STATE OF NEW YORK

TAX APPEALS TRIBUNAL

In the Matter of the Petition	:	
of	:	
CAFE EUROPA, INC.	:	DECISION
for Revision of Determinations or for Refunds of Sales and Use Taxes under Articles 28 and 29 of the Tax Law for the Period September 1, 1980 through May 31, 1984.	:	
	:	

The Division of Taxation filed an exception to the determination of the Administrative Law Judge issued on August 11, 1988 with respect to the petition of Cafe Europa, Inc., 347 East 54th Street, New York, New York 10022, for revision of determinations or for refunds of sales and use taxes under Articles 28 and 29 of the Tax Law for the period September 1, 1980 through May 31, 1984 (File No. 802239). Petitioner appeared by Howard Tanz, CPA. The Division of Taxation appeared by William F. Collins, Esq. (Michael B. Infantino, Esq., of counsel).

The petitioner filed a brief in reply to the Division's exception. Oral argument was heard at the Division's request on January 17, 1989.

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

ISSUES

I. Whether the Division properly based its determination on an estimated audit consisting of a two-day observation test of petitioner's restaurant.

II. Whether the penalty asserted against petitioner should be restored.

FINDINGS OF FACT

We find the facts as stated by the Administrative Law Judge and the relevant facts are stated below, except that we modify findings of fact "3(b)", "5", "6" and "7." We also find additional facts as indicated below.

Cafe Europa, Inc., operated a restaurant at 347 East 54th Street, New York City. It was open for lunch and dinner six days a week. During the audit period one owner worked in the dining room. The other owner, currently the sole owner, worked as a chef. The restaurant generally had three chefs and three or four waiters on duty. It had no cash register.

On March 20, 1985, two notices of determination and demands for payment of sales and use taxes due were issued against petitioner. One was for theperiod September 1, 1980 through February 29, 1984 in the amount of $71,780.26, penalty of $17,113.11 and interest of $27,435.74, for a total of $116,329.11. The other was for the period March 1, 1984 through May 31, 1984 in the amount of $5,090.66, penalty of $661.79 and interest of $477.94, for a total of $6,230.39. Valid consents had been signed on September 28, 1983, April 24, 1984 and November 5, 1984, extending the period of limitation for assessment to March 20, 1985. The penalty was imposed under Tax Law § 1145(a)(1) because, according to the auditor, petitioner failed to provide purchase invoices and cash register tapes and did not otherwise have complete records for the test period. We find in addition to the facts found by the Administrative Law Judge that the penalty was also imposed for petitioner's underreporting of sales and use tax due (transcript p. 25).

Petitioner had a cash receipts journal, and a general ledger, and kept guest checks and purchase invoices. We find in addition to the facts found by the Administrative Law Judge that petitioner maintained bank statements reflecting credit card deposits (Petitioner's Exhibit 10A-10G) and maintained a cash disbursement journal (transcript p. 26).

We modify the Administrative Law Judge's finding of fact "3(b)" to read as follows:

> The auditor examined petitioner's purchase invoices for the months of April and May 1983 and compared these purchases to the general ledger. This comparison revealed that not all purchases for these two months were reflected on the invoices. The purchase invoices were not available at the hearing.[1]

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[1]The Administrative Law Judge's finding of fact "3(b)" read as follows:

"3(b). The purchase invoices were available at the hearing. No particular invoices were specified by the

We find in addition to the facts found by the Administrative Law Judge that the only request made to petitioner to produce books and records for this audit was a request for the records for the period September 1, 1980 through May 31, 1983. This request was made by a letter issued by the Audit Section of the New York City Department of Finance which was performing the audit on behalf of the Division.

The guest checks were kept separately by days. They were kept in the order in which they were presented to the cashier and not according to their imprinted number. Even when put in sequence by their imprinted number, there were gaps in the sequence of numbers caused by missing checks. The usual cause of this was a waiter with a later numbered pad of checks using all of his checks and a waiter with an earlier numbered pad not doing so and carrying the checks over to the next day or the next time he worked.

We also find in addition to the facts found by the Administrative Law Judge that although the Division initially requested all of the petitioner's books and records for the period September 1, 1980 through May 31, 1983, while performing the audit at the petitioner's premises, the auditor requested guest checks only for the month of August, 1982 (transcript pp. 34 and 35). We also find that the auditor's purpose in requesting records only for August 1982, was to "test" the sufficiency of petitioner's books and records for the entire audit period (transcript pp. 35 and 36). We also find that petitioner supplied its guest checks for August 1982 following the auditor's request for the same (transcript p. 38).

