

STATE OF NEW YORK

DIVISION OF TAX APPEALS

In the Matter of the Petition :
of :
MOUNTAIN STAR COMPANY, INC. :
for Redetermination of a Deficiency or for Refund of :
Corporation Franchise Tax under Article 9-A of the Tax :
Law for the Period June 1, 1998 through May 31, 2002. :

In the Matter of the Petition :
of :
MOUNTAIN STAR COMPANY, INC. : DETERMINATION
for Revision of a Determination or for Refund of Sales : DTA NOS. 820630,
and Use Taxes under Articles 28 and 29 of the Tax Law : 820631 AND 820632
for the Period September 1, 1999 through May 31, 2002. :

In the Matter of the Petition :
of :
MOUNTAIN STAR COMPANY, INC. :
for Revision of a Determination or for Refund of Tax :
on Cigarettes and Tobacco Products under Article 20 :
of the Tax Law for the Period September 1, 1999 :
through May 31, 2002. :
:

Petitioner, Mountain Star Company, Inc., 412 Hillside Avenue, New Hyde Park, New York
11040, filed a petition for redetermination of a deficiency or for refund of corporation franchise
tax under Article 9-A of the Tax Law for the period June 1, 1998 through May 31, 2002, 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, 1999 through May 31, 2002, and a petition for revision of a determination or for refund of tax on cigarettes and tobacco products under Article 20 of the Tax Law for the period September 1, 1999 through July 31, 2002.

A consolidated hearing was held before Thomas C. Sacca, Administrative Law Judge, at the offices of the Division of Tax Appeals, 641 Lexington Avenue, New York, New York, on May 10, 2006 at 10:30 A.M., with all briefs to be submitted by July 28, 2006, which date began the six-month period for the issuance of this determination. Petitioner appeared by Peter J. Murphy, CPA. The Division of Taxation appeared by Mark F. Volk, Esq. (Jennifer A. Murphy, Esq., of counsel).

ISSUES

I. Whether the audit method employed by the Division of Taxation was reasonable or whether petitioner has shown error in either the audit method or result.

II. Whether the Division of Taxation properly determined additional corporation franchise tax due.

III. Whether the Division of Taxation properly determined additional tax due on cigarettes and tobacco products.

FINDINGS OF FACT

1. Petitioner, Mountain Star Company, Inc., is a retailer of tobacco products, tobacco accessories, cigarettes, candy, gift items, drug store products, flashlights, lighters, batteries, soda, newspapers and magazines. The size of the business operation is approximately 4,000 square feet, with approximately 2,500 square feet being used directly in the retail business. Petitioner dedicated space at the rear of the store for tobacco products and has installed humidifiers to keep

the products fresh. Behind the tobacco shop, petitioner has an office and two storage rooms. Petitioner provides parking at both the front and rear of the store and customers may enter the premises from either location. The business is located at 412 Hillside Avenue, New Hyde Park, New York, and is open seven days a week from 7:30 A.M. to 9:30 P.M.

Mr. Yung K. Myung is president and a 50-percent shareholder of petitioner. His wife, Maryann Myung, holds the other 50 percent of the stock of the corporation.

2. On April 23, 2002, the Division of Taxation ("Division"), issued to petitioner a letter indicating that a sales and use tax audit of petitioner's books and records for the period March 1, 1999 through February 28, 2002 was scheduled for May 15, 2002. The letter requested that all books and records pertaining to petitioner's sales and use tax liability for the period under audit were to be made available on the appointment date. These records were to include financial statements, accountant's work papers, journals, ledgers, sales invoices, purchase invoices, cash register tapes, exemption certificates, Federal income tax returns, New York State income tax returns, documentation to substantiate all business expenses deducted, sales and use tax returns, cigarette and tobacco tax returns and Federal and New York State personal income tax returns for all officers and owners of the business and all business checking account bank statements with checks written.

3. During the audit period, petitioner reported gross and taxable sales based on cash register tapes. At the end of each day petitioner would print a daily summary report and prepare a schedule based on the cash register tape totals. The schedule summarized the daily sales for each sales tax quarter and petitioner would then report sales revenue on the sales and use tax returns based upon the summary schedule.

