STATE OF NEW YORK

DIVISION OF TAX APPEALS

In the Matter of the Petition	:	
of	:	
WILLIAM P. AND JANICE MACKIEWICZ, JR.	:	
for Redetermination of a Deficiency or Refund of Personal Income Tax under Article 22 of the Tax Law for the Years 1997, 1998 and 1999.	:	
	:	DETERMINATION DTA NOS. 821166 AND 821167
In the Matter of the Petition	:	
of	:	
121 GRANT STREET, INC.	:	
for Redetermination of a Deficiency or Refund of Corporation Franchise Tax under Article 9-A of the Tax Law for the Years 1997, 1998 and 1999.	:	

Petitioners William P. And Janice Mackiewicz, Jr., filed a petition for redetermination of a deficiency or for refund of personal income tax under Article 22 of the Tax Law for the years 1997, 1998 and 1999.

Petitioner 121 Grant Street, Inc., 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 years 1997, 1998 and 1999.

A consolidated hearing was held before Joseph W. Pinto, Jr., Administrative Law Judge, at the offices of the Division of Tax Appeals, 130 West Main Street, Rochester, New York, on September 18, 2007 at 9:15 A.M., with all briefs submitted by February 1, 2008, which date

began the six-month period for the issuance of this determination. Petitioners appeared by Gary M. Kanaley, Esq. The Division of Taxation appeared by Daniel Smirlock, Esq. (Kevin M. Law, Esq., of counsel).

ISSUES

I. Whether the Division of Taxation properly determined additional personal income tax and corporation franchise tax for the audit period.

II. If petitioners are determined to owe additional tax, whether they have established that their failure to pay was due to reasonable cause and not willful neglect.

FINDINGS OF FACT

1. Petitioner William P. Mackiewicz was the sole shareholder of petitioner 121 Grant Street, Inc., which operated a business known as Frontier Liquor.

2. During the years 1997, 1998 and 1999 (the audit period), Frontier Liquor was located on the west side of Buffalo, New York, in a poor neighborhood with high crime and many storefront vacancies. In fact, the store was very close to the Canadian border and a duty free shop, where liquor could be purchased at deep discounts.

3. The building which housed the store had one entryway and contained two business operations: a liquor store and a corner delicatessen, or discount beverage shop, which sold beer and grocery items.

4. These matters originated as follow-up audits from sales tax audits conducted by the Buffalo District Office and the Revenue Crimes Bureau. After a preliminary review of petitioners' business operations and records, sales tax auditors referred the matter to the Revenue Crimes Bureau, which further investigated Mr. Mackiewicz and Frontier and then turned the matter over to the Erie County District Attorney for prosecution. Ultimately, on

December 19, 2002, Mr. Mackiewicz pled guilty to the crime of grand larceny in the third degree for failing to pay New York State sales tax in his business operations for the period March 1997 through February 2000, a class D felony. Mr. Mackiewicz received three years probation and agreed to pay restitution in the sum of $286,527.31.

5. Following the criminal disposition, the Division of Taxation's (Division) sales tax auditors informed petitioners that the sales tax liability appeared to be larger than the negotiated amount of the restitution determined by the Revenue Crimes Bureau. After reviewing taxable purchases per third-party invoices and petitioners' records, a summary worksheet was prepared by the sales tax audit bureau listing suppliers of liquor, beer, wine, cigarettes and additional products to 121 Grant Street, Inc., during the years in issue. It was concluded, after negotiation, that petitioners owed a total additional tax of $500,378.23, which included the amount of restitution. Therefore, the sales tax auditors increased the amount of additional sales tax due by $213,850.92.

6. The additional sales tax due was established by applying a markup percentage to the additional purchases found and verified by the Division. The markup percentage was negotiated by the parties based upon many factors, including national statistics. The parties agreed to use a 27.52% markup for the first four quarters of the audit period and a 28.52% markup percentage for the last eight quarters of the audit period.

