

STATE OF NEW YORK

DIVISION OF TAX APPEALS

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In the Matter of the Petition	:	
of	:	
NINA SPALLINA T/A NINA'S CORNER	:	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, 1984	:	
through February 28, 1987.	:	

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Petitioner, Nina Spallina T/A Nina's Corner, 133 McClean Avenue, Staten Island, New York 10305, 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, 1984 through February 28, 1987 (File Nos. 806651 and 806652).

A hearing was held before Arthur S. Bray, Administrative Law Judge, at the offices of the Division of Tax Appeals, Two World Trade Center, New York, New York on March 27, 1990 at 9:45 A.M., with all briefs to be submitted by June 18, 1990. Petitioner appeared by Murray Selman, C.P.A. The Division of Taxation appeared by William F. Collins, Esq. (Gary Palmer, Esq., of counsel).

ISSUES

I. Whether the audit methodology employed by the Division of Taxation was reasonably calculated to reflect tax due from petitioner.

II. Whether, if the audit methodology was reasonable, petitioner has established that the results obtained were incorrect.

FINDINGS OF FACT

The Division of Taxation ("Division") issued to petitioner, Nina Spallina, two notices of determination and demands for payment of sales and use taxes due dated February 24, 1988. One notice assessed tax due for the period June 1, 1984 through February 28, 1987 of

\$72,601.31 plus penalty and interest.<sup>1</sup> The other notice assessed an additional penalty of \$4,627.74 for the period June 1, 1985 through February 28, 1987.

Petitioner requested a conciliation conference with the Division to address both notices issued to her. By the issuance of a conciliation order dated December 23, 1988, the Division denied petitioner's request with regard to that notice which assessed tax due, on the ground that the request was not timely made. At hearing, the Division conceded that there were timely requests for a conciliation conference with regard to both notices, and it withdrew its contention that the Division of Tax Appeals lacked subject matter jurisdiction over these matters.

The audit of petitioner's business, Nina's Corner, began in May 1987. On May 21, 1987, two auditors visited Nina's Corner and found it to be a pizzeria, selling pizzas, sandwiches, calzones, and prepared dinners. The store was very small, but there were three tables and a counter to serve customers. There were three employees on the premises at the time of the auditor's visit. Apparently, the auditors did not identify themselves or speak with the employees at this time. The auditors obtained a copy of a menu showing prices of each item sold.

On or about May 27, 1987, the Division mailed a letter to petitioner scheduling an audit appointment and requesting books and records for the period June 1, 1983 through February 28, 1987, including: journals,

ledgers, sales invoices, purchase invoices, cash register tapes, exemption certificates and all other sales tax records. In addition, oral requests were made for petitioner's Federal income tax returns, bank statements, purchase invoices and cash register tapes. Petitioner's accountant provided the Division with records of bank deposits, Federal income tax returns and copies of 1986 purchase invoices. Petitioner's accountant informed the Division that he prepared petitioner's sales tax returns by estimating taxable sales as a percentage of gross sales.

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<sup>1</sup>On August 3, 1987, petitioner executed a consent extending the period of limitation for assessment of sales and use taxes for the period June 1, 1984 through November 30, 1984 to March 20, 1988.

Petitioner never furnished the Division with any records of individual sales.

During the course of the audit, petitioner's accountant informed the Division that Nina's Corner was operated as a combination delicatessen and grocery store during the audit period and that it was not operated as a full-time pizzeria. To test this statement, the auditor consulted yellow pages of the 1985 Staten Island telephone directory. He found a one-quarter page advertisement holding the business out as Nina's Pizzeria. According to the advertisement, Nina's sold small (14 inch), medium (16 inch) and large (19 inch) pizzas, complete dinners, soups, salads, calzones and hero sandwiches. Petitioner advertised her hours as 11:00 A.M. to midnight during the week and 4:00 P.M. to 11:00 P.M. on Sundays. She also offered free delivery and catering. Because of this advertisement, and because the business was not operated as a grocery at the time of the auditor's visit, the Division concluded that petitioner operated as a pizzeria throughout the audit period.

Other than the observation which took place on May 21, 1987, the Division's only contact with petitioner consisted of telephone calls between the auditor and petitioner's accountant and documents exchanged by mail.

The auditor who conducted this audit was supplied by the Division with a schedule of mozzarella cheese purchases made by petitioner. The schedule lists weekly purchases for the period December 5, 1985 through February 27, 1986. For each week, it shows an invoice number, total invoice amount, pounds of mozzarella cheese purchased, and the dollar amount of the cheese purchases. There are also columns on the schedule for flour purchases and pizza box purchases, but these columns are blank. The total invoice amounts for these periods was \$8,393.45, while total mozzarella cheese purchases amounted to \$7,266.28. The supplier is identified as C & F Dairy. The auditor who conducted this audit did not prepare this schedule and did not know how it was prepared.

