

STATE OF NEW YORK  
TAX APPEALS TRIBUNAL

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In the Matter of the Petition :  
of :  
**SPARTAN COFFEE SHOP, 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 Period December 1, 1981 :  
through February 28, 1985. :  
: DECISION

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In the Matter of the Petition :  
of :  
**JOHN ZAHARIS,** :  
**OFFICER OF SPARTAN COFFEE SHOP, 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 Period December 1, 1981 :  
through February 28, 1985. :

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Petitioners, Spartan Coffee Shop, Inc., 1470 Second Avenue, New York, New York 10021 and John Zaharis, as officer of Spartan Coffee Shop, Inc., 87-23 168th Street, Jamaica, New York 11432, filed exceptions to the determination of the Administrative Law Judge issued on August 25, 1988 with respect to their petitions for revision of a determination of sales and use taxes under Articles 28 and 29 of the Tax Law for the period December 1, 1981 through February 28, 1985 (File Nos. 802800 and 802801).

The Division of Taxation, as well as petitioners, filed an exception to that part of the determination of the Administrative Law Judge which reduced parts of the assessment.

Petitioners appeared by James Vittas, C.P.A. The Division of Taxation appeared by William F. Collins, Esq. (Gary Palmer, Esq., of counsel).

Petitioners and the Division of Taxation filed briefs in support of their respective exceptions. At the request of the petitioners, oral argument was heard on March 21, 1989.

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

***ISSUE***

Whether an observation test properly determined sales and use taxes due from Spartan Coffee Shop, Inc.

***FINDINGS OF FACT***

We accept and repeat the facts as determined by the Administrative Law Judge except that we modify findings of fact "2" and "5" as indicated below.

Petitioner Spartan Coffee Shop, Inc. ("the corporation") operates a restaurant at 1470 Second Avenue, New York, New York. Petitioner John Zaharis is president and sole shareholder of the corporation.

We modify finding of fact "2" as follows:

A sales tax field audit of the corporation's business operations was conducted by the New York District Office commencing in November 1984 and concluding in July 1985. The audit period was December 1, 1981 through February 28, 1985. The audit was conducted as follows:

(a) The auditor scheduled an appointment in his office for the taxpayers and requested that all books and records pertaining to the sales tax liability of the corporation be produced. The taxpayers, appearing by their authorized representative, produced some books and records including a sales register and a purchase register. The auditor requested cash register tapes, guest checks and back-up for any cash purchases made by the vendor. The taxpayers' representative advised the auditor that these records were not maintained by the taxpayers and, therefore, were unavailable. Accordingly, books and records were deemed to be inadequate.

that: (b) The corporation's Federal income tax returns disclosed

(i) Salaries and wages for the fiscal year ending September 30, 1982 were \$13,815.00, compensation of officers (John Zaharis) was \$8,320.00 and rent for the fiscal year was \$21,837.37.

(ii) Salaries and wages for the fiscal year ending September 30, 1983 were \$7,800.00, compensation of officers (John Zaharis) was \$8,320.00 and rent for the fiscal year was \$24,266.07.

(c) The auditor was told by the accountant for the corporation that the restaurant was a small, one-man business with "some help in the morning". The auditor visited the restaurant at about 1:45 P.M. on December 18, 1984. He found five people working there, including John Zaharis, and saw that business at the restaurant was "brisk". There were 17 counter seats and 12 other seats with tables. All but four of the seats were occupied.

(d) In view of the above, the auditor and his supervisor determined that reported sales of \$217.00 a day did not appear to be accurate and in the absence of original sales records, that an observation test of the business was appropriate. Observation was conducted as follows:

(i) Observation of the business was made on March 5, 1985 from 6:25 A.M. until 4:00 P.M. Sales to 12:30 P.M. were \$618.80. Total sales for the day were \$882.93.

