STATE OF NEW YORK

DIVISION OF TAX APPEALS

In the Matter of the Petition	:	
of	:	
XUE QUN LIN D/B/A CHINA KING CHINESE RESTAURANT	:	DETERMINATION DTA NO. 820966
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, 2001 through February 29, 2004.	:	

Petitioner, Xue Qun Lin d/b/a China King Chinese Restaurant, 13123 Broadway Street, Alden, New York 14004, 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, 2001 through February 29, 2004.

A hearing was held before Catherine M. Bennett, Administrative Law Judge, at the offices of the Division of Tax Appeals, 641 Lexington Avenue, New York, New York, on September 27, 2006 at 10:30 A.M., with all briefs to be submitted by April 10, 2007, which date began the six-month period for the issuance of this determination. Petitioner appeared by David Yan, Esq. The Division of Taxation appeared by Daniel Smirlock, Esq. (Robert Maslyn, Esq., of counsel).

ISSUES

I. Whether the audit methodology used by the Division of Taxation was reasonably calculated to determine the sales tax liability for China King Chinese Restaurant, a sole proprietorship operated by Xue Qun Lin, during the period in issue.

II. Whether the Division of Taxation properly imposed penalties in this matter.

FINDINGS OF FACT

1. Petitioner is Xue Qun Lin d/b/a China King Chinese Restaurant, located in Alden, New York, 20 to 30 miles east of Buffalo. The restaurant operated seven days each week; 11 to 12 hours on 6 days and 10 hours on Sunday. Petitioner and 3 other members of his family worked in the restaurant, and ate all of their meals there.

2. The Division of Taxation ("Division") sent correspondence to petitioner dated March 30, 2004, scheduling a field audit appointment for May 4, 2004 at petitioner's place of business. The appointment letter requested that all books and records pertaining to petitioner's sales and use tax liability for the period under audit, June 1, 2001 through February 29, 2004, be available for review. A list of records to be presented included sales tax returns, worksheets and canceled checks, Federal income tax returns and New York State corporation franchise tax returns, general ledger, general journal and closing entries, sales invoices and all exemption documents supporting nontaxable sales, a chart of accounts, fixed asset purchases and expense purchase invoices, bank statements, canceled checks and deposit slips for all accounts, cash disbursements journal, cash register tapes and guest checks for the entire audit period. The letter also advised petitioner that:

> an owner, officer or employee with personal knowledge of your business operations attend the opening conference, even if a representative will be present. A firsthand explanation will help to eliminate possible misunderstandings and will provide quick answers to help establish the initial audit plan.

3. After petitioner and the Division met on June 29, 2004, petitioner provided Federal tax returns and schedules C for the business, bank statements for the audit period, some cost of goods sold information and some purchase invoices. There were no cash register tapes or guest

checks, and no sales records. All other requested records were not made available to the auditor and the Division deemed the records inadequate to perform a detailed audit.

4. When the submission by petitioner to the Division of books and records appeared incomplete, the Division inquired of petitioner's third-party vendors, suppliers of food and beverages, for purchase information to potentially be used in the audit. The Division sent correspondence to vendors that sell food products to Chinese restaurants and chose the entire year 2002 as the test period, in order to cover any cyclical business activity throughout a full tax year. The Division utilized all the information provided to it by the third-party vendors, but was not able to verify petitioner's purchases of produce in this manner.

5. The Division noted that in comparing petitioner's purchase information shown on the invoices provided for the audit period in the amount of $17,032.00, and its cost of goods sold reported on the Federal income tax returns for the audit period of $33,316.00, to the third-party purchases of food and beverages from suppliers in the amount of $64,732.85, the discrepancy between this amount and both amounts provided by petitioner was significant, and no explanation was offered for the differences during the audit.

6. The third-party vendor information for petitioner's purchases for 2002 totaled $30,700.83, without produce. In order to estimate petitioner's purchases of produce, the auditor reviewed the produce purchases determined on a prior audit ($5,804.45) of a separate chain of Chinese restaurants with locations in shopping mall food courts in the same geographical area. He then determined that the ratio of produce purchases to total purchases in the chain audit was 14.65%. Applying that percentage in this case, the auditor calculated estimated produce purchases for 2002 in the amount of $4,497.39, and when this amount was added to the third-

party vendor information acquired, the auditor arrived at total estimated purchases for petitioner of $35,198.22 for 2002.

