STATE OF NEW YORK

TAX APPEALS TRIBUNAL

In the Matter of the Petition

of

**FOKOS LOUNGE, INC.**
**T/A TEENS**

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 September 30, 1987.

In the Matter of the Petition

of

**AL SCAFORDI**
**OFFICER OF FOKOS LOUNGE, 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 September 1, 1984 through September 30, 1987.

DECISION

In the Matter of the Petition

of

**WILLIAM GENICEVITCH**
**OFFICER OF FOKOS LOUNGE, 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 September 1, 1984 through February 28, 1985.

In the Matter of the Petition

of

**MIDWAY MANAGEMENT GROUP, 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 September 1, 1984 through September 30, 1987.

The Division of Taxation filed an exception to the determination of the Administrative Law Judge issue on May 3, 1990 with respect to the petitions of the following:

Petitioner, Fokos Lounge, Inc., c/o Al Scafordi, 591 Irene Street, South Hempstead, New York 11550, 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 September 30, 1987 (File No. 806137);

Petitioner, Al Scafordi, as officer of Fokos Lounge, Inc., 591 Irene Street, South Hempstead, New York 11550 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 September 30, 1987 (File No. 806143);

Petitioner, William Genicevitch, as officer of Fokos Lounge, Inc., 242-03 133rd Avenue, Rosedale, New York 11422, 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 February 28, 1985 (File No. 806138); and

Petitioner, Midway Management Group, Inc., 514 Hempstead Turnpike, West Hempstead, New York 11552, 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 September 30, 1987 (File No. 806650).

The Division of Taxation appeared by William F. Collins, Esq. (Michael B. Infantino, Esq., of counsel). Petitioners appeared by Arthur Riber, Esq. The Division and petitioners filed briefs. Oral argument was heard on September 26, 1990 at the Division's request.

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

## *ISSUE*

Whether the methodologies employed by the Division in estimating the sales tax due were reasonable.

## *FINDINGS OF FACT*

We find the facts as determined by the Administrative Law Judge and make additional findings of fact. The Administrative Law Judge's findings of fact and the additional findings of fact are set forth below.

On December 31, 1987, the Division of Taxation ("Division") issued to petitioner Fokos Lounge, Inc., T/A Teens, two notices of determination and demands for payment of sales and use taxes due for the period September 1, 1984 through September 30, 1987. The first notice assessed sales tax in the amount of $192,012.62 plus penalty and interest. The second notice assessed a penalty (a so-called "omnibus" penalty) for the period June 1, 1985 through September 30, 1987 of $15,529.27. On the same date, identical statutory notices were issued to petitioner Al Scafordi as officer of Fokos Lounge, Inc.

Also on December 31, 1987, the Division issued to petitioner William Genicevitch, as officer of Fokos Lounge, Inc., a Notice of Determination and Demand for Payment of Sales and Use Taxes Due for the period September 1, 1984 through February 28, 1985, assessing sales tax in the amount of $27,147.02 plus penalty and interest.

On December 31, 1987, the Division issued to petitioner Midway Management Group, Inc. ("Midway"), a notice of determination assessing sales tax in the amount of $250,000.00 for the period ended September 30, 1987. The notice explained that the assessed taxes were determined due from Fokos Lounge and were being assessed against Midway as the purchaser in a bulk sale. The notice also stated that the sales tax assessed was limited to the fair market value of the assets exchanged in the bulk sale.

The statutory notices were issued as the result of a field audit of the business operations of Fokos Lounge, which began in August 1987. On August 21, 1987, an auditor made a telephone call to Fokos Lounge and received a recorded message indicating that Fokos Lounge was operating as "Teens" and was doing business only on Friday and Saturday nights.

By letter to Fokos Lounge dated August 21, 1987, the Division attempted to schedule a field audit for the period September 1, 1984 through August 31, 1987. The letter stated:

> "All books and records pertaining to your Sales and Use Tax liability for the period under audit are to be available on the appointment date. This would include journals, ledgers, sales invoices, purchase invoices, cash register tapes, federal income tax returns and exemption certificates."