(ii) Petitioners objected to the results of the first test, claiming that the sales were too high. Consequently, the auditor agreed to make another observation from early in the morning until 12:30 P.M., as most sales took place between 6:30 A.M. and 12:30 P.M. The second test was performed on May 24, 1985 when sales to 12:30 P.M. were determined to be \$641.29.

(iii) The auditor used the March 5, 1985 figures (as they were lower) and, after allowing for sales tax deemed to be included, calculated net daily audited sales of \$815.70. This figure was multiplied by 6½ days per week for 13 weeks per quarter for 13 quarters arriving at \$896,047.00 in adjusted sales and tax of \$73,923.88. Taxes reported were \$22,842.00 resulting in additional tax due of \$51,081.88.

(e) No allowance was made for inflation, as the auditor learned that the menu in use by the restaurant at the time of the tests had been printed in 1981. The restaurant also used a wall menu and the prices listed thereon are contained in the audit

workpapers. The prices on the wall menu and the printed menu were substantially the same.<sup>1</sup>

On September 11, 1985, the Division issued similar notices of determination and demands for payment of sales and use taxes due to the corporation and to petitioner John Zaharis, as officer, in the following amounts for the period December 1, 1981 through February 28, 1985: tax due \$51,081.88; penalty \$11,089.62; interest \$14,422.12; total due \$76,593.62.

The corporation showed a net operating loss on its Federal income tax returns for all of the fiscal years 1976 through 1982. For fiscal 1983 it showed taxable income before net operating loss deduction of \$2,960.14 and utilized a net operating loss deduction of the same amount to arrive at "zero" taxable income.

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<sup>1</sup>The portions of the Administrative Law Judge's finding of fact "2" which have been modified originally read as follows:

"(a) The auditor requested cash register tapes and guest checks which were not produced by the corporation. Accordingly, books and records were deemed to be inadequate.

\* \* \*

"(d) In view of the above, the auditor and his supervisor determined that an observation test of the business was appropriate. Observation was conducted as follows:

(i) Observation of the business was made on March 5, 1985 from 6:25 A.M. until 4:00 P.M. Sales to 12:30 P.M. were \$618.80. Total sales for the day were \$882.93.

(ii) Petitioners objected to the results of the first test, claiming that the sales were too high. Consequently, the auditor agreed to make another observation from early in the morning until 12:30 P.M., as most sales took place between 6:30 A.M. and 12:30 P.M. The second test was performed on May 24, 1985 when sales to 12:30 P.M. were determined to be \$641.29.

(iii) The auditor used the March 5, 1985 figures (as they were lower) and, after allowing for sales tax deemed to be included, calculated net daily audited sales of \$815.70. This figure was multiplied by 6½ days per week for 13 weeks per quarter for 13 quarters arriving at \$896,047.00 in adjusted sales and tax of \$73,923.88. Taxes reported were \$22,842.00 resulting in additional tax due of \$51,081.88.

"(e) No allowance was made for inflation, as the auditor learned that the menu in use by the restaurant at the time of the tests had been printed in 1981. The restaurant also used a wall menu and the prices listed thereon are contained in the audit workpapers. It is unclear, however, how the wall menu prices compared to the printed menu prices."

Subparagraphs (a) and (d) of this finding of fact have been modified to reflect the record in more detail. In addition, the last sentence of the Administrative Law Judge's subparagraph (e) has been modified as the uncontroverted testimony of the auditor was that the wall menu and the printed menu prices were "substantially the same."

