of :
MARIE TODARO :
OFFICER OF DELAWARE DRAPERY, INC. :
:
for Revision of a Determination or for Refund of Sales and :
Use Taxes under Articles 28 and 29 of the Tax Law for the :
for the Period March 1, 1981 through August 31, 1983. :
: **DECISION**

In the Matter of the Petition :
of :
DELAWARE DRAPERY, INC. :
:
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Use Taxes under Articles 28 and 29 of the Tax Law for the :
Period March 1, 1981 through August 31, 1983. :

Petitioners Marie Todaro, Officer of Delaware Drapery, Inc., 4992 Regina Court, West Palm Beach, Florida 33406 and Delaware Drapery, Inc., 1414 Delaware Avenue, Buffalo, New York 14209 filed an exception to the determination of the Administrative Law Judge issued on June 14, 1990 with respect to their petition for revision of a determination or for refund of sales and use taxes under Articles 28 and 29 of the Tax Law for the period March 1, 1981 through August 31, 1983 (File Nos. 801709 and 801710). Petitioners appeared by Boreanaz, Carra & Boreanaz (Harold J. Boreanaz, Esq., of counsel). The Division of Taxation appeared by William F. Collins, Esq. (Deborah J. Dwyer, Esq., of counsel).

Petitioner filed a brief on exception. The Division of Taxation filed a letter in lieu of a brief. Oral argument, at the request of petitioners, was heard on January 30, 1991.

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

ISSUE

Whether, as a result of a field audit, the Division of Taxation properly determined additional tax due.

FINDINGS OF FACT

We find the facts as determined by the Administrative Law Judge except for finding of fact "15" which has been modified. We have also made an additional finding of fact. The Administrative Law Judge's findings of fact, the modified finding of fact and the additional finding of fact are set forth below.

On October 15, 1984, following an audit, the Division of Taxation issued a Notice of Determination and Demand for Payment of Sales and Use Taxes Due to petitioner Delaware Drapery, Inc. which assessed \$22,890.34 in tax due, plus penalty and interest, for the period March 1, 1981 through August 31, 1983.

On October 31, 1984, the Division issued a Notice of Determination and Demand for Payment of Sales and Use Taxes Due to petitioner Marie Todaro, officer of Delaware Drapery, Inc. This notice assessed identical amounts of tax, penalty and interest due with respect to the same periods as the October 15, 1984 notice issued to the corporation.

At hearing the Division withdrew its assessment of tax, penalty and interest against petitioner Marie Todaro with respect to the sales tax period March 1, 1981 through May 31, 1981.

Delaware Drapery, Inc., formed in or about 1974, was in the business of selling and installing custom-made draperies, rods and blinds. Marie Todaro, the corporation's sole shareholder, ran the business on a day-to-day basis. Mrs. Todaro was assisted in this business endeavor by her husband, Samuel Todaro. Mrs. Todaro conceded her status as a person required to collect tax on behalf of Delaware Drapery, Inc.

During the period at issue, the corporation's accountant was one Cyrus Trossman of the firm Trossman and Trossman. Martin E. Trossman, C.P.A., was Cyrus Trossman's partner.

Cyrus Trossman prepared the corporation's Federal income tax returns during this period. He used records of the corporation's bank deposits to determine gross receipts for the corporation's Federal income tax returns.

From the record it cannot be determined precisely how the corporation's sales tax returns were prepared. The returns were signed by Mrs. Todaro. For each of the sales tax periods at issue, the corporation's sales tax returns listed the same sales figure for both gross sales and taxable sales. Petitioner reported \$249,622.00 in gross and taxable sales during the audit period.

In the summer of 1983, because of the failing health of both Mrs. Todaro and her husband, the entire Delaware Drapery, Inc. stock was sold by Mrs. Todaro to Priscilla Carcales and her husband. The effective date of this transfer of ownership was September 1, 1983. After this date, with the exception of some transitional help for about one month, Mrs. Todaro had no involvement with the business operations of Delaware Drapery, Inc. After this transitional period, certain business records and invoices for sales for the period at issue herein which had been maintained by petitioner were located at the Delaware Drapery premises. Also, for this same period, certain cancelled checks and bank statements were in the possession of the corporation's accountant, Cyrus Trossman. The corporation continued its same business to the present date.

Cyrus Trossman died in February 1984. The Division's auditor was unaware of Mr. Trossman's death until sometime after the issuance of the notices herein.

