STATE OF NEW YORK

DIVISION OF TAX APPEALS

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| In the Matter of the Petition | : |
| of | : |
| BAGEL BOSS EAST, INC. AND | : |
| JERRY ROSNER AND MICHAEL FICCO, AS OFFICERS | DETERMINATION DTA NO. 812215 : |
| 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, 1987 through November 30, 1990. | : : |

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Petitioners, Bagel Boss, Inc., 555 Montauk Highway, Bayshore, New York 11706, Jerry Rosner, 6 Charles Circle, Islip, New York 11751, and Michael Ficco, 2546 Wantagh Avenue, New York 11793, 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, 1987 through November 30, 1980.

A hearing was held before Jean Corigliano, Administrative Law Judge, at the offices of the Division of Tax Appeals, 500 Federal Street, Troy, New York, on July 12, 1994 at 9:30 A.M. The Division of Taxation filed a brief on November 1, 1994. Petitioners filed a reply brief on November 26, 1994 which began the six-month statutory period for issuance of a determination.[1] Petitioners appeared by Morris D. Weintraub, Esq.

The Division of Taxation appeared by William F. Collins, Esq. (Mary R. Hurteau, Esq., of counsel).

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[1]At hearing, a brief date of September 12, 1994 was established for the filing of petitioners' brief, and the parties were informed that late briefs would be returned. Petitioners' brief was mailed to the Division of Tax Appeals on September 16, 1994. It was returned to petitioners' representative who had not sought or received an extension of time in which to file the brief.

ISSUES

I. Whether petitioners provided the Division of Taxation with books and records adequate for the purpose of verifying petitioners' reported taxable sales for the audit period.

II. Whether the one-day observation test conducted by the Division of Taxation was a reasonable method of determining the taxable sales of the business operated by petitioners.

FINDINGS OF FACT

The Division of Taxation ("Division") issued to petitioner Bagel Boss East, Inc. ("Bagel Boss") a Notice of Determination and Demand for Payment of Sales and Use Taxes Due dated December 18, 1991 assessing sales tax due for the period September 1, 1987 through November 30, 1990 in the amount of $69,704.36, plus penalty and interest. A second notice of determination, also dated December 18, 1991, was issued to Bagel Boss assessing a penalty of $6,970.44. Identical notices of determination were issued to petitioners Michael Ficco and Jerry Rosner, as officers of Bagel Boss.

The assessments were issued as a result of a field audit of the business operations of Bagel Boss. During the audit period, Bagel Boss operated a wholesale bagel bakery and a retail store which sold deli items, bagels, coffee and other beverages, milk, eggs and some prepackaged foods (e.g., lox, bacon and processed cheese). There was a cooking area in the store with a grill and deep fryer. Tables and chairs were provided for consumption of food and drink on the premises.

In 1983, Bagel Boss began doing business in a strip mall located on Montauk Highway. Before 1986, there were two anchor stores located on opposite ends of the mall, Gimbel's Department Store and a Grand Union supermarket. Bagel Boss was located in the middle of the mall with approximately 12 small retail stores around it. Both of the anchor stores closed before the end of 1986. On Halloween evening 1986, a fire began in the vacant Gimbel's store and swept through the mall destroying seven stores in all. After the fire, only four or five stores remained operating, including Bagel Boss.

Ownership of the strip mall changed about 12 to 18 months after the fire. In the spring

of 1988, the mall owners began renovation of the mall, including the stores and parking area. Bagel Boss acquired a new facade in the summer of 1989. In September 1990, renovations were begun on the interior of Bagel Boss; they were completed by April 1991.

The field audit of Bagel Boss began in September 1990. The auditor visited Bagel Boss's premises for the first time on September 27, 1990. Shortly thereafter, the auditor contacted Bagel Boss's accountant, Arthur I. Siegel, to set up an appointment to discuss the audit. Because Mr. Siegel was recovering from surgery, the first audit appointment was not scheduled until February 20, 1991. A letter was sent to Bagel Boss by the auditor to confirm that appointment. The letter, dated January 18, 1991, states, in part:

> "Please have available all books and records pertaining to your sales tax liability for the period under audit. This would include journals, ledgers, sales invoices, purchase invoices, cash register tapes, exemption certificates, and all sales tax records."

The audit period was identified in the letter as September 1, 1987 through November 30, 1990.