4. Petitioner provided the auditor with purchase invoices, schedules supporting prepaid sales tax, distributor of tobacco products tax returns, Form MT-203, and the summary cash register tapes. Petitioner did not provide the auditor with either detailed cash register tapes describing what products were sold per each transaction or guest checks.

5. The cash register tapes did not detail each and every individual sales transaction and were therefore deemed to be inadequate as source documentation in attempting to determine the accuracy of petitioner's sales and use tax returns. The auditor also determined that the summarized tapes contained inconsistencies and information which could not be verified. A check of the period March 1, 2001 through May 31, 2001 revealed that the ending reading for March 8, 2001 was lower than the beginning reading for that day. In addition, there were many voided transactions on the summarized cash register tapes which could not be verified due to the unavailability of detailed cash register tapes or other source documentation detailing sales or other transactions.

The auditor also performed a detailed analysis of purchases and reported taxable sales for the period December 1999 through May 2001. The analysis revealed that purchases were consistently higher than reported sales. The auditor requested that Center Candy, Inc., a supplier of petitioner, provide the amount of sales to petitioner on a monthly basis. These purchases were compared to reported taxable sales and revealed that the amount of purchases was more than the reported sales for the entire audit period.

6. Given the lack of source documentation to verify petitioner's reported sales and the excess of purchases over reported sales, the Division determined that petitioner's books and records were inaccurate and unreliable for the purpose of verifying petitioner's taxable sales and therefore determined to estimate petitioner's sales tax liability using a purchase markup method.

The auditor chose the test periods of December 1, 1999 through February 29, 2000 and March 3, 2001 through May 31, 2001. Petitioner's representative agreed with the auditor that these periods were representative of the business operation for the entire audit period.

7. The third-party verification received from Center Candy, Inc. agreed with the purchases submitted by petitioner to the auditor for both test periods. This third-party information was therefore used for the entire audit period to determine audited purchases. The tobacco purchases used were based upon the purchases reported on petitioner's MT-203 tax returns.

8. The auditor added to the purchases of Candy Center, Inc., as indicated on the third-party information, the tobacco purchases from other suppliers as indicated on the MT-203 returns, which list tobacco suppliers and purchases separately. For the entire audit period, reported sales of \$1,743,076.00 were less than total audited purchases of \$2,539,578.32.

A review of the summary cash register tapes revealed that petitioner also sold nontobacco items such as soda, candy, magazines, newspapers and greeting cards. The auditor computed a percentage of 3.18% representing the ratio of miscellaneous sales to total sales for the test period. Audited purchases from Center Candy, Inc. and other tobacco suppliers was multiplied by 3.18% to arrive at total audited purchases for the audit period. A markup was then applied to purchases.

9. A 16.35% markup was determined based upon a weighted average markup of the actual markups determined for cigarettes (10.88%) and tobacco (100%) using information from petitioner's own internal records and a 40% agreed upon markup for candy. This 16.35% markup was applied to audited purchases of cigarettes, tobacco and candy to arrive at audited sales for these items. A 50% markup was applied to the miscellaneous sales to determine audited sales. The 50% markup was based on audit experience.

The auditor computed underreported taxable sales by subtracting reported taxable sales from total audited taxable sales. Total underreported taxable sales were divided by reported taxable sales to determine an error rate for computing audited taxable sales for each of the three years under audit. The applicable error rate was applied to the sales tax reported by quarter to arrive at additional taxable sales and additional sales tax due for each quarter. Total additional audited taxable sales for the audit period was \$988,579.49.

10. On June 20, 2003, the Division issued to petitioner a Notice of Determination assessing sales and use tax due of \$84,029.27, plus penalty and interest, for the period March 1, 1999 through May 31, 2002.

