

STATE OF NEW YORK
TAX APPEALS TRIBUNAL

In the Matter of the Petition	:	
of	:	
ESTATE OF ALICE M. FASHANA	:	DECISION
D/B/A ANGELO'S CORNUCOPIA	:	
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 September 1, 1984 through May 31, 1987.	:	

Petitioner, Estate of Alice M. Fashana, d/b/a Angelo's Cornucopia, 412 North Main Street, North Syracuse, New York 13212, filed an exception to the determination of the Administrative Law Judge issued on January 12, 1989 concerning 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 September 1, 1984 through May 31, 1987 (File No. 805356). Petitioner appeared by Edward R. DeLaura, C.P.A. The Division of Taxation appeared by William F Collins, Esq. (James Della Porta, Esq., of counsel).

The Division submitted a letter brief on exception; petitioner did not file a brief. Neither party requested oral argument.

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

ISSUES

- I. Whether a rational basis existed for the computation of petitioner's assessment herein.
- II. Whether petitioner has shown that its failure to comply with the Tax Law was due to reasonable cause and was not due to willful neglect.

FINDINGS OF FACT

We find the facts as stated by the Administrative Law Judge and such facts are stated below.

On December 18, 1987, the Division of Taxation (the "Division") issued to petitioner, Estate of Alice M. Fashana d/b/a Angelo's Cornucopia, a Notice of Determination and Demand for Payment of Sales and Use Taxes Due, for the period September 1, 1984 through May 31, 1987, assessing tax due of \$50,647.13, plus penalty and interest.

Angelo's Cornucopia was a full-service Italian restaurant. A review by the Division of petitioner's 1984 Federal income tax return disclosed a substantial difference between sales reported on petitioner's sales tax returns for that year and gross receipts reported on its Federal schedule C. As a result, an audit of petitioner's business was commenced.

The auditor sent a letter to Angelo's Cornucopia scheduling a field audit appointment. The letter requested that the following documents be made available on the appointment date: all books and records pertaining to petitioner's sales and use tax liability for the audit period, including journals, ledgers, sales invoices, purchase invoices, cash register tapes, Federal income tax returns and exemption certificates. The auditor was referred to petitioner's accountant, Edward R. DeLaura, for any information which would be needed to complete the audit.

During the course of the audit, the auditor made a request to Mr. DeLaura for all records of Angelo's Cornucopia then in his possession, including specifically, records of all purchase expenditures, e.g., a purchases journal. The only records made available by Mr. DeLaura were monthly bank statements, cancelled checks, payroll records, and 1983 and 1984 Federal returns. Worksheets used in preparing the income tax returns were requested but not provided. Petitioner did not file Federal income tax returns for the years 1985, 1986 and 1987.

Mr. DeLaura calculated petitioner's gross receipts for the 1983 Federal returns by adding sales, as shown on the sales tax returns, to the business's payroll costs. He did so because he considered reported taxable sales to be understated. He stated at hearing that he could not recall how gross receipts were determined for other years.

The auditor compared reported sales as shown on sales tax returns filed for the period December 1, 1983 through November 30, 1984 to gross receipts as found on the 1984 schedule C

and found that gross receipts exceeded taxable sales by approximately \$49,156.00. The auditor also examined petitioner's bank statements for the period September 1, 1984 through February 28, 1987 and found total deposits of \$404,361.41. Sales reported on sales tax returns filed for the same period were approximately \$121,440.00.

Because petitioner's records indicated that sales were inaccurately reported and no sales records were made available to verify reported taxable sales, the auditor used a formula based on payroll records to estimate sales tax due.

During the audit period, petitioner's payroll records were prepared by an independent company called Paychex. As these were the only complete and accurate records available, the Division used them as a basis for estimating petitioner's sales. The auditor's supervisor had in his files a chart entitled "How Does Your Business Compare?". The chart lists, by type of business, the cost of various items to the business (e.g., material purchases, salaries and wages, direct labor, rent, taxes). The cost is expressed as a percentage of gross income. A statement at the bottom of the chart declares: "The ratios represent a percentage of gross income (sales). All percentages were derived from representational samples of over 6,000,000 Federal Income Tax returns (Statistics of Income, Internal Revenue Service, U.S. Treasury Department, Statistics Division)." According to the field audit report, the data which formed the basis for the Treasury Department's chart was "in-dated" in November 1984. The same date is handwritten across the top of the chart. In a memorandum of law submitted after hearing, the Division referred to the chart as "Dun and Bradstreet Data".

The chart shows that for drinking and eating establishments, the cost of salaries and wages is 14.1 percent of gross income. Based on the 14.1 percent figure, the auditor calculated that petitioner's sales should amount to approximately seven times its payroll costs (100 divided by 14.1). The auditor computed total salaries and wages for the audit period of \$129,556.23, as reported by Paychex. This amount was multiplied by seven to calculate audited sales for the audit period of \$906,893.61 with a tax due on that amount of \$63,482.56. Sales tax paid was subtracted from this amount to determine additional tax due of \$50,647.13.

