

STATE OF NEW YORK

DIVISION OF TAX APPEALS

In the Matter of the Petition :

of :

33 VIRGINIA PLACE, INC. :

for Redetermination of a Deficiency or for Refund of
Corporation Franchise Tax under Article 9-A of the Tax
Law for the Period January 1, 2001 through
December 31, 2002. :

In the Matter of the Petition :

of :

MARK SUPPLES AND AMY TAYLOR :

for Redetermination of a Deficiency or for Refund of
Personal Income Tax under Article 22 of the Tax Law
for the Period January 1, 2001 through December 31,
2003. :

In the Matter of the Petition :

of :

MATTHEW J. AND MELISSA A. CONROY :

for Redetermination of a Deficiency or for Refund of
Personal Income Tax under Article 22 of the Tax Law
for the Period January 1, 2002 through December 31,
2003. :

DETERMINATION
DTA NOS. 821181, 821182,
821183, 821290, 821291
AND 821859

In the Matter of the Petitions :
of :
33 VIRGINIA PLACE, INC. :
for Revision of Determinations or for Refund of Sales :
and Use Taxes under Articles 28 and 29 of the Tax Law :
for the Period March 1, 2001 through August 31, 2006. :

In the Matter of the Petition :
of :
MARK SUPPLES :
for Revision of a Determination or for Refund of Sales :
and Use Tax under Articles 28 and 29 of the Tax Law :
for the Period September 1, 2001 through :
November 30, 2003. :

Petitioner 33 Virginia Place, 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 period January 1, 2001 through December 31, 2002.

Petitioners Mark Supples and Amy Taylor filed a petition for redetermination of a deficiency or for refund of personal income tax under Article 22 of the Tax Law for the period January 1, 2001 through December 31, 2003.

Petitioners Matthew J. and Melissa A. Conroy filed a petition for redetermination of a deficiency or for refund of personal income tax under Article 22 of the Tax Law for the period January 1, 2002 through December 31, 2003.

Petitioner 33 Virginia Place, Inc., filed petitions for revision of determinations or for refund of sales and use tax under Articles 28 and 29 of the Tax Law for the period March 1, 2001 through August 31, 2006.

Petitioner Mark Supples filed a petition for revision of a determination or for refund of sales and use tax under Articles 28 and 29 of the Tax Law for the period September 1, 2001 through November 30, 2003.

A consolidated hearing was commenced before Brian L. Friedman, Administrative Law Judge, at the offices of the Division of Tax Appeals, 130 West Main Street, Rochester, New York, on January 9, 2008 at 9:15 A.M. and was concluded at the same location on January 10, 2008 at 9:15 A.M., with all briefs to be submitted by May 19, 2008, which date began the six-month period for the issuance of this determination. Petitioners appeared by Amigone, Sanchez, Mattrey & Marshall, LLP (Vincent J. Sanchez and B.P. Oliverio, Esqs., of counsel). The Division of Taxation appeared by Daniel Smirlock, Esq. (James Della Porta, Esq., of counsel).

ISSUES

I. Whether the audit method utilized by the Division of Taxation in its audit of 33 Virginia Place, Inc., was reasonable or whether such petitioner has shown error in either the audit method or the result.

II. Whether penalties asserted against petitioners should be abated.

III. Whether it was proper for the Division of Taxation to assert personal income tax and corporation franchise tax deficiencies based upon the sales tax audit of 33 Virginia Place, Inc.

FINDINGS OF FACT

First Sales Tax Audit

1. 33 Virginia Place, Inc. (petitioner) operates a bar and restaurant known as Mother's which is located in the Allentown district of Buffalo, New York. Petitioner is a subchapter S corporation; its shareholders during the periods at issue were Mark Supples, Amy Taylor and Matthew Conroy. Mark Supples is the president of petitioner and is the general manager of Mother's.

