

STATE OF NEW YORK  
TAX APPEALS TRIBUNAL

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In the Matter of the Petition :  
of :  
**JOHN ROSEMELLIA** :  
**D/B/A THE BURT RESTAURANT** :  
for Revision of a Determination or for Refund of Sales and :  
Use Taxes under Articles 28 and 29 of the Tax Law for the :  
Period December 1, 1984 through November 30, 1987. :

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DECISION  
DTA Nos. 807113  
and 807705

In the Matter of the Petition :  
of :  
**JOHN A. AND NANCY F. ROSEMELLIA** :  
for Redetermination of Deficiencies or for Refund of :  
Personal Income Tax under Article 22 of the Tax Law for :  
the Years 1985 through 1987. :

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Petitioner John Rosemellia d/b/a The Burt Restaurant, 2083 Lockport-Olcott Road, Burt, New York 14028 filed an exception to the determination of the Administrative Law Judge issued on June 20, 1991 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 December 1, 1984 through November 30, 1987.

Petitioners John A. and Nancy F. Rosemellia, 2083 Lockport-Olcott Road, Burt, New York 14028 filed an exception to the determination of the Administrative Law Judge issued on June 20, 1991 with respect to their petition for redetermination of deficiencies or for refund of personal income tax under Article 22 of the Tax Law for the years 1985 through 1987.

Petitioners appeared by Hodgson, Russ, Andrews, Woods & Goodyear (Christopher L. Doyle, Esq., of counsel) and Saul Glazer, C.P.A. The Division of Taxation appeared by William F. Collins, Esq. (Deborah J. Dwyer, Esq., of counsel).

Petitioners filed a brief in support of their exception. The Division of Taxation filed a letter in reply. Petitioner's 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 the Division of Taxation's denial of petitioner's refund claim made in respect to certain penalties assessed and paid pursuant to a Statement of Proposed Audit Adjustment for Sales and Use Taxes was proper.

II. Whether the Division of Taxation properly determined additional income tax due by using the results of the prior sales tax audit.

III. Whether petitioner demonstrated reasonable cause to justify abatement of penalties asserted in respect to the income tax deficiencies.

### ***FINDINGS OF FACT***

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

Petitioner John A. Rosemellia owns and operates The Burt Restaurant, a small, neighborhood-type bar located in Burt, New York.

Petitioner filed joint New York State personal income tax returns with his wife, petitioner Nancy F. Rosemellia, for the years 1985 through 1987. Nancy F. Rosemellia is a petitioner herein solely by reason of her having filed such joint returns. Accordingly, unless otherwise indicated, all references to "petitioner" herein shall refer to John A. Rosemellia.

On January 6, 1988, the Division of Taxation (hereinafter the "Division") commenced a sales tax audit at petitioner's premises. At that time, the Division reviewed petitioner's sales and income tax returns, purchase and sales journals, and purchase invoices. Petitioner did not maintain cash register tapes. Indeed, although petitioner had a cash register, he used it only to store money and to get change; he did not use it to record any individual sales.

Petitioner's Federal schedule C's filed in respect of the years 1984 through 1986 indicated gross receipts, cost of goods sold, gross profit and markup percentage<sup>1</sup> amounts as follows:

	<u>1984</u>	<u>1985<sup>2</sup></u>	<u>1986</u>
Gross Receipts	\$37,527.00	\$33,999.00	\$35,302.00
Cost of Goods Sold	30,619.00	30,421.00	35,111.00
Gross Profit	6,908.00	3,578.00	191.00
Markup Percentage	22.6%	11.8%	.5%

Given petitioner's failure to maintain records of any individual sales and what the Division considered to be a low markup percentage (as reflected in petitioner's Federal returns), the Division endeavored to conduct a markup audit of petitioner's purchases. The Division used petitioner's 1986 purchases as indicated by his records to determine petitioner's markups on liquor, beer and food (snacks). First, the Division separated petitioner's 1986 purchases into three categories and determined additional taxable sales as follows:

(a) With respect to beer, petitioner sold 12-ounce bottles, 7-ounce bottles (splits) and 6-packs (12-ounce bottles). The Division first totaled the number of cases of beer purchased by petitioner in 1986. From this total the Division subtracted the number of cases of beer sold in 6-packs by petitioner during this year. Petitioner advised the Division that 199 cases were attributable to 6-pack sales. At four 6-packs per case, petitioner thus sold 796 6-packs in 1986. Based on discussions with petitioner, the Division determined a selling price of \$5.00 per 6-pack, or \$3,980.00 in receipts for 6-pack sales. The Division then took the difference between total cases purchased and cases attributable to 6-pack sales, determined the total number of bottles at 24 bottles per case, made a 15% allowance for spillage and giveaways, and, using \$1.00 per bottle as a selling price, determined \$47,736.00 in total receipts from sales of 12-ounce bottles of beer during 1986. The \$1.00 per bottle selling price was determined by the Division pursuant to

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<sup>1</sup>The schedule C's did not list a markup percentage. The percentage set forth herein constitutes the ratio of gross profit to cost of goods sold figures as set forth on the schedule C's.

