

STATE OF NEW YORK

DIVISION OF TAX APPEALS

In the Matter of the Petition :
of :
CRONOS ENTERPRISES, INC. :
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 March 1, 2001 through November 30, 2003. :
DETERMINATION
DTA NOS. 820738,
820739 AND 820741

In the Matter of the Petitions :
of :
STEVEN PALOUBIS AND GEORGE REKKAS :
for Revision of Determinations or for Refund of Sales :
and Use Taxes under Articles 28 and 29 of the Tax Law :
for the Period March 1, 2001 through November 30, 2003. :

Petitioner Cronos Enterprises, Inc., 2101 Middle Country Road, Centereach, New York 11720, 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 March 1, 2001 through November 30, 2003.

Petitioner Steven Paloubis, 15 Sachem Court, Farmingville, New York 11738, 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 March 1, 2001 through November 30, 2003.

Petitioner George Rekkas, 11 Elderwood Drive, St. James, New York 11780, 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 March 1, 2001 through November 30, 2003.

A consolidated hearing was held before Arthur S. Bray, Administrative Law Judge, at the offices of the Division of Tax Appeals, 641 Lexington Avenue, New York, on June 15, 2006 at 10:30 A.M., with all briefs to be submitted by September 29, 2006, which date began the six-month period for the issuance of this determination. Petitioners appeared by Paul Kalker, Esq. 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 petitioners have shown error in either the audit method or result.

II. Whether penalties imposed pursuant to Tax Law § 1145(a)(1)(i) and (vi) should be sustained.

FINDINGS OF FACT

1. Petitioners Steven Paloubis and George Rekkas operated petitioner Cronos Enterprises, Inc. (“Cronos”), which did business as the Suffolk Diner. It was in a freestanding glass building, surrounded by a parking lot. The diner was located on Middle Country Road in Centereach, New York, which is a very busy main road. There were many retail stores in the vicinity of the diner. The diner served a variety of dishes including Greek, Italian and continental cuisine.

2. On December 23, 2003, the Division of Taxation (“Division”) received a notification of bulk sale for Cronos. In response, the Division mailed a letter to Cronos, dated December 26, 2003, which stated that its sales and use tax records had been scheduled for a field audit for the

period March 1, 2001 through November 30, 2003. The letter further explained that all books and records pertaining to the sales and use tax liability for the audit period must be available on the appointment date. Among the records specifically requested, in an attached Records Requested List, were the general ledger, cash receipts journal, Federal income tax returns, purchase invoices, sales invoices, guest checks, cash register tapes, bank statements, financial statements and exemption documents.

3. In response to the audit appointment letter, the auditor received a telephone call from an individual who said that an accountant would be making an appointment with her. Thereafter, the auditor received a telephone call and a power of attorney from Alvin Silverman, Esq., who ultimately represented Cronos on the audit. On the telephone, Mr. Silverman stated that he had adequate books and records for Cronos. However, when he came to the district office he presented only a handwritten journal of the daily sales and samples of cash register tapes and guest checks.

4. The auditor reviewed the records and specifically looked for the daily tape and guest checks for the day that an observation test was conducted during a prior audit. Those tapes were not available. The cash register tapes which were provided did not state what was sold and bore a handwritten date. In addition, the auditor found some guest checks evidencing sales which did not appear on the cash register tapes.

5. The auditor concluded that she could not reconcile the tapes to what was reported because the tapes lacked detail. Since the tapes had a handwritten date, the auditor could not independently determine when the tapes were actually made. She also noted that not all sales were reported on the tapes, and as a result, she could not use the tapes in order to reconstruct the sales tax that was reported.

6. The Division considered different factors in deciding upon the audit method. One factor was that the Division had received notice that the business was being sold. As a result, it needed to conduct the audit in less time than was normally the case. A second factor was that this was a second audit. On the prior audit, the Division conducted an observation test. The Division decided to conduct a second observation test of the diner because the auditor did not think it was fair to utilize the previous observation, which took place in August, to calculate sales in the winter.

7. In order to obtain accurate audit results, the auditor believed that she needed to duplicate the circumstances of the first audit during the second audit as much as possible. The auditor and her team leader thought that using the same day of the week would be helpful in obtaining an accurate picture of the amount of “traffic” that the diner received. For this reason, the auditor chose to conduct the second observation test on a Friday. However, the auditor decided not to conduct a 24-hour observation test because she already had the results of a 24-hour observation test of the diner from the prior audit.