We also find that the auditor sorted and examined those checks which he believed corresponded to August 10th and 18th, discovered gaps in their numerical sequencing, and evidenced this review by detailing the results within his workpapers (transcript pp. 35 and 36,

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Division of Taxation as being missing."

The record indicates that the Division specified that some invoices from the months of April and May 1983 were missing (transcript pp. 22, 23). The record does not indicate that purchase invoices were offered at the hearing. In response to the Administrative Law Judge's question, "On the books and records, Mr. Tanz, did you say you have some books and records to present?" In reply, Mr. Tanz refers only to a cash receipt and disbursements journal (transcript p. 54).

Exhibit 8, pp. 66-69). Inferring from the record as a whole, we also find that the auditor discontinued any further attempt to thoroughly review the guest checks after the gaps in the two days examined were discovered.

We also find that petitioner maintained no internal control over the use of guest checks. No system was in place to account for the guest checks taken by the waiters or those actually used (transcript pp. 60-62).

For the purpose of computing additional taxable sales, an observation test was made on two separate days, Wednesday, October 26, 1983 and Friday, February 17, 1984. A tax examiner stood by the cashier on each day and inspected the guest checks. He tallied amounts for the net sale, the sales tax charged and the bar total as shown separately on the bill. These were examined as each customer left and not in numerical order.

On October 26, 1983, there were a total of 44 checks consisting of check numbers 00616 through 00618, 00640, 00641, 00687 through 00705, 00721 through 00736 and 00738 through 00741. Check numbers for 83 checks were missing. On February 17, 1984, there were a total of 39 checks consisting of check numbers 37695 through 37712, 37736 through 37740, 37742 through 37744 and 37746 through 37758. Check numbers for 26 checks were missing.

On October 26, the net sales were $2,221.60, sales tax collected was $182.96 and total sales were $2,404.56. On February 17, the net sales were $1,973.80, sales tax collected was $163.71 and total sales were $2,137.51.

We also find that on the day of October 26, the auditor found that 84% of all sales were transacted with a credit card, the remainder were in cash (Division's Exhibit 8 p. 8) and that on the day of February 17, 82.5% of all sales were transacted by credit card and the remainder in cash (Division's Exhibit 8 p. 10).

From these figures the auditor computed average per-day sales figures. He then multiplied these totals by 6 to compute per-week figures, then by 52 to compute yearly figures and then divided by 4 to compute quarterly figures. Since 15 quarters were being audited, he

multiplied the quarterly totals by 15 to arrive at totals for the audit period. The total sales thus computed exceeded the reported sales by about 62 percent.

We modify the Administrative Law Judge's finding of fact "6" to read as follows:

> A purchase markup of petitioner was performed by the auditor. A combined markup percentage for liquor, beer and wine was computed at 221% over cost. A markup percentage for food was computed at 158% over cost. These markup percentages were applied to purchases for the period September 1, 1980 to August 31, 1983 to determine gross sales for this period. From this calculation a margin of error was calculated and applied to reported gross sales for the period September 1, 1980 to May 31, 1984 to determine additional tax due for this period at $34,315.78 (Exhibit 8 unnumbered schedule).
>
> We find no credible explanation for the abandonment of this audit by the Division. The auditor's explanation at the hearing that the markup audit could not be completed because purchase invoices were missing for April and May 1983 is completely contradicted by the audit report which indicates that the markup audit was completed to the point of calculating tax due for the entire assessment period. Further, the audit report (Exhibit 8, Contact and Comment Sheet) indicates that at least 40 hours were spent working on the markup audit after the date (8/8/83) the auditor examined the April and May purchase invoices. Although the schedule reconciling the invoices to the general ledger is not dated, it was sent to the representative on February 1, 1984, which was after the first observation test was conducted on October 26, 1983. The schedule calculating tax due based on the markup audit is dated November 26, 1985.[2]

We modify the Administrative Law Judge's finding of fact "7" to read as follows:

> Petitioner, for the purpose of corroborating its sales tax returns as filed, performed an audit of its credit card sales. Petitioner added up the deposits from credit card receipts for portions of the audit period, as evidenced by bank account statements from Bank Leumi and Citibank. We also find that statements were supplied

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[2]The Administrative Law Judge's finding of fact "6" read as follows:

> "A purchase markup audit was performed by the auditor. He apportioned to each item on the menu the cost of all ingredients including vegetables, spices and herbs. Purchase invoices were apparently available for these items. As a result of the markup audit, the auditor arrived at an additional tax due. Some of the costs arrived at, as petitioner points out and the Audit Division concedes, are highly unrealistic. The auditor abandoned this audit, he states, because of the absence of purchase invoices. The auditor did not attempt an audit based on the purchase of only major items such as meat and fish. The Division of Taxation does not now argue for the validity of the purchase markup audit."