In response to the above letter, a representative of Fokos Lounge contacted the Division requesting a postponement of the scheduled field audit. By letter dated September 11, 1987, confirming the postponement, the Division scheduled a field audit to begin on October 20, 1987 and made a second request for the books and records detailed in its prior letter. Attached to the letter was a list detailing the information and documents which would be needed to complete the sales tax audit.

The only records made available to the Division were Federal and State income tax returns with worksheets used to prepare those returns and bank statements. These records were insufficient for the purpose of verifying sales tax returns filed by Fokos Lounge.

On October 2, 1987, the Division received a Notification of Sale, Transfer, or Assignment in Bulk indicating that the tangible assets of Fokos Lounge were sold to Midway for a total price of $10,000.00. The notice stated that no other assets were transferred in this bulk sale. The last day of business of Fokos Lounge was shown as August 22, 1986, but the scheduled date of sale was shown as August 1, 1987. On October 6, 1987, the Division issued a Notice of Claim to Purchaser to Midway, and on October 30, 1987, the Division issued a Notice to Seller to Fokos Lounge. Both notices indicated that the Division received $800.00, representing tax on the transfer of tangible personal property in the bulk sale.

According to the audit report, the Division received contradictory evidence regarding the date on which Fokos Lounge stopped doing business. The bulk sale notification shows the last day of business of Fokos Lounge as August 22, 1986; an accountant representing Fokos Lounge stated that the business ceased operations in November 1986; no business records were made available for periods after February 1987. Quarterly sales tax returns were filed through May 31, 1987, with a final sales tax return filed in December 1987 for the period ended November 30, 1987. However, Fokos Lounge reported zero sales for all periods after February 28, 1987.

A Newsday article and a telephone call to Fokos Lounge indicated that business was being conducted at least until August 1987. By letter dated December 2, 1987, the Division requested that Fokos Lounge provide the following records in addition to those already requested: a lease agreement, an insurance policy covering furniture and fixtures, Long Island Lighting Company ("LILCO") bills for 1986 and 1987, and Federal income tax returns (a year is not indicated).

Because the books and records provided by Fokos Lounge were so deficient, the Division resorted to external indices to determine the sales tax due.

The Division obtained utility bills issued to Fokos Lounge by LILCO which disclosed that Fokos Lounge continued doing business throughout the audit period. They also provided the Division with evidence of the amount Fokos Lounge paid for utility services during the audit period which was $56,008.00. The Division elected to use Fokos Lounge's utility expenses as a basis for calculating its sales tax liability.

The Division had in its possession charts showing certain expenses as a percentage of gross sales. One of these charts was headed "Taverns". It showed the cost of utilities as 2.30 percent of sales. The second chart showed the cost of utilities as 2.40 percent of sales. This second chart had no heading on it. A legend on each chart stated: "Source: 'Barometer of Small Business', Accounting Corporation of America, 1929 First Ave., San Diego, Calif. 92101." There are no dates on either chart. These charts were identified in the audit report and by the Division's witness as having been prepared by National Cash Register. A notation on one of the worksheets states: "Though vendor is a disco and would use more electricity than a tavern or cocktail lounge, the vendor has not presented any information that may be used to determine an actual tax due, therefore this is the only reasonable method left."

The Division calculated the average of the utility factors shown on the two charts to determine a utility factor of 2.35 percent. Fokos Lounge's utility expenses for the audit period were divided by the utility factor to calculate audited taxable sales of $2,383,319.15 with a tax due on that amount of $193,403.62. An additional tax of $19,200.00 was assessed on fixed assets transferred in the bulk sale to Midway. Sales tax paid was subtracted from sales tax due

to calculate additional tax due of $192,012.62. A penalty for failure to file a return or pay tax due was imposed, and, because the audit disclosed additional taxable sales in excess of 25 percent of reported taxable sales, the Division imposed an additional penalty of $15,529.27.