The Division compared cheese purchases taken from petitioner's 1986 purchase invoices with the information provided by petitioner's supplier and concluded from this that the invoices

supplied by petitioner were incomplete.<sup>2</sup> Because of this and petitioner's failure to provide any records of sales, the Division decided to estimate petitioner's taxable sales using an indirect audit method.

The information from petitioner's supplier, showing that for the period December 1, 1985 through February 28, 1986, petitioner purchased

4,753 pounds of mozzarella at a cost of \$7,266.28, became the basis for a test period audit.

(a) The Division obtained a recipe for the commercial preparation of pizza at the public library. The recipe is published in Food Products Formulary, Vol. II, by Tressler and Sultan. It calls for 12 ounces of dough to be used with 3 ounces of mozzarella and other ingredients to make one pizza. The Division estimated that petitioner would use 8 ounces of mozzarella to make one medium sized (16 inch) pizza. The difference between the recipe and the Division's estimate was meant to give an allowance for waste, self-use, spoilage, the use of cheese in products other than pizza and other variables.

(b) The Division estimated that petitioner sold 9,506 medium sized pizzas in the test period by dividing the number of pounds of cheese purchased by petitioner by .5. The number of pizzas sold was multiplied by \$5.60, the price of a medium sized pizza as shown on the menu obtained by an auditor in May 1987, to estimate pizza sales for the test period of \$53,234.00.

(c) The Division estimated that sales of all other items (soda, sandwiches, dinners, etc.) were 25 percent of pizza sales, or \$13,308.00. Thus, total sales for the test period were estimated to be \$66,542.00.

Total taxable sales reported by petitioner for the same period were \$1,796.00. The

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<sup>2</sup>The extent of the difference is not established by the record. The supplier information shows cheese purchases of \$4,871.68 for the months of January and February 1986. The auditor testified that "purchases supplied by the vendor for the entire year 1986 for cheese, total \$25,646.90 (Transcript, p. 27). The Field Audit Narrative states that purchase invoices provided by petitioner totalled \$2,564.90 for the entire year. Since neither party offered the invoices themselves, or a schedule of the invoices, into evidence, this disparity cannot be reconciled.

difference between audited taxable sales and reported taxable sales was deemed to be additional taxable sales of \$64,746.00. An error rate of 36.05 was calculated by dividing additional taxable sales by reported taxable sales.

To determine petitioner's unreported taxable sales, the Division increased reported taxable sales for the audit period by the error rate, calculating total additional taxable sales of \$880,016.00 with a tax due on that amount of \$72,601.31.

Petitioner provided the Division with Federal income tax returns for the years 1983 through 1986. On the 1985 and 1986 return, petitioner identifies the main business activity of Nina's Corner as that of a grocery. Petitioner also supplied the Division with bank statements for the period June 14, 1983 through February 13, 1987. Generally, gross sales reported to New York State exceeded both gross receipts reported for Federal purposes and bank deposits. Federal gross receipts reported for 1984, 1985 and 1986 totaled \$128,551.00. Gross sales reported on sales tax returns for the period June 1, 1984 through February 28, 1987 totaled \$135,336.00. Bank deposits for the period June 15, 1983 through February 13, 1987 totaled \$111,147.00.

During the audit period, Nina's Corner operated as a combination grocery and delicatessen, selling cheese, tomato sauce, uncooked pizza dough, milk, newspapers and a few other small items, as well as prepared pizzas and sandwiches. It was located in a small building next door to the home of petitioner and her husband. The business's telephone and other utilities were connected to the home and billed as one account. A sign on the side of the building indicates that the business sold bread, milk, soda and bagels in addition to pizza. The space occupied by the business was approximately 11 feet by 15 feet. There were no tables or chairs on the premises. There was a counter and a large refrigerator where milk and other perishables were kept. There was only one pizza oven on the premises. Prepared pizzas and pizza slices were sold in the late afternoon and evening and were delivered by petitioner's husband in the family car. He delivered five to six pizzas per evening.

In January 1987, petitioner's son joined the business. At that time, a corporation, named

Spallina's Corner, Inc., was formed to operate the business, the inside of the building was renovated, tables and chairs were added, and the business discontinued its sales of grocery items and began selling dinners and other prepared foods exclusively. Beginning in March 1987, the corporation began filing sales tax returns under its own name, with a separate certificate of authority. Thus, the business was operated differently during the audit period than at the time the audit was conducted.

