

STATE OF NEW YORK

DIVISION OF TAX APPEALS

In the Matter of the Petition :
of :
MICHAEL T. WAPLES : DETERMINATION
D/B/A JACK'S 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 :
September 1, 1981 through February 28, 1985. :

Petitioner, Michael T. Waples d/b/a Jack's Restaurant, 117 Main Street, Vestal, New York 13850, 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 September 1, 1981 through February 28, 1985 (File No. 802575).

A hearing was held before Timothy J. Alston, Administrative Law Judge, at the offices of the Division of Tax Appeals, 164 Hawley Street, Binghamton, New York, on May 25, 1988 at 9:15 A.M., with all briefs to be submitted by August 12, 1988. Petitioner appeared by Frederick A. Griffen, Esq. The Audit Division appeared by William F. Collins, Esq. (Deborah J. Dwyer, Esq., of counsel).

ISSUES

I. Whether the Audit Division properly assessed additional tax due, determined, in part and in the absence of books and records, by information provided by petitioner's beer and liquor suppliers.

II. Whether the Audit Division properly resorted to external indices to determine additional tax due for an extended period of audit in the absence of a request for records.

III. Whether the Audit Division has met its burden of proof to show that its imposition of the fraud penalty pursuant to Tax Law § 1145(a)(2) was proper.

IV. If not, whether the Audit Division may assert, at hearing, as an alternative to the fraud penalty, penalty pursuant to Tax Law § 1145(a)(1) for failure to timely file sales tax returns or timely pay sales tax.

V. If so, whether the Audit Division has met its burden to show that imposition of the Tax Law § 1145(a)(1) penalty was proper.

FINDINGS OF FACT

1. On July 15, 1985, following an audit, the Audit Division issued to petitioner, Michael T. Waples d/b/a Jack's Restaurant, a Notice of Determination and Demand for Payment of Sales

and Use Taxes Due for the period September 1, 1981 through February 28, 1985 which assessed \$46,482.79 in tax due, plus fraud penalty pursuant to Tax Law § 1145(a)(2) and interest.

2. During the period at issue petitioner owned and operated Jack's Restaurant, a neighborhood bar and restaurant. Petitioner was the sole proprietor of Jack's. The restaurant portion of the Jack's operation served a lunch/snack menu consisting of sandwiches, hamburgers, sausages, and chicken. During the months of June through October, Jack's operated an outdoor barbecue on its premises on which chicken, hamburgers, sausages, and "spiedies" were cooked and sold to customers. Picnic tables were set up outside. At the time the audit was conducted, petitioner had been in business for about 16 years, and he had, at that time, two part-time employees.

3. To commence the audit, the Audit Division mailed a letter to petitioner on September 28, 1984 which advised petitioner that his business was to be audited and set an appointment to meet with petitioner on October 4, 1984. On October 4, 1984 petitioner did meet with the Audit Division's representative and at that time advised her that his business had been burglarized on October 1, 1984. Stolen in the burglary, according to petitioner, was his file cabinet which contained all of his business records.

4. Petitioner reported the burglary to the Vestal Police, and, as part of that report, told the police that along with some cash, rolled coins and loose coins, the burglar had stolen his file cabinet containing his business records.

5. In the absence of records, the audit proceeded as follows:

a) Petitioner provided the Audit Division with the names of his beer and liquor suppliers during the audit period. These suppliers were, in turn, contacted by the Audit Division and subsequently provided the Division with information regarding petitioner's purchases during the period.

b) The Audit Division used the actual purchase figures provided by each of petitioner's suppliers to determine petitioner's beer and liquor purchases for each of the sales tax periods comprising the original audit period. For certain of the periods the information provided by the suppliers did not indicate any purchases by petitioner. For such periods the Audit Division estimated purchases by petitioner from that supplier by computing an average of petitioner's actual purchases from that supplier made in other periods.

c) Information provided by petitioner's beer and liquor suppliers indicated that petitioner made \$142,020.55 in actual purchases during the original audit period. In addition, the Audit Division determined that petitioner made \$11,475.35 in purchases from his suppliers during the same period, estimated as described above. Total audited purchases from beer and liquor suppliers was therefore \$153,495.90.