The Division determined that furniture and fixtures sold by Fokos Lounge to Midway were insured for $250,000.00. An assessment in that amount was issued to Midway on the ground that the insured amount represented the fair market value of the assets exchanged in the bulk sale.

On or about December 30, 1987, the Division sent to the representative for Fokos Lounge copies of the assessments and workpapers with a cover letter which stated, in part: "Please note that the assessments issued are '90 day hold' assessments. The vendor has 90 days from the date of the assessment to present additional information to the tax department." Petitioners contacted the Division and protested the audit results. At a meeting held on February 10, 1988, Fokos Lounge presented an appraisal listing the fair market value of its furniture and equipment as $4,000.00. The record does not indicate that any other documentation was offered at this meeting. The auditor's notes for this day state: "No decision could be reached at the conference and the [representatives] were notified that they would be called when a decision regarding the assessment can be reached."

Following the February meeting, the Division recalculated petitioners' tax liability using two different methods. A rent factor was used to calculate sales tax due for the period September 1, 1984 through August 31, 1986. The results of an observation test of an unrelated teen disco were used to calculate sales tax due for the period September 1, 1986 through September 30, 1987.

The Division obtained a copy of the lease agreement between Fokos Lounge and its landlord. It shows an annual rent of $43,750.00 for the period January 1, 1982 through December 31, 1986, and an annual rent of $47,500.00 for the period January 1, 1987 through December 31, 1991. From this information, the Division determined that Fokos Lounge paid a monthly rental of $3,646.00 for the period September 1, 1984 through December 31, 1986, and

a monthly rent of $3,958.00 for the period January 1, 1987 through September 30, 1987. This yielded a total rent expense for the entire period of assessment of $137,710.00.

In addition to the charts described above, the Division had in its possession, a chart which showed that "Eating & Drinking Places" expended approximately 5.78 percent of total business receipts on rent. The Division elected to use this rent factor because it yielded a lower tax liability than either the utility factors or rent factors shown on the other charts.

The Division divided the total rent expense of $137,710.00 by the rent factor of 5.78 to calculate taxable sales of $2,382,525.95 for the assessment period and monthly sales of $63,079.58. These monthly sales became the basis for calculating petitioners' sales tax liability for the period September 1, 1984 through August 31, 1986.

The Division determined that Fokos Lounge's license to sell alcoholic beverages was suspended in August 1986 and it began doing business as a teen disco, named "Teens", in September or October 1986. An article entitled "Teenybopper Barhoppers", published in Newsday on July 15, 1987, listed Teens as an active teen disco. On August 26, 1987, the Division conducted an observation test of a teen disco located in the same geographic area as Teens. The results of that observation test were used to determine tax due from Fokos Lounge for the period in which it operated Teens.

Daily admission sales per the observation test were $2,576.00. The teen disco under observation imposed a $12.00 admission charge, while Teens charged only $5.00 for admission. To adjust for this difference admission sales per the observation test were divided by 2.40 (12 divided by 5 equals 2.40) to calculate average daily admissions for Teens of $1,073.33. Daily soda sales per the observation test of $144.00 were added to admissions, yielding average daily taxable sales of $1,217.33.

A telephone call made to Teens in August 1987 established that Teens was open at that time on Friday and Saturday nights only. The Newsday article indicated that Teens was open three nights per week. In explanation of this difference, Fokos Lounge's representative stated that the teen disco was open on Wednesday nights when the business began, but it dropped the

weekday night because of lack of business. The Division estimated weekly taxable sales by applying a figure of 2.5 to daily sales. This yielded weekly sales of $3,043.33 and audited taxable sales per month of $13,187.78.

