

STATE OF NEW YORK
DIVISION OF TAX APPEALS

In the Matter of the Petition :
of :
WEST GAIETY CORPORATION : DETERMINATION
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 June 1, 1977 :
through February 29, 1980. :

Petitioner, West Gaiety Corporation, c/o Steven M. Coren, 8 West 40th Street, New York, New York 10018, filed a 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 June 1, 1977 through February 29, 1980 (File No. 800826).

A hearing was commenced before Jean Corigliano, Hearing Officer, at the offices of the State Tax Commission, Two World Trade Center, New York, New York, on December 11, 1986 at 9:45 A.M., and continued to conclusion on June 18, 1987 at 11:30 A.M., with all briefs to be filed by January 15, 1988. Petitioner appeared by Steven M. Coren, Esq. The Audit Division appeared by John P. Dugan, Esq. (Michael B. Infantino, Esq., of counsel).

ISSUES

I. Whether petitioner was entitled to apply for a tax refund under the refund provisions set forth at Tax Law § 1139.

II. Whether petitioner maintained adequate books and records from which the Audit Division could determine the exact amount of tax due for the audit period.

III. Whether, if adequate books and records were available, petitioner consented to the use of a test period and markup of purchases audit to determine its tax liability.

IV. Whether, if adequate books and records were not maintained, petitioner established either that the audit method was flawed or that the amount of tax assessed was erroneous.

FINDINGS OF FACT

1. Petitioner, West Gaiety Corporation ("West Gaiety"), operated a restaurant and delicatessen where it served prepared foods, alcoholic and nonalcoholic beverages and carry-out foods, such as cold cuts and fruits.

2. The restaurant was managed by West Gaiety's president, Lewis Feldman. Since Mr. Feldman was often unable to be present at the restaurant, he hired an accountant to establish a recordkeeping system, to maintain books and records and to prepare tax returns. The restaurant's employees prepared numbered guest checks for all restaurant sales. A cashier recorded the amounts shown on the guest checks on a cash register which produced a tape. The register had a separate key for sales tax. Guest checks were not prepared for over-the-counter sales of carry-out items, such as cold cuts and fruits. These sales were rung up directly on the register. At the end of each day, totals were taken from the cash register tape, which separately recorded food sales, liquor sales and sales tax. These totals plus cash payments made from the day's cash receipts were recorded in a daily book. A reconciliation was made between cash in the register and the totals recorded on the register tape. Cash receipts were deposited into one bank account and sales taxes were deposited into another. On a monthly or quarterly basis, the accountant, or one of his employees, would summarize the daily sheets, reconcile these summaries with bank statements and record the summaries in a cash receipts book. The guest checks were retained for several months and then discarded. The cash register tapes were maintained, but for how long and in what condition are not known.

3. An audit of West Gaiety was begun in April 1980, when a letter was sent arranging an appointment between Mr. Feldman and a tax auditor. During the following four months, there was a series of meetings and conversations between the auditor and either Mr. Feldman or West Gaiety's accountant. The auditor requested, and was provided with, sample menus, selling prices of alcoholic beverages, Federal and State income tax returns, a cash receipts journal, a check disbursements journal, purchase invoices for March, April and May 1980, and monthly bank statements. The auditor requested guest checks for the period December 1, 1978 through

February 29, 1980. He was told that guest checks were kept for only three to six months; therefore, they were not available for the entire period requested.

4. From an analysis of the records made available to him, the auditor concluded that petitioner's sales and purchases, as shown in its records, were greater than reported on its Federal and State income tax returns and its sales tax returns. Because of this and because guest checks were not available for the audit period, the auditor determined the need for a test period audit. The auditor conducted three different analyses.

(a) The auditor examined petitioner's claimed nontaxable sales for the month of February 1980. These consisted of sales to exempt organizations and over-the-counter sales of cold cuts and other food items petitioner considered to be exempt from sales tax. Guest checks were not prepared for such items. Petitioner determined its own taxable and nontaxable sales by reference to its register tapes. If sales tax was recorded, the item was deemed to be taxable. If sales tax was not recorded, the item was deemed to be nontaxable. Petitioner had some exempt organization certificates on file, but sales to such organizations were not separately stated. Since petitioner's records were not sufficiently detailed to allow an independent determination of the taxable status of each sale, the auditor disallowed 75 percent of petitioner's claimed nontaxable sales for the test period.

(b) The auditor examined petitioner's recurring expense purchases such as straws and napkins for the period November 1, 1978 through February 28, 1979 and determined that sales taxes had not been paid on these items.

