

STATE OF NEW YORK

DIVISION OF TAX APPEALS

In the Matter of the Petition :
of :
YEE WA LAM : SMALL CLAIMS
 : DETERMINATION
 : DTA NO. 820982
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 November 30, 2003. :

Petitioner, Yee Wa Lam, 84 Sandhurst Court, Williamsville, New York 14221-3100, 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 November 30, 2003.

A small claims hearing was held before Joseph W. Pinto, Jr., Presiding Officer, at the offices of the Division of Tax Appeals, 641 Lexington Avenue, New York, New York, on May 23, 2007 at 10:45 A.M., which date began the three-month period for the issuance of this determination. Petitioner appeared by Kevin K. Tung, Esq. The Division of Taxation appeared by Daniel Smirlock, Esq. (James M. Gastle).

ISSUE

I. Whether the Division of Taxation properly determined additional sales and use taxes due from China King Siu, Inc., and its president, Yee Wa Lam, for the audit period herein.

II. Whether the Division's use of an external index, here a utility ratio, to determine additional sales was proper.

III. Whether petitioner has demonstrated reasonable cause for the abatement of the penalty asserted.

FINDINGS OF FACT

1. Yee Wa Lam was the president of China King Siu, Inc. (“China King”) between March 1, 2002 and November 30, 2003 (the “audit period”)¹ and a person responsible for the collection and payment of sales and use taxes on the company’s behalf.

2. During the period in issue, the company operated a Chinese restaurant, “China King,” at 726 Maple Road, Williamsville, New York, making taxable sales of food and beverages.

3. The Division of Taxation (“Division”) commenced an audit of China King with the mailing of a request for books and records on July 6, 2004, which requested the production of certain records including sales tax returns, Federal income tax returns, New York State corporation tax returns, a general ledger, sales invoices, bank statements and checks, a cash disbursements journal, cash receipts journal, cash register tapes and guest checks for the audit period. As of December 28, 2004, petitioner had submitted cash register tapes for the period September 2001 to May 2002 and purchase invoices for the period December 2001 to November 2003.

4. By letter dated December 28, 2004, the Division specifically requested cash register tapes for June 2002 to November 2003 and purchase invoices from September 2001 to November 2001. In response, petitioner produced ten additional bags of register tapes. Although requested, the following records were not made available on audit: cash register tapes for the period June 2003 through November 2003; register tapes for the months of January and February 2003 (tapes were illegible); and purchase records for September, October and November 2001.

¹The Division of Taxation had originally included the quarters ended November 30, 2001 and February 28, 2001 but these were cancelled at conference because the Division of Taxation did not procure a consent to extend the period of limitation from petitioner. Therefore the Notice of Determination was modified by the Bureau of Conciliation and Mediation Services Order and the amount remaining in issue is \$45,002.40, plus penalty and interest.

5. The Division determined that it could not trace transactions back to an original source or forward to a final total because of inadequate sales records. Since cash register tapes were the record of sales utilized by the taxpayer, and complete cash register tape data were not available for the audit period, it was determined that China King had inadequate records for an audit to be performed in detail. In addition, the business was missing approximately 22 percent of its guest checks for the audit period and several months of purchase invoices. Further undermining the Division's ability to utilize petitioner's records for a purchase markup audit was an investigator's discovery that China King had done business with a purveyor of vegetables named David C. Haas, a relationship that was on a cash basis and not recorded on the books of either company, and a discrepancy in the purchases from Will Poultry, where that vendor's records indicated more purchases than China King's invoices.

6. Having established the inadequacy of China King's purchase and sales records for the period in issue, the Division determined that an estimated audit methodology was warranted. It chose to estimate petitioner's sales tax liability by using a methodology which determined total sales using a ratio of utility service expenses as established by the "2003 Restaurant Industry Operations Report" authored by the National Restaurant Association and the firm of Deloitte & Touche.

7. The Division analyzed the utility bills submitted by petitioner for the months of June 2002 through August 2003 (the "tested period"). The total utility service expense for each month was divided by a percentage, established by the report for single unit, independent restaurants like China King. The report listed three possible ratios for use in determining total sales: lower (2%), median (3%) and upper (4%) quartiles. These quartiles represented lower, median and higher utility rates to reflect the relative cost of utilities for different areas of the United States.

8. The Division of Taxation chose to use the median quartile, three percent, because it believed the result of using it would be “fair,” notwithstanding the fact that its auditor testified at hearing, at least twice, that utility rates in western New York State were among the highest in the country and that he could not name an area that had higher utility rates. The choice of the median quartile was not stated specifically to be based on an historical office policy or experience, despite the fact that application of the different ratios produced greatly divergent results in the calculations of total sales.

9. After dividing each of the utility expense totals for each month of the tested period, the Division determined total sales of \$659,454.00. This number was divided by the gross sales actually reported by petitioner for the tested period, \$246,595.00, and yielded an error rate of 2.674. When the error rate was applied to gross sales as reported for each of the quarters in the audit period, the result was additional unreported gross sales of \$1,126,993.00, yielding additional tax due of \$56,599.44, after credit for previous payments totaling \$34,196.00.