Bagel Boss provided the auditor with copies of sales tax returns and Federal income tax returns, a cash receipts journal, a check disbursements journal, payroll records, a general ledger (in the form of ledger sheets prepared by Mr. Siegel), cancelled checks and monthly bank statements. The auditor reviewed the records to determine how Bagel Boss prepared its sales tax returns. Bagel Boss used two cash registers which produced tapes which recorded receipts in four categories: taxable sales, nontaxable sales, sales tax collected and total sales. Each day, totals from each of these categories were taken from the register tapes and entered into a daily journal which served as a cash receipts journal. Mr. Siegel posted the amounts entered in the daily journal to ledger sheets on a monthly basis. The figures in the general ledger were then used to prepare sales tax returns. The auditor worked on the premises of Bagel Boss when she reviewed the books and records on February 20, 1991.

The auditor verified that sales recorded in the daily journals reconciled with sales reported on sales tax returns. Also, there was no significant difference between reported Federal gross receipts and gross sales as shown in Bagel Boss's books and records.

Nonetheless, the auditor determined that the books and records were inadequate for the purpose of verifying Bagel Boss's reported taxable sales. The auditor gave two reasons for this conclusion. First, Bagel Boss did not retain the cash register tapes that were used to prepare its records of daily sales so the postings in the daily journals could not be verified. Second, the tapes produced by Bagel Boss's registers did not identify the individual items sold; therefore, the auditors could not use the tapes to determine whether Bagel Boss was collecting sales tax on all taxable items.

To determine Bagel Boss's taxable sales for the audit period, the Division conducted a one-day observation test. The auditor visited the premises on March 6, 1991 to acquaint herself with the layout of the store and to decide how many auditors would be needed for the test. The observation test was conducted on Thursday, April 11, 1992 from 6:00 A.M. to 9:00 P.M. (the posted hours of operation). It was conducted in two shifts with two auditors on each shift. There were two registers in the store; one was used for deli sales and the other for the bagel counter. One auditor was stationed at each register. The auditor testified that the store was very busy on the day of the observation test with about six clerks handling sales. She also stated that it was difficult to keep track of the taxable sales being made by the clerks. Since there were many fewer nontaxable sales than taxable sales, the auditors recorded only the nontaxable sales. Using pencil and paper, the auditors kept track of each nontaxable item sold and multiplied the item sold by the posted selling price to determine the amount of sales in the nontaxable sales category. Total sales figures were taken from each of the two registers. The auditor subtracted nontaxable sales per the observation test from total sales as shown on the register tapes to determine taxable sales for the day.

Petitioners complained to the auditor that the observation test was unfair because it did not reflect the nature of Bagel Boss's business prior to the renovations. Petitioners told the auditor that the deli business, which sells taxable prepared foods, was greatly expanded by the renovation. They also said that the date of the observation test was the day after the start of a "Grand Opening" promotional campaign which caused Bagel Boss to be particularly busy on the

observation day.

To address some of petitioners' claims, the auditor eliminated sales from the deli counter register from the test. Nontaxable sales at the bagel counter register (register number 1 in the auditor's workpapers), as counted by the auditors, amounted to $868.00. Total sales per the register reading was $1,914.71. By subtracting nontaxable sales from total sales, the auditor determined taxable sales for the test day of $1,046.70.

The auditor computed taxable sales for the audit period essentially by projecting the results of the test day. This entailed several different computations. Recognizing that inflation would cause sales figures to be higher in later years than in earlier years, the auditor reduced audited taxable sales on the test day ($1,046.70) by 5% to estimate audited taxable sales for an average day in April 1990 of $994.36. This figure was reduced by 5% to determine audited taxable sales for an average day in April 1989 of $944.64. This figure was reduced by 5% to determine audited taxable sales for an average day in April 1988 of of $897.41.

The auditor then set out to calculate a ratio which would allow her to compare audited taxable sales with taxable sales as shown in the daily journals. First, she transcribed daily figures from the daily journals for the month of April of 1988, 1989 and 1990. Since the day of the observation test was a Thursday, the auditor then selected Thursday sales in April of each year to use as a point of comparison. She computed average Thursday taxable sales as shown in the daily journals of $183.96 for 1988, $186.13 for April 1989 and 186.70 for April 1990. She then computed a margin of error comparing audited taxable sales (see, Finding of Fact "11") with taxable sales according to Bagel Boss's records. This resulted in margins of error of 3.8783 for 1988, 4.0752 for 1989 and 4.3243 for 1990.

The error rates for each calendar year were applied to reported taxable sales for the four sales tax quarters most closely corresponding to the calendar year to determine additional taxable sales for each quarter. This resulted in additional taxable sales for the audit period of $929,391.00, with a tax due on that amount of $69,704.36.