Taxable sales as determined through use of the rent factor were added to taxable sales determined from the observation to calculate total audited sales of $1,685,351.06, with a tax due on this amount of $137,351.34. Sales taxes paid by Fokos Lounge were subtracted from audited sales tax to determine additional sales tax due for the period September 1, 1984 through September 30, 1987 of $116,760.34.

On June 21, 1988, the Division issued notices of assessment review to petitioners Fokos Lounge, Al Scafordi and William Genicevitch. The notices issued to Fokos Lounge and Mr. Scafordi reduced the tax assessment to $116,760.34 plus penalty and interest and reduced the omnibus penalty to $7,590.38. The notice issued to Mr. Genicevitch increased the tax assessment from $27,147.02 to $28,169.42 plus penalty and interest. This increase came about because use of the rent factor yielded taxable sales for the periods ended November 30, 1984 and May 31, 1985 which were greater than those calculated through use of the utility factor.

On August 3, 1988, the Division issued to Midway a Notice of Assessment Review, reducing its tax liability to $25,000.00 plus penalty and interest of $6,605.50. This adjustment was based upon the contract of sale between Fokos Lounge and Midway Management which showed a total purchase price of $25,000.00 for fixtures, furniture, and the remainder of Fokos Lounge's lease. The auditor's workpapers indicate that the contract of sale was provided to the Division before the statutory notice was issued.

The Division entered into evidence several different charts which purported to reflect industry-wide average percentages of expenses to gross income. The charts used to obtain the utility factor contain no information regarding the publisher, the publication date or the manner in which the information used to prepare the charts was gathered. The chart relied on by the Division to obtain a rental factor was identified by a Division witness as a Dun & Bradstreet chart. A legend on the chart indicates that the percentages were derived from "a representative

sample of the total of all Federal Income Tax Returns filed for 1982." The record was left open to provide the Division with an opportunity to submit a copy of the publication from which the Dun & Bradstreet chart was taken or information regarding the title of the publication and the publication date. This information was never submitted.[1]

Fokos Lounge began doing business as an adult disco in 1977. It was operated by William Genicevitch who was also president of the corporation. Mr. Genicevitch is the father-in-law of Al Scafordi. In 1978, Mr. Scafordi retired from the Nassau County police department and took over the operation of Fokos Lounge. Mr. Genicevitch continued to occupy the office of president of the corporation, but his involvement in Fokos Lounge lessened over time. He continued to be a signatory on the corporation's bank account until September 1984 when that account was closed, and he was not made a signatory on the new account opened at that time. Mr. Genicevitch was in his seventies during the audit period and was not physically present at Fokos Lounge. He signed two sales tax returns for the quarters ended May 31, 1985 and February 28, 1986 at the direction of his son-in-law. He signed both returns as president of the corporation, although he was neither president nor even a stockholder at that time. An application for corporate change filed with the New York State Liquor Authority and dated March 19, 1985 shows that all of Mr. Genicevitch's shares of stock were transferred to Mr. Scafordi and that Mr. Scafordi took over the position as president of the corporation before the date of the application. Mr. Scafordi occasionally took documents to Mr. Genicevitch for his signature in order to give the older man a continued sense of involvement in the business.

From 1978 through August 1986, Fokos Lounge was open as a discotheque three nights per week, providing recorded music and serving alcoholic beverages. In 1984, New York raised its legal drinking age to 19 and then in 1985 to 21. The change in the law caused a decrease in Fokos Lounge's business. Mr. Scafordi attempted to sell the business in 1984, but the prospective buyer was unable to obtain a liquor license and withdrew. In August 1986, Fokos

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[1]The record was left open at the suggestion of the Administrative Law Judge, rather than the request of the Division. Testimony at hearing indicated that the rental factor was the basis for the issuance of the statutory notices. The field audit report establishes that the utility factor formed the basis for the tax assessed by the notices of determination.