7. Subsequent to the period in issue, petitioners were subjected to a second sales tax audit for the period June 1, 2000 through May 31, 2003, the period immediately following the period in issue. A statement of proposed audit change was issued for that period on September 11, 2007, which asserted tax due of $269,063.48 plus interest. Attached to the statement was a worksheet which set forth purchases by month during the audit period for liquor, tobacco

products, beverages and miscellaneous products. In addition, the worksheet noted a three percent adjustment for theft and a reduction of $163,296.00 for the audit period for exempt items like milk, eggs and bread. The worksheet stated that the Division used markups of 15% for liquor, 12% for beverages and 7% for cigarettes.

8. During the audit period, Mr. Dale Buehlmann was a Pepsi distributor who delivered the Pepsi "line up" to petitioner 121 Grant Street, Inc. He priced his products, erected displays and negotiated deals with petitioners. His Pepsi products occupied approximately 15% of the delicatessen shelf space. During the audit period, the markup on Pepsi products in petitioners' store was between 0% and 15%, but was usually closer to 0%. This markup was generally the same as that attested to by Mr. Michael Jablonski, a salesman for Buffalo Beverage Corp., which distributed beer and soda to petitioner during the audit period. Mr. Jablonski stated that petitioners' profit margin on these products was between 8% and 15%.

9. During the audit period, Mr. Joseph Amigone was a salesman for Universal Liquor, which sold wine and liquor to petitioners. He applied markups to a wholesale price for each item, placed stickers with prices on bottles and then placed the products on petitioners' shelves. Most items sold to petitioners were marked up between 10% and 13%.

10. During the audit period, Mr. Cosimo Polino, was the owner of and a salesman for Buffalo Tobacco Products, Inc., which sold cigarettes to petitioner approximately twice a week. Mr. Polino personally priced all cartons and packs of cigarettes sold at petitioners' business and stated that during the audit period, petitioner always priced cigarettes at the state minimum price of cost plus seven percent.

11. During the period in issue and earlier, petitioners employed Gary Wilkinson, an accountant, who prepared income tax returns for all the petitioners. However, upon review of

Mr. Wilkinson's work product, it became apparent to Mr. Mackiewicz and his current representatives that proper returns had not been prepared and, for some periods, not filed at all for petitioners. For other periods, it was discovered that duplicate returns with different entries were prepared. However, despite the confusing entries, Mr. and Mrs. Mackiewicz signed and filed their New York income tax returns for the years 1997, 1998 and 1999.

12. Both the New York S corporation franchise tax returns and the U.S. corporation income tax returns for S corporations for the years 1997 and 1998 were filed by 121 Grant Street, Inc. The entire net income figures stated on both New York returns were identical for 1997 and 1998. The federal returns also reported identical total income, deductions and ordinary income. It is not apparent that corporation tax returns were filed for 1999 but Mr. and Mrs. Mackiewicz filed a joint federal income tax return for 1999 which reported income on a federal schedule 1040 E from 121 Grant Street, Inc., in the sum of $166,414.00. In addition, the audit report for 121 Grant Street, Inc., contained the first page of a U.S. Corporation Income Tax Return for 1999 with the handwritten notation "For Bank Only." That cover page indicated $166,414.00 in ordinary income, which was the same amount presented on the schedule 1040 E as passive income from 121 Grant Street, Inc.

13. Petitioner 121 Grant Street, Inc., filed quarterly sales and use tax returns during the audit period. Those filed for the quarters ended August 31, 1997, February 28, 1998, May 31, 1998, August 31, 1998, November 30, 1998, February 28, 1999, May 31, 1999, August 31, 1999 and November 30, 1999 were signed by Mr. Mackiewicz and indicated no paid preparer and stated a significant amount of nontaxable sales.

14. The Division initially contacted petitioner 121 Grant Street, Inc., by letter, dated July 8, 2003, to inform it that the case had been referred to the income/franchise tax field audit bureau

for audit for the period January 1, 1997 through December 31, 2000. A second letter to the corporation confirmed a field visit at its accountant's office on May 17, 2004 and requested all books and records pertinent to verifying the accuracy of the corporation's franchise tax returns. As stated by the auditor in the narrative of the income tax audit file, the case was referred to the income/franchise tax field audit bureau "to carry the changes [from the sales tax audit] through for franchise and personal income tax."