11. The auditor reviewed the schedules supporting gross receipts as reported on petitioner's U.S. corporation income tax returns, Form 1120. The purchases as reported on the forms 1120 were not consistent with the purchase information obtained during the sales and use tax audit. The Division resorted to the markup audit to determine petitioner's corporation franchise tax liability. Sales as determined on the sales tax audit were deemed gross receipts. Petitioner's purchases were recomputed by adding purchases per the third-party information obtained from Center Candy, Inc. to purchases from other sources as determined from petitioner's tobacco tax returns. Purchases of other products were determined to be 3.49% of cigarette and tobacco purchases. Beginning inventory per the Federal forms 1120 was added to purchases and then ending inventory per the Federal forms 1120 was subtracted to compute the costs of goods sold. Based upon these computations, it was determined that petitioner owed additional corporation franchise tax and MTA surcharge tax. As a result, the Division issued to petitioner, on June 26, 2003, two notices of deficiency assessing corporation franchise tax of

\$33,717.00 and general business corporation MTA surcharge of \$6,210.00, for the period June 1, 1998 through May 31, 2002.

12. The auditor reviewed petitioner's purchases for the two test periods (December 1, 1999 through February 29, 2000 and March 1, 2001 through May 31, 2001) which revealed actual purchases of cigarette and tobacco products of \$23,470.89, while petitioner had reported purchases of \$22,397.00 for the test periods. The difference of \$1,073.89 was comprised of purchases from SAG Imports, Inc. in the amount of \$919.89 and from CAO International, Inc. in the amount of \$154.00 during the month of May 2001. Purchase invoices from SAG Imports, Inc., dated May 25 and 30, 2001 indicated the amount of the purchases. An error rate of 4.79% was computed and then multiplied by the purchases of tobacco as reported on petitioner's distributor of tobacco products tax returns for the audit period to determine audited tobacco purchases. Tobacco purchases reported were subtracted from audited tobacco purchases to arrive at additional tobacco purchases for the audit period.

The auditor also determined that petitioner had overstated its prepaid sales tax on cigarette and tobacco purchases for the two test periods. The error rate computed was applied to the tax-paid purchases claimed on petitioner's tobacco tax returns to arrive at total cigarette and tobacco products on which no sales tax had been paid.

As a result of the additional tobacco purchases and nonpayment of tax on purchases, the Division issued to petitioner a Notice of Determination, dated June 23, 2003, assessing tax on cigarettes and tobacco products for the period September 1, 1999 through July 31, 2002 of \$2,933.51, plus penalty and interest.

13. On May 15, 2002, petitioner executed a Consent Extending Period of Limitation for Assessment of Corporation Franchise Tax under Article 9-A of the Tax Law for the taxable

period June 1, 1998 through May 31, 1999 to August 15, 2003. On October 16, 2002, petitioner executed a Consent Extending Period of Limitation for Assessment of Cigarette and Tobacco Tax under Article 20 of the Tax Law for the taxable period September 1, 1999 through May 31, 2000 to June 30, 2003. On December 4, 2002, petitioner executed a Consent Extending Period of Limitation for Assessment of Sales and Use Taxes under Articles 28 and 29 of the Tax Law for the taxable period September 1, 1999 through August 31, 2000 to September 20, 2003.

14. In a letter dated May 23, 2006, SAG Imports, Inc. stated that petitioner's last purchase of cigars occurred on August 8, 1999. The letter further indicated that petitioner did make purchases after that date, but SAG Imports, Inc. received the shipments back, and credited petitioner's account. Mr. Myung testified that the items were returned because SAG Imports, Inc. refused to agree to the payment arrangement requested by petitioner. Two invoices from CAO International, Inc., dated October 16, 2001 and December 30, 2002, indicated that the supplier credited petitioner's account a total of \$1,299.35. Mr. Myung testified that petitioner was credited with \$154.00 in purchases made during May 2001 because the goods delivered from CAO International, Inc. were damaged and returned to the supplier.

CONCLUSIONS OF LAW

A. Tax Law § 1105(a) imposes a sales tax on the receipts from every "retail sale" of tangible personal property except as otherwise provided in Article 28 of the Tax Law. A "retail sale" is "a sale of tangible personal property to any person for any purpose, other than . . . for resale as such . . ." (Tax Law § 1101[b][4][i]). Tax Law § 1138(a)(1) provides, in relevant part, that if a sales tax return was not filed, "or if a return when filed is incorrect or insufficient, the amount of tax due shall be determined [by the Division of Taxation] from such information as may be available. If necessary, the tax may be estimated on the basis of external indices"

(Tax Law § 1138[a][1].) When acting pursuant to section 1138(a)(1), the Division is required to select a method reasonably calculated to reflect the tax due. The burden then rests upon the taxpayer to demonstrate that the method of audit or the amount of the assessment was erroneous (*see, Matter of Your Own Choice, Inc.*, Tax Appeals Tribunal, February 20, 2003).