8. During the first audit, the managers of the restaurant would not permit the Division to observe the restaurant’s operations from inside the restaurant. Consequently, the observers stayed in the parking lot, in different shifts, and observed activity for a 24-hour period. Through this process, the Division knew the exact number of people that went to the diner at different times of the day. The auditor thought that the prior observation test, which was conducted on August 10, 2001, was particularly useful because it was performed during the current audit period.

9. On Friday, January 23, 2004, the Division carried out a second observation test of the diner. It was a sunny day but very cold. The parking lot had an accumulation of ice from

previous snowstorms. At this time, the business had been acquired by a new owner. The auditor did not feel that this affected the validity of the observation test because the name of the business was the same, the physical location was the same and the establishment continued to be operated as a diner with the same menu.

10. The observation test was conducted in a series of three shifts because the auditor wished to reconstruct the level of sales during breakfast, lunch and dinner. The time of the shifts was considered representative of the breakfast, lunch and dinner periods.¹ During the observation, an auditor sat in a car in the parking lot of the diner and observed the doors of the diner. The auditor wanted to count only customers of the diner and therefore attempted to exclude employees, delivery people or friends of people who worked at the diner. Therefore, people who went in and out of the diner quickly were excluded.

11. On the Monday immediately following the Friday observation, petitioners' representative, Mr. Silverman, came to the district office with what he said were the cash register tapes and the corresponding guest checks for January 23, 2004. On the basis of the food that was ordered on the guest checks and the position of the food order on the cash register tape, the auditor determined whether the meal should be attributed to breakfast, lunch or dinner. The auditor was also able to obtain an accurate count of the number of people who visited the restaurant.

12. The cash register tape for January 23, 2004 showed total sales of \$5,807.06.² This amount was adjusted to reflect the following: there were two "over-rings" for a total amount of \$14.35, the auditor found that there were a small number of sales without a corresponding guest

¹ The time periods were 7:30 A.M. to 10:30 A.M., 11:30 A.M. to 2:30 P.M. and 4:00 P.M. to 7:00 P.M.

² Although it did not have a time or date stamp on it, the total on the tape was accepted for audit purposes.

check in the total amount of \$10.26 and there were guest checks showing sales without a corresponding sale on the tape in the amount of \$220.28. Taking each of these items into account, the auditor determined that there were total receipts, net of tax, in the amount of \$5,519.75. Based on the number of people that she counted and an examination of the guest checks, the auditor calculated an average expenditure per person of \$8.02.³

13. The auditor compared the total number of customers from the observations on August 10, 2001 and January 23, 2004 and determined that the diner had more customers in the summer than in the winter. Consequently, the auditor chose to distinguish between the winter months and the remainder of the year when she calculated the amount of tax due.

14. For the months of December, January and February, the auditor utilized the following methodology. On the basis of her observation on January 23, 2004, the auditor estimated that sales on Fridays during the months of December, January and February were \$5,519.75. Saturday's sales were estimated to be the same as Friday's sales. Following the methodology utilized on the prior audit, the auditor estimated that 60 percent of the people who patronized the diner on Fridays would patronize the diner on Mondays through Thursdays. Therefore, the auditor used a daily sales figure for Monday through Thursdays of \$3,311.85. The auditor similarly estimated that sales on Sundays were 90 percent of Friday's sales or \$4,967.78.⁴ On the basis of the forgoing figures, the auditor estimated weekly sales. The estimated weekly sales became the basis for the auditor's estimate of the diner's monthly and quarterly sales.

³ The auditor determined that 688 people ordered food from the diner that day.

⁴ The 60 and 90 percentages were obtained during the prior audit by a comparison of the results of the Division's observation and an observation previously conducted by Suffolk County on March 17, 2000.

Ultimately, the auditor estimated that the diner's quarterly sales during the months of December through February were \$377,385.45.