Petitioner established that the wage figures used by the Division included tips as well as wages paid by petitioner. The figure used by the Division was shown as "Wages, tips and other compensation" on Federal W-3 forms prepared by Paychex for petitioner. The actual amounts paid by petitioner to its employees were the amounts shown as "Social Security Wages" on the W-3 forms. "Social Security Wages" paid by petitioner for the period September 1, 1984 through May 31, 1987 were \$115,675.15.

Petitioner introduced a copy of a publication called the Restaurant Industry Operations Report. The report was published in 1987 by the National Restaurant Association, and it was based on replies to a questionnaire received from 920 restaurant operators. It showed that in Italian restaurants with full-menu table service total payroll averaged approximately 34.2 percent of total sales. Petitioner's representative estimated petitioner's sales by dividing petitioner's gross payroll of \$115,675.15 by 34.2 percent. Sales estimated in this way totaled \$338,231.00 for the audit period.

Petitioner's representative employed a second methodology to show that the Division overestimated taxable sales for the audit period.

Bank deposits for the months of March, April and May 1987 were totaled. These amounted to \$63,894.57.

Total deposits were reduced in two ways. First, \$215.65, representing a correction made by the bank, was subtracted from the total. An additional \$2,279.88 was also subtracted. The latter amount represented amounts paid to petitioner by its employees to reimburse petitioner for group health and life insurance purchased by petitioner. This resulted in "net business deposits" of \$61,399.04.

Net business deposits were divided by 1.07 to reduce for sales tax included in the deposits, resulting in sales of \$57,382.28.

An error rate of 1.699 was calculated by dividing estimated sales of \$57,382.28 by sales reported on the sales tax return filed for the period ended May 31, 1987 of \$33,770.00.

The error rate was applied to reported sales for the audit period to estimate taxable sales for the audit period of \$311,515.00.

To lend further support to his own estimate of taxable sales, petitioner's representative performed two more alternative estimates of tax due. Both employed figures taken from the Restaurant Industry Operations Report and a methodology similar to the one used by the auditor. The first method used the cost of food and beverage as a percentage of total sales. The second method used the cost of food and beverage and gross payroll costs divided by the "prime cost" (this term was not defined in the exhibits offered). Both methods resulted in estimated sales of less than \$300,000.00 for the audit period.

Petitioner offered menus showing its prices during the audit period and advertisements from the Syracuse, New York telephone book showing the restaurant's hours of operation. These were offered to show that the restaurant could not have been opened enough hours or sold enough menu items to have had \$906,893.00 in gross sales during the audit period.

The relevant portion of the chart used by the Division to estimate petitioner's sales is reprinted below:

<u>Type of Business</u>	<u>Gross Income</u>	<u>Cost of Sales</u>	<u>Gross Profit</u>	
Drinking and Eating	100.00	55.5	44.5	
<u>Total Expenses</u>	<u>Net Profit</u>	<u>Material Purchases</u>		
35.4	9.1	50.5		
<u>Salaries and Wages</u>	<u>Direct Labor</u>	<u>Depreciation</u>	<u>Supplies</u>	
14.1	2.7	2.7	1.3	
<u>Rent</u>	<u>Taxes</u>	<u>Repairs</u>	<u>Interest</u>	<u>Bad Debts</u>
3.6	3.4	1.2	0.7	0.0

Each of the categories as shown above corresponds to a line on a Federal schedule C.

On the Federal schedule C attached to its 1984 Federal income tax return, petitioner reported gross income of \$86,538.00 and wages of \$29,190.00. No entry was made on the line provided for cost of labor.

The Statistics of Income Division of the Internal Revenue Service ("IRS") publishes a number of reports presenting statistical information based on samplings of Federal tax returns.

Among these publications are Individual Income Tax Returns, Publication 1304; Partnership Returns, Publication 369; Statistics of Income Bulletin (published quarterly), Publication 1136; and Corporation Income Tax Returns, Publication 16. None of the tables prepared by the IRS expresses salaries and wages or labor costs as a percentage of gross receipts or sales, as does the chart relied on by the Division.

The tables published in Publication 16 show money amounts in thousands of dollars in various categories corresponding to Federal corporation incometax returns. Cost of sales and operations is shown as one total figure, and it is not subdivided into purchases, cost of labor, materials and supplies, etc., as is the case with the Federal schedule C. Statistics of Income Reported for sole proprietorships and partnerships state cost of labor and salaries and wages as separate categories. Accordingly, it would be possible to prepare a chart like the one relied on by the Division from statistical reports published by the IRS.