During the period at issue, the corporation recorded job orders on worksheets. At the time a customer placed an order, that job received a job number. The job number followed the job through the ordering of materials and, finally, to installation. These worksheets listed the customer's name, the job number, the date of the order, and the amount of the sale. The worksheets did not indicate whether sales tax was charged on a given sale or whether a sale was tax-exempt. An envelope bearing the job number was also assigned to the job. This envelope contained orders for materials to be used in connection with the job, any drawings submitted in connection with that job, etc.

Also during the period at issue, the corporation issued invoices only to customers that were billed upon completion of the job. Generally, such billed customers were commercial customers. The corporation required residential customers (i.e. homeowners and renters) to pay a deposit upon placing an order and then to pay in full upon completion of the job. Such customers were not issued invoices. The invoices issued by the corporation to its billed customers did not bear the job number.

During the audit period, the corporation maintained an account at Marine Midland Bank and an account at M & T Bank. Corporate sales receipts were deposited, usually daily, into the M & T account. Petitioners used funds in this account to pay suppliers and to pay general operating expenses. Petitioners generally used the Marine Midland account to pay taxes and payroll. Cyrus Trossman was aware of the existence of the Marine Midland and M & T accounts.

The audit herein resulted from the Division's IRTF/STM Computer Tape Match program whereby reported gross receipts for Federal income tax purposes are compared with gross sales reported on sales tax returns. On audit, the Division's auditor first contacted Mrs. Carcales by telephone on June 28, 1984 and advised her of the audit and the periods in question. Mrs. Carcales advised the auditor of the change in ownership of the corporation on September 1, 1983. Mrs. Carcales further advised the auditor that she was not in possession of corporate records pertaining to periods before September 1, 1983 and directed the auditor to petitioner Marie Todaro, the previous owner, for the pre-September 1, 1983 corporate records. The auditor then telephoned Mrs. Todaro (also on June 28, 1984). The two had a conversation wherein the auditor advised Mrs. Todaro that an audit of Delaware Drapery, Inc. was to be conducted whereupon Mrs. Todaro advised the auditor that the corporation's records with respect to the period of her ownership were located at the office of Martin E. Trossman, C.P.A. The auditor then made three unsuccessful attempts to contact Mr. Trossman by telephone, and on the final attempt advised Mr. Trossman's office that he (the auditor) would be at the Delaware Drapery

premises on July 12, 1984. Mr. Trossman appeared at the Delaware Drapery premises on July 12 and the auditor advised Mr. Trossman of the apparent disparity between the corporation's gross receipts per Federal income tax returns and gross sales reported on sales tax returns in respect of the period October 1, 1981 through September 30, 1983. Mr. Trossman advised the auditor that bank deposit records were used to determine the corporation's gross receipts for Federal tax purposes. Mr. Trossman speculated that a loan to the corporation might account for a part of the difference and indicated to the auditor that he (Mr. Trossman) would attempt to document or reconcile this difference. The auditor did not request any specific records from Mr. Trossman.

The auditor was not contacted by Mr. Trossman in connection with Mr. Trossman's attempt to reconcile the difference between the corporation's reported gross receipts and reported gross sales. The auditor therefore commenced to compute the assessment herein based upon this difference. The corporation reported \$209,862.00 and \$241,297.00 in gross receipts on its Federal income tax returns for its fiscal years ended September 30, 1982 and September 30, 1983, respectively. It reported \$99,941.00 and \$95,578.00, respectively, in gross/taxable sales on its quarterly sales tax returns for these same periods.¹ The difference between gross receipts per Federal returns and gross sales per sales tax returns for this two-year period thus totaled \$255,640.00. The ratio of this difference to gross sales reported for the two-year period amounted to 1.31. The Division then applied this ratio to gross sales reported for each of the ten sales tax periods encompassed by the audit period herein to reach \$22,890.34 in tax due as set forth in the notices of determination.

¹The corporation's fiscal year did not correspond with the quarterly sales tax reporting periods, e.g., the quarter ended November 30, 1981 fell partly in fiscal year ended September 30, 1981 and partly in fiscal year ended September 30, 1982. In order to reconcile this overlap, the Division apportioned the gross sales reported for the November 30 quarter into the appropriate fiscal year. For example, the Division determined that two-thirds of gross sales reported in the November 30, 1981 quarter and one-third of the gross sales reported in the November 30, 1982 quarter fell in fiscal year ended September 30, 1982. The Division applied the same apportioning method with respect to fiscal year ended September 30, 1983.

Mrs. Carcales provided the auditor with copies of the corporation's Federal income tax returns and New York State franchise tax reports for the fiscal years ended September 30, 1982 and September 30, 1983.