(c) A markup test was conducted for April and May 1980. Using petitioner's purchase invoices, selling prices provided by petitioner, and his own auditing experience, the auditor estimated petitioner's taxable sales for the audit period and determined that petitioner had underreported sales.

5. The auditor asked that Mr. Feldman execute a Consent Extending the Period of Limitation for Assessment of Sales and Use Taxes. Because a consent was not received, on September 19, 1980, the Audit Division issued to petitioner a Notice of Determination and

Demand for Payment of Sales and Use Taxes Due for the period June 1, 1977 through November 30, 1977, assessing tax of \$44,230.00 plus interest. The tax assessed was calculated on the basis of the auditor's examination of petitioner's records as described above, but the notice was issued solely for the purpose of assessing a tax within the three-year period required by the statute of limitations found at Tax Law § 1147(b). Petitioner's accountant was so informed and was told that he would have an opportunity to contest the assessment before it became final. Nonetheless, petitioner formally protested the tax assessment by letter dated October 8, 1980.

6. On or about November 25, 1980, the auditor sent Mr. Feldman a Statement of Proposed Audit Adjustment, asserting sales and use taxes due for the period June 1, 1977 through February 28, 1980 in the amount of \$47,174.56 plus penalty and interest.

7. Petitioner disagreed with the audit results and engaged the services of a second accountant to represent West Gaiety in its contacts with the Audit Division. Several meetings and discussions were held, with Mr. Feldman, the new accountant, the auditor and the auditor's supervisor participating. At these meetings, petitioner presented its case for recomputation of the tax assessment. Primarily, petitioner argued that insufficient allowances had been made for nontaxable sales and sales to exempt organizations, food spoilage and shrinkage from cooking, food given to customers without charge (such as pickles placed on each table and refills of coffee), customer and employee theft, employee meals, discounts given to theatrical groups, employee discounts and sales of liquor by the bottle. As a result of these discussions and of documents produced by petitioner, the auditor made several adjustments to his previous calculations.

(a) Corrections were made to the auditor's categorization of food, beer and liquor purchases.

(b) The auditor recalculated petitioner's average beer and liquor markups and arrived at a markup of 210 percent for beer and 496.7 percent for liquor. The prices used to calculate the markups were estimates based on menu prices and prices provided by petitioner.

(c) The markup on food was reduced to 175 percent. This figure was intended to give

some allowance for many of the unquantifiable claims made by petitioner, such as price discounts to certain customers.

(d) Food purchases were reduced by \$45,252.00 as an allowance for employee meals.

(e) An allowance of one-half percent was applied to purchases to account for food spoilage and theft.

(f) It was agreed that purchases of beer and liquor should be reduced by 10 percent as an allowance for discounted sales to employees.

(g) The disallowance of claimed nontaxable sales was reduced to 25 percent.

(h) It was established that petitioner paid all sales taxes on recurring expense purchases and fixed asset purchases; therefore, no tax was assessed on this basis.

8. Using West Gaiety's purchase records and the markups and allowances described above, the auditor calculated total taxable sales for the audit period of \$1,875,761.00. This figure was reduced by reported taxable sales and allowed nontaxable sales (75 percent of the amount reported on petitioner's returns), and increased by sales of alcoholic beverages purchased by employees at cost. This resulted in unreported taxable sales of \$199,915.00. The latter figure was divided by reported taxable sales of \$1,625,578.00 to calculate an error rate of .123. Petitioner's reported taxable sales of \$1,494,478.00 for the quarters within the period of limitation on assessment,¹ were increased by the error rate, resulting in adjusted taxable sales for the audit period of \$1,678,300.00. A tax rate of 8 percent was applied to taxable sales per quarterly period to determine sales tax due for the period June 1, 1977 through November 30, 1977 of \$2,304.04 and for the period March 1, 1978 through February 29, 1980 of \$11,623.37.

9. On June 10, 1981, petitioner, by its president, executed a consent extending the period of limitation for assessment of sales and use taxes for the period June 1, 1977 through February 29, 1980 to December 20, 1981.

¹The taxable period December 1, 1977 through February 28, 1978 was not included in the assessment because it was barred by the three-year statute of limitations found at Tax Law § 1147(b).

10. On June 17, 1981, petitioner, by its president, executed a Consent to Fixing of Tax Not Previously Determined and Assessed for the period June 1, 1977 through February 29, 1980 in the amount of \$13,927.41.

11. On or about September 8, 1981, the Audit Division issued a Notice of Assessment Review reducing the tax assessed for the period June 1, 1977 through November 30, 1977 to \$2,304.04 plus interest.