15. In order to estimate quarterly sales occurring during the months of March through November the auditor utilized an average expenditure of \$8.02 person net of tax⁵ multiplied by a head count of 1,294 which was determined from the observation conducted on August 10, 2001. Thus, receipts for Fridays were estimated to be \$10,377.88. Saturday sales were estimated to be the same as Friday sales. Following the same methodology as was performed above, the auditor estimated that sales for Mondays through Thursdays were 60 percent of Friday's sales or \$6,226.73 and Sunday's sales were estimated to be 90 percent of Friday's sales or \$9,375.38. As had been done with the winter months, the auditor estimated weekly sales from the estimated daily sales. The estimated weekly sales became the basis for the auditor's estimate of the diner's monthly and quarterly sales. Ultimately, the auditor estimated that the diner's quarterly sales during the months of March through November were \$709,990.86.

16. The auditor compared the estimated taxable sales to the reported taxable sales over the same period of time to calculate additional taxable sales. This amount was then multiplied by the tax rate in effect at the time to arrive at additional tax due.

17. On the basis of the forgoing audit, the Division issued a Notice of Determination to Cronos, dated February 13, 2004, which assessed a deficiency of sales and use tax in the amount of \$318,030.65 plus interest in the amount of \$66,106.43 and penalty in the amount of \$105,094.42 for a balance due of \$489,231.50. The Division also issued separate notices to petitioners George Rekkas and Steven Paloubis, dated March 8, 2004, which assessed tax in the amount of \$318,030.65 plus interest in the amount of \$69,509.60 and penalty in the amount of

⁵ See Finding of Fact "12."

\$107,136.99 for a balance due of \$494,677.24. The later notices explained that the individuals were assessed as responsible officers or persons of Cronos. Each of the statutory notices assessed penalties pursuant to Tax Law § 1145(a)(1)(i) and (vi). Both statutory and omnibus penalties were assessed because the additional tax due was more than 25 percent of the audited tax due.

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 is 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” 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 the 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.* (Tax Appeals Tribunal, February 20, 2003), 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 the diner's books and records. In response, petitioners presented a handwritten journal of the daily sales and samples of cash register tapes and guest checks. These records were clearly insufficient to verify taxable sales since the tapes were not complete, they did not state what was sold on them and they only bore a handwritten date (20 NYCRR 533.2[b][2]; *see, Matter of Licata v. Chu*, 64 NY2d 873, 487 NYS2d 552). The poor state of the records presented made it impossible to verify taxable sales through a complete audit from which the exact amount of tax due could have been determined.

Accordingly, it was proper for the Division to resort to the use of external indices (*Matter of Karay Restaurant Corp. v. Tax Appeals Tribunal*, 274 AD2d 854, 711 NYS2d 853, *lv denied* 96 NY2d 702, 722 NYS2d 794; *Matter of Sarantopoulos v. Tax Appeals Tribunal*, 186 AD2d 878, 589 NYS2d 102). The courts have upheld the use of observation tests as an external index and have found it reasonable to extrapolate the results of a one-day observation or multiple-day test over a multi-year audit period (*see, Matter of Sarantopoulos v. Tax Appeals Tribunal, supra; Matter of Vebol Edibles v. Tax Appeals Tribunal*, 162 AD2d 765, 557 NYS2d 678, *lv denied* 77 NY2d 803, 567 NYS2d 643). Accordingly, it was reasonable to utilize an observation test to estimate the diner's sales and the resultant sales tax liability (*see, Matter of Marte*, Tax Appeals Tribunal, August 5, 2004).

D. Initially, petitioners argue that the audit team picked a Friday to conduct the first observation test on August 10, 2001 on the basis that Friday was a representative day for the diner. Petitioners submit that Friday was the busiest day and that the other days were substantially slower. Petitioners further maintain that the audit method does not adequately account for the decrease in business on the other days of the week.

The forgoing arguments do not satisfy the taxpayers' burden of proving by clear and convincing evidence that the audit methodology was erroneous or that the assessment was incorrect (*see, Matter of Sarantopoulos v. Tax Appeals Tribunal, supra*). First, there is no evidence in the record that would support the proposition that the observation test should not have been conducted on a Friday. Second, petitioners' argument overlooks the fact that the Division adjusted the level of sales to reflect the day of the week. Again, there is no evidence in the record to show that the adjustments to sales were inadequate.