<sup>2</sup>Petitioner's 1985 schedule C actually listed gross receipts and cost of goods sold amounts that were erroneously doubled. Gross receipts and cost of goods sold were listed on the return as \$67,998.00 and \$60,842.00, respectively. This error flagged petitioner for audit.

discussions with petitioner. The Division then determined petitioner's sales of splits in the same manner, i.e., total number of bottles purchased, less 15% spillage and giveaway allowance, multiplied by a 50 cents per bottle selling price, which resulted in 1986 receipts from splits of \$1,295.00. The selling price for splits was also determined pursuant to discussions with petitioner.

(b) Next, the Division totaled beer sales from each of the three categories and divided that total by 1.07 to allow for the inclusion of sales tax in the selling price to reach taxable sales of beer for 1986 of \$49,543.00. Petitioner's 1986 beer purchases totaled \$24,230.00. The Division thus determined petitioner's markup on beer to be 105%.

(c) For liquor, the Division totaled petitioner's purchases for 1986 and listed the size of each bottle purchased. On audit, petitioner advised the Division that he used a one-ounce shot of liquor in his drinks and that the selling price for drinks was \$1.00. Using this information, the Division determined the total number of drinks sold based on the liquor purchases. As with the beer sales, the Division made a 15% spillage allowance in this determination. The Division calculated total receipts from liquor sales during 1986 of \$24,548.00. This total was divided by 1.07 to allow for inclusion of sales tax in the purchase price. The resulting additional taxable liquor sales totaled \$22,942.00. Petitioner purchased \$6,407.00 worth of liquor in 1986. Petitioner's markup on liquor was thus 258%.

(d) For food (or snacks), the Division determined that, during 1986, petitioner paid 22 cents for a bag of chips and sold it for 40 cents including tax. This resulted in a 68% markup on food. Petitioner did not dispute this component of the audit.

(e) The Division next applied the markups on beer, liquor and food as determined above to petitioner's purchases per his records throughout the audit period. This resulted in a determination of additional taxable sales during the audit period of \$112,631.00 and additional tax due of \$7,884.17.

The sales tax audit was conducted at petitioner's premises. The auditor was at the premises for at least part of five days during January 1988. The final day that the auditor was on

petitioner's premises was January 27, 1988. At that time, the auditor reviewed the results of the audit with petitioner. The auditor advised petitioner that his supervisor was unconvinced that petitioner's selling price for drinks during the audit period was \$1.00, but that the Division would accept the \$1.00 selling price if petitioner would accept the results of the audit. Petitioner advised the auditor that he would think it over. The Division subsequently sent petitioner a Statement of Proposed Audit Adjustment (Form AU-3), dated January 29, 1988, which set forth the tax determined due on audit of \$7,884.17, plus penalty and interest, for the period December 1, 1984 through November 30, 1987. The penalty set forth on the AU-3 included penalty pursuant to Tax Law § 1145(a)(1)(i) and (vi). Petitioner signed the AU-3 which, by the terms of said form, indicated agreement with the proposed assessment of tax, penalty and interest and also indicated that petitioner consented to the fixing of tax, penalty and interest as set forth thereon. Petitioner dated his signature February 10, 1988 and mailed the form back to the Division. The form was stamped received by the Division's Buffalo District Office on February 16, 1988.

On May 11, 1988, the Division issued to petitioner a Notice and Demand for Payment of Sales and Use Taxes Due which demanded payment of the tax consented to by petitioner by his signature on the AU-3, plus Tax Law § 1145(a)(1)(i) penalty and interest.

Also on May 11, 1988, the Division issued a Notice of Determination and Demand for Payment of Sales and Use Taxes Due which assessed \$693.77 in Tax Law § 1145(a)(1)(vi) penalty set forth on the AU-3.

On January 10, 1989, petitioner filed an Application for Credit or Refund of State and Local Sales or Use Tax (Form AU-11) claiming a refund of \$693.77 in "penalty paid on sales tax assessments."

