STATE OF NEW YORK

DIVISION OF TAX APPEALS

In the Matter of the Petition	:	
of	:	
ANN MARIE ROPERTI	:	DETERMINATION DTA NO. 821171
for Revision of a Determination or for Refund of Sales and Use Taxes under Articles 28 & 29 of the Tax Law for the Period March 1, 2002 through February 28, 2005.	:	

Petitioner, Ann Marie Roperti, 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, 2002 through February 28, 2005.

A hearing was held before Joseph W. Pinto, Jr., Administrative Law Judge, at the offices of the Division of Tax Appeals, 641 Lexington Avenue, New York, New York, on, January 30, 2007 at 10:30 A.M., with all briefs submitted by June 13, 2007, which date began the six-month period for the issuance of this determination. Petitioner appeared by William J. Bernstein, Esq. The Division of Taxation appeared by Daniel Smirlock, Esq. (Osborne K. Jack, Esq., of counsel).

ISSUES

I. Whether the Division of Taxation properly determined additional sales and use taxes due using an indirect audit methodology.

II. Whether the Division of Taxation erred in not utilizing an indirect audit methodology that it employed in a prior audit period.

III. Whether petitioner has established reasonable cause for the abatement of penalties.

FINDINGS OF FACT

1. Petitioner, Ann Marie Roperti, was the owner of Friendly Deli during the period March 1, 2002 through February 28, 2005 (the audit period). The business sold items such as beer, soda, bread, milk, cigarettes, cold cuts, salads, cookies and cakes.

2. The business, operated as a sole proprietorship by petitioner between 1996 and March 7, 2005, was located at 150 North Delaware Avenue, Lindenhurst, New York. It was open six days per week.

3. On or about February 23, 2005, the Division of Taxation (Division) sent petitioner a letter informing her that her sales and use tax records for the period March 1, 2002 through November 30, 2004 were scheduled for audit and that all books and records pertaining to her sales and use tax liability were requested for examination. An exhaustive list of books and records was attached to the letter. In a letter, dated April 6, 2005, the audit period was extended through February 28, 2005, and a request for books and records for that period was made. The reason for the extended audit period was that a notification of a bulk sale of the business had been filed with the Division, and its tax liability needed to be determined quickly.

4. Petitioner's sales and use tax records had been audited for the prior periods September 1, 1996 through May 31, 1999 and June 1, 1999 through February 28, 2002, with agreed upon determinations of additional tax due for both periods in the sums of $27,925.74 and $25, 524.20, respectively.

5. Petitioner produced her records at her accountant's office on April 27, 2005. As was the case in the two prior audits, petitioner once again failed to produce books and records adequate to perform an audit in detail. Instead, petitioner supplied incomplete bank statements, bags of cash register tapes and invoices which were also incomplete and a partial day book (day sheets). From the information produced, a gross sales reconciliation could not be performed.

6. The register tapes did not accurately break down taxable and nontaxable sales since the register was broken, a fact petitioner was aware of but chose to ignore. In general, the sales records provided did not allow transactions to be traced back to source documentation or forward to a final total. The sales invoices (guest checks) that were produced were not in any order, were not issued to all customers, were undated, not numbered and mostly illegible. It was estimated that only 1% of sales invoices were found and that those that were found were not correlated to register tapes or a cash receipts journal. In general, the auditor determined that the business lacked internal controls over its sales operations.

7. The records available on this third audit of petitioner's business were essentially the same type as those produced in the prior audits. Petitioner conceded that the records she kept for this audit period were incomplete and inadequate, as they had been in the prior audits, and that she had disposed of records before the audit began. In addition, she knew her cash register was broken and was not capable of recording taxable and nontaxable sales, but she chose to estimate nontaxable sales rather than fix the register.

8. In the audit performed for the period June 1, 1999 through February 28, 2002, referred to in the record as the second audit, the Division utilized two separate observations of petitioner's business to establish prepared food sales for the audit period and then marked up third-party purchases, as provided by vendors of cigarettes, beer, soda, candy and other miscellaneous items, using percentages obtained in the audit period September 1, 1996 through May 31, 1999.

9. In the current audit, the auditor decided to use only the observation performed on June 26, 2002, after determining that it was the best method available to calculate the sales and use taxes due in an expedient manner. The auditor rejected a markup of purchases from third-party information gleaned from vendors because, in the absence of general ledgers, he would be unable to correlate the purchase

records with claimed taxable sales. Further, as markup percentages are calculated using current prices, they could not be ascertained since the business had been sold.