d) Petitioner also advised the Audit Division that each week he purchased approximately one case of liquor and 25 cases of beer at retail which were sold at Jack's. The Audit Division estimated such liquor purchases at \$80.00 per week and such beer purchases at \$200.00 per week.

e) The Audit Division then determined petitioner's retail selling prices of beer and liquor from information provided by petitioner. Petitioner advised the Division that he used 3/4 ounces of liquor in his drinks. The Audit Division estimated that 20% of petitioner's sales were made at

his happy hour prices and 80% at his regular prices. The Audit Division also made a 15% allowance for spillage.

f) Using the above information and detailed invoices which were supplied by two of petitioner's liquor suppliers the Audit Division developed a liquor markup of 404% of petitioner's cost. The Audit Division also developed a markup for beer of 144.88%. Petitioner's retail purchases of liquor and beer were also marked up pursuant to these percentages. These percentages were then applied to petitioner's audited purchases of beer and liquor, resulting in petitioner's audited taxable sales of liquor and beer for the period September 1, 1981 through August 31, 1984 of \$553,137.82 including sales tax.

g) With respect to outside food sales, the Audit Division, with petitioner's cooperation, determined petitioner's receipts from such sales for a 90-minute period (11:30 A.M. - 1:00 P.M.) on October 12, 1984. Petitioner tallied his receipts during this period and provided his list to the Audit Division. The receipts collected during the test period were determined to be outside food sales per day and were then projected over 5 days per week and 5 months per year throughout the original audit period. With respect to inside food sales, the Audit Division tested such sales for the week of October 29 through November 2, 1984. Petitioner retained guest checks for this period and based on these checks total receipts were \$330.75. This weekly total of inside sales was then projected throughout the original audit period. Inside and outside audited food sales for the period September 1, 1981 through August 31, 1984 amounted to \$63,661.50, including sales tax.

h) Petitioner's total audited taxable sales for the period September 1, 1981 through August 31, 1984 thus totaled \$576,447.96, after subtracting out sales tax.

6. On December 5, 1984, in response to an Audit Division inquiry, petitioner advised that his records which were reported stolen had not been recovered.

7. In April of 1985, the Audit Division updated the audit to include the period September 1, 1984 through February 28, 1985. Audited beer and liquor purchases for these two quarters were estimated based on audited purchases of the previous periods and were marked up in accordance with the percentages determined on audit. Audited food sales were estimated for these two quarters based upon audited food sales of the previous periods. The extension of the audit resulted in an additional \$105,413.25 in audited taxable sales and a total audited taxable sales figure of \$681,861.21 for the period September 1, 1981 through February 28, 1985. From this audited taxable sales amount, the assessment set forth in the notice of determination herein was calculated.

8. The Audit Division did not request records from petitioner prior to its extension of the audit to February 28, 1985.

9. Following a prehearing conference with petitioner's representative the Audit Division adjusted the deficiency herein to allow for one ounce of liquor in drinks served in Jack's during the entire audit period. This adjustment resulted in a markup on liquor purchases of 282 percent, and an adjustment of the tax deficiency herein to \$43,762.66.

10. Petitioner maintained no bank accounts of any kind during the audit period. As a result, he paid his suppliers and his employees in cash.

11. The sales tax audit herein was petitioner's first.

12. For the period September 1, 1981 through February 28, 1983 petitioner consistently filed his quarterly sales tax returns late. Petitioner filed these returns from about 1½ months to 5 months after their respective due dates, and reported on these returns taxable sales ranging from \$760.00 to \$1,155.00. Petitioner prepared, signed and filed these returns.

13. For the period March 1, 1983 through May 31, 1984 petitioner failed to file sales tax returns. In response to such failure, the Audit Division issued to petitioner delinquency assessments based upon his taxable sales reported on prior returns and increased by an arbitrary percentage. Petitioner paid the delinquency assessments issued in respect of these periods.