Petitioner opened her business in 1979 or 1980. She always planned to convert her business into a full-time pizzeria; therefore, she placed an advertisement in the yellow pages of the telephone directory, paying approximately \$400.00 per month for this service. She was convinced by a telephone company salesperson that it was essential to maintain this advertisement if she ever wanted to operate exclusively as a pizzeria.

During the audit period, petitioner purchased cheese from C & F Dairy for herself and for a Mr. Borillo. Mr. Borillo owned and operated a pizzeria in Philadelphia. He knew that he would be able to purchase cheese at a lower price from C & F than he could buy it in Philadelphia; however, C & F would not deliver to Philadelphia. An arrangement was worked out whereby C & F sales to Mr. Borillo were delivered to him at Nina's Corner. This arrangement benefitted petitioner as well because it allowed her to purchase cheese from C & F at a lower price than she would otherwise be able to do. C & F Dairy billed petitioner for all cheese delivered to her. The C & F invoices did not separately state the purchases made by Mr. Borillo; however, there were informal notations attached to the invoices, indicating the amounts of Mr. Borillo's purchases. Petitioner paid for all cheese delivered to her, and in turn, she was paid by Mr. Borillo in cash. Petitioner did not keep records of her transactions with Mr. Borillo. A letter from C & F indicates that four to five cases were delivered at a time for Mr. Borillo. Petitioner's son testified that each C & F bill had a piece of paper attached "saying that Borillo picked up three or four, or five cases of cheese that week" (transcript, p. 82). The schedule of information taken from petitioner's supplier indicates that there were weekly deliveries of cheese.

Petitioner's sales tax returns were prepared by her accountant, Murray Selman. They met at least once per quarterly period in her home or in the store. Apparently, all of petitioner's bills were paid in cash. He reviewed petitioner's bank statements, purchase invoices and any other records she had of cash payments. The accountant calculated petitioner's gross sales by adding together bank deposits, cash purchases and payments to petitioner and her husband. Based on what he was told by petitioner he estimated taxable sales to be approximately 20 percent of gross sales. Petitioner did not maintain any records of sales or complete records of purchases.

Mr. Selman was familiar with petitioner's business operations. In preparing tax returns, he reviewed some purchase invoices from C & F Dairy which included notations regarding purchases made by Mr. Borillo. He discussed the business operations with petitioner and her son. When petitioner's son decided to enter the business run by his parents, Mr. Selman advised him to form a corporation for the operation of the business. He also advised him to discontinue operating Nina's Corner as a grocery and part-time pizzeria, and to begin operating only as a pizzeria with a wider variety of menu items and with seating space on the premises. Based on his familiarity with the business, information supplied by petitioner and her son and his review of purchase invoices during the audit period, Mr. Selman calculated petitioner's cheese purchases and sales for the test period used by the Division. Purchases by Mr. Borillo from C & F Dairy amounted to 1,976 pounds for the test period. This was based on deliveries of four cases of cheese per week containing 38 pounds of cheese per case. Cheese sold in bulk as a grocery item totaled 1,560 pounds, or twenty pounds per day. Waste and self-use was estimated at 164 pounds of cheese for the test period. The balance of petitioner's cheese purchases, 1,053 pounds, was used as a basis to estimate pizza sales.

Mr. Selman estimated petitioner's sales for the audit period, again based on his own familiarity with the business and information provided by petitioner. He estimated that petitioner used approximately  $1\frac{1}{4}$  pounds of cheese per medium sized pizza. Dividing this into cheese purchased during the test period for use in making pizzas (1,053 pounds), he calculated

that petitioner sold 842.4 pizzas during the test period at a price of \$5.60 per pizza. Thus, pizza sales for the test period were computed to be \$4,718.00. Mr. Selman increased this amount by 15 percent to account for sales of soda and prepared sandwiches, thus estimating total taxable sales for the test period of \$5,426.00. He multiplied this number by 12 to estimate taxable sales for the audit period of \$65,112.00, with a tax due on this amount of \$5,371.74. For the audit period, petitioner reported taxable sales of \$24,411.00.