Petitioners claimed that their business was particularly busy on the day of the

observation test because there was an advertisement in the local Pennysaver offering free bagels and muffins as well as price specials from April 10th through April 24th. The advertisement was placed in evidence. It offers: special prices on three kinds of deli meats sold by the pound; one-half dozen bagels or bialys free with the purchase of a dozen at regular price; and one free muffin with the purchase of three others.

The auditor testified that she did not believe any adjustment to the audit results was warranted because of the promotional special. The coupons were all for nontaxable items and any sales made with a coupon would have been counted as nontaxable sales by the auditors as part of the observation test. Thus, an increase in sales resulting from the coupons would not have caused an increase in audited taxable sales. Also, the auditor testified that Bagel Boss seemed no more busy on the day of the observation than it had seemed to her on her prior visits to the premises. She also claimed to have seen few customers using the coupons.

The auditor offered to perform a second observation test, but petitioners declined the offer. Mr. Ficco testified that petitioners believed that their business was growing and that a second test would be no more representative of Bagel Boss's business during the audit period than the first test had been.

Both on audit and at hearing, petitioners maintained that their business had changed so significantly from the audit period to the day of the observation test that the test results could not be valid. Mr. Ficco, vice-president of Bagel Boss, testified about the effect of the fire and the renovations on Bagel Boss's business. He stated that the retail business significantly decreased after the fire and especially after construction began in the parking lot of the mall, approximately the spring of 1989 through the fall of 1990. He testified that Bagel Boss attempted to compensate for the lost revenue by increasing its wholesale bagel bakery business. He also testified that the business struggled financially through this period because the wholesale business is significantly less profitable than the retail business.

Photographs of the area outside of Bagel Boss show piles of dirt, torn up sidewalks, and an unpaved parking area. According to Mr. Ficco's testimony, the worst of these conditions

existed for a couple of months in the summer of 1989.

Mr. Ficco described the operation of the Bagel Boss retail store before and after the renovations. Before the renovations, there was a grill on the left side of the front of the store where hot food was prepared, primarily eggs and other breakfast foods. Towards the right of the store, there was a bagel display counter and dairy cases containing milk, eggs, soda, juice, carbonated juice drinks and prepackaged foods. One cash register was located on the deli counter and a second was located at the bagel counter. As part of the renovations, petitioners removed the dairy cases and installed large walk-in coolers. They also removed the grill and put in a complete deli department. The seating area was increased from about 20 to 39.

Mr. Ficco testified that new employees are provided with a list of taxable items and are required to familiarize themselves with that list. They are then instructed to collect sales tax in accordance with the list. He and his co-owner, Jerry Rosner, are on the premises during business hours and monitor their employees using a one-way mirror and a video camera.

Bagel Boss's accountant, Arthur I. Siegal, testified concerning the recordkeeping practices of Bagel Boss and its financial difficulties. He stated that the business was not profitable during the audit period and operated at a loss or close to it. He also stated that Bagel Boss had undergone audits by the Internal Revenue Service in 1985 and 1989. The 1989 audit was a detailed audit, and the Internal Revenue Service made no changes to the amounts of income reported.

To establish that the nature of the business changed during the audit period and after from one that emphasized wholesale sales to one that emphasized retail sales, Mr. Siegel provided a breakdown of Bagel Boss's total sales, wholesale sales and taxable sales taken from records he maintained. Using his figures, and subtracting wholesale sales from total sales results in calculated retail sales for the same periods as follows:[2]

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[2]Bagel Boss changed its Federal income tax reporting period from a fiscal year to a calendar year in 1987. Only the last month of 1987 was included in the sales tax audit period.

| | Total Sales | Wholesale Sales | Taxable Sales | Retail Sales |
|---|---|---|---|---|
| 1988 | $716,216.64 | $398,126.57 | $ 66,856.21 | $318,090.07 |
| 1989 | 703,935.70 | 290,420.01 | 70,061.82 | 413,515.69 |
| 1990 | 608,247.58 | 88,145.55 | 76,421.47 | 520,102.03 |
| 1991 | 724,357.94 | 66,244.77 | 179,790.91 | 658,113.17 |

Sales, as transcribed by the auditor from the accountant's worksheets, are substantially the same as the figures testified to by Mr. Siegel. The auditor's transcription shows nontaxable sales during the audit period as follows:

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| 1988 | $251,163.86 |
| 1989 | 343,453.87 |
| 1990 | 443,680.56 |

Petitioners placed in evidence wholesale invoices, bank statements, checkbook stubs and the daily journals for the audit period. Mr. Ficco testified that he threw out the cash register tapes after posting the totals to the daily journals.

