STATE OF NEW YORK

TAX APPEALS TRIBUNAL

In the Matter of the Petition	:	
of	:	
FRANCESCO LOMBARD D/B/A PHIL'S PIZZA	:	DECISION DTA No. 806622
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 August 31, 1987.	:	

Petitioner Francesco Lombard d/b/a Phil's Pizza, 75-63 31st Avenue, Jackson Heights, New York 11370 filed an exception to the determination of the Administrative Law Judge issued on December 6, 1990 with respect to his 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 August 31, 1987. Petitioner appeared by Meyer Zimmerman, C.P.A. The Division of Taxation appeared by William F. Collins, Esq. (Gary Palmer, Esq., of counsel).

Both petitioner and the Division of Taxation filed briefs on exception. Oral argument, requested by petitioner, was denied.

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

ISSUES

I. Whether the sales tax field audit of petitioner's business was reasonably calculated to reflect sales tax due.

II. Whether petitioner has established that either the audit methodology or tax assessed was erroneous.

FINDINGS OF FACT

We find the facts as determined by the Administrative Law Judge. These facts are set forth below.

The Division of Taxation ("Division") issued to petitioner, Francesco Lombard d/b/a Phil's Pizza, two notices of determination and demands for payment of sales and use taxes due, dated December 10, 1987. The first notice assessed sales taxes for the period September 1, 1984 through August 31, 1987 in the amount of $99,750.60 plus penalty and interest. The secondnotice assessed a penalty of $7,705.52 for the period June 1, 1985 through August 31, 1987.

The issuance of the notices followed a sales tax field audit of petitioner's business operations and records. The audit began on or about May 27, 1987, when the Division first contacted petitioner to schedule an appointment. Petitioner placed the Division in contact with his accountant, Meyer Zimmerman.

On June 17, 1987, an auditor spoke with Mr. Zimmerman by telephone and reviewed with him the records which would be needed for audit, including: a power of attorney; a general ledger for the period, September 1, 1984 through May 31, 1987; a cash receipts journal for the audit period; a cash disbursements journal for the audit period; Federal income tax returns and sales tax returns for the audit period; merchandise and expense purchase invoices for the period December 1, 1985 through May 31, 1986; sales invoices, guest checks and cash register tapes for the audit period; monthly bank statements; and a daybook for the audit period. During the conversation, Mr. Zimmerman informed the auditor that petitioner was in the process of selling his business and expected to close in the near future. He also stated that he would be on vacation and could not meet with the auditor until the end of July. Following this conversation, the auditor sent to Mr. Zimmerman an audit appointment letter, requesting books and records for the period September 1, 1984 through May 31, 1987 but not scheduling an audit appointment.

On June 22, 1987, the Division conducted an observation test of petitioner's business. An auditor was on the premises from 10:30 A.M. until 9:50 P.M. An auditor noted that petitioner used a cash register without a register tape and had no guest checks. An auditor counted the number of tables and chairs and made note of the general set up of the business. The restaurant menu stated that business hours were 11:00 A.M. to 11:00 P.M., but on the date of the observation, the business was closed by 10:00 P.M. The auditors maintained a list of all menu

items sold and applied menu prices to each item. The items sold included pizza (whole and by the slice), calzones, hero sandwiches, Italian ices, antipasto and soda (by the cup and in bottles). Petitioner also offered for sale hot plates such as spaghetti with meatballs and lasagna. By the end of the day, the Division calculated gross sales of $871.48. The observation test was conducted before petitioner's books and records were reviewed because the Division was informed that the business was about to be sold, and the business's records might not be available until after the sale occurred. At the time of the observation, the Division had reached no conclusion as to the adequacy of petitioner's books and records.