15. The corporation was unable to provide documentation to substantiate its income as reported on its corporation franchise tax reports. Checks and credit card information supported a conclusion that there had been income from lottery sales, issuance of money orders, and bill payments, but no attempt was made to account for cash, although the Division had evidence of invoices that had been paid in cash.

16. The Division utilized information that had been determined in the sales tax audit to assist it in calculating additional corporation franchise tax due for the audit period. However, in analyzing the sales tax returns filed by the corporation during the audit period, it noted that the corporation reported a significant amount of nontaxable sales for each of the years in issue:

Period Ended	Nontaxable Sales per Sales Tax Returns
12/31/1997	$463,648.00
12/31/1998	$358,872.00
12/31/1999	$368,311.00

The Division assumed that these reported nontaxable sales were additional unreported sales and considered them additional gross receipts for each of the years in the audit period despite the fact that the total sales per the sales tax returns were about the same as the gross receipts reported on the corporation franchise tax returns. Those totals were as follows:

Period Ended	Total Sales per Sales Tax Returns	Gross Receipts per 1120S
12/31/1997	$2,049,006.00	$1,873,315.00
12/31/1998	$1,699,180.00	$1,777,234.00
12/31/1999	$1,726,734.00	$1,798,361.00

17. In a departure from the sales tax audit and the income/franchise tax auditor's intention of "carrying the changes [of the sales tax audit] through" for the franchise tax, the Division calculated additional gross receipts by applying a markup percentage which it took directly from petitioners' own U.S. income tax returns for S corporations for each of the years in issue. That percentage was determined by dividing the gross profit reported by the stated cost of goods sold. The markup was applied to the unreported purchases of liquor, wine, beer, soda, cigarettes and "additional purchases" (presumably everything else, including nontaxable products such as milk, bread and eggs) determined in the sales tax audit from third-party documentation.

18. For the year 1997, the markup as determined from the federal income tax return was 56.1838%. When this was applied to the unreported purchases of $1,712,931.00, it yielded additional gross receipts of $2,675,320.00. The Division then gave petitioners a credit for the additional purchases of $1,712,931.00 and added back the nontaxable sales reported on petitioners' sales tax returns for the same period in the sum of $463,468.00. The total net adjustment was $1,426,038.00, which, when added to reported entire net income of $106,789.00, resulted in an entire net income base of $1,532,827.00 and additional corporation franchise tax due of $137,954.00, additional Article 22 tax due of $120,710.00, or additional tax on entire net income base of $17,244.00. After credit for the corporation's payment of $325.00, the amount left due and owing was determined to be $16,919.00.

19. For the year 1998, the markup as determined from the federal income tax returns was 69.0201%. When this markup was applied to the unreported purchases of $1,872,578.00, it yielded additional gross receipts of $3,165,033.00. The Division then gave petitioners a credit for the additional purchases of $1,872,578.00 and added back the nontaxable sales reported on petitioners' sales tax returns for the same period in the sum of $358,872.00 and the additional sum of $62,208.00, representing a math error made in carrying the federal entire net income to the New York S Corporation Franchise Tax Report for 1998. The total net adjustment was $1,713,535.00, which, when added to reported entire net income of $106,789.00, resulted in an entire net income base of $1,820,324.00 and additional corporation franchise tax due of $163,829.00, additional Article 22 tax due of $143,351.00, or additional tax on entire net income base of $20,478.00. After credit for the corporation's payment of $325.00, the amount left due and owing was determined to be $20,153.00.

20. For the year 1999, the markup as determined from the federal income tax return was 63.5915%. When this was applied to the unreported purchases of $1,811,638.00, it yielded additional gross receipts of $2,963,686.00. The Division then gave petitioners a credit for the additional purchases of $1,811,638.00 and added back the nontaxable sales reported on petitioners' sales tax returns for the same period in the sum of $368,311.00. The total net adjustment was $1,520,359.00, which, when added to reported entire net income of $166,739.00, resulted in an entire net income base of $1,687,098.00 and additional corporation franchise tax due of $151,839.00, additional Article 22 tax due of $132,859.00, or additional tax on entire net

income base of $18,980.00. After credit for the corporation's payment of $100.00, the amount left due and owing was determined to be $18,880.00.[1]