SUMMARY OF THE PARTIES' POSITIONS

Petitioners claim that the use of the one-day observation test to determine taxable sales for a three-year period was inappropriate. They maintain that they kept adequate books and records and that the Division was not justified in using an indirect audit method to determine taxable sales.

The Division contends that the books and records made available were not adequate for the purpose of verifying taxable sales. The Division also maintains that petitioners' claim that Bagel Boss's business changed significantly between the end of the audit period and the day of the observation test is not supported by the evidence.

CONCLUSIONS OF LAW

A. Pursuant to Tax Law § 1135(a)(1), every person required to collect sales and use taxes is also required to maintain records of all receipts upon which the tax is imposed. Such records must include a true copy of each sales slip, invoice, statement or other memorandum of sale, separately stating the amount of tax due (Tax Law § 1135[a][1]; see also, 20 NYCRR 533.2[b]). The failure to maintain such records is deemed to establish the incorrectness of the filed sales tax returns under Tax Law § 1138(a)(1) (20 NYCRR 533.2[g]).

If a return required by article 28 is not filed, or if a return when filed is incorrect or insufficient, the Commissioner of Taxation and Finance is authorized to determine the amount of tax due "from such information as may be available", and to estimate the tax on the basis of external indices if necessary (Tax Law § 1138[a][1]). "When the vendor maintains a comprehensive set of books and records, 'such information as may be available' (Tax Law § 1138[a][1]) is restricted to his books and records, and not external indicia, because 'the honest and conscientious taxpayer who maintains comprehensive records as required has a right to expect that they will be used in any audit to determine his ultimate tax liability'" (Matter of Cafe Europa, Tax Appeals Tribunal, July 13, 1989, quoting Matter of Chartair, Inc. v. State Tax Commn., 65 AD2d 44, 411 NYS2d 41, 43).

To determine the adequacy of a taxpayer's records, the Division must first request and thoroughly examine the taxpayer's books and records for the complete audit period (Matter of Adamides v. Chu, 134 AD2d 776, 521 NYS2d 826, 828, lv denied 71 NY2d 806, 530 NYS2d 109). The purpose of the examination is to determine, through verification drawn independently from these records, whether they are adequate for the purpose of verifying the taxpayer's sales tax liability (Matter of Chartair, Inc. v. State Tax Commn., supra). The Commissioner cannot simply ignore a taxpayer's records and use an indirect method of estimating tax due if the taxpayer's records are readily available and provide an adequate basis on which to determine the amount of tax due (Matter of Christ Cella v. State Tax Commn., 102 AD2d 352, 477 NYS2d 858, 859; Matter of Chartair, Inc. v. State Tax Commn., supra). If the taxpayer's books and records do not provide an adequate basis for determining the tax liability, the Division must select an audit method which results in a reasonable calculation of the taxpayer's sales tax liability (Matter of W. T. Grant Company v. Joseph, 2 NY2d 207, 159 NYS2d 150,157, cert denied 355 US 869). When the Division follows this procedure, the burden of proof is on the taxpayer to show that the method of audit or the amount of tax assessed was erroneous (Matter of Surface Line Operators Fraternal Org. v. Tully, 85 AD2d 858, 859, 446 NYS2d 451, 453); however, if it is shown that the Division's audit methodology

is fundamentally flawed, the taxpayer need not prove that the result produced by that methodology is different from that which a detailed examination would have produced (Matter of Babylon Milk & Cream Co. v. Bragalini, 5 AD2d 712, 169 NYS2d 124, 126, affd 5 NY2d 736, 177 NYS2d 717; see also, Matter of Adamides v. Chu, supra; Matter of King Crab Rest. v. State Tax Commn., 134 AD2d 51, 522 NYS2d 978, 980).

B. There is no merit to petitioners' claim that they provided the Division with books and records adequate for the purpose of verifying Bagel Boss's taxable sales. Records are sufficient when they comply with the requirements of Tax Law § 1135(a)(1) and are subject to independent verification (Matter of Bonnano v. State Tax Commn., 145 AD2d 693, 534 NYS2d 829; Matter of Giordano v. State Tax Commn., 145 AD2d 726, 535 NYS2d 255). Petitioners did not provide such records. The cash register tapes which were purportedly the source of the figures entered in the daily journals were destroyed. Moreover, the tapes did not individually identify the items sold; therefore, they could not serve to determine whether petitioners were accurately collecting tax on all taxable items (see, Matter of Licata v. Chu, 64 NY2d 873, 487 NYS2d 552). The Division was not required to accept the veracity of daily journals which could not be verified for accuracy (see, Matter of Goldner v. State Tax Commn., 70 AD2d 978, 418 NYS2d 477, lv denied 48 NY2d 608, 423 NYS2d 1025).

