

STATE OF NEW YORK

DIVISION OF TAX APPEALS

In the Matter of the Petition :

of :

YOUR OWN CHOICE, INC. :

DETERMINATION
DTA NO. 817104

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, 1993 through November 30, 1997. :

Petitioner, Your Own Choice, Inc., 687 Broadway, Brooklyn, New York 11206, 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, 1993 through November 30, 1997.

A hearing was held before Gary R. Palmer, Administrative Law Judge, at the offices of the Division of Tax Appeals, 641 Lexington Avenue, New York, New York, on June 26, 2001 at 10:30 A.M., with all briefs to be submitted by November 9, 2001, which date began the six-month period for the issuance of this determination. Petitioner appeared by Franklin D. Pacheco, CPA. The Division of Taxation appeared by Barbara G. Billet, Esq. (Jennifer A. Murphy, Esq. and James DellaPorta, Esq., of counsel).

ISSUES

I. Whether the indirect audit method utilized by the Division of Taxation was reasonably calculated to determine sales tax due.

II. Whether the Division of Taxation effectively extended the audit period to include the period from September 1, 1996 to November 30, 1997.

FINDINGS OF FACT

1. Petitioner, Your Own Choice, Inc., was incorporated in New York State in 1987.

During the period at issue, Mohammed Alam was its president and sole shareholder. During this period he operated petitioner as a grocery/convenience store at 687 Broadway, Brooklyn, New York. Petitioner made nontaxable sales of food and Lottery tickets and taxable sales of beer, soda, candy, cigarettes and photo processing services.

2. The Division of Taxation (“Division”) commenced a sales tax audit of petitioner’s business operation, and on October 4, 1996, an appointment letter was mailed to petitioner by Chae Kuo, the Division’s sales tax auditor, which letter stated in part:

Your New York State tax records for the tax(es) listed above have been scheduled for a field audit at your office on **November 4, 1996 at 9:30 am**.

All books and records pertaining to your sales and use tax liability, for the period under audit, must be available on the appointment date. This includes financial statements, journals, ledgers, sales invoices, purchase invoices, cash register tapes, sales and use tax returns, federal income tax returns, and exemption certificates.

The letter stated the tax type to be “Sales and Use Tax” and identified the audit period as “09/01/93-08/31/96.” Attached to the letter was a check list of records to be presented for audit.

The check list restated the items listed in the letter and requested the following additional records: cash disbursements journal, cash receipts journal, general ledger, expense purchase invoices, fixed asset purchase invoices, bank statements, canceled checks and deposit slips.

3. Among the records made available by petitioner to the Division were copies of sales tax returns, Federal income tax returns, New York State franchise tax reports and bank statements. Among the records requested in the appointment letter or the attached check list, but which were not furnished to the Division by petitioner, were the general ledger, cash receipts journal, sales invoices, cash register tapes and canceled checks. At the outset of the audit and

again on November 27, 1996, Mr. Kuo met with petitioner's representative. No source records of sales such as cash register tapes or sales invoices were made available to the Division.

Purchase invoices were incomplete, especially in the area of taxable beverages. The auditor was informed by Mr. Pacheco, petitioner's accountant, that petitioner's reported gross sales were computed, in part, by applying a mark-up rate to the purchase records, and, in part, by relying on bank deposit information. Some of petitioner's purchases were cash purchases, which served to reduce the amount of cash deposited in the bank at the end of the day.

4. Petitioner's representative conceded on the record that petitioner's books and records needed to verify taxable sales were insufficient for purposes of performing a detailed audit.

5. The auditor started to do an observation test, but was instructed by his supervisor, Mr. Dolan, to discontinue the observation test when it became apparent that petitioner's two cash registers did not generate totals or produce register tapes. Another reason for discontinuing the observation test was that despite being informed that petitioner had abandoned its film processing activities, the auditor's assistant noticed that customers were coming in during the observation test seeking to drop off film for developing or to pick up finished photos.