21. The Division issued a Notice of Deficiency to 121 Grant Street, Inc., dated March 14, 2005, in which it asserted additional corporation franchise tax, interest and penalties. Penalties were asserted for negligence, substantial understatement of liability and failure to file a return. The following is a summary of the deficiencies:

Year	Tax	Interest	Penalty	Total
1997	$16,919.00	$11,269.74	$8,170.87	$36,359.61
1998	$20,153.00	$10,892.04	$8,467.52	$39,512.56
1999	$18,880.00	$ 7,980.42	$9,704.71	$36,565.13

22. The Division conducted a personal income tax audit of William P. and Janice A. Mackiewicz at the same time it audited 121 Grant Street, Inc., for the years 1997, 1998 and 1999. The audit involved adding the total net adjustments calculated in the S corporation franchise tax audit set forth above to the adjusted gross income reported on petitioners' tax returns for the years in issue to arrive at a corrected adjusted gross income. From this figure the Division allowed certain deductions and exemptions to arrive at corrected New York State taxable income. For the years in issue the values were as follows:

Year	AGI per Return	S Corp Income	Corrected AGI	Corrected Taxable	Corrected Liability
1997	$140,536	$1,426,038	$1,566,574	$1,087,926	$106,283
1998	$142,397	$1,713,535	$1,855,932	$1,484,060	$126,241
1999	$244,901	$1,520,359	$1,765,260	$1,382,171	$119,893

[1]Despite the fact that the audit workpapers clearly set forth the markups used by the Division in calculating the deficiencies for all three years in issue, the auditor adamantly testified that these numbers were not correct and that the actual markups applied from the federal 1120S were 34.53 for 1997, 40.83 for 1998 and 38.87 for 1999. The auditor also testified that the markup negotiated for the sales tax audit was "21 or 22 percent."

After giving petitioners credit for tax paid, the Division asserted penalties pursuant to Tax Law § 685(b) and (p) for negligence and substantial understatement of liability, respectively.

23. The Division issued to petitioners a Notice of Deficiency, dated March 14, 2005, which set forth additional personal income tax, penalties and interest due for the years 1997, 1998 and 1999 in the following amounts:

Year	Tax	Penalty	Interest	Total
1997	$97,861.00	$42,805.90	$56,253.81	$196,920.71
1998	$117,662.00	$45,417.22	$55,536.44	$218,615.66
1999	$104,152.00	$34,990.48	$38,736.96	$177,879.44

24. After the audit period, the corporation employed a bookkeeper to begin organizing its records. In the course of the bookkeeper's duties, she located various bills and evidence of expenses that she organized by year. For 1997, the bookkeeper found bills she associated with delivery expenses in the sum of $20,673.00, which included an insurance payment, repair bills and gas receipts. For the year 1998, the bookkeeper found interest paid of $21,464.00, bank fees of $4,698.00 and delivery expenses of $19,427.00. For 1999, numerous checks were found which were offered to show bad debts incurred in the sum of $107,905.73, and other evidence offered to show interest paid of $74,875.00, bank fees of $14,769.11 and delivery expenses of $20,050.00.

25. With respect to the delivery expenses claimed to have been incurred for each of the years in issue, the corporation offered no evidence of the number of vehicles it owned or if there was a charge for this service. Mr. Mackiewicz testified that the drivers paid for products and then delivered them at the retail cost plus any tips they might receive. The bookkeeper testified that she did not know the number of vehicles but was sure a delivery fee of five dollars was charged.

In any event, for all three years there was no evidence produced that the expenses incurred for delivery were incurred by the corporation for its vehicles being used in the operation of the business. Generally, the gas receipts were invoices for cash payments by unknown parties. Payment of insurance premiums was established but with no evidence that the policies related to specific vehicles used by the corporation for a business purpose. Likewise, the numerous repair invoices were not specifically related to vehicles owned by the corporation and used in the operation of the business.