This audit commenced as a result of the audit of another business wherein an improperly issued resale certificate from petitioner was found to have been issued for the purchase of furniture. On December 9, 2002, Mark Supples, on behalf of Mother's, issued a resale certificate to Jay's Furniture Products of Buffalo when Mother's purchased furniture. Mr. Supples indicated that the furniture purchased consisted of booths which he believed to be a capital improvement. He stated that he did not read the resale certificate and that it was given to him by the vendor of the booths.

2. Mark Supples purchased Mother's in 1992. Mother's is open from 4:00 P.M. until 4:00 A.M. It serves its full menu (typically steak and sea food) until 3:00 A.M. Mother's accepts reservations on Thursdays, Fridays and Saturdays, and it is busiest at around 7:30 or 8:00 P.M. Mother's occupies the ground floor of a two-story building and the establishment is comprised of approximately 2,500 square feet which includes 16 tables with seats for 58 diners, 16 bar stools at the bar and 6 additional bar stools against a side wall of the bar area. There is also an outdoor patio which is open during the summer months.

Mr. Supples described the City of Buffalo as "downtrodden," and that, in his opinion, approximately 50% of its population lives below the poverty line. Because there is little tourism

in Buffalo, the success of the restaurant depends upon regular customers. Mr. Supples stated that the key to the success of Mother's is providing good value for the customers' dollar. To provide good value, Mother's provides larger portions than those of its competitors at a lower price.

Mother's dinners include vegetables, rice, soup or salad, while dinners at its primary competitors, Buffalo Chophouse and Kennedy's Cove, include only rice. Credit card sales account for slightly more than 50% of Mother's sales.

Vincent J. Sanchez, a partner in the firm of Amigone, Sanchez, Mattrey & Marshall, LLP, the firm which represents petitioners in this proceeding, is a regular customer of Mother's (he dines at the restaurant at least once per week). Mr. Sanchez often dines there on Mondays which he states "[are] very slow. I mean, I've been there when I've been the only person in there and I've been there where there are a few people at the bar and maybe a table or two going." Mr. Sanchez stated that Mother's has a terrific reputation for food and price.

3. On January 29, 2004, the auditor contacted petitioner's owner, Mark Supples, and set up an appointment for February 18, 2004. An appointment letter, confirming the aforesaid date, was sent to Mr. Supples. Attached to the letter was a Records Requested List which set forth all of the books and records which were required to be made available for the audit. Pursuant to the appointment letter, the audit period was March 1, 2001 through November 30, 2003.

A few days prior to the scheduled appointment, Mr. Supples telephoned the auditor and requested that the audit be conducted at a storage facility in Williamsville, New York, where he stated that petitioner's records were located.

Along with the auditor's team leader, she met Mr. Supples at the storage facility. The auditor and team leader requested that they be permitted to take the records to their office, but

Mr. Supples declined to allow them to take the records with them. The auditor and her team leader took an inventory of the records presented and reviewed them at the storage facility.

4. On February 27, 2004, a second letter was sent to Mr. Supples which stated that a review of the records presented disclosed that not all of the records requested were made available, to wit: cash register tapes for the entire audit period; guest checks for the entire audit period; federal income tax returns for 2001, 2002 and 2003; bank statements for October and November 2003, merchandise and expense purchase invoices for 2001; sales sheets for March 2001 through December 2001, November 2002, January through May 2003 and August through November 2003; and fixed asset purchases for the entire audit period.

5. On March 15, 2004, Mr. Supples dropped off records to the auditors. At that time, he stated that he had no guest checks or register tapes for any portion of the audit period. He also stated that he made no cash purchases, except for miscellaneous small items and that any of these purchases would be listed on the daily sales sheets.

6. On March 25, 2004, another letter was sent by the auditor to Mark Supples. Enclosed with the letter was a copy of the Division's Technical Services Bureau memorandum (TSB-M-85[5]S) which sets forth a vendor's responsibilities and the records which are required to be kept. At the hearing, petitioner's representatives stipulated, on the record, that petitioner failed to maintain the records which complied with the provisions of this memorandum.

7. According to the field audit record, an investigator employed by the Division went to Mother's in early April 2004 on a Friday evening. The investigator indicated that the bar was full (approximately 50 people) with mainly wine and alcohol sales and that there was seating for approximately 100 people with one-quarter of the tables full.