6. A mark-up audit was considered and rejected by the Division because of the lack of adequate purchase invoices.

7. Noting that petitioner's annual rent for its business premises was readily apparent on the face of its Federal income tax returns for each fiscal year falling within the audit period, the Division consulted a publication entitled "Cost of Doing Business - Corporations" for fiscal year July 1987 to June 1988 and published by the Dun & Bradstreet Corporation. This publication is a self-described "guide to selected operating expenses for corporations" which covered 191 lines of business. The tables within the publication set forth the average amount spent by corporations

for 11 selected operating expenses, including rent paid on business property, for each of the 191 business lines, expressed as a percentage of business receipts reported by a representative sample of all corporate Federal income tax returns filed for 1987. The table chosen by the auditor included a group of business lines headed "Retail Trade," which group includes the business line "Food Stores." This table reveals that food stores doing business in the corporate form, on average, pay as rent an amount that is equal to 1.73 percent of their business receipts.

8. Based on the office experience of the auditors, the ratio of taxable sales to gross sales of a convenience store or corner grocery store can be as high as 70 or 80 percent, while that of a supermarket can range from about 29 percent to 38 percent.

9. The Division, in the course of its audit, assumed a taxable ratio of 29.7 percent for petitioner, and it assumed further that petitioner's rent was 1.73 percent of its reported gross sales. Using these figures, the Division compiled a test computation of petitioner's additional taxable sales for the audit period of \$1,839,915.88 and additional sales tax due thereon in the sum of \$151,793.06.

10. The Division then substituted 10 percent for the 1.73 percent rent factor and repeated the tax computation as follows:

4 qtrs. ending	reported gross sls	rent paid	rent factor	audited gross sls	taxable %	audited taxable sls	reported taxable sls	additional taxable sls	additional sls tax due
8/94	\$189,272	\$27,188	.1	\$271,880	.297	\$80,748	\$19,346	\$61,402	\$5,065.69
8/95	224,243	28,174	.1	281,740	.297	83,677	24,703	58,974	4,865.34
8/96	246,931	27,328	.1	273,280	.297	81,164	25,217	55,947	4,615.64
8/97	234,886	27,328	.1	273,280	.297	81,164	51,227	29,937	2,469.82
10/97	39,147	4,555	.1	45,550	.297	13,528	8,538	4,990	411.70
Total	\$934,479	\$114,573		\$1,145,730		\$340,281	\$129,031	\$211,250	\$17,428.19

11. The reasons given by the Division for its adoption of the 10 percent rent factor in place of 1.73 percent from the Dun & Bradstreet study was out of consideration of a number of factors bearing on the volume of petitioner's business, including its location in a commercial

neighborhood with plenty of competition that served to reduce traffic in the store and the Division's inability to rule out that petitioner's gross sales included Lottery commissions.

12. In December of 1997 the Division learned that petitioner's assets were to be sold in a bulk sale. By letter dated December 31, 1997, the auditor informed petitioner's representative that the Division was updating the audit period to "10/97." No request for records for the updated period was included in this letter.

13. On February 23, 1998, the Division issued a notice of determination to petitioner assessing additional sales tax due in the sum of \$17,428.24 plus penalty and interest for the period from September 1, 1993 to November 30, 1997. Petitioner, by its representative, timely filed a request for a conciliation conference with the Bureau of Conciliation and Mediation Services. The conference was held on December 2, 1998 and a conciliation order was issued on February 9, 1999 sustaining the notice of determination.

14. Petitioner's president, Mr. Mohammed Alam, testified that in the winter he closed his store between 5:00 and 6:00 P.M., and in the summer he closed the store between 6:00 and 7:00 P.M. The audit questionnaire, completed by Mr. Pacheco, states that closing time is 8:00 P.M. and that the store was open for business from Monday through Saturday and was closed on Sundays. Mr. Alam further testified that no more than 15 to 20 percent of the merchandise sold at petitioner's store consisted of taxable items. The Division examined petitioner's filed sales tax returns and determined that the ratio of reported taxable sales to reported gross sales for the sales tax quarters ending August 31, 1995, November 30, 1995, February 29, 1996, May 31, 1996 and August 31, 1996 were, respectively, 11 percent, 8.9 percent, 9.2 percent, 9.3 percent and 13 percent. The Division's initial appointment letter was mailed to petitioner on October 4, 1996. The taxable ratios for the four quarters ending November 30, 1996, February 28, 1997,

May 31, 1997 and August 31, 1997 are, respectively, 26 percent, 15 percent, 25 percent and 24 percent.

15. Petitioner sold New York Lottery tickets during the years at issue on which it received a commission of six percent of its on-line and instant ticket sales. During calendar year 1995 petitioner's total Lottery sales were \$971,100.00 and during 1996 such sales totaled \$820,567.00. Petitioner's Lottery sales were not included in its gross sales reported on its quarterly sales tax returns. It is not clear from the record whether petitioner's reported gross sales included the Lottery commissions it earned.