We have modified this finding of fact to reflect the record in more detail.

for the years 1981 and 1982 and the months of January and February 1983; but no information regarding the remaining portions of the audit period was provided. Petitioner then determined what it asserts should be considered the total estimated sales for 1981, 1982 and the first two months of 1983. Petitioner calculated total sales by assuming that the ratio of credit card sales to total sales for the two observed days and for the audit period as a whole were equal (Exhibit 10A). Petitioner also assumed that every credit card sale included tips of 20 percent and tax of 8.25 percent (Exhibit 10A). Petitioner's figure for estimated taxable sales for 1981, 1982 and the first two months of 1983 was greater than what it alleges were its reported sales by less than 5 percent.[3]

OPINION

The Administrative Law Judge held that the auditor's examination of petitioner's books and records was insufficient to justify an estimated audit and therefore the additional tax of $76,870.92 based on an observation audit of petitioner's restaurant and the penalty thereon could not be sustained. On appeal, the Division asserts that: (1) petitioner maintained incomplete guest checks and purchase invoices for the audit period and that petitioner's records were so inadequate as to virtually preclude any method of estimating sales tax liability other than an observation test, (2) the record cannot support a finding that any or all of petitioner's purchase invoices were available at the hearing, (3) unsworn factual allegations by petitioner's representative cannot be considered, (4) petitioner provided guest checks only for the 10th and 18th of August, 1982, and that (5) penalties should be restored. In response, petitioner reasserts that (1) the auditor insufficiently examined its books and records, (2) the auditor failed to use markup tests and analyze its credit card sales instead of relying upon the observation test, and

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[3]The Administrative Law Judge's finding of fact "7" read as follows:

"Petitioner, for the purpose of corroborating its own books and records, performed an audit of its credit card sales. Petitioner added up the deposits in its bank accounts which originated in credit card sales. Petitioner then assumed that they comprised 86 percent of total sales and that they included tips of 20 percent and tax of 8.25 percent. A figure for taxable sales was arrived at which was higher than reported taxable sales by less than 5 percent. (The figure of 86 percent had been found by the auditor to be the ratio of credit card sales to total sales during an observation test made by the auditor.)

We have modified this finding of fact to reflect the record in greater detail.

that (3) petitioner's credit card sales clearly and convincingly demonstrate that the method of audit and assessment herein was erroneous.

We affirm the determination of the Administrative Law Judge.

As a vendor of food and beverages, petitioner was responsible for collecting sales tax on its retail sales (Tax Law §§ 1105[d][i], 1132[a]). Petitioner was also obligated to keep records of every sale and the tax due thereon, including "a true copy of each sales slip, invoice, receipt, statement or memorandum" (Tax Law § 1135[a]) upon which the sales "tax shall be stated, charged and shown separately on the first of such documents given to (the purchaser)" (Tax Law § 1132[a]).

The Division has the authority to determine, "from such information as may be available," the amount of tax actually due from a taxpayer for a given period when any one of its sales tax returns is either not filed or states an incorrect or insufficient amount of tax due (Tax Law § 1138[a][1]). When the vendor maintains a comprehensive set of books and records, "such information as may be available" (Tax Law § 1138[a][1]) is restricted to his books and records, and not external indicia, because "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" (Chartair, Inc. v. State Tax Commn., 65 AD2d 44; 411 NYS2d 41, 43).

To determine the adequacy of a taxpayer's records, the Division must first request (Matter of Christ Cella v. State Tax Commn., 102 AD2d 352, 477 NYS2d 858, 859) and thoroughly examine (Matter of King Crab v. State Tax Commn., 134 AD2d 51, 522 NYS2d 978, 979-80) 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). The purpose of the examination is to determine, through verification drawn independently from within these records (Matter of Meyer v. State Tax Commn., 61 AD2d 223, 402 NYS2d 74, 76, lv. denied 44 NY2d 645, 406 NYS2d 1025; Matter of Giordano, B & G v. State Tax Commn., 125 AD2d 726, 535 NYS2d 255, 256-57; Matter of Urban Liquors, Inc. v. State Tax Commn., 90 AD2d 576, 456 NYS2d 138, 139; 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" (Chartair, Inc., supra, at 43; Matter of Christ Cella v. State Tax Commn., supra), "from which the exact amount of tax can be determined" (Matter of Mohawk Airlines, Inc. 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 Liquors, Inc. v. State Tax Commn., supra). The estimate methodology utilized must be reasonably calculated to reflect taxes due, but exactness is not required from such a method (Matter of W. T. Grant Company v. Joseph, 2 NY2d 207, 159 NYS2d 150, 157; Matter of Markowitz v. State Tax Commn., 54 AD2d 1023, 388 NYS2d 176, 177).

