STATE OF NEW YORK

TAX APPEALS TRIBUNAL

In the Matter of the Petition	:	
of	:	
CONTINENTAL CARPET CO. AND STANLEY MALTZ, AS PRESIDENT	:	DECISION DTA No. 807098
for Revision of Determinations or for Refund of Sales and Use Taxes under Articles 28 and 29 of the Tax Law for the Period March 1, 1984 through February 29, 1988.	:	

Petitioners Continental Carpet Co. and Stanley Maltz, as president, 233 Libbey Parkway, Weymouth, Massachusetts 02190 filed an exception to the determination of the Administrative Law Judge issued on June 13, 1991 with respect to their petition for revision of determinations or for refund of sales and use taxes under Articles 28 and 29 of the Tax Law for the period March 1, 1984 through February 29, 1988. Petitioners appeared by DeGraff, Foy, Holt-Harris and Mealey, Esqs. (James H. Tully, Jr., Esq. and Kenneth J. Bulko, Esq., of counsel). The Division of Taxation appeared by William F. Collins, Esq. (Kevin A. Cahill, Esq., of counsel).

Petitioners filed a brief on exception. The Division of Taxation filed a letter in lieu of a brief in response. Petitioners' request for oral argument was denied.

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

ISSUES

I. Whether a markup percentage provided by petitioner Stanley Maltz to the Division of Taxation during the audit was an external index.

II. Whether the Division of Taxation properly resorted to an external index in calculating the assessment.

III. Whether petitioners have shown reasonable cause for the remittance of penalties asserted against them pursuant to Tax Law § 1145(a)(1)(i) and (vi).

FINDINGS OF FACT

We find the facts as determined by the Administrative Law Judge except for findings of fact "4" and "5" which have been modified. We have also made additional findings of fact. The Administrative Law Judge's findingsof fact, the modified findings of fact and the additional findings of fact are set forth below.

On May 4, 1989, the Division of Taxation (hereinafter the "Division") issued to Continental Carpet Co. (hereinafter "Continental") a Notice of Determination and Demand for Payment of Sales and Use Taxes Due for the period March 1, 1984 through August 31, 1987, setting forth total tax due of $18,652.05, penalty of $5,177.51 and interest of $8,787.44, for a total amount due of $32,617.00. On the same date, a second Notice of Determination and Demand for Payment of Sales and Use Taxes Due was issued to Continental for the period September 1, 1987 through February 29, 1988 which set forth additional tax due of $6,242.61, penalty of $1,519.97 and interest of $997.03, for a total amount due of $8,759.61. Finally, on May 4, 1989, the Division issued to Continental a Notice of Determination and Demand for Payment of Sales and Use Taxes Due for the period June 1, 1985 through February 29, 1988 setting forth penalty only of $1,697.35 which was assessed pursuant to Tax Law § 1145(a)(1)(vi).

On May 4, 1989, the Division issued three notices of determination and demands for payment of sales and use taxes due to Stanley Maltz, as president of Continental Carpet Co. (hereinafter "Maltz"), which set forth the same total tax, penalty and interest due for the same periods as those set forth on the notices issued to Continental. The explanation for Maltz's assessments indicated that he was liable individually and as president of Continental under Tax Law §§ 1131(1) and 1133 as determined to be due in accordance with Tax Law §§ 1138(a) and 1145.

During the audit period, Continental was a vendor of installed and uninstalled carpeting and tiles and associated products located in Massachusetts. At no time during the audit period did it file New York State sales and compensating use tax returns or pay over any taxes to the Commissioner of Taxation and Finance.

We modify the Administrative Law Judge's finding of fact "4" to read as follows:

> On April 8, 1988, the auditor mailed to Continental an appointment letter and questionnaire which requested a meeting with petitioners on May 9, 1988. The Division was unable to provide a copy of this letter at the hearing; however, a witness testified that, according to general office practice, the request would have stated "[a]ll 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 . . . . During the course of the audit, you may be required to furnish additional records and/or information" (Exhibit "H"). The auditor travelled to Continental's offices at its Massachusetts location and spent three days auditing the books and records of the company on May 9, 10 and 11, 1988. The audit included an analysis of sales invoices and purchase records for the period March 1, 1984 through February 29, 1988. Additionally, the auditor spoke with Maltz regarding the business and his tax obligations to New York State. It was learned that Continental purchased its carpeting tax-free and then either resold the carpeting uninstalled or incorporated it into installed sales (capital improvements).
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> The auditor that performed the audit did not testify at the hearing. Nothing in the audit report prepared by this auditor indicates that Continental failed to provide any records requested or that the records provided were inadequate in any respect. To the contrary, on the field audit report, under the heading "Adequacy of Sales Records," the box was checked next to the line stating: "Sales records were adequate and the Audit Election Method Agreement was not signed because:". This line was completed by the insertion of the words "DETAIL AUDIT WAS CONDUCTED." Under the heading "Adequacy of Purchase Records," the words "N/A NO N.Y. LOCATIONS" were inserted and the box was checked next to the line stating: "Purchase records were adequate and the Audit Election Method Agreement was not signed because:". This line was completed by the insertion of the words "DETAIL AUDIT CONDUCTED ON SALES INVOICES SHOWING PURCHASES OF MATERIALS USED FOR CAPITAL IMPROVEMENTS." Under the heading "Updating of Audit" the line was checked that states "Audit period has not been updated because:". The entry was completed by the insertion of the words "The additional audit time required would result in unproductive man-days because of the availability of the records are [sic] not easily accessible."