We modify the Administrative Law Judge's finding of fact "5" as follows:

In 1982 and 1983 the personal income tax returns of petitioner John Zaharis showed that he had income from sources other than his officer's salary from the corporation as follows<sup>2</sup>:

| <u>1982</u>   |                 |
|---------------|-----------------|
| Dividends     | \$33,074.00     |
| Rental income | 3,515.00        |
| Capital gains | <u>7,122.00</u> |
| Total         | \$43,711.00     |

| <u>1983</u>   |                  |
|---------------|------------------|
| Dividends     | \$34,000.00      |
| Rental income | 3,300.00         |
| Capital gains | <u>12,000.00</u> |
| Total         | \$49,300.00      |

An analysis was performed by petitioners' accountant in conjunction with the hearing. The accountant started with the \$36,136.00 in sales reported on the sales tax return for the quarter in

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<sup>2</sup>Petitioners' representative submitted a copy of a Decree on Accounting purportedly filed in the Bronx County Surrogate's Court on February 19, 1985 ostensibly to show that petitioner John Zaharis was the beneficiary of a sizeable distribution from his father's estate. The decree shows that petitioner John Zaharis was a co-executor under the will of Atha Zaharis a/k/a Tom Zaharis and that the estate had assets of over \$1 million. Although the decree shows that John Zaharis was entitled to \$29,904.47 in executor's fees, it does not show that he was a beneficiary under the will. The decree indicates that the residuary estate, approximately \$535,000, was to be placed in a charitable trust for the benefit of the testator's native village in Greece.

The Administrative Law Judge's original footnote read as follows:

"Petitioners' representative submitted a copy of a Decree on Accounting filed in the Bronx County Surrogate's Court on February 19, 1985 ostensibly to show that petitioner John Zaharis was the beneficiary of a sizeable distribution from his father's estate. While the decree does not show precisely that, it does show that petitioner John Zaharis was a co-executor under the will of Atha Zaharis a/k/a Tom Zaharis and that the estate had assets of over \$1 million."

The footnote has been modified to more accurately reflect what was in the document submitted by petitioners' representative.

which the observation test was performed and divided said figure by 84½ days (13 weeks x 6½ days per week) arriving at average daily sales of \$427.64. As the net sales per the observation test were \$815.70 per day, additional taxable daily sales for said quarter were \$388.06. The accountant thus concluded that there was an error ratio of 90.74 percent<sup>3</sup>. Applying said percentage to the taxable sales of \$275,541.00 reported for the audit period, the accountant arrived at additional taxable sales of \$250,025.90 and additional sales tax of \$20,627.13.

Petitioners did not contest petitioner John Zaharis' status as a person required to collect tax on behalf of the corporation.

### ***OPINION***

The Administrative Law Judge found that the petitioners had failed to sustain their burden of proof by showing that either the method of audit or the amount of tax assessed was erroneous. He upheld the notices of determination except that he reduced the amount assessed for parts of the audit period by various percentages intended to reflect the existence of lower prices which he felt would have been in use during these periods.

The petitioners in their exceptions claim that the observation tests were arbitrary and that the Division should have determined the amount of the assessment using the books and records supplied by the petitioners. However, in addition, petitioners claim that the method presented by them at the hearing, which was based upon an error ratio using the observation test daily sales figures, should be used to determine the amount of additional sales tax due. Petitioners also challenge as arbitrary the reduction of the assessment by the Administrative Law Judge arguing that their method, which results in a lower assessment than the determination of the Administrative Law Judge, should be adopted.

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<sup>3</sup>\$388.06 divided by \$427.64 = .9074

The Division excepts only to the Administrative Law Judge's reduction of the assessment as unsupported by the evidence produced at the hearing, and asserts that the notices of determination should be upheld as issued.

Tax Law section 1138(a)(1) provides, in pertinent part, as follows:

"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 tax commission from such information as may be available. If necessary, the tax may be estimated on the basis of external indices, such as stock on hand, purchases, rental paid, number of rooms, location, scale of rents or charges, comparable rents or charges, type of accommodations and service, number of employees or other factors."

Where a taxpayer's records are incomplete and insufficient, the Division may select a method reasonably calculated to reflect the sales and use taxes due. The burden then rests upon the taxpayer to demonstrate by clear and convincing evidence that the method of audit or amount of tax assessed was erroneous (Surface Line Operators Fraternal Organization, Inc. v. Tully, 85 AD2d 858).