10. The Division issued a Notice of Determination to Yee Wa Lam, dated April 11, 2005, which set forth additional tax due of \$56,599.43 plus penalty and interest. As noted above in footnote 1, the additional tax due was reduced to \$45,002.40 by order of the Bureau of Conciliation and Mediation Services. Penalty was asserted because petitioner had been audited previously, counseled to keep better records, and still did not maintain adequate records. Penalties were imposed for failing to pay over the tax due in a timely manner and underreporting tax in excess of 25%.

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. 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. (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 the books and records. In response, petitioner presented some documents. However, they were inadequate to conduct a complete audit since original records such as guest receipts, cash register tapes and purchase records were incomplete, and evidence of cash sales undermined the Division’s ability to discern whether the proper tax had been charged and collected. Accordingly, it was proper for the Division to resort to the use of third-party information to obtain petitioner’s purchases and calculate the sales tax due (*see, Matter of Roebling Liquors v. Commissioner of Taxation & Finance*, 284 AD2d 669, 728 NYS2d 509 *appeal dismissed* 97 NY2d 637, 735 NYS2d 493, *cert denied* 537 US 816, 154 L Ed 2d 20).

D. Since the Division’s decision to resort to external indices was justified, petitioner bears the burden of establishing that the assessment was erroneous or that the audit method was unreasonable (*Matter of Scarpulla v. State Tax Commn., supra.*) Here, petitioner argues that the utility factor employed by the Division was inherently flawed because it was not demonstrated that the utility expense ratios in the “2003 Restaurant Industry Operations Report” accounted for both fixed and variable utility costs. Petitioner contends that a successful restaurant should be assigned a ratio which would produce more total sales than a struggling

restaurant. Since the report listed only one ratio for all restaurants within a specific quartile, petitioner argues that its application to China King is flawed.

However, petitioner has not presented any clear and convincing evidence to support this argument and therefore an adjustment to the assessment on this basis is unwarranted (*see, Matter of Cronos Enterprises*, Tax Appeals Tribunal, January 26, 2006). Further, it must be emphasized that, in the absence of adequate records, the Division's methodology must be reasonable, not exact, and it is allowed latitude in its estimate.

E. Despite the fact that the Division was warranted in using an estimated audit methodology and justified in using the utility expense ratio to determine an error rate and additional gross sales (*cf. Matter of Fokos Lounge, Inc.*, Tax Appeals Tribunal, March 7, 1991 [where taxpayer proved through expert witness that the utilities factor was without a rational basis as applied to its business]), it went beyond the "considerable latitude" granted to it in its methodology when it chose the median quartile for purposes of the utility ratio. The Division did not demonstrate that it had a policy for assigning particular taxpayers specific quartiles and the auditor's concession at hearing that he believed western New York State had some of the highest utility rates in the country underscored the irrationality of choosing the median quartile, when it was apparent that the upper quartile was clearly more accurate. The auditor's speculation that the median was "fair" lends no credence to the Division's choice of that ratio and belied his knowledge of the actual climatological circumstances facing petitioner's business in Buffalo, New York. As such, this portion of the generally accepted utility ratio estimated methodology was not properly applied and was not reasonable. (*Matter of Surface Line Operators Fraternal Org. v. Tully, supra.*)

The Division is directed to recalculate additional tax due for the revised audit period (*see* Finding of Fact “1”) using the upper quartile, four percent, figure set forth in the “2003 Restaurant Industry Operations Report.”

F. Tax Law § 1145(a)(1)(i) authorizes the imposition of a penalty for the failure to file a return or to pay or pay over the sales and use tax due within the time required. Tax Law § 1145(a)(1)(vi) authorizes the imposition of a penalty upon a taxpayer for his omission from the total amount of sales and use taxes required to be shown on a return an amount which is in excess of 25 percent of the amount of such taxes required to be shown on the return. Such penalties may be abated, pursuant to Tax Law § 1145(a)(1)(iii) and (vi), when the taxpayer establishes that such omission was due to reasonable cause and not due to willful neglect. Reasonable cause includes any cause for delinquency which would appear to a person of ordinary prudence and intelligence as reasonable cause for the delay in filing a sales tax return and paying the tax imposed under Articles 28 and 29 of the Tax Law (*see*, 20 NYCRR 2392.1[d][5]). Petitioner has not presented any evidence or argument warranting the waiver of the penalties asserted.

G. The petition of Yee Wa Lam is granted to the extent set forth in Conclusion of Law “E”, but in all other respects the Notice of Determination, dated April 11, 2005, as modified by the Conciliation Order, dated December 9, 2005, is sustained.

DATED: Troy, New York
August 9, 2007

/s/ Joseph W. Pinto, Jr.
PRESIDING OFFICER