The auditor met with Mr. Zimmerman on August 7, 1987. At that appointment, Mr. Zimmerman supplied the following records: daysheets for 1985; Federal income tax returns for 1984 and 1985; a cash disbursements journal for 1985; and bank deposit records for 1985 and 1986. The auditor left Mr. Zimmerman a list of additional information which would be needed at the next appointment, including: a power of attorney; daysheets for the periods September 1, 1984 through December 31, 1984 and January 1, 1986 through the date of sale of petitioner's business; the contract of sale and closing statement; proof that sales tax had been collected and paid on the bulk sale of fixtures and equipment; bank statements for the periods September 11, 1984 through March 11, 1986 and March 11, 1987 to the then current time; a 1986 Federal income tax return; purchase invoices for 1986; and a cash disbursements journal for 1987.

Some of the requested records were supplied at the next meeting held on October 1, 1987. Records required for audit and not supplied included: sales invoices, cash register tapes or guest checks for the entire period of audit; a general ledger; day sheets for the periods September 1, 1984 through December 31, 1984 and January 1, 1986 through the end of the audit period (quarterly sales sheets for the period June 1, 1987 through August 31, 1987 were provided); and a cash disbursements journal for the period January 1, 1987 through the end of the audit period.

The Division obtained information regarding petitioner's purchases for the quarter ended February 28, 1986 from one of petitioner's suppliers, C & F Dairy Co. The auditor was supplied with a schedule showing a date, an invoice number, the total invoice amount, and the quantity

and dollar amount of purchases in three categories: mozzarella, flour and pizza boxes. The schedule states that the invoices included other miscellaneous items, and in fact, invoices offered in evidence by petitioner show purchases by petitioner of fruit punch, cold cuts, pasta, cooking oil and other items.

The auditor's analysis of petitioner's cash disbursements journal, for the periods for which it was available, showed that checks were written to only one supplier, C & F Dairy. The cash disbursements journal for the period ended February 28, 1986 had no entry corresponding to one of the invoices listed on the schedule of information provided by C & F Dairy. That invoice showed a purchase of 2,000 pounds of flour, approximately one-third of the total amount of flour purchased for the quarter. The auditor's review of petitioner's daily sheets for 1985 showed cash purchases of soda and other unidentified items which were not otherwise recorded in ledgers or journals. Daily sheets were available only for 1985. Based on these findings, the Division determined that petitioner's records of purchases were too unreliable to support a markup test.[1]

At the October 1 audit meeting, the auditor informed Mr. Zimmerman of the Division's intention to use the results of the observation test to determine tax due for the audit period. Mr. Zimmerman objected to this and requested that a markup test be employed, similar to one used by the Division on a prior audit. The Division declined to do a markup test, primarily on the ground that petitioner's records of purchases were incomplete.

To address petitioner's objection to the results of the one-day observation test, the Division attempted a second observation test on October 2, 1987. By this time petitioner's business had been sold. The new owner would not cooperate with the auditor. Although he allowed the auditor on the premises, he thwarted her attempt to record sales by blocking her line of sight and

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[1]The auditor testified that she assumed that C & F Dairy sold only flour, mozzarella and pizza boxes as indicated on the schedule supplied to her. Based on this assumption, she concluded that, since petitioner's cash disbursements journal showed checks written only to C & F Dairy, he must have had unrecorded cash purchases from other suppliers. The auditor was not provided with the actual C & F invoices during the audit. C & F invoices submitted into evidence at the hearing show purchases of a wide array of food items from C & F, plus syrups used to make beverages and a small amount of soda. Therefore, the auditor's assumption was incorrect. However, the auditor's conclusion that there were cash payouts for soda and other items is supported by her analysis of the daily sheets for 1985.

insisting that she sit at a distance from the food counter. This observation test was abandoned after several hours.

Because of the inadequacy of petitioner's records, the Division decided to estimate tax due on the basis of the June 22nd observation test.