14. Petitioner filed returns for the period June 1, 1984 through November 30, 1984 and reported taxable sales of \$1,925.00 and \$3,006.00 for these periods. The record does not indicate whether these returns were timely filed.

15. With respect to the final period at issue herein, December 1, 1984 through February 28, 1985, no return was filed and no payment was made.

16. Petitioner did not file New York State personal income tax returns for the years 1982 or 1983. The record does not indicate whether income tax returns were filed for other years.

17. Petitioner did not file any withholding tax returns during the period at issue and paid no withholding tax over to the State.

18. Petitioner was cooperative with the Audit Division throughout the course of the audit.

19. Petitioner did not personally appear at the hearing in this matter.

20. At the commencement of the hearing, the Audit Division asserted, as an alternative to the fraud penalty, the penalty for failure to file a return or pay tax imposed under Tax Law § 1145(a)(1). This alternative penalty was not asserted in either the notice of determination or the Audit Division's answer. Petitioner's representative objected to this assertion of delinquency penalty.

21. At hearing the Audit Division introduced into the record purchase information obtained from petitioner's beer and liquor suppliers. As stated previously, from this information the Audit Division determined that petitioner had actually made purchases totaling \$142,020.55 from his beer and liquor suppliers for the original audit period at issue (Finding of Fact "5[c]"). Included in this information were detailed purchase invoices showing \$88,610.29 in beer purchases by petitioner from one of his beer suppliers and \$4,314.94 in purchases from two of petitioner's liquor suppliers during the audit period. The purchase information provided by petitioner's other suppliers consisted of summary purchase information or detailed information of uncertain origin.

CONCLUSIONS OF LAW

A. In the absence of records, the Audit Division properly resorted to external indices to determine tax due for the initial audit period of September 1, 1981 through August 31, 1984 (S.H.B. Supermarkets, Inc. v. Chu, 135 AD2d 1048). In such circumstances, the Audit Division must select a method of audit reasonably calculated to reflect tax due (Tax Law § 1138[a][1]; Matter of Grecian Square v. State Tax Commn., 119 AD2d 948), and the burden is on petitioner

to establish by clear and convincing evidence that both the method used to arrive at the tax assessment and the assessment itself are erroneous (Matter of Sol Wahba, Inc. v. State Tax Commn., 127 AD2d 943).

B. The audit method employed for the initial audit period was reasonably calculated to reflect tax due (see, Matter of Urban Liquors v. State Tax Commn., 90 AD2d 576; Matter of Korba v. State Tax Commn., 84 AD2d 655) and petitioner has failed to sustain his burden of showing error in either the method or the result. Petitioner contended that the audit was in error to the extent that it made no allowance for petitioner's inventory and assumed constant selling prices throughout the audit period. This challenge to the audit fails, for any imprecision in the audit method results from a complete absence of records and not from arbitrary and capricious conduct on the part of the Audit Division (Sol Wahba, Inc. v. State Tax Commn., supra).

C. The Audit Division's resort to external indices for the extended period of the audit (9/1/84 - 2/28/85) was improper. The Audit Division did not request records for this period. It is, therefore, impossible to determine the sufficiency of petitioner's records, and the use of external indices, i.e., audited sales for prior periods, was improper (Matter of King Crab Restaurant, Inc. v. Chu, 134 AD2d 51). The deficiency for the period September 1, 1984 through February 28, 1985 must therefore be cancelled (Matter of Adamides v. Chu, 134 AD2d 776, lv denied 71 NY2d 806; Matter of Anton's Car Care Center, Ltd., Tax Appeals Tribunal, November 23, 1988).

In reaching this conclusion, it is noted that the Audit Division used a week's worth of guest checks to determine petitioner's indoor food sales for the initial audit period. There is thus some evidence in the record indicating that petitioner had sales records for the period September 1, 1984 through February 28, 1985. The record is unclear as to whether petitioner had guest checks for the entire extension period or whether he had cash register tapes for this period. Indeed, the record is unclear as to whether petitioner even had a cash register. In any event, the request for records for the extended period was not made (see, Matter of Christ Cella, Inc. v. State Tax Commn., 102 AD2d 352); the above-noted factual issues remain unresolved; and the resort to external indices was therefore unjustified (Matter of Anton's Car Care Center, Ltd., supra).