B. The standard for reviewing a sales tax audit where external indices were employed was set forth in *Matter of Your Own Choice, Inc.* (*supra*), as follows:

To determine the adequacy of a taxpayer's records, the Division must first request (*Matter of Christ Cella, Inc. v. State Tax Commn.*, [102 AD2d 352, 477 NYS2d 858] *supra*) and thoroughly examine (*Matter of King Crab Rest. v. Chu*, 134 AD2d 51, 522 NYS2d 978) the taxpayer's books and records for the entire period of the proposed assessment (*Matter of Adamides v. Chu*, 134 AD2d 776, 521 NYS2d 826, *lv denied* 71 NY2d 806, 530 NYS2d 109). The purpose of the examination is to determine, through verification drawn independently from within these records (*Matter of Giordano v. State Tax Commn.*, 145 AD2d 726, 535 NYS2d 255; *Matter of Urban Liqs. v. State Tax Commn.*, 90 AD2d 576, 456 NYS2d 138; *Matter of Meyer v. State Tax Commn.*, 61 AD2d 223, 402 NYS2d 74, *lv denied* 44 NY2d 645, 406 NYS2d 1025; *see also, Matter of Hennekens v. State Tax Commn.*, 114 AD2d 599, 494 NYS2d 208), that they are, in fact, so insufficient that it is "virtually impossible [for the Division of Taxation] to verify taxable sales receipts and conduct a complete audit" (*Matter of Chartair, Inc. v. State Tax Commn.*, 65 AD2d 44, 411 NYS2d 41, 43; *Matter of Christ Cella, Inc. v. State Tax Commn.*, *supra*), "from which the exact amount of tax due can be determined" (*Matter of Mohawk Airlines v. Tully*, 75 AD2d 249, 429 NYS2d 759, 760).

Where the Division follows this procedure, thereby demonstrating that the records are incomplete or inaccurate, the Division may resort to external indices to estimate tax (*Matter of Urban Liqs. v. State Tax Commn.*, *supra*). The estimate methodology utilized must be reasonably calculated to reflect taxes due (*Matter of W.T. Grant Co. v. Joseph*, 2 NY2d 196, 159 NYS2d 150, *cert denied* 355 US 869, 2 L Ed 2d 75), but exactness in the outcome of the audit method is not required (*Matter of Markowitz v. State Tax Commn.*, 54 AD2d 1023, 388 NYS2d 176, *affd* 44 NY2d 684, 405 NYS2d 454; *Matter of Cinelli*, Tax Appeals Tribunal,

September 14, 1989). The taxpayer bears the burden of proving with clear and convincing evidence that the assessment is erroneous (*Matter of Scarpulla v. State Tax Commn.*, 120 AD2d 842, 502 NYS2d 113) or that the audit methodology is unreasonable (*Matter of Surface Line Operators Fraternal Org. v. Tully*, 85 AD2d 858, 446 NYS2d 451; *Matter of Cousins Serv. Station*, Tax Appeals Tribunal, August 11, 1988). In addition, “[c]onsiderable latitude is given an auditor’s method of estimating sales under such circumstances as exist in [each] case” (*Matter of Grecian Sq. v. Tax Commn.*, 119 AD2d 948, 501 NYS2d 219, 221).

C. In this matter, the Division made a proper request for petitioner’s books and records for the period March 1, 1999 through February 28, 2002 which resulted in the production of only purchase invoices, schedules supporting prepaid sales tax, tax returns and summary cash register tapes. Petitioner was unable to produce source documentation of sales made during the audit period such as detailed cash register tapes or guest checks. Due to petitioner’s insufficient records and lack of source documentation, the Division found it impossible to verify taxable sales through a complete audit which could have determined the exact amount of tax due. A detailed analysis of purchases and reported sales for the period December 1999 through May 2001 revealed purchases to be consistently higher than reported sales. Based upon this discrepancy and the lack of source documentation detailing petitioner’s sales, the Division properly deemed petitioner’s records to be inaccurate and unreliable and therefore resorted to a markup audit methodology.