We modify the Administrative Law Judge's finding of fact "15" to read as follows:

The auditor did not make any requests for books and records to either Mrs. Carcales, Mrs. Todaro or Mr. Trossman.²

On its sales tax return for the quarter ended November 30, 1983, the corporation reported \$54,520.00 in gross sales and \$50,227.00 in taxable sales. On its sales tax return for the quarter ended February 28, 1984, the corporation reported \$41,177.00 in gross sales and \$38,151.00 in taxable sales.

In addition to the facts found by the Administrative Law Judge, we find the following:

By letter dated August 8, 1989, Mr. Trossman indicated that his firm prepared only annual State and Federal income tax returns, not sales tax returns, for petitioners and that such work was done by Cyrus Trossman who died in February 1984.

OPINION

The Administrative Law Judge determined, contrary to the Division of Taxation's (hereinafter the "Division") assertion, that the audit methodology utilized by the Division was an indirect estimate of petitioners' sales tax liability and not an audit which purported to calculate the exact amount of tax due for each of the sales tax periods;³ that the audit fell under the rule of

²The Administrative Law Judge's finding of fact "15" read as follows:

"The auditor did not make any written requests for books and records to either Mrs. Carcales, Mrs. Todaro or Mr. Trossman."

We have modified this fact to more accurately reflect the record.

³The Division asserted at hearing that the audit was one of limited scope, not a complete audit of all typical sales tax areas; that no external indices were used to estimate tax but that "the determination of tax due arrived at was exact, and based on the petitioners' records." This assertion is contrary to the notices of deficiency which state
(continued...)

Matter of Chartair, Inc. v. State Tax Comm., (65 AD2d 44, 411 NYS2d 41); that the Division's request for books and records from petitioners was not "weak and casual" and did not violate the principles laid down in Matter of Christ Cella, Inc. v. State Tax Commn. (102 AD2d 352, 477 NYS2d 858).

He determined further that, even if the request was deemed "weak and casual," the Division was nevertheless authorized to estimate petitioners' tax liability because the evidence adduced at hearing established that petitioners' sales tax records were, in fact, inadequate and the Division is not required to examine insufficient records.

The Administrative Law Judge sustained the method used by the Division to estimate petitioners' tax liability as one reasonably calculated to reflect the tax due. He sustained the assessment for the period October 1, 1981 through August 31, 1983. He cancelled the assessment for the period March 1, 1981 through September 30, 1981 on the basis that the Division did not request any records for such periods. Specifically, that there is no evidence in the record that the auditor and Mr. Trossman ever discussed these periods and that since no request for records was made for such periods the assessment must be cancelled.

On exception, petitioners assert that the Division did not properly request books and records from petitioners; that the failure to do so was a fundamental flaw in the audit procedure rendering it invalid; that such flaw cannot be rectified at hearing; and that petitioners had adequate books and records.

On exception, the Division asserts that the audit was properly conducted and that a proper request was made for the books and records.

³(...continued)

that the taxes "have been determined in accord with section 1138 of the Tax Law, and are based on an audit of your records" and that the "tax assessed has been estimated and/or determined to be due in accordance with section 1138 of the Tax Law." The Division makes no such assertion on exception.

We reverse the determination of the Administrative Law Judge with respect to the assessment for the period October 1, 1981 through August 31, 1983.

Tax Law § 1138(a)(1) provides that if "a return required by this article is not filed, or if a return when filed is incorrect or insufficient, the amount of tax due shall be determined by (the Division of Taxation) from such information as shall be available. If necessary, the tax may be estimated on the basis of external indices . . ." This language has been interpreted to provide that "[t]he 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 liability" (Matter of Chartair, Inc. v. State Tax Commn., *supra*).

To determine the adequacy of a taxpayer's records the Division must first request (Matter of Christ Cella, Inc. v. State Tax Commn., *supra*, 477 NYS2d 858, 859) and thoroughly examine (Matter of King Crab Rest. v. Chu, 134 AD2d 51, 522 NYS2d 978, 979-980) the taxpayer's books and records for the entire period of the proposed assessment (Matter of Adamides v. Chu, 134 AD2d 776, 521 NYS2d 826, 828, *lv denied* 71 NY2d 806, 530 NYS2d 109). The request for records must be explicit and not "weak and casual" (Matter of Christ Cella, Inc. v. State Tax Commn., *supra*).

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, 256-57; Matter of Urban Ligs. v. State Tax Commn., 90 AD2d 576, 456 NYS2d 138, 139; Matter of Meyer v. State Tax Commn., 61 AD2d 223, 402 NYS2d 74, 76, *lv denied* 44 NY2d 645, 406 NYS2d 1025; *see also*, Matter of Hennekens v. State Tax Commn., 114 AD2d 599, 494 NYS2d 208, 209), 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., *supra*, 411 NYS2d 41, 43), "from which the exact amount of tax 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 Division did not follow the procedure in this case.