Petitioners' reliance on Matter of King Crab Rest. v. State Tax Commn. (supra) is misplaced. In that case, the auditor was provided with guest checks which he "spotchecked" and then dismissed because they were not kept in chronological order. The court found that the auditor's conclusion that the records were inadequate was arbitrary in view of his failure to review the records that were presented, especially the guest checks. Guest checks are the kind of source document required to be kept by Tax Law § 1135(a)(1) because they can be used to verify journals, ledgers and other accounting records. In this case, petitioners admitted destroying the cash register tapes which allegedly were the source of the entries made in the daily journals. Without the register tapes, petitioners' books and records were inadequate to verify the sales tax returns.

C. Since petitioners did not provide verifiable records of taxable sales, the Division was warranted in using an indirect audit method. A one-day observation test to determine taxable sales for a three-year audit period is not inherently suspect where verifiable records of taxable sales are not provided (see, Matter of Vebol Edibles v. State of New York Tax Appeals Tribunal, 162 AD2d 765, 557 NYS2d 678, lv denied 77 NY2d 803, 567 NYS2d 643; Matter of Sarantopoulos, Tax Appeals Tribunal, February 28, 1991, confirmed 186 AD2d 878, 589 NYS2d 102). Furthermore, petitioners have not established that the nature of their business changed so significantly after the audit period that the results of the observation test had to be arbitrary and unreasonable.

On the day of the observation test, the auditors kept a record of all nontaxable retail sales. Taxable sales were determined by subtracting audited nontaxable sales from total retail sales as recorded on one of petitioners' cash registers. Using this method, taxable sales were determined to be approximately 55% of all retail sales. Bagel Boss reported taxable sales for the audit period of between 15 and 21% of retail sales. Petitioners presented no evidence which would explain the discrepancy between the taxable and nontaxable ratio as determined on audit as compared with petitioners' own records.

Petitioners claimed that their retail sales decreased during the audit period because of the disruption caused by mall construction, and Mr. Ficco and Mr. Siegel testified that Bagel Boss increased wholesale sales in order to survive during this period. But Bagel Boss's records show a gradual increase in retail sales and a corresponding decrease in wholesale sales throughout the audit period. Petitioners have failed to establish that there is a connection between the decrease in wholesale sales and the accuracy of their reported taxable sales. Petitioners did not present convincing evidence that the nature of their retail sales operation changed significantly after the end of the audit period. During the audit period, Bagel Boss had a bagel counter and a deli counter; tables and chairs; coolers for soda, juice and dairy products; and two cash registers, one at each counter. The renovation of the store apparently increased the volume of the store's coolers, its seating capacity and the size of its delicatessen. It is conceivable that these changes

resulted in greater taxable sales; however, the nature of the business did not change so dramatically as to render the observation test unreasonable. Where verifiable records of taxable sales are not maintained, the Division is only required to select a reasonable audit method, not one that is exact (Matter of Markowitz v. State Tax Commn., 54 AD2d 1023, 388 NYS2d 176, affd 44 NY2d 684, 405 NYS2d 454). Furthermore, the Division eliminated sales recorded on the deli register from its calculations in order to respond to petitioners' claim that the renovated deli counter produced a higher level of taxable sales than the old deli counter. In addition, the Division reduced sales by 5% per year to adjust for inflation. These were reasonable attempts to fashion an audit method which took into account any changes in petitioners' business operations.

At hearing, petitioners established that a fire destroyed a portion of the shopping mall in which Bagel Boss was located and that renovations to the shops and parking area took place thereafter. However, these facts do not establish that petitioners accurately reported taxable sales during the audit period. The fire occurred over a year before the start of the audit period, and the major portion of the mall renovations was completed before the audit period ended. As the Division notes, petitioners have presented only conclusory allegations that their business suffered as a result of the fire and the mall construction. They have not established that their taxable sales decreased during the audit period as a result of those events. They could not do so since their own records show an increase in both taxable and nontaxable sales during the audit period.

D. The petition of Bagel Boss East, Inc. and Jerry Rosner and Michael Ficco, as officers, is denied; the notices of determination dated December 18, 1991 are sustained.

DATED: Troy, New York
April 27, 1995

/s/ Jean Corigliano
ADMINISTRATIVE LAW JUDGE