26. For the years 1998 and 1999, petitioners offered evidence of interest paid on loans to various banks. However, there was no explanation of the purpose of the loans, and petitioners' 1997 New York Resident Income Tax Return indicated that they were involved in several businesses and held substantial real estate interests, any of which may have benefited from the proceeds of the loans. In fact, the workpaper submitted in support of the interest payments even indicated that one of the entries was for Spartacus Enterprise, a business interest listed on the 1997 Schedule E, Form 1040, attached to petitioners' New York income tax return.

27. Bank service charges for both 1998 and 1999 were transcribed by the bookkeeper and summary sheets were submitted into evidence. The summary provided a transaction date, bank name and an explanation of a charge, but no information on what constituted the underlying charge, i.e, whether it was solely a service charge or included other components, or whether the charge was incurred for a legitimate purpose related to petitioner 121 Grant Street, Inc.

28. The corporation introduced numerous checks that it contended were returned for various reasons in 1999 including insufficient funds, closed accounts or stopped payment. Other checks appear to have been negotiated with no indication of nonpayment. No detailed explanation was offered for why each of the checks substantiated a bad debt other than the

stamped payment notations on some of the checks. In addition, petitioners employed a collection company during the years in issue, and there was no explanation of whether subsequent payments or part payments were received for bad checks such as the ones offered in evidence, or if petitioners had an internal control for tracking such transactions.

29. The Division's income/franchise tax audit began on or about July 8, 2003. On numerous occasions throughout the audit, the auditor referenced the markup utilized in the sales tax audit in her log. The auditor noted the "statistical" markup percentage used by the sales tax bureau in reaching additional sales tax due in her log in entries on May 17, 2004 and May 18, 2004. In her June 3, 2004 entry, the auditor noted that her team leader advised her that they were going to adjust for changes in inventory and then apply the same markup used in the sales tax audit, to which he noted petitioners had consented. She also stated in the June 3, 2004 entry that "there is no evidence to show another mark up number should be used."

30. The auditor remarked in her log on June 3, 2004 that the markup used by the sales tax bureau was obtained from the federal 1120 returns. However, in her entry for July 29, 2004, she reported that, in a meeting with her section head, her team leader and the sales tax team leader, it was noted that the "original sales tax work papers used the markup from the 1120 which would be 1.6XX . . ." but that the parties agreed to "use a magazine publication of statistics of 1.2XX."

31. On August 13, 2004, the auditor again met with her team leader and section head in preparation for the closing conference, and stated for the first time that "[o]ur position is that we should start with the 1120S return. . . . We however clearly seeing [sic] the 1120S appeared high for a gross profit percentage, used the sales tax gross taxable sales and allowed for additional purchases as well."

32. In his final remarks at the closing conference as reported by the auditor in her log entry of August 13, 2004, the section head gave petitioners the option of awaiting the results of the next sales tax audit to determine the gross profit percentage and applying that percentage to all years, even if it exceeded "the 28%," or accepting the gross profit figures from the 1120S returns.

33. In the auditor's log entry for September 10, 2004, she revisited the subject of the markup to be applied. She stated that, at the closing conference, the section head,

> made it clear that the offer on the table was accept the audit finding which did not include nontaxable sales and commission income or the case would be closed using the additional purchases determined by sales tax from third party documentation and marking them up using the reported 1120 mark up which was about 70%. Although this mark-up seemed high, we would use it and let a conferee determine anything less at CMS.

34. The auditor spoke with petitioners' representative by telephone on February 15, 2005. In that conversation, the auditor informed the representative that the Division was closing the case using the higher markup and that the Division's other offers were withdrawn. The log entry for February 15, 2005 repeated that the sales tax settlement utilized a negotiated markup and never considered over one million dollars in nontaxable sales reported on the sales tax returns filed during the audit period. The auditor told the representative that the Division would use the markup of "about 70%" to determine additional unreported sales, mindful of the fact that it was "about 3 time [sic] higher than the negotiated mark up offer on the table. Also, we would include the nontaxable sales tax sales of greater than 1 million dollars. It would be there that they would start there [sic] disagreement at BCMS conference."

In all the auditor spent 87 hours working on the franchise tax audit and another 17 hours on the income tax audit. The team leader had expressed concern over the time spent on the case in May 2004, but the matters still did not conclude until March 2005.