The prior audit also allowed the auditor to determine a markup percentage of 387.16% by comparing gross sales in that audit to the cost of goods sold (less paper products),[1] which when multiplied by petitioner's estimated purchases in the amount of $35,198.22, resulted in projected gross sales per markup for 2002 of $136,274.15. On that amount 8% sales tax of $10,901.93 was calculated, less tax remitted by petitioner of $3,536.00, for additional tax due of $7,365.93. Based upon that computation, the auditor determined that petitioner's error percentage was 208.3125% ($7,365.93/$3,536.00) for 2002, and he applied that error rate to the tax reported by petitioner for the entire audit period in the amount of $9,295.00, and the result was the Division's determination of additional tax due of $19,362.65 for the entire audit period.

7. The Division issued a Notice of Determination, dated February 14, 2005, which assessed additional sales and use taxes in the amount of $19,362.65, plus penalties and interest, for a total amount due of $32,664.46 for the period September 1, 2001 through February 29, 2004 (Assessment ID L-025032249-4) to petitioner, as follows:

Xue Qun Lin
China King Chinese Restaurant
JFT Tax Service Inc.
13518 37th Ave #168
Flushing, NY 11354-4149

SUMMARY OF THE PARTIES' POSITIONS

8. Petitioner maintains that the third-party information and markup percentage applied were incorrect, and that the Division failed to take into account that petitioner and his family ate

[1] Paper products were not a part of petitioner's cost of goods sold.

all of their meals at the restaurant, which reduced the amount of purchases subject to markup and sale.

9. The Division argues that for the period assessed petitioner failed to produce complete books and records to enable a detailed audit to be conducted. Having established the records were insufficient, the Division properly resorted to an indirect audit methodology. The Division agrees that its method of audit must be reasonable, but it is not required to utilize the most exact method of audit when petitioner's records are inadequate. The Division contends that petitioner failed to substantiate any of his claims, and in the absence of complete books and records, he cannot meet his burden of proving that the audit method was unreasonable or erroneous. The Division asserts it properly imposed penalties in this case.

CONCLUSIONS OF LAW

A. Under Tax Law § 1135(a), "[e]very person required to collect tax shall keep records of every sale . . . in such form as the commissioner of taxation and finance may by regulation require." These records must be kept in a manner suitable to determine the correct amount of tax due and must be available for the Division's inspection upon request (Tax Law § 1135[g]; 20 NYCRR 533.2[a][2]). The regulations provide that among the sales records required to be maintained are "sales slip, invoice, receipt, contract, statement or other memorandum of sale, . . . guest check, . . . cash register tape and any other original sales document" (20 NYCRR 533.2[b][1]).

In this case, petitioner did not produce cash register tapes, sales invoices or any other original sales documentation to verify the amount of sales for the period in question. There were incomplete purchase records, and no journals or ledgers for the period in issue. Petitioner conceded that he was not aware he should keep certain records and did not maintain such records

until he became aware of what he should retain. Thus, the Division made a proper determination that petitioner's records were inadequate for purposes of conducting a complete and accurate audit (Tax Law § 1135; 20 NYCRR 533.2).

B. There is no dispute that the audit methodology utilized in this matter was an indirect methodology based on purchase information acquired from petitioner's third-party vendors and, in part, from percentages adapted from another Chinese restaurant audit in the same geographic area. In order for the Division to utilize an indirect methodology, it must show that it made an adequate request for books and records for the entire audit period (***see***, ***Matter of Christ Cella v. State Tax Commn.***, 102 AD2d 352, 477 NYS2d 858), and that it reviewed the records provided in order to determine that the records were inadequate for the purposes of conducting a complete audit (***see***, ***Matter of King Crab Rest. v. Chu***, 134 AD2d 51, 522 NYS2d 978). To determine the adequacy of a taxpayer's records, the Division must first request ***(Matter of Christ Cella, Inc. v. State Tax Commn.***, ***supra***, 477 NYS2d at 859) and thoroughly examine (***Matter of King Crab Rest. v. Chu***, ***supra***) 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 estimates to determine the 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 Organization. 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. New York State Tax Commn.***, 119 AD2d 948, 501 NYS2d 219, 221).

In this case, the original appointment letter sent by the Division to petitioner constituted an adequate request for books and records and covered the entire audit period in issue. This was followed by other requests for records, telephone conversations and messages discussing the providing of records and meetings wherein records were requested. The records provided by petitioner during the audit were scant at best (***see,*** Finding of Fact "3"), and the Division made a proper determination that petitioner's records were inadequate for the purposes of conducting a complete audit.