We agree with the Administrative Law Judge that the records of petitioner Spartan Coffee Shop, Inc. were incomplete and that the Division was entitled to estimate petitioner's liability.

Petitioners argue that although an estimated audit may be permissible here, the use of the observation test method to estimate liability was not appropriate and that the estimate proposed by them at the hearing should be adopted.

We disagree.

It is admitted that the corporation did not maintain cash register tapes, guest checks or any other original documents reflecting sales. In addition, purchase records were incomplete (invoices for cash purchases were not available). Although petitioners allege that they had books and records which would have been sufficient to determine liability, no proof of this allegation was produced at the hearing. This case is unlike Matter of Cafe Europa (Tax Appeals Tribunal,



July 13, 1989), where the Division's actions, in preparing a complete assessment based upon the taxpayer's books and records which was then abandoned without explanation, proved the taxpayer's assertion that an estimated audit could have been prepared using its books and records. At the hearing, petitioners did not produce any evidence to support their allegation that the amount of the assessment could have been determined from its books and records. In fact, the analysis prepared by petitioners' representative which petitioners claim accurately estimates their additional liability was not prepared by using the books and records which petitioners allege are accurate and complete.

The use of an observation test and the application of the results to an entire audit period has been sustained where the books and records of a taxpayer have been determined to be so insufficient as to make the observation test virtually the only means available to the Division to estimate tax liability (Meskouris Bros., Inc. v. Chu, 139 AD2d 813, 526 NYS2d 679 [3d Dept 1988]; Matter of Vebol Edibles, Inc. d/b/a Hickory House, Tax Appeals Tribunal, January 12, 1989; Matter of Gaetano Vendra d/b/a Pete's Pizzeria, Tax Appeals Tribunal, February 9, 1989). There is no dispute that the observation test was performed properly. The Division's application of the results of the test to the audit period is upheld.

However, we reverse the Administrative Law Judge's determination that the amount of the assessment for some periods of the audit should be reduced by various percentages ranging from 15 to 5 percent. Both the petitioners and the Division challenge the Administrative Law Judge's conclusion as arbitrary and not based on the evidence produced at the hearing. We agree that there is no evidence in the record to support the Administrative Law Judge's conclusion that the assessment should be so reduced.

Finally, we note that the petitioners' representative alleged many things at the hearing and at oral argument (for example: that Mr. Zaharis was the beneficiary of a large estate, which was the major source of Mr. Zaharis' income; that the number of employees was different from what

the auditor said; that the auditor's supervisor did or did not do certain things; that the menu obtained by the auditor at the coffee shop was not in use; that he never refused to provide purchase invoices). None of these alleged facts were presented through testimony or documents in a way that would permit cross-examination by the Division.<sup>4</sup> Therefore, even if relevant, such unproved assertions can be given no weight.

Accordingly, it is ORDERED, ADJUDGED and DECREED that:

1. The exceptions of petitioners, Spartan Coffee Shop, Inc. and John Zaharis, as officer of Spartan Coffee Shop, Inc. are in all respects denied;
2. The determination of the Administrative Law Judge is reversed as to his conclusion that the assessment should be reduced but is in all other respects affirmed;
3. The petitions of Spartan Coffee Shop, Inc. and John Zaharis, as officer of Spartan Coffee Shop, Inc. are in all respects denied;
4. The exception of the Division of Taxation is granted; and

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<sup>4</sup>The hearing record indicates that the Administrative Law Judge clearly stated that the evidence on which his decision and that of the Tribunal would be based, had to be presented at the hearing through testimony or documents (Tr. pp. 3-4). He offered the petitioners' representative the opportunity to be sworn as a witness and in response to questions from petitioners' representative, indicated the kinds of things he could testify to, such as his personal knowledge of the books and records (Tr. p. 59). He appears to have explained off the record the difference between testimony and argument (Tr. p. 60). Petitioners' representative declined to testify.

5. The notices of determination issued on September 11, 1985 are sustained.

DATED: Troy, New York  
September 14, 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