We first consider whether the Division adequately requested petitioner's books and records.

Having found as a fact that petitioner was only requested to produce records for the period September 1, 1980 through May 31, 1983, we conclude that the assessments for the period June 1, 1983 through May 31, 1984 must be cancelled. Without a specific request for the records for the period June 1, 1983 through May 31, 1984, it is not possible to determine the adequacy of these records, and the resort to external indices to estimate tax for this period was improper (Matter of Adamides v. Chu, 134 AD2d 776, 521 NYS2d 826, lv. denied 71 NY2d 806, 530 NYS2d 109; Matter of Anton's Car Care Center, Ltd., Tax Appeals Tribunal, November 23, 1988; Matter of Ahmed S. Ahmed and Yahya Ahmed d/b/a A & A Grocery Store, Tax Appeals Tribunal, November 10, 1988). The remainder of our decision will address only the period September 1, 1980 through May 31, 1983 (hereinafter referred to as the "adjusted assessment period") for which we find an adequate request for records was made.

We next address whether the auditor conducted a sufficient examination of petitioner's books and records for the adjusted assessment period to support the conclusion that the records were inadequate.

Petitioner conducted business without the benefit of a cash register and thus had no cash register tapes. Petitioner's only source documents amongst its "other records" were the guest checks. While auditing petitioner, the auditor requested guest checks for the month of August, 1982, and received them. This was done in order to "test" the sufficiency of petitioner's books and records by examining the checks for two days within this month. When the auditor discovered gaps in the numerical sequence of the checks examined, he abandoned any further review of the guest checks.

At this point, the instant audit very closely resembles the audit in King Crab (supra). The auditor in King Crab spot checked one box of guest checks which were found to be out of chronological order. Based on this spot check and a lack of cash register tapes, the auditor determined that the taxpayer's records were inadequate. The Appellate Division, Third Department, held that the auditor "did not make a sufficient investigation of the records made available to him to justify his conclusion that the records were incapable of supporting a complete audit." (Matter of King Crab, supra, at 979). The court concluded "[a]s a consequence of the auditor's failure to conduct a thorough examination of the records before him, it is impossible to assess the sufficiency of the records and therefore the use of a test period was improper" (Matter of King Crab, supra, at 980, cites omitted). What distinguishes the instant audit from that in King Crab is that evidence was adduced at the hearing on this matter that establishes that petitioner's sales records were in fact inadequate.

This evidence came from petitioner's owner, who, when asked what a waiter would do with a voided guest check, testified "They are supposed to submit it. They don't always submit it. They are supposed to. What they are supposed to do and what they do is different." (transcript p. 62.) This same witness also testified that each waiter took eight or ten guest checks and put them in his pocket for use during the day. Each waiter was supposed to return unused guest checks at the end of the day, but waiters frequently, unintentionally, took unused checks home with them. This testimony establishes that petitioner had no internal controls over the waiters' use of the guest checks. As a result, the guest checks by themselves were useless as a verifiable record of

petitioner's total sales because all guest checks issued could not be accounted for. The Division of Taxation is not required to thoroughly examine guest checks that are clearly defective (Matter of Korba v. State Tax Commn., 84 AD2d 655, 444 NYS2d 312, 314, mot for lv to appeal denied 56 NY2d 502, 450 NYS2d 1023; Matter of Hanratty's v. Chu, 88 AD2d 1028, 451 NYS2d 900). Since petitioner offered no other record, like a cash register tape, that would confirm that the guest checks in fact represented petitioners total sales, we conclude that it is possible to assess the sufficiency of petitioner's sales records, and these records were inadequate. The inadequacy of the sales records justified the Division's resort to external indices to estimate tax (Matter of Licata v. Chu, 64 NY2d 873, 487 NYS2d 552).

Having established that the resort to external indicia can be sustained, we now address whether petitioner has met its burden of demonstrating by clear and convincing evidence that the method of audit or the amount of the tax assessed was erroneous (Matter of Surface Line Operators Fraternal Organization, Inc. v. Tully, 85 AD2d 858, 446 NYS2d 451). We conclude that it has.

The Division asserts that "[t]he requirement that the audit method chosen be reasonably calculated to reflect taxes due must be considered in view of the information made available to it to estimate tax liability" (Division's exception p. 14). Here the Division contends that the inadequacy of petitioner's purchase records precluded a markup audit and made the observation test performed virtually the only audit technique possible.