8. The auditor indicated that since there were no guest checks or cash register tapes for the audit period, she attempted to conduct a markup using petitioner's selling prices. She computed a markup for beer of 225 % above cost (this markup pertained to canned and bottled beer since Mother's did not serve draught beer). The auditor gave Mr. Supples a bar fact sheet which he agreed to prepare. However, the auditor concluded that a markup for wine and liquor could not be performed because wine was sold by the bottle and by the glass and liquor was sold in shots, mixed drinks and cocktails. As to food, the auditor stated that because there were a number of daily specials in addition to the regular menu items, register tapes and guest checks were needed to determine the quantity of items sold.

The auditor did not review petitioner's credit card sales. She determined that petitioner's net bank deposits (subtracting out sales tax paid on the sales tax returns) were approximately \$170,000.00 greater than sales reported on the sales tax returns.

9. The auditor advised Mr. Supples, both orally and in writing, as to the records that he was required to maintain but at a meeting with Mr. Supples and a prior representative, he advised the auditor and her supervisor that he did not intend to keep such records.

10. To determine petitioner's markup percentages, the auditor utilized the 2002 edition of Restaurant Industry Operations Report by the National Restaurant Association and Deloitte & Touche. The auditor used the 2002 edition because the year 2002 was the one full year within the audit period. She indicated that she did not compare the data in the 2002 edition with any other editions of the report, including the 2001 and 2003 editions.

During direct examination, the auditor indicated that she used Exhibit C-10, Full Service Restaurants (Average Check Per Person \$25 and Over), Statement of Income and Expenses - Amount Per Seat, to compute the markup percentage to be used in her audit. However, on cross

examination, she corrected herself and stated that she used Exhibit C-12, Full Service Restaurants (Average Check Per Person \$25 and Over), Statement of Income and Expenses - Amount Per Seat, to calculate the markup percentages. Using the median¹ figures in Exhibit C-12, the auditor calculated markup percentages for food and beverages of 181% and 185%, respectively, above cost.

The markup percentages were then applied to petitioner's purchases per its disbursements journal for food and beverages. Third-party verification was used to verify purchases and purchases did reconcile to petitioner's books. According to petitioner's disbursements journal, food purchases were approximately 62% and beverages were approximately 38% of total purchases. The disbursements journal contained only petitioner's purchases made by check; however, there were indications that some purchases of food and beverages had been made with cash. These purchases were noted on the sales summary sheets and consisted of smaller purchases made at supermarkets.

The 185% beverage markup was applied to beer, liquor and wine purchases of \$741,808.29 which resulted in audited beer, wine and liquor sales of \$2,114,153.63 for the audit period. The 181% food markup was applied to food purchases of \$1,189,681.05 which resulted in audited food sales of \$3,343,003.75. Total audited sales were, therefore, determined to be \$5,457,157.38. After subtracting reported sales of \$3,714,329.00, additional taxable sales were found to be \$1,742,828.38, with tax due thereon (computed at 8%) of \$140,369.88. The error percentage in terms of underreporting of sales was approximately 46%.

¹ Median means that one-half of the restaurants surveyed had higher markup percentages and one-half had lower markup percentages than the median number.

11. The auditor also performed a detailed audit of petitioner's fixed asset acquisitions. Some of the invoices indicated that petitioner had paid cash for some of the items purchased. For the audit period, it was determined that petitioner made purchases totaling \$118,653.34 and had paid tax of \$181.83. Accordingly, tax was found to be due on purchases totaling \$118,470.71, with additional tax due thereon of \$9,299.79. Petitioner indicated that this amount was not in dispute.

In May 2003, Mother's closed for 10 or 11 days for remodeling. Mr. Supples indicated that some of the items used in the remodeling were purchased with cash. At the time, he obtained a loan in the amount of \$70,000.00 from M& T Bank and also used additional moneys from his personal funds (his bank account, his wife's bank account, stock sales and his weekly check from the restaurant).