The record is clear that the Division made no request for books and records.

The auditor had a single phone conversation with Marie Todaro and a single meeting with Mr. Trossman (Tr., p. 45). He testified, at several points in the hearing, that he did not request any records from Mr. Trossman or Marie Todaro, either formally or otherwise (Tr., pp. 32, 36, 219, 220, 221).⁴

The basis for the auditor's action was his belief that this was a "special audit" designed to look only for differences between gross receipts on the Federal income tax returns and State sales tax returns of petitioners and seek an explanation for any such difference (Tr., p. 221). In this context, the auditor testified he did not know which records to request and that although it would have been helpful to look at records concerning exempt sales and transfers of funds into various accounts of the petitioners he did not request such records (Tr., p. 222). The auditor's testimony reveals his understanding that the unexplained discrepancy between the Federal and State returns in itself justified an estimated audit and made a request for records unnecessary.

Under these circumstances we conclude that the Division did not conduct this audit in a manner which provided petitioners with an adequate, meaningful opportunity to produce their books and records for a sales tax audit. The Division's conduct of the audit was clearly inconsistent with the principles underlying the decision in Christ Cella, Inc. where a weak and casual request for books and records was held insufficient to justify a resort to an estimate audit (Matter of Christ Cella, Inc. v. State Tax Commn., supra). While the difference between gross

⁴The auditor also indicated that the tax period covered by the audit and for which records would have been requested and examined was not communicated to petitioners until the Division issued its statement of audit adjustment on July 26, 1984, one month after the audit was commenced, i.e., June 28, 1984 (Tr., pp. 220, 225, 226).

receipts as shown on Federal income tax returns and State sales tax returns may have been proper cause to initiate the audit of petitioners, it does not, in and of itself, make such sales tax returns incorrect or insufficient and it certainly does not indicate that petitioners' books and records were inadequate. That determination requires a request for and examination of petitioners' sales tax records.

We deal next with that portion of the Administrative Law Judge's determination which stated that even if the Division's request did not meet the standard in Christ Cella, Inc., the Division was nonetheless authorized to use the audit method employed because the evidence adduced at hearing established that petitioners' sales tax records were, in fact, inadequate. The Administrative Law Judge relied on Matter of Cafe Europa (Tax Appeals Tribunal, July 13, 1989) and Matter of Korba v. State Tax Commn. (84 AD2d 655, 444 NYS2d 312, 314, lv denied 56 NY2d 502, 450 NYS2d 1023).

We disagree.

We reverse the Administrative Law Judge on this issue and conclude that because a clear specific request for petitioners' records was never made, that it was not possible at the time of the hearing to determine what books and records petitioner would have produced had the Division made a demand for specific books and records at the time of the audit. Since it is not possible to know what records would have been produced, it is not possible to determine the adequacy of such records. Without a sufficient basis to find the records inadequate, the resort to external indices was arbitrary and capricious (see, Matter of King Crab Rest. v. Chu, supra).

In our view, the failure of the Division to make an adequate request for petitioners' records is fundamentally different from the Division's failure in Cafe Europa to make an adequate examination of the records at the time of the audit. In Cafe Europa, for the period where a clear, specific request by the Division for records had been made, the taxpayer's response and the justification for the audit technique came into existence at the time of the audit. Consequently, the Administrative Law Judge and this Tribunal could, at least on the particular facts of Cafe

Europa, address the adequacy of the records that were produced by the taxpayer. In contrast, in 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 petitioners' 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 (Matter of Chartair, Inc. v. State Tax Commn., *supra*).

Accordingly, it is ORDERED, ADJUDGED and DECREED that:

1. The exception of petitioners Marie Todaro, Officer of Delaware Drapery, Inc. and Delaware Drapery, Inc. is granted;
2. The determination of the Administrative Law Judge is reversed to the extent that it sustained the notices of determination dated October 15, 1984 and October 31, 1984 for the period October 1, 1981 through August 31, 1983, but is otherwise affirmed;
3. The petition of Marie Todaro, Officer of Delaware Drapery, Inc. and Delaware Drapery, Inc. is granted; and

4. The notices of determination dated October 15, 1984 and October 31, 1984 are cancelled.

DATED: Troy, New York
July 25, 1991

/s/John P. Dugan
John P. Dugan
President

/s/Francis R. Koenig
Francis R. Koenig
Commissioner

/s/Maria T. Jones
Maria T. Jones
Commissioner