CONCLUSIONS OF LAW

A. Indirect auditing methodologies are proper in audits of income where the taxpayer's income is not accurately reflected in his books and records (***see***, ***Matter of Giuliano v. Chu***, 135 AD2d 89, 521 NYS2d 883 [1987]; ***Matter of Hennekens v. State Tax Commn.***, 114 AD2d 599, 494 NYS2d 208 [1985]; ***Matter of Checho v. State Tax Commn.***, 111 AD2d 470, 488 NYS2d 859[1985]). In this matter, there was no dispute by either party that the corporation's books and records were inadequate and its returns inaccurate. To this end, the distinction between audit standards for sales and use tax audits and franchise/income tax audits was not in issue. (***See Matter of R & J Automotive, Inc.***, Tax Appeals Tribunal, April 1, 1993; ***Matter of Mountain Star Company, Inc.***, Tax Appeals Tribunal, March 13, 08 [which noted the inapplicability of the standards in sales tax audits to franchise tax audits].) The franchise/income audit bureau understood this when it received the case file from the sales tax audit bureau within its own district office in Buffalo and was aware of petitioner William Mackiewicz's criminal conviction and restitution paid as well as the additional sales tax asserted.

Although a tax determination must have a rational basis to sustain review, the Division's issuance of an income tax deficiency is presumed correct as long as no evidence is introduced to challenge the deficiency (***Matter of Leogrande v. Tax Appeals Tribunal***, 187 AD2d 768, 589 NYS2d 383 [1992]; ***Matter of Tavolacci v. State Tax Commission***, 77 AD2d 759, 431 NYS2d 174 [1980]). In ***Matter of Atlantic & Hudson Limited Partnership*** (Tax Appeals Tribunal, January 30, 1992), the Tribunal stated:

> Although a determination of tax must have a rational basis in order to be sustained upon review, the presumption of correctness raised by the issuance of the assessment, in itself, provides the rational basis, so long as no evidence is introduced challenging the assessment. Evidence that both rebuts the presumption of correctness and indicates the irrationality of the audit may appear: on the face of the audit as described by the Division through testimony or documentation; from factors underlying the audit which are developed by the petitioner at hearing; or in the

> inability of the Division to identify the bases of the audit methodology in response to questions posed at the hearing. However, where, as here, petitioner has failed to make any inquiry into the audit method or calculation, the presumption of correctness raised by the issuance of the assessment provides the rational basis for the assessment. To hold otherwise would be in irreconcilable conflict with the principles that the Division does not have the burden to demonstrate the propriety of its assessment and that the petitioner has a heavy burden to prove the assessment erroneous. (Citations omitted.)

As applicable to this matter, in response to taxpayer inquiries at hearing, the Division has the obligation to describe the audit methodology used, and as described, that method must be rational.

Unlike ***Atlantic & Hudson***, petitioners presented credible and substantive evidence to rebut the presumption of correctness raised by the issuance of the assessment. Here, petitioners raised several issues with respect to how the Division first adopted then modified and distorted the methodology employed by the sales tax bureau. In fact, the Division's own audit file corroborated and elaborated on the irrationality of the audit. The evidence in the record not only rebutted the presumption of correctness but also established that the assessment had no rational basis. Since it is the well established law of New York that a notice of deficiency that has no rational basis must be set aside (***Matter of Donahue v. Chu***, 104 AD2d 523, 479 NYS2d 889, 892 [1984];***Matter of Rosenthal v. State Tax Commn.***, 102 AD2d 325, 477 NYS2d 767, 769 [1984]; ***Matter of Welch v. State Tax Commn.***, 89 AD2d 683, 453 NYS2d 802, 803 [1982]), these assessments must be canceled.

B. The record indicates that the agreement reached with the sales tax bureau of the Buffalo District Office for substantially the same period was based on a markup of purchases that were verified by the Division and agreed to by petitioners. The summary worksheet prepared by the sales tax audit bureau lists suppliers of liquor, beer, wine, cigarettes and additional products

which Mr. Mackiewicz credibly testified were all his suppliers during the years in issue.[2] The negotiated markup applied to these purchases was determined using a statistical average gleaned from a periodical brought to the Division's attention by petitioners, and was determined to be 27.52% for the first four quarters and 28.52% for the last eight quarters. Notations in the auditor's log in the present audit demonstrated that she and her supervisors were well aware of these percentages and their origin. This is in stark contrast to the statement in the Division's brief that tried to justify resorting to the federal gross profit margins by stating that the sales tax figures from the sales tax audit for the same period, the basis for the referral audits, did not include a markup. A cursory review of the auditor's log does not support such a statement because there are several references to the markup used by the sales tax audit bureau.