10. The observation test was conducted at Friendly Deli on Wednesday, June 26, 2002, a date within the current audit period, and was performed by two investigators, Linda Loesch and Linda Caracappa. The test ran from 6:45 A.M. to 8:30 P.M. and indicated $1,478.69 in gross receipts per the register tapes, $802.75 in taxable sales (prepared food and other taxable items) and $553.61 in nontaxable sales. This resulted in a taxable ratio of 61.14%.

11. The auditor took the daily taxable sales total and multiplied by six to reach a weekly total of $4,816.50 and then by 13 to arrive at a quarterly audited taxable sales figure of $62,614.50. This figure was compared to the taxable sales reported by petitioner for each of the quarters in the audit period to arrive at additional taxable sales. The Division applied the applicable tax rate to additional taxable sales to arrive at total additional sales tax due of $32,753.32.

The auditor concluded that the underreported taxable sales were underreported sales and that the result was that there were increases in both the reported sales and the taxable portion of those sales for this audit period.

12. The Division asserted penalties against petitioner based on the fact that petitioner never changed her compliance behavior after two prior audits and, in fact, record keeping had deteriorated in the third audit period.

13. During the audit, the auditor was informed that petitioner was selling the business and that a notice of determination had to be issued by May 16, 2005 if there was any additional sales and use tax liability for the current audit period. Petitioner had actually contracted for the sale of the business on January 25, 2005.

14. The Division issued a Statement of Proposed Audit Change for Sales and Use Tax, dated May 5, 2005, which asserted additional sales and use tax due of $32,753.32, penalty of $11,266.31 and interest of $8,054.18. Penalty included an additional amount for underreporting in excess of 25% of the tax due.

15. The Division issued a Notice of Determination to petitioner, dated June 13, 2005, which asserted additional tax due as set forth in the Statement of Proposed Audit Change for Sales and Use Tax, together with updated penalty and interest.

16. After issuance of the Notice of Determination, and prior to the issuance of the Bureau of Conciliation Services order, petitioner disputed the results reached using the observation test and requested that the Division review third-party information and consider a markup test as a more equitable methodology, which had been done in the prior audit.

17. Between June 13, 2005 and November 9, 2005, the Division pursued third-party vendors and utilized petitioner's 2003 day book for purchases of beer, cigarettes and soda. Additional requests for third-party information were unproductive. The Division attempted to use the beer sales from the observation to calculate a markup and then reformulated its audit findings, but found that it resulted in a higher tax liability. Upon discovery of the higher tax liability, the Division abandoned the markup methodology.

SUMMARY OF THE PARTIES' POSITIONS

18. Petitioner contends that the sales tax returns for the audit period, some bank statements, bills and cash register tapes for some of the audit period, day sheets which were attached to the sales tax returns and daily sales totals were produced for the auditor at the April 27, 2005 meeting. Petitioner contends that the auditor, who inspected the documents for five hours did not perform a "concerted study of the records."

19. Petitioner argues that the Division should have used the audit methodology used in the second audit, since petitioner produced the same records on the third audit and had an expectation that the Division would determine its additional tax in the same manner. In addition, petitioner points to the fact that the Internal Revenue Service issued a "no change" letter, indicating no additional tax due, after an audit of her joint federal income tax return for the year 2001.

20. The Division contends that it was within its authority to estimate petitioner's tax liability using the observation test once it determined that petitioner's books and records were inadequate for a detailed audit.

21. The Division maintains that it was under no obligation to utilize any specific audit methodology, only one that was reasonable, and the observation test was such a method.

22. Petitioner contends that she has demonstrated reasonable cause for her underpayment of sales tax and an absence of willful neglect in that her cash register was broken. The Division disagrees, noting that petitioner knew of her responsibilities for collecting and paying over sales taxes, keeping adequate records and the consequences for not doing so, as reflected in the two prior audits. Therefore, the Division requests that penalties be sustained.

CONCLUSIONS OF LAW

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

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

B. The standard for reviewing a sales tax audit where external indices were employed was set forth in ***Matter of Your Own Choice, Inc***., 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]) 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).
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> 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 books and records which resulted in the production of only tax returns, incomplete bank statements, bags of cash register tapes and mostly illegible invoices, which were also incomplete, and a partial day book (day sheets). Petitioner destroyed a substantial amount of records for the audit period and knowingly used a broken cash register. These failures were magnified by petitioner's experience with two prior sales tax audits for periods immediately preceding the one in issue, each with findings of incomplete records and substantial additional sales tax due.

