STATE OF NEW YORK

TAX APPEALS TRIBUNAL

In the Matter of the Petition

of

QUEENSTRAW, 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 March 1, 1989 through February 28, 1991.

In the Matter of the Petition

of

ALBERT ERANI
OFFICER OF QUEENSTRAW, 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 March 1, 1989 through February 28, 1991.

In the Matter of the Petition

of

ALAN ADES
OFFICER OF QUEENSTRAW, 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 March 1, 1989 through February 28, 1991.

DECISION
DTA NOS. 812793, 812792 AND 812853

The Division of Taxation filed an exception to the determination of the Administrative Law Judge issued on March 28, 1996 with respect to the petitions of Queenstraw Inc., 71-24 Austin Street, Forest Hills, New York 11375, Albert Erani, Officer of Queenstraw, Inc., Farm Road, Briarcliff Manor, New York 10510, and Alan Ades, Officer of Queenstraw, Inc., 19 Heathcote Road, Scarsdale, New York 10583. Petitioners appeared by Jeffrey A. Baddish,

CPA and Lester D. Janoff, Esq. The Division of Taxation appeared by Steven U. Teitelbaum, Esq. (Michael B. Infantino, Esq., of counsel).

The Division of Taxation submitted a brief in support of its exception. Petitioners submitted a brief in opposition. The Division of Taxation's request for oral argument was denied.

The Tax Appeals Tribunal renders the following decision per curiam. Commissioner Jenkins took no part in the consideration of this decision.

ISSUES

I. Whether petitioners' books and records were adequate to conduct a detailed audit.

II. Whether petitioners have proven by clear and convincing evidence that the Division of Taxation's audit method was unreasonable.

III. Whether there is reasonable cause to abate the penalty.

FINDINGS OF FACT

We find the facts as determined by the Administrative Law Judge except for findings of fact "2(a)," "2(b)," "2(c)," "3(a)," "3(b)," "3(d)" and "4(d)" which have been modified. Findings of fact "3(c)" and "4(c)" have been deleted. The Administrative Law Judge's findings of fact and the modified findings of fact are set forth below.

1(a). Petitioner Queenstraw, Inc. is a retail clothing store selling moderately priced women's casual clothing. It is located in Forest Hills, Queens and does business under the name of "Strawberry." It is part of a chain of 40 stores.

(b). Petitioner Alan Ades is president of Queenstraw and petitioner Albert Erani is its secretary-treasurer. Their responsibility as officers for the tax due from Queenstraw, Inc. has not been contested.

(c). Petitioner's[1] stock is seasonal in nature. Its mark-up is typically about 100 per cent, but it has mark downs to prices as low as one-third of cost.

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[1]When petitioner is referred to in the singular, the reference is to Queenstraw, Inc.

We modify finding of fact "2(a)" of the Administrative Law Judge's determination to read as follows:

> 2(a). Petitioner has three cash registers. These are computer point-of-sale machines. Each cash register ties into a main computer at petitioner's home offices. Each time an item is sold, the cash register prints out two tapes. One tape is given to the customer and the other is an internal tape retained, for a time, by petitioner. Petitioner keeps the internal register tape for its internal audit of daily sales, and then discards the register tape. The store's cash receipts and journals were, during the audit period, manually written up based on the daily sales summaries. There is no evidence that petitioner ever informed the auditor that its cash registers were "computer point-of-sale machines" or that these registers were tied to a mainframe at petitioner's home offices.[2]

We modify finding of fact "2(b)" of the Administrative Law Judge's determination to read as follows:

> (b). At the end of the day, the store manager balances the registers and summarizes the transactions. He makes a daily bank deposit of the cash.[3]

We modify finding of fact "2(c)" of the Administrative Law Judge's determination to read as follows:

> (c). At the end of each day, the home computer "polls" (i.e., the home office computer, at that point in time, electronically connects with the cash registers themselves) the cash registers of each of its stores to determine their total sales and categories of sales. The internal cash register tapes are used by petitioner to verify its other sales records and are then discarded.[4]

(d). The main computer tracks sales and calculates inventory. It is also a security system controlling "shrinkage" of inventory in each location and department. Petitioner's CPA found that he could trace a sale from inception right through to the general ledger.

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[2] This fact was modified to accurately reflect the evidence in the record.

[3] We modified this finding of fact by deleting the last sentence of the Administrative Law Judge's finding of fact which was unsupported by the record.

[4] We modified this finding of fact to accurately reflect the testimony of petitioner's accountant.