The observation test was conducted on a Monday. Daysheets were not provided for June 1987, but they were available for June 1985. Since reported gross sales for the quarter ended August 31, 1985 were comparable to those reported for the quarter ended August 31, 1987 ($30,559.00 and $30,450.00, respectively), it was deemed reasonable to make a comparison using figures taken from the 1985 records. The 1985 daysheets showed average taxable sales on Mondays in June to be $202.31. Petitioner's taxable sales per the observation test were $871.48. Using these figures, the auditor calculated a margin of error of 3.3076.

The margin of error was applied to reported taxable sales for the period September 1, 1984 through August 31, 1987 to calculate additional taxable sales of $1,166,024.92 with a tax due on that amount of $94,555.40. Information regarding tax reported for the last two sales tax quarters was obtained from petitioner, but the information could not be verified by the auditor. In addition to tax assessed on additional taxable sales, the Division assessed sales tax in the amount of $2,759.20 for the quarter ended May 31, 1987 and $2,436.00 for the quarter ended August 31, 1987, representing taxes which petitioner claimed to have paid which could not be verified by the auditor.

The Division assessed a penalty based upon petitioner's failure to accurately report and pay over all sales tax when due. An additional penalty was assessed for the period June 1, 1985 through the end of the audit period because the amount of the omitted tax exceeded 25 percent of the tax required to be reported.

Following the administrative hearing, the Division conceded that petitioner paid sales taxes for the last two quarters of the audit period as he had claimed. Therefore, the amount of tax in dispute is conceded by the Division to be $94,555.40, rather than the amount assessed by the notice of determination.

As a check against the observation test, the Division estimated petitioner's sales for the audit period based upon the selling price of the business. The sale of petitioner's business was reported to the Division by the filing of a notification of sale showing a purchase price of $250,000.00. A published study conducted by Robert Morris Associates provided a ratio of gross annual sales to total assets of 2.1. Utilizing this ratio as a basis for its calculations, the Division determined additional taxable sales for the audit period of $1,222,464.81. The Division believed that this method of estimating tax generally confirmed the results of the observation test.

The Division attempted to reconcile petitioner's bank deposits, reported Federal gross receipts, reported taxable sales, and sales shown on his daily sheets, but it was unable to do so. In 1985, petitioner had bank deposits of $142,100.50, reported Federal gross receipts of $127,807.00, reported taxable sales of $117,697.00, and sales on his day sheets of $128,130.00. Petitioner never offered an explanation for the discrepancies. Furthermore, petitioner's records showed that employees were paid in cash, as were some of his suppliers, indicating that bank deposits did not necessarily include all gross receipts. Similar discrepancies were found for 1986, although daysheets were not available for that year.

At hearing, petitioner continued to assert that a markup test would have yielded a more accurate determination of sales tax due. Furthermore, petitioner challenged the auditor's contention that a markup test could not be performed because adequate purchase records were not available.

The Division had conducted an audit of petitioner for the period June 1, 1981 through August 31, 1984. As a part of that audit, the Division conducted an observation test on a Friday afternoon, from 11:00 A.M. to 4:00 P.M. Sales in this period amounted to $317.00; however, it appears from the documents submitted that only menu items made with flour (pizzas and calzones) were counted. Based on the five-hour test, the Division and petitioner agreed that total gross receipts for the day amounted to approximately $650.00; however, this figure was not used to calculate petitioner's tax liability.

The Division's records show that two notices of determination were issued to petitioner for the period June 1, 1981 through August 31, 1984. On audit, the Division initially determined that petitioner's own records understated purchases by 53.2 percent. To estimate petitioner's taxable sales, the Division initially increased petitioner's purchases per books by 53.2 percent and applied a markup on purchases of 432% which was calculated from petitioner's Federal income tax returns. These calculations resulted in additional tax due of $12,157.28. When these calculations were reviewed for accuracy, it was discovered that the auditor had made an arithmetic error, and the actual understatement of purchases was approximately 113 percent. This led to the issuance of a second notice of determination for the same period in the amount of $11,405.56.