Lounge surrendered its liquor license and opened in September as a teen disco. This business was never entirely successful. The Newsday article on teen discos described the operation of Teens on a Saturday night as follows:

> "By Midnight, Teens, the West Hempstead disco, was almost empty. About a hundred teenagers had come to dance. The club a former bar, expects to regain its suspended liquor license in the fall and will change its name, one of the managers said."

Fokos Lounge had a cash register at the bar which produced a register tape. Mr. Scafordi discarded the tape after reconciling cash received with the total on the tape. The business receipts were deposited in the corporation's bank accounts. Certain expenses were paid in cash from the business's cash receipts, including the payroll. Cash payouts were added to bank deposits to determine gross receipts and sales taxes due.

Midway Management purchased the assets of Fokos Lounge in early August 1987. Those assets consisted of furniture, fixtures and equipment and the remainder of Fokos Lounge's lease. While awaiting approval of its application for a liquor license, Midway Management continued to operate Teens in the same manner in which it was operated by Fokos Lounge. In January or February 1988, Teens was closed while Midway renovated the premises in preparation for reopening as an adult disco.

Petitioner offered testimony of an expert witness to establish that Fokos Lounge's utility bills were not a reflection of its business activity. LILCO provided Fokos Lounge with a demand meter, suitable for heavy industries with a constant demand for electricity. During a single month, the meter registered the peak demand placed on the system, and Fokos Lounge was billed as though that peak was the constant demand throughout a given period. Thus, if all equipment was turned on at once, even if only for a short time, Fokos Lounge would be charged as if all the equipment were turned on constantly for a predetermined period.

We find the following additional facts.

Petitioners also offered testimony of witnesses to establish that the level of business at Teens was not similar to the teen disco observed in

the observation test. Petitioners presented testimony by the manager, landlord, Albert Scafordi and the subsequent purchaser to establish that the business had relatively few customers and that the level of business was extremely low after the drinking age changed.

***Opinion***

In the determination below, the Administrative Law Judge held that the evidence in the record was insufficient to establish a rational basis for the utility factor audit employed by the Division in its original estimation of petitioners' taxes. At the hearing, the Division failed to offer any evidence identifying the publisher, the dates of publication or the method used as a basis for the utility audit, and when given the opportunity to submit additional evidence after the close of the hearing, did not do so. Therefore, the Administrative Law Judge cancelled the notices of determination issued December 31, 1987. The Administrative Law Judge further noted that the original statutory notices were issued solely on the basis of the utility factor and could not be upheld based upon audits conducted after the original notices were issued. Accordingly, the Administrative Law Judge did not address the reasonableness of the rent factor or the observation test methodologies upon which the notices of assessment review were based.

On exception, the Division asserts that the Administrative Law Judge exceeded her authority by conducting a sua sponte investigation into the reasonableness of the utility factor audit. It is argued that when the attorney for the Division failed to make a complete post-hearing submission, the Administrative Law Judge had an affirmative duty to make a further inquiry to determine whether those materials in fact existed. The Division further alleges that petitioners had "stipulated" that the only audit issues in controversy were those relating to the notices of assessment review and that the original notices and underlying audit methodology were therefore no longer at issue. The Division also argues that the original audit method, i.e., the utility factor audit, as well as the two subsequent methodologies, are supported by a rational basis. It is further asserted that the notice issued to Midway be sustained and that William Genicevitch is a person responsible for the taxes owed by Fokos. The Division requests that all

the notices of assessment review be sustained.

In the alternative, the Division requests that if the Tribunal decides that the Division must establish a rational basis for the original notices of determination, this matter should be remanded to give it an adequate opportunity to establish that such a basis exists.