We modify finding of fact "3(a)" of the Administrative Law Judge's determination to read as follows:

> 3(a). The auditor noted that gross sales per petitioner's general ledger were not in agreement with sales
>
> reported on its Federal income tax and sales tax returns.[5]

We modify finding of fact "3(b)" of the Administrative Law Judge's determination to read as follows:

> (b). The auditor sent out an appointment letter, dated May 13, 1991, which included a request for books and records. It requested: "[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. Exemption certificates not made available may be disallowed in which case you will be held liable for the tax on the transaction." Furthermore, attached to the appointment letter is a list of records requested and it notes that "[a]dditional information and records may be required" (see, exhibit "N"). The audit report shows that additional requests for records were made on June 4, 1991 and September 17, 1991.
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> Petitioner did not provide the cash register tapes or copies of sales invoices since petitioner's representative stated that Queenstraw did not maintain such records. There was no documentation presented to establish each sales transaction at the time of the sale showing the amount of the sale and the separately stated tax paid. Petitioner did provide to the auditor corporate tax returns, a general ledger and sales tax returns. Petitioner's sales tax returns were prepared using the amount of petitioner's bank deposits.[6]

4(a). The auditor's computation of the tax due began with a list of prices from a random selection of items exhibited in the store. This was done for one day, September 13, 1991. There was no attempt to select items that reflected the proportion of items actually sold by the store. The prices recorded were those on the price tags, as reduced by any further mark down on that day. These prices were compared with costs computed from petitioner's books.

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[5] We modified this finding of fact to accurately reflect the testimony of petitioner's accountant.

[6] We modified this finding of fact by incorporating the relevant portions of the Administrative Law Judge's finding of fact "3(d)" and by adding additional facts in order to accurately reflect the record.

(b). The auditor sampled 31 items. Seven items were priced below $10.00 and the remainder were $10.00 and above and the median price was $25.00. She grouped the items into profitable items and loss items. Loss items were 9.67% of total sales. She calculated a mark-up of 111.98% on the profitable items and a mark down of 67% on the loss items.

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

> 4(d). The audit did not take into account "shrinkage." Petitioner has estimated its shrinkage to be 2.3% to 3.0% of its inventory although there was no explanation for how these percentages were derived.[7]

(e). Petitioner's own test of its overall markup was 88%. This test used a sample of actual sales made. The workpapers for this test are not in evidence.

5. The notice of determination in each case finds an amount due of $19,396.00, plus interest and penalty. The amount due is composed of $399.00 for use tax on fixtures and equipment, $6,614.00 for unsubstantiated exempt sales and $12,383.00 for unreported gross sales. The amounts determined for use tax and for unsubstantiated exempt sales were not contested at the hearing.

OPINION

In his determination below, the Administrative Law Judge stated that, from his review of the record, there was only one issue before him which was whether petitioners' records from computer point-of-sale cash registers were "source documents." The Administrative Law Judge concluded that these records were, in fact, source documents. He reasoned that all entries into the computer system originate simultaneously with the single entry on the cash register made at the time of the sales transaction. Therefore, the Administrative Law Judge concluded that the Division of Taxation (hereinafter the "Division") erred by not considering these records as source documents and the Division was not entitled to resort to an indirect audit method in this case.

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[7] We modified the last sentence of this finding of fact to note that the claimed shrinkage percentages were not supported by any substantiation.

The Administrative Law Judge also noted that the Division, for the first time in its brief, raised the argument that the computer records at issue were inadequate for the reason that they failed to establish each individual sale.[8] Therefore, the Administrative Law Judge reasoned that this issue was not properly before him for consideration. Accordingly, the Administrative Law Judge reduced the notices of determination by $12,383.00 which was the tax asserted on unreported gross sales.

On exception, the Division argues that petitioners' books and records were inadequate in order to conduct a detailed audit. Therefore, it was proper for the auditor to resort to an indirect audit method to estimate the tax due. The Division argues that the markup test of petitioners' purchases was a reasonable method and petitioners have failed to demonstrate that the method was unreasonable.

Moreover, the Division asserts that the penalty imposed pursuant to Tax Law § 1145(a)(1)(i) was proper and that petitioners have failed to establish reasonable cause in order for the penalty to be abated.

In response, petitioners argue that the Administrative Law Judge correctly determined that the point-of-sale computer record was a source document. Petitioners argue that the computer data recorded and stored the total daily sales subject to tax with a breakdown of the type of item sold, method of payment and summarized all daily transactions.

Petitioners assert that if their records are found to be inadequate, the Division's audit methodology was flawed, arbitrary, irrational and inaccurate. Petitioners state that the number of items employed in the markup test was insufficient, that the selection of only one day to use for the markup test was inadequate, that the items chosen for the markup test were chosen at random

[8]In his determination, the Administrative Law Judge found that this issue was not properly before him since it was not raised at the hearing. This conclusion is in error. Both parties to this proceeding framed the issues at the beginning and conclusion of the hearing and they agreed that this case involved whether petitioners' books and records were adequate and, if not, whether the audit method employed by the Division was unreasonable. In determining whether petitioners maintained adequate books and records, it is necessary to address whether the records maintained were sufficient to verify all transactions (see, Tax Law § 1135[a]). Accordingly, the argument made by the Division was properly before the Administrative Law Judge for consideration.

without any consideration given to the percentage of total sales represented by the various categories, that the auditor failed to account for seasonality, that the auditor failed to account for shrinkage, that petitioners did not consent to the methodology used by the auditor and that the auditor had never conducted a markup test prior to this case.

We reverse the determination of the Administrative Law Judge.