By letter dated May 2, 1989, the Division denied petitioner's refund claim in full.

Following the issuance of the notice and demand and notice of determination, the Division commenced an income tax audit of petitioner for the years 1985 through 1987. On this audit, the Division reviewed the sales tax audit workpapers. Next, the Division conducted a bank deposits

analysis and cursory source and application of funds analysis of petitioner's records with respect to the years in question.<sup>3</sup> The Division used these two income reconstruction methods to verify the existence of additional receipts as indicated by the sales tax audit results. These methods revealed additional income attributable to petitioner as follows:

<u>Method</u>	<u>1985</u>	<u>1986</u>	<u>1987</u>
Source and Application	\$ 3,307.00	\$ 8,431.00	\$17,749.00
Bank Deposits	10,629.00	10,631.00	24,227.00

Given the existence of the signed consent to the results of the sales tax audit, the Division redetermined petitioner's personal income tax liability based solely on the results of that audit. On November 21, 1988, the Division issued to petitioner two statements of personal income tax audit changes that indicated increases in petitioner's income, based on the sales tax audit, as follows:

	<u>1985</u>	<u>1986</u>	<u>1987</u>
Increase in income	\$34,215.00	\$44,631.00	\$29,639.00

On February 10, 1989, the Division issued to petitioner two notices of deficiency which asserted additional personal income tax due totaling \$9,737.86, plus penalty and interest, for the years 1985 through 1987. The tax asserted in the notices was premised on the additional audited income set forth in the statements of personal income tax audit changes.

Petitioner entered into evidence certain computations prepared by his accountant. Such computations purported to recalculate petitioner's gross receipts during the audit period using the same basic methodology as that used by the sales tax auditor, except that petitioner's accountant used 85 cents as the average selling price of beer, 75 cents as the average selling price of mixed drinks, and \$3.85 for 6-packs. The accountant also used a larger amount of alcohol per mixed drink. (The auditor used one ounce of liquor per drink with a 15% spillage allowance resulting in 28.7 drinks per liter. The accountant used a figure of 20 drinks per liter.) The accountant also

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<sup>3</sup>In the auditor's opinion, the bank deposits analysis was sufficiently completed such that a Notice of Deficiency could have been issued based upon this method. The source and application analysis was incomplete and would have required further information before a Notice of Deficiency could have been issued.

made adjustments for ladies' night and happy hour by a determination that 56 drinks were given away at a weekly ladies' night during 1985 and 1986 and that 86 drinks per day were given away during a Monday through Friday happy hour in 1985 and 1986. The accountant thus determined that petitioner lost a total of \$27,841.00 in sales as a result of such giveaways during 1985 and 1986. The accountant's calculations indicated total sales of \$134,713.00 for the three years at issue, a difference of \$28,174.00 from sales reported on petitioner's sales tax returns for the same period.

***OPINION***

The Administrative Law Judge held that petitioner had voluntarily signed the consent portion of the Statement of Proposed Audit Adjustment, and by his signature was bound pursuant to Tax Law § 1138(c) to the results of the sales tax audit which, therefore, could not be challenged through the administrative hearing process. Further, the Administrative Law Judge denied petitioner's claim for refund of the omnibus penalty finding that petitioner had not shown reasonable cause or the absence of willful neglect. With regard to the income tax deficiencies, the Administrative Law Judge found that petitioner had failed to establish any errors in the Division's audit methodology. With regard to the penalties, the Administrative Law Judge found that petitioner's underreporting of income was due to his failure to maintain accurate records and not due to reasonable cause. Consequently, the Administrative Law Judge sustained the notices in full.

On exception, petitioner asserts that it was not proper for the Division to use the results of the sales tax audit as the basis for the income tax deficiencies issued to petitioner and, further, that petitioner established that the sales tax and the income tax penalties should be abated because the sales tax audit on which the penalties were based did not accurately reflect the amount of additional tax due.

In response, the Division relies on the determination of the Administrative Law Judge, asserting that petitioner has not raised on exception any issues which were not covered by that determination. The Division reiterates that petitioner signed the consent to the sales tax

adjustments, thereby agreeing that the figures were correct. Having so agreed, the Division asserts, petitioner cannot now challenge the factual basis of the audit or the use of these figures to calculate the income tax deficiencies.

We uphold the determination of the Administrative Law Judge.

Where there is some factual basis for determining that a taxpayer's income is not accurately reflected in his books and records, the Division may use indirect methods to determine the proper income (Matter of Giuliano v. Chu, 135 AD2d 893, 521 NYS2d 883, 885-886; Matter of Hennekens v. State Tax Commn., 114 AD2d 599, 494 NYS2d 208, 209; see, Matter of Holland v. United States, 348 US 121, 131-132).