We cannot agree.

The most recent discussion of the use of an observation test as an audit methodology for estimating sales and use tax is in Matter of Meskouris Brothers, Inc. v. Chu (139 AD2d 813; 526 NYS2d 679). The issue presented to the State Tax Commission was whether the audit methodology (i.e., observation test) resulted in a reasonable estimation of petitioner's sales and use tax liability. The State Tax Commission concluded that petitioner's books and records were so deficient that the auditing method selected was virtually the only technique reasonably calculated to reflect the sales and use taxes due.

The Appellate Division, in confirming the determination of the Commission, stated that "[G]iven the abysmal state of the petitioner's records, we are unwilling to fault the Tax Commission for its conclusion that the audit method devised, though clearly not immune from attack, was reasonably designed to ascertain what petitioner's taxes should have been. At best, petitioner has only demonstrated that the Commission's tax calculation is imprecise . . ." (Meskouris, supra, at 814.)

The facts here could not be more different than those in Meskouris. Here, petitioner maintained bank statements reflecting credit card deposits, a cash disbursement journal, a cash receipts journal, and a general ledger, and kept guest checks and purchase invoices. Based on these records the Division was able to do a markup audit which resulted in a determination of $34,315.78 in additional tax due. The markup audit was abandoned by the Division with no credible explanation, and the observation test upon which the assessment at issue (i.e., $71,780.26 in additional tax) is based and which is in no way related to the books and records provided by petitioner, was substituted. The very fact that the Division did a markup audit belies a finding of the fact we consider essential to the holding in Meskouris, i.e., that petitioner's books and records were so abysmal, so deficient, that the auditing methodology selected was virtually the only technique calculated to reflect the sales and use tax liability of the petitioner. Meskouris is not an abandonment of the fundamental principle which runs throughout the sales tax law and which is embraced fully in the Chartair decision that the taxpayer has the right to have his liability determined from the books and records required to be maintained by law. Under the circumstances found in this case, we cannot conclude that the observation test was a method reasonably calculated to reflect petitioner's sales tax liability.

Finally, we address the Division's assertion that the unsworn testimony of petitioner's representative cannot be given any weight. Though we do not agree with the Division's assertion, we do agree that the Administrative Law Judge's conduct of this hearing, where he consistently encouraged the representatives to offer unsworn statements by directing factual

questions to them, is not to be condoned.[4] This practice is potentially damaging to the integrity of the hearing for two reasons. First, it effectively denies the other party the right to cross-examine the declarant, a right protected by the State Administrative Procedure Act (SAPA § 306.2). Second, it may misdirect or confuse the representative/declarant in the presentation of his case. Accordingly, we caution all Administrative Law Judges against encouraging representatives for either side to offer their own unsworn statements as proof of facts. Representatives are cautioned that the weight given to unsworn statements may be affected by the fact that the statements are unsworn or hearsay and may result in their being given little weight.

Accordingly, it is ORDERED, ADJUDGED and DECREED that:

1. The exception of the Division of Taxation is in all respects denied;

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

3. The petition of Cafe Europa, Inc. is granted; and

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[4]The Division excepts generally to an Administrative Law Judge's encouraging unsworn statements of fact made by a party's representative. In the instant case there were many instances where a party's representative was asked a question to which the answer was or would necessarily have been legally relevant and which the party seemingly would want to be considered as supportive evidence. For example:
1. (Tr. p. 10)
ALJ: "Would you tell me how the determination of tax was computed?"
Mr. Infantino (Division's Representative): "Would you like me to present the auditor for the presentation of --"
ALJ: "Not really. I don't want that, yet. Could you (emphasis supplied) point out the way it was computed?"
Mr. Infantino: "Certainly. Basically this is ... ."
2. (Tr. p. 39, with petitioner's officer, Mr. Colthup, on the witness stand)
ALJ: "Could you describe the books and records, how they were kept?"
Mr. Tanz (Petitioner's representative): "Yes."
ALJ: "Have you seen the Department's regulations on bookkeeping?"
Mr. Tanz: "Not in full ... . Basically the books were kept as follows: All sales were recorded --"
Mr. Infantino: "Excuse me, I don't mean to interrupt, but we have a witness on the stand."
3. (Tr. p. 43, addressed to Mr. Tanz)
ALJ: "Do you want to get to (factual proof that the Division's results are erroneous), please? This is a test that you made, personally (emphasis supplied)?"

4. The notices of determination issued March 25, 1985 are cancelled.

DATED: Troy, New York
July 13, 1989

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

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

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