In response, petitioners strenuously object to the Division's assertion that they had "stipulated" that the original notices and underlying audit methodology were not in controversy. Petitioners also observe that the Division had the opportunity both at the hearing, and thereafter by the specific direction of the Administrative Law Judge, to submit evidence relating to the rationality of the audits but simply failed to do so. Petitioners further point out that the Division's attempt to shift the burden of producing documentation relating to the audit onto the Administrative Law Judge is without any legal basis whatsoever. In addition, it is argued that the rent factor audit and observation test which formed the basis for the revised notices are also without a rational basis. Petitioners further contend that the grant of a remand here to allow the Division to prove that the audits are supported by a rational basis would be entirely inappropriate because it would give the Division a second opportunity to prove that which it failed to prove at the hearing in the first instance. Petitioners request that the determination be sustained in full.

We affirm the determination of the Administrative Law Judge for the reasons set forth below.

Where, as here, the records of the taxpayer are insufficient or inadequate to permit an exact computation of the sales and use tax due, the Division is authorized to estimate the tax liability on the basis of external indices (Tax Law § 1138[a][1]; see, Matter of Ristorante Puglia v. Chu, 102 AD2d 348, 478 NYS2d 91, 93; Matter of Surface Line Operators Fraternal Org. v. Tully, 85 AD2d 858, 446 NYS2d 451, 452). The methodology selected must be reasonably calculated to reflect the taxes due (Matter of Ristorante Puglia v. Chu, supra; Matter of W.T. Grant Co. v. Joseph, 2 NY2d 196, 159 NYS2d 150, 157, 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, 177, affd 44 NY2d 684, 405 NYS2d 454; Matter of Lefkowitz, Tax Appeals Tribunal, May 30, 1990). While it is true that "considerable 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), certain limitations have been placed on this principle. It is necessary that the record contain sufficient evidence to allow the trier of fact to determine whether the audit has a rational basis (Matter of Grecian Sq. v. New York State Tax Commn., supra) and, further, that the record contain specific information identifying the external index employed by the Division in estimating the taxpayer's liability (Matter of Fashana, Tax Appeals Tribunal, September 21, 1989). The burden rests with the taxpayer to show by clear and convincing evidence that the methodology was unreasonable or that the amount assessed was erroneous (Matter of Meskouris Bros. v. Chu, 139 AD2d 813, 526 NYS2d 679; Matter of Surface Line Operators Fraternal Org. v. Tully, supra).

The record is clear here that the resort to external indicia was proper since petitioners' records were clearly insufficient and inadequate. The threshold issue before us is whether the external indicia chosen by the Division are supported by a rational basis in the record.

Three separate audit methodologies were employed by the Division in estimating the amount of the assessments due here. Originally, the Division employed a utility factor audit to estimate the sales tax due. The notices of determination were issued based upon that audit method. Thereafter, the Division apparently abandoned the utility audit and instead chose a rent factor and observation test to recalculate petitioners' sales tax liability. A rent factor methodology was utilized for that portion of the audit period when Fokos Lounge operated as a disco; an observation test was used to estimate petitioners' liability for the remainder of the period when it was operating as a teen disco. The notices of assessment review were issued based upon the latter two audit methodologies.[2]

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[2]Contrary to the Division's assertion, all three audit methodologies are before us for review. All three methods were specifically raised, addressed and contested at the hearing. We note further that there is absolutely no support anywhere in the record for the Division's position that a stipulation was entered into between the parties limiting

Since we conclude below that each of the three audit methodologies has been shown to be unreasonable, it is not necessary that we address the issue of whether it was appropriate for the Division to completely abandon the first audit methodology in favor of the latter two audit methodologies.