The available records were produced at petitioner's representative's office on April 27, 2005. Given more than two months to assemble her records, petitioner was still only able to produce those mentioned above. The auditor spent five and a half hours examining the records and concluded that they were inadequate for purposes of conducting a full audit. Given the records produced, it is reasonable to assume that the auditor could discern "through verification" within the records that they were so insufficient that it was impossible to conduct a complete audit.

Because petitioner had contracted to sell her business on January 25, 2005 and a notification of bulk sale had been filed with the Division, it was imperative for any tax liability to be finally determined by the Division by May 16, 2005 in order to protect the State's interests in the event additional taxes were due and owing. (***See generally*** Tax Law § 1141[c].)

Given the incomplete records, the inability to determine taxable sales from register tapes due to the broken register, the lack of sales records to allow transactions to be traced to source documentation or forward to a final total and the absence of internal controls over its sales

operations, the Division chose to utilize an indirect audit methodology, an observation test, to determine petitioner's sales tax liability for the audit period.

D. The one-day observation test performed by the Division to determine petitioner's taxable sales for the audit period was a methodology well suited to the circumstances, where petitioner failed to maintain adequate source documentation of her sales, and is supported by a large body of case law. (***See e.g. Matter of Lombard v. Commr. of Taxation & Fin***., 197 AD2d 799, 602 NYS2d 972 [1995] [one-day observation test]; ***Matter of Vebol Edibles v. Tax Appeals Tribunal***, 162 AD2d 765, 557 NYS2d 678 [1990], ***lv denied*** 77 NY2d 803, 567 NYS2d 643 [1991] [two-day observation test]; ***Matter of Club Marakesh v. State Tax Commn.,*** 151 AD2d 908, 542 NYS2d 881 [1989], ***lv denied*** 74 NY2d 616, 550 NYS2d 276[1989] [one-day observation test].)

The illegible and minuscule number of guest checks, the incomplete register tapes which failed to record a date or taxable sales, the partial day sheets, bank statements and tax returns did not constitute clear and convincing evidence sufficient to demonstrate that the assessment was erroneous. (***See Matter of Scarpulla v. State Tax Commn.***, ***supra***; ***Matter of Surface Line Operators Fraternal Org. v. Tully***, ***supra***.) Petitioner has not produced evidence to establish that the observation test reached an erroneous result. Had petitioner been able to demonstrate through source documentation that her returns were more accurate than the Division's estimate generated by the observation test, then her argument might have had more credibility. But her inadequate and otherwise nonexistent records gave the Division the authority to use a method, which, although less than precise, was reasonably calculated to reflect the taxes due, and nothing she produced or said clearly or convincingly challenged the audit methodology or the amount of tax determined to be due.

E. Petitioner argues that even if she did not maintain adequate books and records, the Division should not have utilized an observation test methodology because she had relied on the results of a prior audit which utilized a different indirect audit methodology. Petitioner relies on ***Matter of Rittling Dispensers, Inc.*** (Tax Appeals Tribunal, May 7, 1992), for the proposition that a petitioner may rely on a prior audit result gained by use of a specific audit methodology and may expect the Division to use that same methodology in future audits with similar results.

Petitioner's reliance on ***Rittling Dispensers*** is in error. In that case, the issue was whether Rittling Dispensers should have been liable for penalties and interest after relying on the results of a prior audit where the Division had assured it the business was in "good order" and assessed no significant additional tax. In fact, Rittling Dispensers argued that regulations and a Technical Services Bureau Memorandum, which contradicted the auditor's recommendation, predated the prior audit and encouraged it to continue its course of conduct, much to its detriment, during the subsequent audit period. In dicta, the Tribunal stated that the argument would have carried more weight with evidence that the prior audit was similar to the one in issue.

In this matter, petitioner had absolutely no right to rely on the prior audit as a harbinger of which estimated audit methodology the Division would use in subsequent periods. The facts of each audit determine which methodology would be best suited to estimate the tax due. As set forth above, "[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.***, ***supra.*** at 221)

Petitioner's argument is further eroded by her failure to keep and produce adequate records for a detailed audit after two previous audits where it was found (and she conceded) her record keeping was faulty and additional sales tax was determined to be due. Indeed, if she had relied on the prior audit she would have kept adequate records and source documentation, maintained her

cash register in working order, issued guest checks and otherwise maintained the documentation the Division requested of her in the list attached to the February 23, 2005 letter. It cannot be concluded that petitioner detrimentally relied on the Division's methodology in the prior audit to challenge the use of a different methodology herein.