### CONCLUSIONS OF LAW

A. It is quite clear that petitioner failed to keep even minimal sales records from which her taxable sales receipts could be verified, as required by Tax Law § 1135(a)(1). Therefore, the Division was required to determine the tax due based upon the information which was available to it and was authorized to resort to external indices if necessary (Tax Law § 1138[a][1]). Where the taxpayer's records are so deficient, considerable latitude is given to the Division's method of estimating sales (Matter of Carmine Rest. v. State Tax Commn., 99 AD2d 581, 471 NYS2d 402). It is only necessary that the Division select an audit method reasonably calculated to reflect the tax due (Matter of Grant v. Joseph, 2 NY2d 196, 159 NYS2d 150, cert denied 355 US 869), and the burden is then placed on the petitioner to show "that the result of the method used was unreasonably inaccurate or that the amount of tax assessed is erroneous" (Matter of Meskouris Bros. v. Chu, 139 AD2d 813, 526 NYS2d 679, 681).

There is no question that a test period markup of purchases audit may be a reasonable way to determine taxable sales in the absence of verifiable records of sales (see, Matter of Zorba Endicott Restaurant Corp. v. Chu, 126 AD2d 820, 510 NYS2d 315; Matter of Korba v. State Tax Commn., 84 AD2d 655, 444 NYS2d 312, appeal den. 56 NY2d 502, 450 NYS2d 1073). Petitioner does not challenge the validity of such a methodology. Petitioner contends, however, that the methodology, as it was applied to her business, was unreasonable in that it failed to take into account her specific business practices. Petitioner proved, by clear and convincing evidence, that her business was operated differently during the audit period than at the time of



the audit. Specifically, the audit was premised on the presumption that the Nina's Corner was operated as a pizzeria selling those menu items shown on the menu obtained by the auditor in May 1987. Through the credible testimony of petitioner, her son and Mr. Selman, as well as through signs appearing on the face of the business premises, petitioner established that during the audit period her business operated primarily as a grocery which also sold prepared pizzas. The crucial fact here is that petitioner sold cheese as a grocery item; consequently, not all of her cheese purchases were used as a pizza ingredient. In addition, petitioner proved that purchase invoices showing sales to her included sales by C & F Dairy to Mike Borillo. In addition, petitioner argues that the Division failed to give adequate allowances for personal use and waste, and she contends that she used 1¼ pounds of cheese per pizza, rather than the eight ounces allowed by the Division.

B. It is important to emphasize that this audit was not premised on the statutory presumption that all sales are subject to tax until the contrary is established by the petitioner (Tax Law § 1132[c]). The case law interpreting section 1132(c) has held that this presumption can only be overcome with documentary evidence establishing not only the existence of nontaxable sales but also the exact amounts of such sales (see, Reference Library Guild, Tax Appeals Tribunal, August 4, 1988). The evidence in the record (Federal income tax returns, bank deposit statements, sales tax returns) indicates that petitioner's gross sales for the audit period were approximately \$135,000.00. The Division did not rely on this information, but rather estimated taxable sales of over one million dollars, based upon a purchases markup audit utilizing cheese purchases as the basis for the audit methodology.

C. Generally, where the petitioner has proven that the audit failed to take into account facts directly related to the petitioner's business (whether those facts were known to the Division at the time of audit or proven for the first time at hearing), the appropriate remedy is a modification of the audit (see, e.g., Matter of Maple Leaf Motor Lodge, Tax Appeals Tribunal, August 30, 1990; Matter of Club Marakesh, State Tax Commn., February 20, 1987 [TSB-H-87(86)S]; Matter of Zorba Endicott Rest., State Tax Commn., [TSB-H-85(76)]; Matter of

Skiadas, State Tax Commn., October 30, 1981 [TSB-H-81(202)]). In effect, the cited decisions conformed the audit method and results to the proof offered at hearing. The problem here is that, although petitioner proved certain of the Division's assumptions to be erroneous (notably that all cheese purchases shown on the C & F Dairy invoices it examined translated into taxable sales), she did not establish the exact amounts of cheese actually sold as grocery items or purchased by Mr. Borillo.

A situation similar to that under consideration here presented itself in Matter of Ristorante Puglia, Ltd. v. Chu (102 AD2d 348, 478 NYS2d 91). There, the Division conducted a test period markup audit of the petitioner's Manhattan restaurant to determine the petitioner's taxable sales. Because the petitioner lacked purchase records, the Division conducted a canvass of its suppliers for the years 1973, 1974 and 1975. This canvass revealed that there were greater purchases in 1974 than in the other two years; consequently, the auditor increased purchases for the years 1973 and 1975 to bring them up to the 1974 level. At hearing, the petitioner proved that the reason that it purchased greater amounts in 1974 than in other years was that it was operating a second restaurant in Brooklyn in that year, and that its suppliers were aware of this. "Petitioner was unable, however, to produce any evidence showing what percentage of the purchases were actually accountable to the second restaurant", and, consequently, the State Tax Commission upheld the audit (Matter of Ristorante Puglia, Ltd. v. Chu, State Tax Commn., February 11, 1983 [TSB-H-83(66)S]). The Appellate Division, Third Department annulled the State Tax Commission determination, stating:

"Here, in our view, the methodology employed was unreasonable because it was not calculated to accurately reflect the tax due. The bureau's auditor knew that Ristorante purchased food and supplies for the restaurant in Manhattan as well as the restaurant in Brooklyn. Yet, the canvass statement sent to suppliers did not request the suppliers to state whether the sales were for the Manhattan restaurant, the Brooklyn restaurant or for both. Next, suppliers should have been asked what sales were made directly to the taxpaying entity that operated the Brooklyn eatery. More important, to arrive at the best estimates, the bureau should have deducted from the sales made by Ristorante the taxable sales reported by the second restaurant. Since the record contains clear and convincing evidence that the canvass results reflected purchases by Ristorante for two restaurants, the determination of taxable sales by applying markup percentages to the canvassed purchases necessarily reflects the erroneous calculation of those purchases."

D. If the audit method here is to be reasonably calculated to reflect the tax due, some allowance must be made for the fact that petitioner did not use all the cheese shown on the invoices inspected by the Division as a pizza ingredient. Petitioner's evidence established that approximately 1,976 pounds of cheese shown on invoices for the test period were actually delivered to petitioner for Mike Borillo. That evidence consisted of the testimony of petitioner's son, the statements of petitioner's accountant, based on his own familiarity with the business, and a letter from petitioner's supplier confirming petitioner's allegations. The Division will recompute the tax due based on this reduction in cheese purchases.

E. Petitioner also established that she sold approximately 1,560 pounds of cheese as a grocery item during the test period. This evidence consisted of the credible testimony of petitioner and her son and statements made by petitioner's accountant. The exact poundage derives from a schedule prepared by petitioner's accountant, which is concededly hearsay evidence. However, hearsay is not only admissible evidence at administrative proceedings, it may also form the basis for a determination if it is deemed to be credible and probative (Matter of Gray v. Adducci, 73 NY2d 741, 536 NYS2d 40; Matter of Flanagan v. New York Tax Commn., 154 AD2d 758, 546 NYS2d 205). Coupled with the testimony of petitioner and her son and the accountant's sworn statement that he is familiar with petitioner's business practices, it is concluded that there is sufficient evidence in the record to support this finding. Accordingly, the Division will reduce cheese purchases for the audit period by an additional 1,560 pounds.

F. To estimate petitioner's pizza sales, the Division used an external index of eight ounces of cheese per pizza. Petitioner asserted that she used approximately (1¼) pounds of mozzarella on each pizza. It is noted that this last fact was put forth by Mr. Selman in various stages of his argument but was not directly testified to by him or other witnesses. While unsworn statements of representatives should not be the sole basis for a determination (see, Matter of East 54th Street Associates, Tax Appeals Tribunal, November 15, 1990; Matter of Cafe Europa, Tax Appeals Tribunal, July 13, 1989), in this case there is ample reason to credit

Mr. Selman's statements. Mr. Selman was familiar with petitioner's business and operating methods and testified to this fact. His assertion that 1¼ pounds of cheese was used on each pizza rests on that familiarity and with conversations he had with petitioner and her son. The recipe used by the Division produced pizzas with a ratio of twelve ounces of dough to three ounces of pizza. There is no evidence in the record to establish that this external index bears any relationship to petitioner's actual practices. The Division applied the external index to petitioner's 16 inch pizzas, without any consideration given to the amount of dough used to make that size pizza. Moreover, the Division did not actually employ the three-ounce figure found in the recipe. Instead, it increased the amount to eight ounces, ostensibly to allow for self-use, waste and a variety of other variables. In fact, there is no basis in the record for using a cheese factor of eight ounces. Accordingly, petitioner's assertion that 1¼ pounds of cheese was used on each pizza is accepted.

G. The Division's use of a factor of 25 percent to estimate taxable sales other than pizza was also without any basis. Petitioner estimated that its sales of such items amounted to 15 percent of pizza sales. This is consistent with the fact that petitioner operated as a grocery during the audit period, rather than a full-time pizzeria.

H. Petitioner presented no other evidence that would warrant a modification of the audit. Notably, the amount of cheese estimated for personal use and waste was not supported by any evidence.

I. The petition of Nina Spallina is granted to the extent indicated in Conclusions of Law "D", "E", "F", and "G", the notices of determination and demands for payment of sales and use taxes due shall be modified accordingly; and, in all other respects, the petition is denied.

DATED: Troy, New York  
2/12/91

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ADMINISTRATIVE LAW JUDGE