D. In 1975, the New York Legislature added the so-called "fraud penalty" to the sales tax by adding section 1145(a) (former [2]) to the Tax Law. Section 1145(a) (former [2]) provided in pertinent part:

"If the failure to file a return or to pay over any tax to the tax commission within the time required by this article is due to fraud, there shall be added to the tax a penalty of fifty percent of the amount of tax due (in lieu of the penalty provided for in subparagraph (i) of paragraph one), plus interest...." (Emphasis added.)

The Legislature modeled the fraud penalty of section 1145(a) (former [2]) on the penalty provisions already existing with respect to deficiencies of, inter alia, income tax. (See, 1975 NY Legis Ann, at 350.) "The burden of showing fraud under section 1145(a)(2) has been consistently interpreted to reside with the [Audit] Division." (Matter of Ilter Sener d/b/a Jimmy's Gas Station, Tax Appeals Tribunal, May 5, 1988.)

E. "The standard of proof necessary to support a finding of fraud requires 'clear, definite

and unmistakable evidence of every element of fraud, including willful, knowledgeable and intentional wrongful acts or omissions constituting false representation, resulting in deliberate nonpayment or underpayment of taxes due and owing.' (See, Matter of Walter Shutt and Gertrude Shutt v. State Tax Commn., State Tax Commn., July 13, 1982.)" (Matter of Ilter Sener, supra.)

F. Upon review of the evidence presented, the Audit Division has met its burden of proving that the imposition of the fraud penalty was proper. The most important factor in reaching this conclusion is petitioner's consistent and substantial underreporting of taxable sales for the period September 1, 1981 through August 31, 1984 (see, Merrit v. Commr., 301 F2d 484 [5th Cir 1962]). To be considered evidence of fraud, the Audit Division must prove such underreporting by clear and convincing evidence (see, Matter of Cousins Service Station, Inc., Tax Appeals Tribunal, August 11, 1988). In this instance, the Audit Division has met its burden. Although the method used to determine petitioner's food sales and the estimates of petitioner's beer and liquor purchases from certain of his suppliers for certain periods were not affirmatively proven by the Audit Division, the balance of the deficiency herein was so proven and constitutes a consistent and substantial underreporting of sales. The Audit Division introduced into the record detailed purchase information from petitioner's beer and liquor suppliers which indicated \$4,314.94 in liquor purchases and \$88,610.29 in beer purchases during the audit period. Petitioner reported or acknowledged by payment of delinquency notices only \$14,815.00 in total sales over the same period. This underreporting appears to be of such a magnitude relative to reported (or acknowledged) sales that the inference which must be drawn is that petitioner knowingly and willfully underreported his taxable sales for the period at issue.

Additional factors which indicate a fraudulent intent on petitioner's part are petitioner's failure to maintain any bank accounts during the period at issue, the resulting absence of records of daily receipts deposits and "cash only" business dealings with suppliers and employees (see, Agnellino v. Commr., 302 F2d 797; Lusk v. Commr., 14 TCM 435, affd 250 F2d 591, cert denied 357 US 932); petitioner's failure to file sales tax returns for certain of the periods at issue and his late filing of returns for certain other of the periods at issue; and his failure to file withholding tax returns for the entire period (see, Bennett v. Commr., 30 TC 114).

G. In light of the determination reached herein in respect of the fraud issue, Issues IV and V are moot.

H. The petition of Michael T. Waples d/b/a Jack's Restaurant is granted to the extent indicated in Conclusion of Law "C"; the Audit Division is directed to modify the notice of determination and demand, as adjusted (Finding of Fact "9"), in accordance therewith; and, except as so granted, the petition is in all other respects denied.

DATED: Albany, New York
January 6, 1989

/s/ Timothy J. Alston
ADMINISTRATIVE LAW JUDGE