F. Petitioner argues that the "no change" audit of her income taxes for the calendar year 2001 by the Internal Revenue Service demonstrated that her gross sales reported were accurate. However, the year 2001 was outside of this audit period and has no specific relevance to the period in issue. Moreover, the evidence submitted does not indicate what was examined by the Internal Revenue Service or what records were produced by petitioner and what standards were applied to those records produced, if any.

The statutory and regulatory schemes that exist in the New York Tax Law are very specific with regard to the records to be kept by a vendor (Tax Law §1132[c]; §1135; §1138[a]; §1142[5]; 20 NYCRR 533.2). These standards may differ substantially from those expected from a taxpayer on an income tax audit. Since no proof was submitted to establish that the Internal Revenue Service utilized the same standards as those set forth in the New York Tax Law and regulations, the weight attributed to the "no change" letter for a year outside the audit period is minimal and it holds no probative value here.

G. As discussed, petitioner's records could not be used to trace transactions back to source documentation or forward to final totals. This eliminated the possibility of confirming gross sales with accuracy and relieved the Division of any responsibility to accept the gross sales as reported. Petitioner's arguments to the contrary never address this glaring inadequacy. The mere argument that the prior estimated audit methodology reached a more advantageous result for the taxpayer does not dictate the methodology used in future audit periods. Under the circumstances in this audit,

including the necessity of determining the tax due in an expeditious manner due to petitioner's bulk sale of the business, the auditor correctly concluded, within the discretion accorded to him by the statute, regulations and case law, that the one-day observation test was best suited to estimating petitioner's tax liability.

H. As a courtesy to petitioner, the Division did evaluate the third-party information as provided by petitioner at the BCMS conference, but its calculations projected an even larger tax liability and it abandoned its examination of those records. Another factor in its determination was that it was not convinced it had, or could have, collected purchase information from all of petitioner's suppliers. The Division's considered review of this methodology and its ultimate conclusion that the one-day observation was more reliable, was proper within the standards set out in the cases cited above.

I. Having concluded that the Division properly utilized an estimated audit methodology and that petitioner was unable to demonstrate that the results were erroneous, it must be determined if petitioner has established reasonable cause to abate the penalties imposed. The Division imposed penalty under Tax Law § 1145(a)(1)(I) which provides for penalty to be imposed where a person fails to pay over any tax within the time required by law and Tax Law § 1145(a)(1)(vi), which provides that any person who omits from the total amount of tax required to be shown on the return an amount in excess of 25% must pay a penalty of 10% of the amount of the omission. Tax Law § 1145(a)(1)(iii) and (vi) provide that the Division can remit the penalty if the failure to pay over the tax was due to reasonable cause and not willful neglect.

Petitioner contends that her underreporting was not willful because it was the result of a broken register which accurately recorded gross sales but not taxable sales. In addition, petitioner maintains that if the audit methodology employed by the Division in the prior audit had been used

in this audit, she would only have underreported her taxable sales by 15%. These arguments do not constitute reasonable cause.

In establishing reasonable cause for penalty abatement, the taxpayer faces an onerous task (***Matter of Philip Morris, Inc.***, Tax Appeals Tribunal, April 29, 1993). Referring to the mandatory language of Tax Law § 1145(a)(1)(I) , the Tribunal said that "the Legislature evidenced its intent that filing returns and paying tax according to a particular timetable be treated as a largely unavoidable obligation" (***Matter of MCI Telecommunications Corp.***, Tax Appeals Tribunal, January 16, 1992). In the instant matter, petitioner neither maintained nor produced records as required, and those she did keep were without any source documentation due to her knowing and willful failure to use a register in operating condition or issue proper guest checks for each sale. The lack of internal controls for her sales transactions was inexcusable after two prior audits which identified the same issues with no effort to change her business operations. As discussed above, the Division was under no obligation to use the same audit methodology as the one used in the second audit. For all of these reasons penalties must be sustained.

J. The petition of Ann Marie Roperti is denied and the Notice of Determination, dated June 13, 2005, is sustained.

DATED: Troy, New York
December 13, 2007

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