D. The Division’s use of third-party information to verify petitioner’s purchase records was also proper (*see, Matter of Roebling Liquors v. Commissioner of Taxation & Finance*, 284 AD2d 669, 728 NYS2d 509, 512, *appeal dismissed* 97 NY2d 637, 735 NYS2d 493, *cert denied* 537 US 816, 154 L Ed 2d 20). Indeed, “verification of books and records is an integral, accepted

part of the audit process” (*Matter of Morano’s Jewelers of Fifth Avenue, Inc.*, Tax Appeals Tribunal, January 2, 1992). Petitioner’s contention that the Division improperly disregarded its records by requesting information from suppliers is thus rejected.

E. The discrepancy between the third-party purchase information and petitioner’s reported taxable sales was sufficient to show the inaccuracy and unreliability of petitioner’s records and justified the Division’s use of an indirect or estimated audit methodology (*see, Matter of Roebling Liquors v. Commissioner of Taxation & Finance, supra*). It was thus incumbent upon petitioner to establish the reason for the difference between the supplier information and the sales tax returns and thereby establish that the Division’s use of a markup audit was improper.

Petitioner contends that the total purchase figure used by the Division in its audit was overstated by \$367,627.07. In support of this position, petitioner introduced into the record purchase invoices from Center Candy to establish the amount of purchases petitioner made from this supplier during the audit period. It is initially noted that there are no invoices for the period March 1, 2002 through May 31, 2002 to support the amount of purchases claimed by petitioner during this quarter. More importantly, however, the purchase invoices themselves illustrate the inadequacy and deficiency in petitioner’s record keeping. Lacking internal controls, there is no way to verify that the purchase invoices presented represent the total amount of purchases made by petitioner from Center Candy during the audit period. Petitioner also contends that certain purchases, although delivered to petitioner, were later transferred to a related business operation. Lacking any documentation relating to this claim, it is rejected. Therefore, the purchase invoices introduced into the record are insufficient to establish that the Division’s markup audit was improper.

Petitioner next contends that the Division improperly computed the cigarette markup by including in the cost of the cigarettes purchased a discount which petitioner receives from the cigarette manufacturers based upon the amount of cigarettes sold. In response, the Division correctly points out that receipts are defined in Tax Law § 1101(b)(3) as “the amount of the sale price of any property . . . whether received in money or otherwise, including any amount for which credit is allowed by the vendor to the purchaser.” In addition, Article 20, which imposes an excise tax on tobacco products based on the wholesale price, defines “wholesale price” as “[t]he established price for which a manufacturer sells tobacco products to a distributor, before the allowance of any discount, trade allowance, rebate or other reduction” (Tax Law § 470[6]). Therefore, the Division properly computed the cigarette markup by including in the cost the manufacturer’s discount received by petitioner.

F. Neither the purchase invoices nor the testimony presented by petitioner rose to a level of clear and convincing evidence sufficient to show that the assessment was erroneous or that the audit methodology was unreasonable. (*See, Matter of Scarpulla v. State Tax Commn, supra; Matter of Surface Line Operators Fraternal Org. v. Tully, supra.*) The problem is that there is no reason to believe that the purchase invoices are sufficiently accurate to establish that the markup audit reached an erroneous result. Had petitioner been able to demonstrate through source documentation that the reported sales were more accurate than the Division’s estimate generated by the markup test, petitioner’s contentions might have had more credibility. But the inadequate and otherwise nonexistent records gave the Division the authority to use a method, which, although less than precise, was reasonably calculated to reflect the taxes due, and nothing that was produced or said clearly or convincingly challenged the audit methodology or the amount of tax determined to be due.