12. On September 25, 1981, the Audit Division issued a Notice and Demand for Payment of Sales and Use Taxes Due for the period March 1, 1978 through February 29, 1980, assessing tax due of \$11,623.37 plus interest.

13. On August 5, 1982, West Gaiety filed an Application for Credit or Refund of State and Local Sales or Use Tax, claiming a refund of \$17,165.89 for the periods June 1, 1977 through November 30, 1977 and December 1, 1977 through February 28, 1980. West Gaiety based its claim for refund on its contention that the use of a test period and markup audit was barred by the Appellate Division's decision in *Matter of Chartair, Inc. v. State Tax Commission* (65 AD2d 44).

14. By letter dated October 24, 1985, the Audit Division denied West Gaiety's application for a refund.

15. The Audit Division's accounts receivable system shows that West Gaiety fully satisfied all liability resulting from the notice and demand issued on September 25, 1981. However, a balance of \$1,840.54 remains due and owing on the liability resulting from the notice of determination issued on September 19, 1980 and revised on September 8, 1981.

16. Petitioner submitted 28 proposed findings of fact. Proposed findings of fact "1", "3", "6", "10", "13", "14", "15", "16", "23", "24" and "28" were substantially incorporated into this determination. The remainder were rejected as not relevant to the determination, not supported by evidence in the record, containing conclusions as well as facts, or some combination of the three. The proposed findings were not stated with sufficient particularity to allow individual statements of the basis upon which each was rejected.

SUMMARY OF PARTIES' POSITIONS

17. The Audit Division asserts that petitioner failed to maintain adequate books and records; and therefore, it was warranted in resorting to a test period audit and a markup of purchases to determine West Gaiety's tax liability. Alternatively, it maintains that West Gaiety consented to the markup of purchases in lieu of a complete audit of its books and records. Finally, the Audit Division argues that Tax Law § 1139(c) requires that a taxpayer fully satisfy all amounts assessed in accordance with a consent to fixing of tax before that taxpayer is entitled to apply for any refund or credit. Since petitioner owes a balance of \$1,840.54 of the amount so assessed, the Audit Division asserts that its refund claim is prohibited.

18. West Gaiety asserts that pursuant to Tax Law § 1139(c) it was entitled to apply for a refund of all tax paid. Furthermore, it is West Gaiety's position that the Audit Division had no authority to resort to a test period audit or to determine the tax due from a markup of purchases because: (1) adequate records were available from which the exact amount of tax due could have been calculated, and (2) petitioner did not knowingly consent to the use of a test period audit. Petitioner characterized the audit as arbitrary and capricious. It maintained that the markup percentages were arbitrarily selected and did not reflect West Gaiety's actual prices. Furthermore, petitioner objected to the Audit Division's failure to grant larger allowances for nontaxable sales, theft, spoilage and shrinkage of food, employee meals and similar items.

CONCLUSIONS OF LAW

A. Pursuant to the provisions of Tax Law § 1138(a)(1), when the Audit Division makes a determination of tax due, notice of that determination must be given to the person liable for the payment or collection of that tax. "Such determination shall finally and irrevocably fix the tax unless the person against whom it is assessed, within 90 days after giving of notice of such determination, shall apply to the tax commission for a hearing..." (Tax Law § 1138[a][1]). The statute also provides an alternative avenue by which a taxpayer may fix the tax due.

"A person liable for collection or payment of tax (whether or not a determination assessing a tax pursuant to subdivision (a) of this section has been issued) shall be entitled to have a tax due finally and irrevocably fixed prior to the ninety-day period referred to in subdivision (a) of this section, by filing with the tax commission a

signed statement in writing, in such form as the tax commission shall prescribe, consenting thereto" (Tax Law § 1138[c] [emphasis supplied]).

Petitioner filed such a consent, purportedly covering two taxing periods: one period for which a notice of determination had been issued and one period for which a notice and demand (as opposed to a notice of determination) was subsequently issued. The clear wording of the statute establishes that a taxpayer is entitled to fix his tax liability through the execution of a consent, whether or not a notice of determination has been issued. But if the notice of determination has been issued, the consent must be filed within 90 days after giving of such notice.

The consent at issue was not filed by petitioner until June 17, 1981, approximately nine months after a notice of determination for the period June 1, 1977 through November 30, 1977 was issued. To the extent that the consent purported to encompass this period, it is null and void. Since petitioner protested the notice of determination issued on September 19, 1980 within the 90 day period required by Tax Law § 1138(a)(1), it was entitled to a hearing to challenge the assessment. Furthermore, by a notice of assessment review, the Audit Division reduced the amount of tax assessed for the period June 1, 1977 through November 30, 1977 to \$2,304.04 plus interest.