> An audit supervisor did testify at the hearing, but this individual had not been involved in the audit while it was being conducted. The witness became the supervisor of the auditor who performed the audit after the audit had been completed. The witness had no knowledge of the actual audit performed, independent of the audit report. This witness testified, based on his experience, that if the records of petitioner were inadequate, there would be an entry somewhere in the audit file indicating this fact (Tr., p. 48). The witness then testified that there was no entry in the audit report showing that the records were inadequate (Tr., p. 49). Specifically, the witness stated that there was no entry in the report indicating that information relating to the cost of materials installed in capital improvements was not available (Tr., p. 50).[1]

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

> Originally, the auditor prepared a worksheet which reflected the material charge from each sales invoice and the applicable use tax due on that amount. However, after speaking with Maltz on May 16, 1988, she allowed a 27% markup on the cost of these materials which resulted in a 27% decrease in material expense and tax thereon.
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> With respect to the use of the 27% markup, the field audit contact sheet has an entry dated May 16, 1988 as follows: "phoned spoke w/ Stanley-mark-up is 27% on Cost-will edit this week" (Exhibit "G"). On the field audit report there is a typed entry that states "EACH INVOICE (MATERIAL CHARGE DIVIDED 127%) WAS AGREED TO AS BEING SUBJECT TO USE TAX AND WAS TREATED AS SUCH" and another that states "AS PER AGREEMENT WITH THE CORPORATE OFFICER, STANLEY MALTZ, MATERIAL PRICE ON EACH INVOICE WAS DIVIDED BY 127%.

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[1] The Administrative Law Judge's finding of fact "4" read as follows:

> "On April 1, 1988, the auditor mailed to Continental an appointment letter and questionnaire which requested a meeting with petitioners on May 9, 1988. In fact, the auditor travelled to Continental's offices at its Massachusetts location and spent three days auditing the books and records of the company on May 9, 10 and 11, 1988. The audit included an analysis of sales invoices and purchase records for the period March 1, 1984 through February 29, 1988. Said analysis determined that the sales and purchase records were adequate, and no audit election method agreement was signed because a 'detailed' audit was conducted, i.e., every invoice indicating a sale in New York State was analyzed and appropriate items were taxed. Additionally, the auditor spoke with Maltz regarding the business and his tax obligations to New York State. It was learned that Continental purchased its carpeting tax free and then either resold the carpeting uninstalled or incorporated it into installed sales (capital improvements)."

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

> There is nothing in the record that indicates any written acknowledgement or written agreement on the part of petitioners to use the 27% mark-up.
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> In addition, the auditor analyzed sales invoices for uninstalled carpeting and tiles as well as associated items and applied the applicable tax rate to same.
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> Additional taxable purchases derived from the material cost components on sales invoices were determined to be $282,745.71, for an additional tax due on same of $21,352.66. Additional taxable sales (of uninstalled carpeting) were determined to be $50,268.58, or an additional tax due thereon of $3,542.00. Total additional taxable sales and/or purchases and expenses were $333,014.29, and additional tax due was determined to be $24,894.66.[2]

Additional penalties and interest were assessed pursuant to Tax Law § 1145(a)(1)(i) for failing to file a return or to pay or pay over any tax to the Commissioner within the time required, and also pursuant to Tax Law § 1145(a)(1)(vi) for omitting from the total amount of State and local sales and compensating use taxes required to be shown on a return an amount in excess of 25% of the amount of such taxes required to be shown on the return.