We turn first to an evaluation of the utility audit. The Division initially argues that it is improper to consider the propriety of the utility audit because that issue was not raised in the proceedings below (Division's brief, p. 21). We cannot agree. At the hearing, the Division's own witness, the audit supervisor, during direct examination by the Division's attorney testified that electric bills were used by the auditor to determine whether the vendor did a steady business throughout the audit period (Hearing Tr., p. 35). The auditor further specifically testified during direct examination that the first audit method used was "a ratio of bar and tavern utilities to gross sales" (Hearing Tr., p. 36). The auditor was further questioned on cross examination about the use of the utility audit (Hearing Tr., pp. 60-61). Additionally, petitioners' representative called an electrical engineer as an expert witness, who testified at length regarding the type of electrical usage of Fokos Lounge (Hearing Tr., pp. 151-160). The manager of Fokos Lounge also offered testimony regarding the utility and electrical consumption of the business (Hearing Tr., pp. 135-137). The cumulative impact of this testimony makes it absolutely clear that the issue of the propriety of the utility audit was not only raised but was specifically addressed at the hearing below. Consequently, the Division's assertion on exception that its "due process" rights were violated based on the Administrative Law Judge's consideration of the utility audit is without merit.

Turning to the merits of the utility audit, we find that it is not supported by a rational basis. The deficiency is the lack of connection between petitioners' actual utility bills from LILCO and petitioners' level of business. Testimony adduced at the hearing indicated that the utility factor employed by the Division was selected from certain charts which relate bar and

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review to the propriety of the rent factor methodology and observation test only.

tavern utilities to gross sales (Hearing Tr., p. 37). Petitioners clearly established at the hearing that the basis for this audit as specifically applied to its business premises was unreasonable. The unrebutted expert testimony offered by petitioners clearly established that the demand metering system utilized at the premises did not in any way correlate to the level of business activity at Fokos Lounge (Hearing Tr., pp. 151-156, 159-160). This expert testimony was not contradicted or in any way called into question by the Division.[3] Accordingly, petitioners have shown that the use of a utility factor as applied to petitioners' business is totally unreasonable where a direct relation between utilities and gross sales is utterly lacking. Therefore, we conclude that the utility audit is without a rational basis.[4]

We now turn to the reasonableness of the rent factor audit and the observation test which form the basis for the notices of assessment review. Tax Law § 1138(a)(1) specifically authorizes the use of rent as an external index to measure the sales tax liability due (see also, 20 NYCRR 535.2). The chart relied on by the Division to obtain a rental factor was referred to by the auditor as a Dun and Bradstreet chart (Hearing Tr., p. 37). The chart in the audit work papers from which the rent factor was apparently derived is not identifiable on its face as a Dun and Bradstreet chart. An incomplete legend on the chart merely indicates that the ratios on the chart were derived from "a representative sample of the total of all federal income tax returns filed for 1982." This statement, however, does not reveal any meaningful information as to how the underlying data was selected, compiled or manipulated. As noted above, the record was left open by specific direction of the Administrative Law Judge to provide the Division with an opportunity to submit a copy of the publication from which the Dun and Bradstreet chart was taken or information regarding the title of the publication and the publication date. The

[3]In its brief, the Division offers a fictional account as to what the auditor "would have" testified to had the Division's attorney questioned her in more detail about the utility audit (Division's brief, pp. 23-24). This attempt by the Division to introduce "testimony" as to what a witness would have stated had the Division's attorney asked her different questions is clearly improper. Our review is limited to the testimony actually presented at the hearing.

[4]As this discussion indicates, petitioners have demonstrated in the first instance that the use of a utility audit is unreasonable as specifically applied to Fokos Lounge due to the absence of any correlation whatsoever between the level of utilities and gross sales of the business. Accordingly, we need not address the issues pertaining to the Division's failure to place into evidence a sufficient evidentiary basis for the external index used as a basis for the utility audit.

Division did not submit any information to further explain the rent factor index. We have held that the record must contain information identifying the external index used by the Division to establish a rational basis for the audit methodology employed (see, Matter of Fashana, supra). Such information is necessary in order to provide petitioners with an opportunity to meet their burden of proving such methodology unreasonable. Accordingly, we are constrained to conclude that the rent factor audit is also without a rational basis.