G. Having concluded that the Division properly utilized an estimated audit methodology and that petitioner was unable to demonstrate that the results were erroneous, it must be determined if petitioner has established reasonable cause to abate the penalties imposed. Tax Law § 1145(a)(1)(i) provides for penalty to be imposed where a person fails to pay over any tax within the time required by law. The Division assessed penalty against petitioner under this section. Tax Law § 1145(a)(1)(iii) and 20 NYCRR 536.1(c) provide that the Division can remit the penalty if the failure to pay over the tax was due to reasonable cause.

In establishing reasonable cause for penalty abatement, the taxpayer faces an onerous task (*Matter of Philip Morris, Inc.*, Tax Appeals Tribunal, April 29, 1993). Referring to the mandatory language of Tax Law § 1145(a)(1)(i), the Tribunal said that “the Legislature evidenced its intent that filing returns and paying tax according to a particular timetable be treated as a largely unavoidable obligation.” (*Matter of MCI Telecommunications Corp.*, Tax Appeals Tribunal, January 16, 1992.) In the instant matter, petitioner neither maintained nor produced records as required, and those that were provided were without any source documentation due to the lack of detailed cash register tapes or guest checks for each sale. In addition, there was a substantial discrepancy between reported sales and audited sales as evidenced by the tax paid with the returns during the audit period and the tax found due as a result of the audit. Finally, it is noted that petitioner’s purchases exceeded reported sales for the audit period (*Matter of Roebling Liquors v. Commissioner of Taxation & Finance, supra*; *Matter of D & V Liquor, Inc.*, Tax Appeals Tribunal, March 10, 2005). For all of these reasons penalties must be sustained.

H. As previously noted, the statutory authority for the use of external indices must be based upon an insufficiency of record keeping which makes it virtually impossible to verify

taxable sales receipts and conduct a complete audit (*Matter of Chartair, Inc. v. State Tax Commn., supra*). In order to determine whether a taxpayer's records are adequate for audit purposes, the Division must first request and then examine the taxpayer's records for the entire audit period (*Matter of Christ Cella v. State Tax Commn., supra; Matter of Adamides v. Chu, supra; Matter of Ahme*, Tax Appeals Tribunal, November 10, 1988).

There is nothing in the record which establishes that the Division made a request for the books and records of Mountain Star Company, Inc. for the period March 1, 2002 through May 31, 2002 before issuing assessments against petitioner. The appointment letter originally sent to the corporation by the auditor listed the period at issue as March 1, 1999 through February 28, 2002. Accordingly, it must be found that the Division's failure to request books and records for the period March 1, 2002 through May 31, 2002 precluded it from resorting to a test period audit to determine the tax due, and the sales and use tax assessed for the period March 1, 2002 through May 31, 2002 is canceled (*Matter of Adamides v. Chu, supra*).

I. As the corporation franchise tax liability is based upon the results of the sales tax audit, and it has been determined that petitioner has failed to establish that the assessment is erroneous or that the audit methodology is unreasonable, no adjustments to the notices of deficiency issued to petitioner are warranted, except for the period March 1, 2002 through May 31, 2002, the liabilities of which are canceled.

J. Petitioner has established through the SAG Import, Inc. letter of May 23, 2006, the credit invoices from CAO International, Inc. and Mr. Myung's testimony that \$1,073.89 in purchases were returned to the suppliers and a credit was received by petitioner (*see*, Findings of Fact "12" & "14"). Therefore, that portion of the Notice of Determination, dated June 23, 2003, which assesses tax on additional tobacco products for the audit period is canceled.

K. The petition of Mountain Star Company, Inc. relating to the sales and use tax liability is granted to the extent indicated in Conclusion of Law “H”, but in all other respects the petition is denied. The Notice of Determination dated June 20, 2003, as modified, is sustained.

The petition of Mountain Star Company, Inc. relating to the corporation franchise tax liability is granted to the extent indicated in Conclusion of Law “I”, but in all other respects the petition is denied. The notices of deficiency dated June 26, 2003, as modified, are sustained.

The petition of Mountain Star Company, Inc. relating to the tax on cigarette and tobacco products is granted to the extent indicated in Conclusion of Law “J”, but in all other respects the petition is denied. The Notice of Determination dated June 23, 2003, as modified, is sustained.

DATED: Troy, New York
January 18, 2007

/s/ Thomas C. Sacca

ADMINISTRATIVE LAW JUDGE