The Division conceded at the hearing that it made two errors in calculating taxes due from petitioner. It agreed with petitioner that salaries and wages paid by petitioner during the audit period totalled \$115,675.15. It also stated that it was in error in not adding direct labor costs as shown on the chart to salaries and wages in computing a percentage to be applied to petitioner's gross sales. It asserted that total labor costs are 16.8 percent of sales, according to the chart used, yielding a labor factor of 5.95 (100 divided by 16.8). Applying the labor factor to the corrected calculation of salaries and wages yields total audited taxable sales for the period of \$688,542.00.

OPINION

The Administrative Law Judge concluded that the Division of Taxation properly resorted to external indices to estimate tax and that the Division's estimate of sales based on information in the chart from an undisclosed source had a rational basis. The Administrative Law Judge also held that petitioner did not prove that the amount of the assessment was erroneous.

On exception, petitioner argues that the record does not contain sufficient information for the Administrative Law Judge to have concluded that the audit had a rational basis. More particularly, petitioner points out that the chart itself has no name on it; that at hearing the auditor

for the Division testified that it was prepared by the Internal Revenue Service; that the Division in its post hearing memorandum of law asserts for the first time that the chart was published by Dun and Bradstreet; and that the only indication of the time of preparation of the chart is handwritten across the face of it. Petitioner also attacks the integrity of the payroll percentage used to estimate sales, arguing that the payroll line on the chart does not express the entire cost of payroll because an element of payroll is also included in the cost of sales line on the chart. Petitioner does not dispute that the Division was entitled to resort to external indices.

In response, the Division argues that it is entitled to use published industry indices to estimate sales, that it is not required to lay an evidentiary foundation to support the introduction of evidence and that petitioner has not established that the amount of tax assessed is erroneous.

We reverse the determination of the Administrative Law Judge.

As noted by the Administrative Law Judge, the record does not reveal the name, nor the year, of the publication from which the chart, which was the foundation of the audit, was derived. On cross examination, the auditor testified as to the source of the payroll percentage "I got it from the IRS. The IRS does a, compiles all restaurant or businesses by category and this happened to be restaurants and we chose labor factors in there and used that." (Transcript p. 22). The chart itself indicates that it was not prepared by the IRS, but instead that it was prepared from information compiled or maintained by the IRS; however, the identity of the creator of the chart is not revealed on the chart. In its memorandum of law to the Administrative Law Judge, the Division stated that the chart was Dun & Bradstreet data, but this statement is completely unsupported by the record.

Although troubled by the unknown source of the chart, the Administrative Law Judge concluded that the Division claimed no more for the chart than that which was stated on the chart and, thus, a rational basis for the audit was established. We disagree.

On its face, the chart states simply "The ratios represent a percentage of gross income (sales). All percentages were derived from representatinal [sic] samples of over 6,000,000 Federal Income Tax returns (Statistics of Income, Internal Revenue Service, U.S. Treasury

Department, Statistics Division)." This statement reveals no meaningful detail as to how the underlying data was selected, compiled or manipulated. Without the means to determine the source of the document we conclude that it is not possible to determine what the chart states or that the Division used the chart in an appropriate manner.

We recognize that "the Audit Division is not responsible for demonstrating the propriety of the assessment, including the basis for its audit" (Matter of Blodnick v. State Tax Commn., 124 AD2d 437, 507 NYS2d 536, 538), that "[c]onsiderable latitude is given an auditor's method of estimating sales under such circumstances as exist in this case." (Matter of Grecian Square, Inc. v. State Tax Commn., 119 AD2d 948, 501 NYS2d 219, 221), and that petitioner bears the burden to prove the audit methodology unreasonable (Matter of Surface Line Operators Fraternal Organization v. Tully, 85 AD2d 858, 446 NYS2d 451, 453); however, there is a limit on these principles. This limitation, recognized by the Administrative Law Judge, is that the record must contain sufficient evidence to allow the trier of fact to determine whether the audit had a rational basis (Matter of Grecian Square v. State Tax Commn., 119 AD2d 948, 501 NYS2d 219, 221; Matter of Willy Savino d/b/a Willy's Service Station, Tax Appeals Tribunal, September 22, 1988). Where the record does not contain sufficient evidence to determine whether a rational basis existed for the audit computations, the appropriate remedy is to remand the matter for further testimony to describe the basis of the audit (Matter of Grecian Square v. State Tax Commn., *supra*; Matter of Willy Savino d/b/a Willy's Service Station, *supra*).

Applying these principles to the facts here, we conclude that this case must be remanded for a further hearing to determine the source, that is the publication and date of publication, of the chart utilized in the audit.

Accordingly, it is ORDERED, ADJUDGED and DECREED that:

1. The case is remanded to the Administrative Law Judge for further proceedings consistent with this decision.

DATED: Troy, New York
September 21, 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