Petitioner offered in evidence a Statement of Proposed Audit Adjustment for the periods covered by the prior audit showing a total tax due of $12,157.28 plus penalty and interest. This form provides a space where the taxpayer may consent to the audit findings by signing a statement to that effect. The document introduced into evidence by petitioner is unsigned.

In the course of the audit for the period June 1, 1981 through August 31, 1984, the auditor recorded the amount of flour used to make each of several menu items (whole pizzas, slices, etc.). This information was provided by petitioner. It is not known whether this information was used by the Division and, if it was, it is not known how it was used.

Petitioner's representative estimated petitioner's sales for the audit period at issue by applying the markup of 432%, taken from the prior audit, to petitioner's purchases as reported on his Federal returns. This resulted in gross sales of $491,685.00. Petitioner reported taxable sales for the audit period of $352,529.00.

Petitioner's representative also made a rough calculation of petitioner's flour purchases for the audit period, using purchase invoices from C & F Dairy. He testified that four invoices were missing for 1986 and a substantial number were missing for 1985; therefore, he estimated the flour purchases based upon the invoices he had.

OPINION

In the determination below, the Administrative Law Judge held that petitioner maintained no records of individual sales, such as cash register tapes or guest checks and, in fact, found that petitioner did not even claim that he maintained verifiable records of sales. The Administrative Law Judge also held that petitioner's records were so insufficient that an observation test was virtually the only means available to the Division to estimate tax due. The Administrative Law Judge further held that the record supports the Division's conclusion that petitioner's purchase invoice records would not support a test period markup audit.

On exception, petitioner alleges that the Division's use of an eleven hour and twenty minute observation test to determine the amount of sales tax owed for a three year period was unreasonable, unfair and improper. Petitioner argues that: 1) the Division failed to use any of its records and also ignored the plea of petitioner's accountant to use a markup test to determine sales tax due; 2) in order to base an audit and tax assessment on even an expanded observation test, the Division bears the burden of showing why petitioner's records are not adequate and, in this case, the Division has made no such showing, and without meeting its burden, its actions lack a rational basis; 3) petitioner relied upon the Division's rulings and considerations in the first audit to comply with his responsibilities in the second audit; however, the Division essentially changed its rules regarding approaches toward not a general class of taxpayers but toward the petitioner, individually and in particular; 4) such action is arbitrary and capricious and the Division's audit and actions were not reasonably calculated to determine the proper sales tax due; and 5) the Division's vastly disparate assessment of tax due from one three year period to the next three year period was arbitrary and capricious.

The Division argues that the audit method employed was reasonably calculated to reflect sales tax due. The Division further argues that, in the brief filed by petitioner's representative, it is clearly conceded that the Administrative Law Judge correctly found that petitioner failed to maintain verifiable records of his sales. Thus, the Division, in the absence of such records, has the burden to select an audit method that is reasonably calculated to determine sales tax due. The Division further argues that the evidence clearly supports a finding that the incomplete state of

petitioner's purchase records rendered the conduct of a meaningful markup test impossible. Finally, the Division argues that the burden of proof is properly on petitioner to show by clear and convincing evidence that the method of audit used or the amount of tax assessed is erroneous and, since petitioner has failed to meet this burden, the determination of the Administrative Law Judge should be, in all respects, sustained.

We find no basis in the record before us for modifying the Administrative Law Judge's determination in any respect. Therefore, we affirm the determination of the Administrative Law Judge for the reasons stated in her determination.

Accordingly, it is ORDERED, ADJUDGED and DECREED that:

1. The exception of petitioner Francesco Lombard d/b/a Phil's Pizza is denied;

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

3. The petition of Francesco Lombard d/b/a Phil's Pizza is granted to the extent indicated in finding of fact "12" of the Administrative Law Judge's determination but is otherwise denied; and

4. The Division of Taxation is directed to modify the notices of determination dated December 10, 1987 in accordance with paragraph "3" above but such notices are otherwise sustained.

DATED: Troy, New York
December 27, 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