16. On May 30, 2001 the Division caused to be served on petitioner's representative, by certified mail, a notice to admit pursuant to 20 NYCRR 3000.6(b)(2) and CPLR 3123. The schedule attached to the notice to admit set forth 15 purported statements of fact that petitioner was asked to admit, deny or explain why such statements could not be admitted or denied. The Division's cover letter to Mr. Pacheco, dated May 25, 2001, stated, "[p]lease be advised that if you do not respond within 20 days after service of request, then all matters in request shall be deemed admitted." No response was made on petitioner's behalf within the 20-day period or thereafter.

SUMMARY OF THE PARTIES' POSITIONS

17. Petitioner, while conceding that its books and records were incomplete, asserted that the Division's audit methodology was not reasonably calculated to determine sales tax due in that the external index relied on by the Division was not adjusted for nontaxable sales. Petitioner also contends that its nontaxable Lottery sales were included in petitioner's gross sales and should have been excluded from the Division's tax computation.

The Division contends that it properly requested petitioner's books and records for the audit period through August 31, 1996, and thereafter duly extended the audit period covered by

its records request to and including the quarter ending November 30, 1997. The Division maintains that it justifiably discontinued its observation test and was prevented from conducting a purchase mark-up test by insufficient purchase invoices. It further contends that its selection of the rent factor from the Dun & Bradstreet Cost of Doing Business study was reasonable because petitioner's audited gross sales were derived from the rent factor which was applied to the actual rent petitioner paid for its business property as reported on its Federal income tax returns, and which rent factor was adjusted in petitioner's favor to take into account the possible inclusion of Lottery commissions in its gross sales, as well as to account for anything in its business operation that might be unusual for a grocery/convenience store.

CONCLUSIONS OF LAW

A. When, as here, the Division resorts to an indirect audit method, it must establish that the taxpayer's books and records were so deficient as to render it virtually impossible to determine the taxpayer's liability solely from those books and records (***Matter of Urban Liquors, Inc. v State Tax Commission***, 90 AD2d 576, 456 NYS2d 138). In order to establish that petitioner's books and records are inadequate, the Division must first request (***Matter of Christ Cella v State Tax Commission***, 102 AD2d 352, 477 NYS2d 858) and then thoroughly examine the books and records for the entire audit period (***Matter of King Crab Restaurant v Chu***, 134 AD2d 51, 522 NYS2d 978). The record clearly supports the Division's clear and unequivocal requests for source documents bearing on petitioner's sales and petitioner's failure to keep or produce such records for the Division's review. The auditor reasonably concluded and petitioner's representative conceded that petitioner's books and records were insufficient to verify its taxable sales for the audit period. Having established the insufficiency of petitioner's books and records, the Division properly resorted to external indices in the form of the Dun & Bradstreet Cost of Doing Business study. It is the Division's obligation to select an audit

method that is reasonably calculated to reflect sales tax due (*see, Matter of W. T. Grant v Joseph*, 2 NY2d 196, 159 NYS2d 150, *cert denied* 355 US 869, 2 L Ed 2d 75; *Matter of Ristorante Puglia Ltd. v Chu*, 102 AD2d 348, 478 NYS2d 91). It is petitioner's burden to show that the audit method or the amount of tax assessed is erroneous (*Matter of Surface Line Operators Fraternal Org. v Tully*, 85 AD2d 858, 446 NYS2d 451). Petitioner has not established that the rent factor selected by the Division, and then adjusted in petitioner's favor by the Division, did not fully take into account petitioner's nontaxable sales. The only component of its sales that petitioner was able to substantiate was its Lottery sales. But doing so does not discredit the audit method or assist petitioner in meeting its burden. What the focus on petitioner's Lottery sales did accomplish was to draw attention to the fact that its Lottery sales were uniformly more than double petitioner's reported gross sales throughout the audit period which, in turn, serves to underscore just how favorable to petitioner the adjusted rent factor employed by the Division was. For example, petitioner's reported gross sales for the four quarters ending August 31, 1996 were \$246,931.00. Its average reported gross sales for the same four quarters on a daily basis for a six-day week were \$789.00 per day. Comparing that to petitioner's average daily Lottery sales for calendar year 1996 computed on a six-day week ($\$820,567/313$) results in average daily Lottery sales of \$2,621.00. The same computation of Lottery sales for 1995 ($\$971,100/313$) results in average daily Lottery sales of \$3,102.00. In terms of the high level of traffic in petitioner's store as revealed by its Lottery sales, the Division's computation of \$1,145,730.00 in audited gross sales over the course of the 1,272 working days from September 1, 1993 to October 31, 1997 for a daily average of \$901.00 in audited gross sales is more than reasonable.