E. Petitioners next argue that there is insufficient evidence that the auditor did not include, as part of the Division's head count, employees, delivery people, children who did not eat or people who were inside the diner for a few moments. This argument also lacks merit. In this case, the Division presented credible testimony that it attempted to exclude employees, delivery people or friends of people who worked at the diner. It also excluded people who entered and exited the premises quickly. Under these circumstances, the burden of proof rested upon petitioners to show by clear and convincing evidence that the audit method was flawed (*Matter of Surface Line Operators Fraternal Org. v. Tully, supra*). Petitioners have not presented any evidence to satisfy this burden. Petitioners' argument also fails because it constitutes an impermissible attempt to shift the burden of proof to the Division.

F. Petitioners maintain that it was arbitrary to extrapolate from the observation tests to the full audit period as if all Fridays during the audit period were identical to the day of observation; that all Saturday sales were identical to Friday sales; that all Sunday sales were 90 percent of Friday sales; and, that all Monday through Thursday sales were 60 percent of Friday sales.

Contrary to petitioners' position, the record shows that the methodology followed by the Division was not at all arbitrary. Rather, the credible testimony offered by the Division showed that the percentages used by the Division to determine sales during the week were calculated by the Division on the prior audit. The previous auditors, in turn, obtained the percentages by a comparison of the results of the Division's initial observation and an observation conducted by Suffolk County on March 17, 2000. A similar challenge to the previous audit was rejected in *Matter of Cronos* (Tax Appeals Tribunal, January 26, 2006).

G. Petitioners point out that the second observation on January 24, 2004 produced a much lower head count than the observation on August 10, 2001. Petitioners submit that if the second

head count were used in place of the first head count the tax due would be close to what was reported and result in the cancellation of penalties and excessive interest.

The testimony in the record clearly establishes that the second observation test was conducted in order to obtain an understanding of whether and the extent to which the patronage of the diner fluctuated from the summer to the winter. The auditor did not think it was fair to utilize the previous observation, which took place in August, to calculate sales in the winter. This process was clearly rational and resulted in lower assessments. Accordingly, this argument is similarly without merit.

H. Lastly, petitioners presented a series of statements to the effect that the auditor lacked sufficient training or experience in conducting audits of diners. They also objected to the use of the results of the first observation to calculate the tax due because the auditor was not involved in the first observation test.

As set forth above, petitioners bear the burden of proving by clear and convincing evidence that the audit methodology was erroneous or that the assessment was incorrect (*see, Matter of Sarantopoulos v. Tax Appeals Tribunal, supra*). Here, there is no evidence that the audit results were impaired by either of the forgoing factors. Any imprecision in the results of the audit arose by reason of petitioners' own failure to keep and maintain records of all of the diner's sales as required by Tax Law § 1135(a)(1) (*Matter of Markowitz v. Sate Tax Commission, supra*).

I. Penalties were imposed pursuant to Tax Law § 1145(a)(1)(i) which authorizes the imposition of penalties for failure to pay any tax imposed under Articles 28 and 29 of the Tax Law. Petitioners have also been assessed penalties pursuant to Tax Law § 1145(a)(1)(vi) for omission of greater than 25% of the tax due.

Tax Law § 1145(a)(1)(iii) provides that if the failure or delay was due to reasonable cause and not due to willful neglect, penalty and additional interest shall be abated. In this case, penalties were properly imposed because of the substantial discrepancy between the amount of reported taxable sales and the amount of tax determined on the audit (*see, Matter of S.B.H. Super Markets v. Chu*, 135 AD2d 1048, 522 NYS2d 985). As noted by the Division, the failure to maintain and provide records is another reason to sustain the imposition of penalties (*Matter of Rosemellia d/b/a The Burt Restaurant*, Tax Appeals Tribunal, March 12, 1992; *see also, Matter of Shukry v. Tax Appeals Tribunal*, 184 AD2d 874, 585 NYS2d 531). Since the initial issue of penalty assessed pursuant to Tax Law § 1145(a)(1)(i) has been determined against petitioners, the additional omnibus penalty must also be sustained.

J. The petitions of Cronos Enterprises, Inc., Steven Paloubis and George Rekkas are denied, and the notices of determination issued on February 13, 2004 and March 8, 2004 are sustained.

DATED: Troy, New York
March 22, 2007

/s/ Arthur S. Bray
ADMINISTRATIVE LAW JUDGE