Tax Law § 1138(a)(1) provides, in part, that if a return required to be filed is incorrect or insufficient, the amount of tax due shall be determined based on such information as may be available including, if necessary, an estimation based on external indices. However, the Division may not utilize external indices unless it first determines that the taxpayer's books and records are inadequate for purposes of verifying sales and purchases subject to sales and use taxes (Matter of Chartair, Inc. v. State Tax Commn., 65 AD2d 44, 411 NYS2d 41). To determine the adequacy of a taxpayer's records, the Division must first request (Matter of Christ Cella, Inc. v. State Tax Commn., 102 AD2d 352, 477 NYS2d 858) and thoroughly examine (Matter of King Crab Rest. v. Chu, 134 AD2d 51, 522 NYS2d 978) the taxpayer's books and records for the entire period of the proposed assessment (Matter of Adamides v. Chu, 134 AD2d 776, 521 NYS2d 826, lv denied 71 NY2d 806, 530 NYS2d 109). In this case, as noted in the findings of fact, the Division properly made a request for books and records. After examining the books and records produced, the auditor determined that they were inadequate in order to conduct a detailed audit. We agree.

Petitioners asserted at hearing that they maintained daily sales reports which recorded and stored the total daily sales subject to tax. They argue that these reports are source documents. Petitioners argue that the auditor should have relied on these reports for her audit. However, these records were not produced on audit. The auditor testified that she had never seen these documents. Furthermore, petitioners' accountant testified that these documents were not initially available for review by the auditor. Moreover, petitioners failed to introduce such documents into the record to support their position that the daily sales reports were available for the entire audit period. As noted above in the findings of fact, petitioners did not maintain cash register tapes or sales invoices. Based upon the information provided to the auditor, we agree that the individual

sales transactions were not verifiable. Accordingly, the Division could properly resort to a methodology for estimating petitioners' taxable sales (Oak Beach Inn Corp. v. Wexler, 158 AD2d 785, 551 NYS2d 375; Matter of Dels Mini Deli, Tax Appeals Tribunal, April 18, 1993, confirmed Matter of Dels Mini Deli v. Tax Appeals Tribunal, 205 AD2d 989, 613 NYS2d 967).

Since we have found that resort to an indirect audit method was proper, it is necessary to determine whether petitioners proved that the method selected by the Division was unreasonable. Petitioners argue that since the auditor chose to conduct a markup test in September, the results are inherently skewed since the month of September is the time of the year when petitioners' prices are the highest. Moreover, petitioners argue that the number of items selected as well as the fact that the markup test utilized only one day is not as accurate an indication of sales as if the auditor chose a selection of items that reflected a proportion of items actually sold by petitioners and if the markup test was conducted using several days. Petitioners also allege that the auditor never took into account shrinkage in her calculations.

It is well established that where a taxpayer has failed to maintain accurate, complete and verifiable books and records, exactness in the audit result is not required and the consequences of a taxpayer's recordkeeping failures will weigh heavily against it (Matter of Meskouris Bros. v. Chu, 139 AD2d 813, 526 NYS2d 679).

With respect to the claimed percentages attributable to shrinkage, petitioners provided absolutely no basis for their figures. Moreover, although conducting a markup test over several more days may have provided a better estimate of tax due, it would still result in being an estimate. Petitioners cannot meet their burden to prove the Division's audit methodology unreasonable by substituting their own estimate in place of the Division's estimate (see, Matter of Vebol Edibles, Tax Appeals Tribunal, January 12, 1989, confirmed Matter of Vebol Edibles v. Tax Appeals Tribunal, 162 AD2d 765, 557 NYS2d 678, lv denied 77 NY2d 803, 567 NYS2d 643). Therefore, we conclude that petitioners have failed to establish that the methodology employed was unreasonable.

Finally, the Division argues that petitioners have not demonstrated reasonable cause for the abatement of penalty in this case.

Tax Law § 1145(a)(1)(i) states, in pertinent part, as follows:

> "[a]ny person failing to file a return or to pay or pay over any tax to the [tax commissioner] within the time required by or pursuant to this article . . . shall be subject to a penalty of ten percent of the amount of tax due if such failure is for not more than one month, with an additional one percent for each additional month or fraction thereof during which such failure continues, not exceeding thirty percent in the aggregate."

However, this penalty can be abated if such failure or delay was due to reasonable cause and not due to willful neglect (Tax Law § 1145[a][1][iii]). Since petitioners failed to introduce any evidence to establish reasonable cause, the penalty is sustained.

Accordingly, it is ORDERED, ADJUDGED AND DECREED that:

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

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

3. The petitions of Queenstraw, Inc., Albert Erani, Officer of Queenstraw, Inc. and Alan Ades, Officer of Queenstraw, Inc. are denied; and

4. The notices of determination are sustained in full.

DATED: Troy, New York
March 27, 1997

/s/Donald C. DeWitt
Donald C. DeWitt
President

/s/Joseph W. Pinto, Jr.
Joseph W. Pinto, Jr.
Commissioner