C. Pursuant to Tax Law § 1132(c)(1), petitioner bears the burden of proving by clear and convincing evidence that the tax assessed was erroneous (***Matter of Rizzo v. Tax Appeals Tribunal***, 210 AD2d 748, 621 NYS 2d 115; ***Matter of Mobley v. Tax Appeals Tribunal***, 177 AD2d 797, 799, 576 NYS 2d 412, ***appeal dismissed*** 79 NY2d 978, 583 NYS2d 195; ***Matter of Surface Line Operators Fraternal Line Organization v. Tully***, ***supra***). Furthermore, a presumption of correctness attaches to a notice issued by the Division, and the taxpayer must overcome this presumption (***see***, ***Matter of Suburban Carting Corporation***, Tax Appeals Tribunal, May 7, 1998, citing ***Matter of Tavolacci v. State Tax Commn.***, 77 AD2d 759, 431 NYS2d 174; ***Matter of Leogrande***, Tax Appeals Tribunal, July 18, 1991, ***confirmed*** 187 AD2d 768, 589 NYS2d 383, ***lv denied*** 81 NY2d 704, 595 NYS2d 398).

In the present case the auditor, having no sales records available and incomplete purchase records, chose to use third-party vendor information and ratios from another Chinese restaurant audit to estimate petitioner's underreported sales tax. Petitioner argues that an estimated $10,000.00 of food purchased each year represented food that was consumed by petitioner's family of four, all of whom worked in the restaurant. Although petitioner did not maintain any records that would substantiate this amount, the factual assertion and amount is a reasonable one, and based on credible testimony. The four members of petitioner's family worked in the restaurant, which was open 11 to 12 hours a day for 6 days each week and 10 hours on Sunday. Petitioner and his two sons testified credibly to the type of food they predominately consumed, their preference for food of their own ethnic background contrasted with American fast food, and the frequency of their eating in the restaurant. In view of these facts, particularly the number of hours petitioner spent in his restaurant business each day, there should have been an allowance for such purchases (***see, Matter of Bernstein-on-Essex St.***, Tax Appeals Tribunal, December 3,

1992). The Division is directed to allow $10,000.00 in family food consumption in calculating total estimated purchases, so that estimated purchases for 2002 should be reduced to $25,198.22.

Although petitioner was critical of the markup used in the audit estimation, petitioner did not provide consistent testimony about his food markup percentages. First, he alluded to the mark up percentages being 10-20% on most food, but later testified that the markup was often over 20%. Petitioner could not calculate with any certainty the costs associated with a particular dish. Furthermore, petitioner did not provide any documentation or calculations that may have supported his claims.

Petitioner asserted that the audit was flawed since it did not take into account any food that spoiled or had to be returned to the supplier. However, petitioner conceded that returns were often replaced by the supplier at no cost to petitioner, and no amount was suggested as an allowance for spoilage for which petitioner did bear the cost.

Thus, with the exception for the family food consumption allowance of $10,000.00 per year, sufficient evidence exists in this record to conclude that the Division otherwise had a rational basis for this audit (***Matter of Grecian Sq. v. New York State Tax Commn.***, ***supra***). It was incumbent upon petitioner to show by clear and convincing evidence that the audit method in all other aspects was unreasonable (***Matter of Meskouris Bros. v. Chu***, 139 AD2d 813, 526 NYS2d 679, 681), and petitioner only carried this burden to the limited extent indicated.

D. Tax Law § 1145(a)(1)(i) imposes a penalty upon persons who fail to timely file a return or timely pay the tax imposed by Articles 28 and 29 of the Tax Law. The penalty and additional interest may be waived if "such failure or delay was due to reasonable cause and not due to willful neglect" (Tax Law § 1145[a][1][iii]). In determining whether reasonable cause and good faith exist, the regulations provide several specific grounds and also a catchall which provides for

a finding of reasonable cause based upon any ground for delinquency which would appear to a person of ordinary prudence and intelligence as a reasonable cause for delay, demonstrating an absence of willful neglect (20 NYCRR 2392.1[d][5]). The taxpayer bears the burden of establishing that the actions were based upon reasonable cause and not willful neglect (***see, Matter of Philip Morris***, Tax Appeals Tribunal, April 29, 1993; ***Matter of MCI Telecommunications Corp***., Tax Appeals Tribunal, January 16, 1992, ***confirmed*** 193 AD2d 978, 598 NYS2d 360; 20 NYCRR 3000.15[d][5]). Petitioner has not offered any information that would allow me to consider an abatement of penalties, and therefore, has not carried his burden.

E. The petition of Xue Qun Lin d/b/a China King Chinese Restaurant is granted to the extent noted in Conclusion of Law "C," and the Notice of Determination dated February 14, 2005, is adjusted accordingly, but is otherwise sustained.

DATED: Troy, New York
October 4, 2007

/s/ Catherine M. Bennett
ADMINISTRATIVE LAW JUDGE