We now turn to an evaluation of the observation test. An observation test conducted by the Division relates to the audit period from September 1, 1986 through September 30, 1987 when petitioners' business was operating as Teens, a teen disco. The auditor testified that the audit team used an audit of another teen disco where an observation test had already been done (Hearing Tr., pp. 38-40). The audit work papers reveal that the observation test occurred on August 26, 1987. Adjustments were made to reflect Teens' five dollar admission price resulting in an average daily admission for Teens of $1,073.33, or approximately 215 admissions per night. Daily soda sales as a result of the observation test of $144.00 were added to admission, resulting in average daily taxable sales of $1,217.33. Weekly sales were calculated based upon a two and a half day business week; monthly figures were then determined.

The use of the observation test was premised on the assumption that the observed disco was similar to Teens because it had the same number of admissions and was located in the same geographic area (Hearing Tr., pp. 38-39, 82-83). The auditor stated that it was assumed that approximately 200 patrons were admitted to Teens on an average evening (Hearing Tr., p. 83).

The use of an observation test of other than the taxpayer's place of business to estimate the taxpayer's taxable sales is a question of first impression for this Tribunal. The questions raised by such an audit methodology with respect to the comparability of the businesses, and thus the rationality of the audit, are obviously different than the questions presented when an observation of the taxpayer's operating business is performed. The most significant difference between the two audit methodologies is the absence of the auditor's personal knowledge of the volume of petitioners' business, gained through direct observation, in the instant case.

Upon review, we find that the evidence in the record negates the Division's basic assumption that the two establishments were conducting a similar volume of business. This assumption was not based on the auditor's personal knowledge; it appears that the auditor visited the premises (Teens) on November 17, 1987, during the daytime when the business was not open and was operating under new management[5] (Hearing Tr., pp. 65-66; Exhibit I). The only information apparently in the Division's possession and available as a basis for comparing petitioners' volume of business to the observed disco was a Newsday article which indicated that petitioners' volume of business was substantially less than the observed disco. The volume of business at the observed disco was approximately 214 admissions while Teens, according to the article, admitted only 100 patrons on the night reported by Newsday. Evidence presented by petitioners at the hearing also established that the level of business activity at Teens was far below the Division's estimation of 215 admissions (Hearing Tr., pp. 87-88, 111-115, 137-138, 141-142). That the observed disco did at least two times the level of business conducted at Teens clearly negates the underlying assumption for the observation audit that the level of business of the two establishments was similar. Further, the notion that the two businesses were similar simply because they were operating in the same geographic area is without merit. The Newsday article, as well as testimony adduced at the hearing, indicated that a competing teen disco operating in the same area as petitioners' business was extremely popular and attracted several hundred patrons while Teens, in contrast, was "almost empty" at the same time (Hearing Tr., pp. 111-114). Since the only evidence in the record with respect to the comparability of the observed disco and Teens negates the Division's premise for the observation audit, i.e., that the two discos conducted a similar level of business, we conclude that the observation test audit lacks a rational basis (see, Matter of Grecian Sq. v. New York State Tax Commn., supra).

In summary, the record before us fails to establish a rational basis for the three audit methodologies employed by the Division in estimating petitioners' sales tax liability.

[5]The record establishes that after the business was sold, the purchaser continued to operate it for a period of time between September and December 1987 as a teen disco while awaiting approval of a liquor license (Hearing Tr., pp. 143-146). Therefore, it appears that the business was open, albeit operating under new management, during part of the period when petitioners were being audited.

Accordingly, the underlying assessments must be annulled.

Accordingly, it is ORDERED, ADJUDGED and DECREED that:

1. The exception of the Division of Taxation is denied;

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

3. The petitions of Fokos Lounge, Inc., Al Scafordi as officer of Fokos Lounge, Inc., William Genicevitch as officer of Fokos Lounge, Inc. and Midway Management Group, Inc. are granted; and

4. The notices of determination and demands for payment of sales and use taxes due issued on December 31, 1987 and the notice of assessment review based thereon issued on June 21, 1988 and August 3, 1988 are cancelled.

DATED: Troy, New York
March 7, 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