Here, petitioner does not argue that his tax returns accurately reflected his income for the years in question or that use of an indirect method was improper. Rather, petitioner challenges the income tax deficiencies on two grounds. First, petitioner argues that it was unreasonably arbitrary to use the sales tax audit figures for determining the deficiencies because the bank deposit analysis performed by the income tax auditor resulted in a smaller amount of additional unreported income, and the auditor did not attempt to reconcile the results from the two audit methods. Secondly, petitioner asserts that the sales tax audit was fatally flawed because the auditor failed to use a "Bar Fact Sheet" as stipulated by the audit guidelines, the drink prices and drink sizes used by the auditor were inaccurate, and the auditor failed to allow sufficiently for free drinks.

We agree with the Administrative Law Judge that the Division's use of the sales tax audit results as the basis for calculating the income tax deficiencies was proper. Petitioner has not demonstrated that the use of the sales tax audit results to determine additional income tax was less appropriate than the use of other indirect methods. The auditor's use of other techniques to confirm that the returns originally filed by petitioner did not accurately reflect the amount of income tax due did not require the Division to use one of those other methods to estimate the tax due. Given that petitioner signed the consent to the Statement of Proposed Audit Adjustments for the sales tax assessment, thus, indicating agreement with the figures contained therein, the



Division's use of these figures to determine the amount of additional unreported income for income tax purposes was clearly proper and appropriate.

Further, we agree with the Administrative Law Judge that petitioner failed to establish that the sales tax audit was erroneous. We do not agree with petitioner that the auditor's failure to use a "Bar Fact Sheet" in and of itself renders the audit results unreasonable or without a rational basis. The auditor testified that he used the drink price and other information on the bar's operation supplied by petitioner to compile the audit results and that he discussed the drink prices and audit results with petitioner prior to petitioner's signing the consent to the audit adjustments. At the hearing, petitioner, through his own testimony, contested the auditor's version of the events which resulted in the sales tax audit figures and, in addition, produced other witnesses to testify as to the drink prices and bar operations. However, the Administrative Law Judge credited the testimony of the auditor and not the testimony of petitioner and his witnesses. We have no reason to overturn the Administrative Law Judge's determination as to credibility here (see, Matter of Stevens v. Axelrod, 162 AD2d 1025, 557 NYS2d 809, 811).

We note that petitioner's testimonial evidence was unsupported by any contemporaneous, corroborating documentary evidence (petitioner had failed to maintain any records of individual sales during the audit period). At best, petitioner's witnesses and the work sheets prepared by petitioner's accountant at the time of the hearing represented only another estimate of petitioner's tax liability. An alternative estimate does not establish that the Division's audit methodology was wrong and is clearly insufficient to establish by clear and convincing evidence that the amount assessed was erroneous (see, Matter of Meskouris Bros. v. Chu, 139 AD2d 813, 526 NYS2d 679, citing Matter of Surface Line Operators Fraternal Org. v. Tully, 85 AD2d 858, 446 NYS2d 451, 452; Matter of Pizza Works, Tax Appeals Tribunal, March 21, 1991). On the other hand, the auditor's testimony was supported by compelling documentary evidence, i.e., petitioner's consent to the results of the sales tax audit at the conclusion of the audit. Given petitioner's agreement with the audit results, the sales tax audit methodology was not unreasonable and the sales tax figures provided a proper basis for the income tax assessment.

In order to abate penalties, a taxpayer must show that the failure to comply with the law was due to reasonable cause and not due to willful neglect (Tax Law § 1145[a][1][iii]). We agree with the Administrative Law Judge that petitioner has not established that his underreporting of sales or income resulted from anything other than his own failure to maintain accurate records of sales and, therefore, as there has been no showing of reasonable cause and the absence of willful neglect for his failure to pay the sales and income taxes, there is no basis for abating the penalties assessed.

Accordingly, it is ORDERED, ADJUDGED and DECREED that:

1. The exception of petitioner John Rosemellia d/b/a The Burt Restaurant and petitioners John A. and Nancy F. Rosemellia is denied;
2. The determination of the Administrative Law Judge is affirmed;
3. The petitions of John Rosemellia d/b/a The Burt Restaurant and John A. and Nancy F. Rosemellia are denied; and
4. The notices of deficiency issued on February 10, 1989 are sustained and the Division of Taxation's denial of petitioner's refund claim is upheld.

DATED: Troy, New York  
March 12, 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