By contrast, the Division's notices of deficiency were based on markup percentages, or gross profit margins, for essentially the same period of 56.1838, 69.0201 and 63.5915 for the years 1997, 1998 and 1999, respectively. These markup percentages represented the ratio of gross profit to cost of goods sold as reported on federal form 1120S for the years 1997, 1998 and 1999 and were utilized with the specific knowledge that the returns were not accurate. The franchise/income tax audit bureau knew the corporation returns understated gross receipts because of the additional sales determined in the sales tax audit. A cursory review of the New York franchise tax reports and federal corporation income tax returns filed for the years in issue revealed that entries for expenses and ordinary income for 1997 and 1998 were reported by 121 Grant Street, Inc. to be identical.

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[2]Mr. Mackiewicz testified in a sincere manner, not surprising given the criminal proceeding he had endured in 2003 with regard to this same matter. In addition, it is noted that his demeanor was corroborated by the fact that he has taken serious steps to improve his record keeping and reporting ability, hiring new accountants and a bookkeeper who have helped him use current technology to improve his business operations and profits, and doing so in compliance with New York and federal tax laws.

The income and franchise tax audits were originally viewed as referrals to "carry the [sales tax] changes through for franchise and personal income taxes." However, the franchise/income tax bureau quickly began to vacillate, as indicated in the auditor's log. Two entries in May 2004 referred to the statistical markup used by the sales tax bureau and, on June 3, 2004, the auditor stated that her team leader instructed her to use the same markup as that used in the sales tax audit, as "there is no evidence to show another mark up number should be used."

The auditor noted that, during a meeting held that same day among herself, the section head, team leader and the sales tax team leader, it was observed that the original sales tax work papers used the markup from the federal 1120S of "1.6XX" but that it was rejected in favor of a magazine publication of statistics which suggested a mark-up of "1.2XX."

On August 13, 2004, the Division made the decision to utilize the markups determined from the 1120S returns for negotiating purposes, despite conceding in the log that the Division was aware these numbers were high. The actual offer made to petitioners at their closing conference was the sales tax markup, with the understanding that a rejection of that offer would result in a Notice of Deficiency based on the "1120 mark-up which was about 70%."[3] Most surprising, if not shocking, was the notation of September 3, 2004 which stated that the Division acknowledged that the markup from the 1120S was high, but that it would use it just the same and "let a conferee determine anything less at CMS," thereby eroding any confidence that there was a rational basis for the notices of deficiency and undermining the presumption of correctness. The Division intentionally abdicated its responsibility for determining in good faith

[3]The Division made another option available to petitioners as well. Petitioners could have chosen to wait until the follow-up sales tax audit was completed and be bound by the markup determined therein, even if it exceeded 28%, once again making reference to the statistical average which provided the basis for the sales tax settlement for the years in issue.

petitioners' franchise and income tax liability for the audit period. Instead, it seemed determined to punish petitioners for not agreeing to its offer.

C. The corporation introduced evidence of its own at the hearing which rebutted the presumption of correctness and established the irrationality of the Division's audit. (***Matter of Atlantic & Hudson Limited Partnership; Matter of Ristorante Puglia, Ltd. v. Chu***, 102 AD2d 348, 478 NYS2d 91 [1984]; ***Matter of Fokos Lounge***, Tax Appeals Tribunal, March 7, 1991 [where petitioner proved that its utility meter readings bore no relationship to its level of business activity].)

Petitioners introduced evidence of the actual markups used during the audit period for each of the purchase categories, which were verified by the sales tax audit bureau and analyzed in its reconstruction of sales. These same purchases in the areas of liquor, beer, soda, cigarettes and miscellaneous items were used by the franchise/income tax bureau to determine additional franchise and income taxes due. The only differences in the latter audits were the application of a different markup, the adding back of reported nontaxable sales, and an allowance for the additional purchases.