Neither Maltz nor any other employee or officer of Continental appeared at hearing. However, on July 23, 1990, Maltz stated in an affidavit that he was present at the audit conducted by the New York State sales tax audit staff and that he conferred with the staff during their conduct of the audit. Maltz contended in his affidavit that various percentages of costing carpeting were discussed, ranging from a low of 27% to a high of 50% markup over cost. Maltz stated in his affidavit that he never agreed verbally or in writing to the use of any test or indirect method to determine the cost of the carpeting going into the sales invoices, and that he was prepared to offer bills for each job to allocate costs directly if he had been asked.

However, Maltz never presented any evidence of the markup percentage to the audit staff and entered only four sales invoices into evidence at hearing through his representatives. Although four invoices from a company called Collins and Aikman, Floor Coverings Division, located in Dalton, Georgia, indicating Continental as the purchaser, were submitted in evidence

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[2] We modified the Administrative Law Judge's finding of fact "5" by adding the second and third paragraphs. We made this change to reflect the record in greater detail.

as substantiation for markup percentages in excess of 27%, there was no clear correlation or tie-in between the purchase invoices from Collins and Aikman and Continental's invoices submitted in evidence. Furthermore, at no time during the audit or at any time through formal hearing were job file folders presented to the audit staff, conferee or administrative law judge which clearly identified the material and its cost used in the specific sales.

In addition to the facts found by the Administrative Law Judge, we find the following:

> Two petitions were received by the Division of Tax Appeals on July 3, 1989. One petition listed Continental Carpet Co. as petitioner and notice numbers S890505005A, S890505004A, S890505008A and S890505009A (copies were attached). The second petition listed Stanley Maltz as petitioner and notice numbers S890505006A and S890505007A (copies were attached). Notice number S890505009A was listed and attached to the wrong petition as it relates to Stanley Maltz and not Continental Carpet Co. However, as it was clear the petition intended to cover that particular notice, failure to list Mr. Maltz as a petitioner on the petition does not invalidate the petition. Due to an apparent oversight by the Division of Tax Appeals, a case was set up in the name of Continental Carpet Co. only and, therefore, the answer of the Division of Taxation and Notice of Hearing were in one name only.
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> At the hearing, only the petition listing Continental Carpet Co. as petitioner was introduced into evidence. The petitioner asked to amend the petition to include petitioner Stanley Maltz and the Division moved to amend its answer accordingly. Neither party objected to the other's motion (see, Tr., pp. 5-8).
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> The Division of Tax Appeals may take official notice of documents in its possession. In this case, while the petition regarding Stanley Maltz and notice numbers S890505006A and S890505007A were not introduced into evidence at the hearing, official notice is hereby taken of such petition which is contained in the file of the Division of Tax Appeals concerning this matter.

OPINION

The Administrative Law Judge determined that using a markup percentage provided by petitioner Maltz was not an external index since the information was generated by petitioners. The Administrative Law Judge, finding that a full, detailed audit was performed, concluded that it was not necessary to reach the issue of whether the Division properly utilized estimation procedures under Matter of Chartair, Inc. v. State Tax Commn. (65 AD2d 44, 411 NYS2d 41). Further, the Administrative Law Judge concluded that since a test period audit was not

performed, it was not necessary for the Division to acquire an audit method agreement showing that petitioners knowingly waived their rights to a complete audit. The Administrative Law Judge also concluded that the Division's request for records was adequate. With respect to the use of a direct pay permit, the Administrative Law Judge concluded that Continental could have only properly used its own direct pay permit with respect to the purchases in issue and that Continental did not prove that it had such a permit. Finally, the Administrative Law Judge determined that petitioners did not establish reasonable cause to abate the penalties and additional interest asserted.

On exception, petitioners contend that the records of Continental were adequate and that the Division failed to request the records necessary to determine Continental's tax liability. Petitioners argue that the use of the markup percentage was an estimate technique, that a detailed audit was not performed, and that the use of the estimate methodology was improper without an adequate request and examination of the available records. In the alternative, petitioners argue that, even if the use of the markup percentage was correct, the percentage applied -- 27% -- was too low.

In response, the Division argues that the 27% markup was based on information provided by petitioners and, thus, is distinguishable from those instances where the Division imposes a reconstructive estimate, i.e., an estimate made by the Division or based on an external index. With respect to the request for records, the Division argues that the Administrative Law Judge weighed the credible evidence and concluded that the request was adequate. Further, the Division asserts that petitioners have never presented the additional documents (the job file folders) that would allegedly demonstrate petitioners' markup. The Division notes that petitioners have abandoned their claims with respect to the use of direct pay permits. Finally, the Division states that, although petitioners have excepted to the imposition of penalties, they have not advanced an argument in support of their position.

We modify the determination of the Administrative Law Judge.