B. Petitioner also takes issue with the Division's use of the 29.7 percent ratio of taxable sales to gross sales. The selection of this taxable ratio was based on the Division's office

experience in its audits of grocery stores in similar neighborhoods including grocery store audits in Brooklyn. Mr. Dolan, the audit supervisor, testified credibly that 29.7 percent was in the lower range of taxable ratios for supermarkets and that taxable ratios for convenience stores and corner grocery stores can be as high as 70 to 80 percent. It remains the burden of petitioner to prove that the Division's audit method was not reasonably calculated to determine sales tax due. Petitioner's reported taxable ratio from its sales tax returns in the five quarters immediately preceding the commencement of the audit was in the range of 8.9 to 13 percent. After the audit began in October, 1996, petitioner's reported taxable ratio for the quarter ending November 30, 1996 jumped to 26 percent, and for the succeeding three quarters the taxable ratio was 15 percent, 25 percent and 24 percent, respectively. Mr. Alam continued to maintain that petitioner's ratio of taxable sales to gross sales was between 15 and 20 percent. When asked to explain the abrupt change in the percentage of taxable sales following the onset of the audit, he stated that he could not recall. I find that the change in the pattern of reporting petitioner's taxable ratio, occurring concurrently with the receipt of the Division's appointment letter, constitutes a tacit admission that petitioner's reported taxable sales were, and continued throughout the balance of the audit period to be, inaccurate. The taxable ratio used by the Division in its computation of additional tax due is reasonable.

C. The thrust of petitioner's arguments in opposition to the Division's audit methodology is directed more toward the audit results being imprecise rather than irrational. It has been held that "where the taxpayer's own failure to maintain proper records prevents exactness in determination of its sales tax liability, exactness is not required" (*Matter of Meyer v State Tax Commission*, 61 AD2d 223, 402 NYS2d 74). In this matter it is petitioner's failure to maintain adequate records of its sales that is the cause of any imprecision in the amount of tax assessed.

D. As noted in Conclusion of Law “A,” the Division must first request and then thoroughly examine all of petitioner’s records for the entire audit period. In its appointment letter dated October 4, 1996, the Division stated the audit period to be “09/01/93-08/31/96.” The auditor testified that the audit period had been extended to 1997, but he made no mention of any request for records for the period after August 31, 1996. Attached to the Division’s field audit report is a copy of a letter from Mr. Kuo to Mr. Pacheco dated December 31, 1997. This letter advised Mr. Pacheco that the Division had “updated the audit period to 10/97” due to a bulk sale filing in November 1997. The letter does not, however, make any reference to a request for books and records for the updated period. Accordingly, the Division’s resort to external indices for the period after August 31, 1996 violates the rule stated in *Matter of Christ Cella v State Tax Commission (supra)* that the Division must first request the taxpayer’s books and records for the entire audit period. In *Matter of Top Shelf Deli, Inc.* (Tax Appeals Tribunal, February 6, 1992), the Tribunal held that “mere knowledge of the audit period does not obligate the petitioner to produce books and records for this period.” (*See also, Matter of Gifts by Gallego, Inc.*, Tax Appeals Tribunal, December 23, 1993 [where the Division advised the taxpayer in writing that the audit period was extended one quarter, but neglected to request records for that quarter].) The Division has failed to effectuate the extension of the audit period beyond August 31, 1996. The Division is directed to recompute the statutory notice so as to exclude from its computation of tax, penalty and interest all sums that apply to any period post-dating August 31, 1996.

E. The petition of Your Own Choice, Inc. is granted to the extent stated in Conclusion of Law “D,” but in all other respects the petition is denied. The notice of determination dated February 23, 1998, as modified by Conclusion of Law “D,” is sustained.

DATED: Troy, New York
April 25, 2002

/s/ Gary R. Palmer
ADMINISTRATIVE LAW JUDGE