In response to the Division's decision to use markups it repeatedly conceded "seemed high," the testimony and affidavits from four vendors with which petitioners did business during the years in issue were introduced to support petitioners' position that the markups supporting the notices in issue were outrageous. The credible testimony of Mr. Buehlmann and the corroborating and credible affidavit of Mr. Jablonski established that soda products were priced with markups of between 0% and 15%, but usually closer to 0%. Soda products were generally used to attract customers into the store in the hope that they would then purchase more profitable items like liquor, beer and wine. Therefore, the markup on soda products was kept deliberately

low, which is why Mr. Buehlmann said he often marked up petitioners' soda between 0% and 2%. In addition, Mr. Jablonski sold beer products to petitioner 121 Grant Street, Inc., and used a markup of between 8% and 15%.

Liquor was generally sold at a markup of between 10% and 13%, as credibly testified to by Mr. Joseph Amigone, who priced, labeled and shelved his products in Frontier Liquor. The store's close proximity to the Canadian border and a duty-free shop necessitated lower markups to be competitive.

Cigarettes were sold to 121 Grant Street, Inc., by Buffalo Tobacco Products exclusively for the entire audit period. Mr. Cosimo Polino, the owner of the business, sold to the corporation twice a week and personally priced the cartons and packs sold on the premises at the state minimum price of cost plus 7%.

Mr. Mackiewicz credibly testified that the markups testified to by Mr. Buehlmann, Mr. Jablonski, Mr. Amigone and Mr. Polino were the markups used to price products in his business during the years in issue. Although beyond the scope of the audit in issue, it is of note that the markup percentages used by the sales tax audit bureau for the second sales tax audit for the period June 1, 2000 through May 31, 2003 were 15% for liquor, 12% for beverages and 7% for cigarettes, confirming the accuracy of the markups testified to at hearing and exposing the arbitrary and unconscionable markup utilized by the Division herein.

D. The federal corporate income tax returns, forms 1120S, were known to be inaccurate from the beginning of the audit. The fact that a substantial number of taxable sales were found on audit by the sales tax bureau was indicative of that. A simple review of the entries on the 1997 and 1998 returns revealed that the preparer used the same numbers for ordinary income and expenses for each year. However, even with these glaring errors, the Division chose to ignore a

markup based on a national average used in resolving the sales tax matter and intentionally utilized a markup it conceded was three times that amount and "seemed high," a departure from the auditor's testimony that the use of the 1120S gross profit margins was "fair."

It appeared incongruent that the Division chose to spend 104 auditor hours on this audit which began with a directive from the team leader to use the same markup as that used in the sales tax audit since "there is no evidence to show another mark up number should be used," and concluded ten months later to use markups from the 1120S and add back nontaxable sales, using no additional information beyond that used in the sales tax audit. The fact that the sales tax team leader was involved with the franchise and income tax audits suggests that there was never a serious and independent inquiry into those taxes, only what the auditor termed a referral to "carry the changes through for franchise and personal income taxes," and the ultimate choice of using unsubstantiated markups and add-backs which had as their goal the maximization of additional tax and punishment for failing to settle.

Given the evidence produced by petitioners it is concluded that they have overcome the presumption of correctness that attached to the notices upon issuance and demonstrated their irrationality.

E. Even if the issuance of the notices were considered to have had a rational basis and the notices not canceled, petitioners have established that the markup percentages they demonstrated were used for each category of product during the audit period, which were confirmed on the sales tax audit for the period June 1, 2000 through May 31, 2003, should be adopted and applied herein, resulting in a recalculation of the additional gross receipts accordingly and modification of the deficiency.

F. The petition of 121 Grant Street, Inc. is granted and the Notice of Deficiency, dated March 14, 2005, is cancelled. The petitioner of William P. and Janice Mackiewicz, Jr. is granted and the Notice of Deficiency, dated March 14, 2005, is cancelled.

DATED: Troy, New York
July 31, 2008

/s/ Joseph W. Pinto, Jr.
ADMINISTRATIVE LAW JUDGE