First, we reject the Administrative Law Judge's conclusions that the use of the 27% markup percentage was not an external index and that a detailed audit was performed by the Division. Section 1138(a)(1) provides that:

> "[i]f 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."

Clearly, what the statute means by external index is external to the exact computation of the tax, not simply external to the taxpayer. This meaning of the statute was long ago confirmed in Matter of Chartair, Inc. v. State Tax Commn. (supra), where it was held that resort to a three-month test period audit to determine liability for a 43-month period was inappropriate where the taxpayer's records were sufficient to determine the exact amount of tax. Since Chartair involved an estimate technique that was based on the taxpayer's books and records, this case established that the determinative question is whether the audit methodology employs an estimate, not whether the estimate is derived from sources internal or external to the taxpayer (see also, Matter of Names in the News v. New York State Tax Commn., 75 AD2d 145, 429 NYS2d 755; Matter of Mohawk Airlines v. Tully, 75 AD2d 249, 429 NYS2d 759). In the instant case, the 27% markup percentage was an estimate employed by the Division to calculate the price at which Continental purchased the material installed in the capital improvements. Therefore, the question that is before us is whether the Division properly resorted to the use of this estimate.

Because the Division's right to utilize estimate methodologies must rest upon a finding that the taxpayer's books and records are inadequate to conduct a complete audit, the Division must be able to justify its conclusion that the taxpayer's records are inadequate (see, Matter of King Crab Rest. v. Chu, 134 AD2d 51, 522 NYS2d 978, 979-980).

In the instant case, we find no basis in the record to support a conclusion that the taxpayer's records were inadequate to support a complete audit. The audit report, which, according to the Division's witness, would be expected to report on inadequacies in the taxpayer's records, does not state that the records were insufficient in any respect, but only

makes affirmative statements as to the adequacy of the records. The auditor who performed the audit did not testify and, thus, could not explain in what way she found the records insufficient. The audit supervisor who did testify had no independent knowledge of the audit performed and, thus, was also unable to describe any inadequacy in the records. In short, although the question was explicitly and thoroughly addressed at the hearing, the Division was unable to identify or explain in what way Continental's records were inadequate and, thus, could not justify its resort to an estimate methodology on this ground.

The only other ground upon which the estimate methodology could be justified would be if petitioners had waived their right to an unabridged audit and consented to the estimate methodology (see, Matter of James G. Kennedy & Co. v. Chu, 125 AD2d 773, 509 NYS2d 199, 201). The only evidence with respect to an agreement is the unspecific statements in the audit report. In one instance, the report refers to an agreement by a corporate officer and in the other instance, does not name the agreeing party (Exhibit "G"). Even the auditor's contemporaneous note of the conversation with "Stanley" does not state that "Stanley" agreed to the 27% figure. Instead, the contact sheet states that the auditor spoke with "Stanley" and the "mark up is 27%" (Exhibit "G"). We conclude that the unclear references to an agreement in a document prepared by the Division's auditor, which have not been corroborated or explained by any other documentary or testimonial evidence, are insufficient to support a finding that petitioners consented to the use of the markup percentage and certainly do not indicate that petitioners made a "considered and affirmative abandonment" of their right to a full audit, as required by Matter of James G. Kennedy & Co. v. Chu (supra).

Since we find no justification for the Division's use of an estimate methodology, we conclude that this methodology lacked a rational basis (see, Matter of King Crab Rest. v. Chu, supra). Accordingly, that portion of the assessment based on the markup percentage, i.e., the $21,352.66 assessed on additional taxable purchases of materials installed in capital improvements, must be cancelled. Since the $3,542.00 assessed with respect to the sale of

uninstalled flooring by Continental was not based on the application of the markup percentage, this portion of the assessment is sustained.

Petitioners presented no facts indicating that their failure to pay tax was due to reasonable cause and not due to willful neglect; therefore, the penalties asserted by the Division are sustained.

Accordingly, it is ORDERED, ADJUDGED and DECREED that:

1. The exception of Continental Carpet Co. and Stanley Maltz, as president, is granted to the extent that the tax assessed on the purchase of materials installed in capital improvements is canceled, but is otherwise denied;

2. The determination of the Administrative Law Judge is modified to the extent indicated in paragraph "1" above, but is otherwise sustained;

3. The petitions of Continental Carpet Co. and Stanley Maltz, as president are granted to the extent indicated in paragraph "1" above, but are otherwise denied; and

4. The Division of Taxation is directed to modify the notices of determination dated May 4, 1989 in accordance with paragraph "1" above, but such notices are otherwise sustained.

DATED: Troy, New York
September 10, 1992

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

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

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