B. Subject to the restrictions contained in Tax Law § 1139(c), petitioner was entitled to request a refund of tax paid for the period March 1, 1978 through February 29, 1980.

"[A] person filing with the tax commission a signed statement in writing, as provided in subdivision (c) of section eleven hundred thirty-eight, before a determination assessing tax pursuant to subdivision (a) of section eleven hundred thirty-eight is issued shall, nevertheless, be entitled to apply for a refund or credit pursuant to subdivisions (a) and (b) of this section, as long as such application is made within the time limitation set forth in such subdivision (a) or within two years of the date of payment of the amount assessed in accordance with the consent filed, whichever is later, but such application shall be limited to the amount of such payment (Tax Law § 1139[c] [emphasis added]).

The emphasized portion of the statute supports the Audit Division's position that payment must be made in an amount equal to the amount assessed pursuant to a consent, including tax, penalty and interest, before a taxpayer is entitled to apply for refund or credit.

The records of the Audit Division establish that petitioner fully paid all amounts assessed for the period March 1, 1978 through February 29, 1980, in accordance with the consent

executed on June 17, 1981. Therefore, petitioner was entitled to apply for a refund for that period.

C. The Tax Law imposes a tax on the sale of food and drinks by restaurants (Tax Law § 1105[d][i]). The vendor of food and drinks is required to collect this tax on behalf of the State, and the burden of proof is placed on the taxpayer to show that any particular item of food or drink is not taxable (Tax Law § 1132[c]). The vendor is obligated "to keep records of every sale...and of all amounts paid, charged or due on each sale" (Tax Law § 1135[a]). Those records are to be kept for a period of three years (20 NYCRR 533.2[a][3]). Where records of individual sales are not maintained, or where, upon examination, the records are found to be insufficient to verify reported taxable sales, the Audit Division is required to determine the amount of tax due from such information as may be available; if necessary, the tax may be estimated on the basis of external indices (Tax Law § 1138[a][1]; Matter of Carmine Restaurant v. State Tax Commn., 99 AD2d 581). When conducting an audit, the Audit Division may not simply ignore a taxpayer's records, if the records provide an adequate basis on which to determine the amount of tax due (Matter of Chartair, Inc. v. State Tax Commn., 65 AD2d 44). However, in the absence of adequate records, the Audit Division is authorized to select a method reasonably calculated to reflect the taxes due, and it is then incumbent upon petitioner to show by clear and convincing evidence that the amount of tax assessed or the method employed was erroneous (Matter of Surface Line Operators Fraternal Org. v. Tully, 88 AD2d 858, 859).

D. Petitioner's primary sales records did not provide sufficient detail to independently determine the taxable status of each sale and the amount of tax due and collected on that sale. Guest checks were retained for a period of only three to six months, and they were not prepared for sales deemed by petitioner's employees to be nontaxable. Since there was no way for an auditor to determine whether each individual sale was rung up on the register or whether petitioner's employees accurately determined the taxable status of each sale, the guest checks, register tapes and daily book were useless for audit purposes (see Matter of Licata v. Chu, 64 NY2d 873). These facts alone warranted the Audit Division's resort to a markup of purchases to

determine petitioner's tax liability. Petitioner's insistence that the discrepancy between its sales records and its income tax returns is explained by the fact that the former were kept on a cash basis while the latter were kept on an accrual basis is rendered irrelevant by the fact that its records of individual sales were patently defective.

E. Since petitioner's records were inadequate, the Audit Division was not required to obtain petitioner's consent to a test period and markup audit. Furthermore, there is ample precedent for the use of such methods where adequate records are not available (e.g. _____, *Matter of Korba v. New York State Tax Commn.*, 84 AD2d 655, 656; *Matter of Murray's Wines and Liquors v. State Tax Commn.*, 78 AD2d 947; *Matter of Sakran v. State Tax Commn.*, 73 AD2d 989).

F. The final tax deficiencies assessed by the Audit Division were based upon petitioner's purchase records and various prices, allowances and markup percentages derived from petitioner's records and from discussions between the parties. As no records were produced of discounts to regular patrons, sales to exempt organizations, theft, food spoilage or any of the other factors upon which adjustments were claimed, petitioner did not carry its burden of proof to show that the markups were too high or that insufficient allowance was given for nontaxable sales.

G. The petition of West Gaiety Corporation is denied and the Audit Division's denial of refund is affirmed.

DATED: Albany, New York
April 14, 1988

ADMINISTRATIVE LAW JUDGE