12. As a result of this audit, total additional tax due was determined to be \$149,669.67, which consisted of \$140,369.88 due on sales of food and beverages and \$9,299.79 due on fixed assets acquired without payment of sales tax.

13. On December 1, 2004, the Division issued a Notice of Determination to petitioner assessing additional sales and use taxes in the amount of \$149,669.69, plus penalty and interest, for a total amount due of \$256,924.22 for the period March 1, 2001 through November 30, 2003.

Previously, on June 3, 2004, petitioner, by its former representative, and again on August 18, 2004, by Mark Supples, petitioner's owner, and the Division executed consents extending the period of limitation for assessment of sales and use taxes whereby it was agreed that taxes for the period March 1, 2001 through November 30, 2001 could be assessed at any time on or before December 20, 2004.

On December 27, 2004, the Division issued a Notice of Determination to Mark Supples which assessed tax in the amount of \$127,688.20, plus penalty and interest, for a total amount due of \$216,304.60 for the period September 1, 2001 through November 30, 2003. The Notice of Determination advised Mr. Supples that it was being issued because he was an officer or responsible person of 33 Virginia Place, Inc.

14. During cross examination, the auditor, when asked why she used the figures set forth in Exhibit C-12 of the Restaurant Industry Operations Report, as opposed to any of the other schedules set forth in Section C - Full Service Restaurants (Average Check Per Person \$25 and Over) stated as follows:

It just seemed to be an average of - - some of the other schedules, exhibits; we didn't have that type of information pertaining exactly to that category, so this seemed as though it was just an average.

When asked why she did not use the total per seat sales figure of \$10,887.00 set forth in Exhibit C-12 to compute petitioner's sales by multiplying this figure by the amount of seats in Mother's, the auditor's response was: "I don't know."

15. The Restaurant Industry Operations Report, 2002 edition, on the first page thereof, states, in relevant part, as follows:

Almost 800 questionnaires were received from restaurant operators, and 660 were used as the basis for this report. This unique study of the operating results of restaurants in 2001

* * *

This data is not intended to be standards or goals for individual restaurants, nor is this report an attempt by the National Restaurant Association or Deloitte & Touche to set or adjust industry prices or operating ratios. Rather, the data and related worksheet at the back of the report are intended to be used as management tools to help you compare your restaurant's performance with that of similar restaurants.

On page 15 of the Report, under "Explanatory notes," it is stated:

Readers should be aware that the operators who participated in this study are not identical with those who participated in prior years' studies. This makes comparisons with previous data difficult, because reporting ratios can be vastly different.

The Report, in section C pertaining to full service restaurants with an average check per person of \$25 and over, indicated that it represented the characteristics of the 102 respondents in this category. More than three-quarters (83.3%) of the respondents represented independent restaurants and 53.9% were the sole occupant of their location. More than three-quarters (80.4%) of the respondents were located within a metropolitan area and restaurants with American menu themes represented 41.2% of the sample.

16. Section C of the Report contains 20 exhibits pertaining to full service restaurants with an average check per person of \$25 and over. Exhibits C-9 through C-19 set forth data relating to statements of income and expenses. In particular, Exhibit C-9 contains data relating to amount per square foot while Exhibits C-10, C-12, C-14, C-16 and C-18 and Exhibits C-11, C-13, C-15, C-17 and C-19 contain figures or percentages pertaining to amounts per seat and ratio to total sales, respectively.

17. The New York State Department of Taxation and Finance's Indirect Audit Methods Trainer's Manual, issued May 2001, sets forth a hierarchy of indirect audit methods. Upon cross examination, the auditor indicated that she never reviewed the manual before deciding which audit method to employ.

According to the manual, the strongest case, as the case goes through the appeals process, is a markup test, using either some of the vendor's records or third-party information to arrive at audit findings. The next strongest method is an observation test. Following the observation test is the use of a prior audit. According to the manual: "The last, and least accurate would be the

use of external indices. These are industry averages throughout the country or region.” The manual further states that “[s]omewhere in between the use of a prior audit and the use of external indices would be the District Office index. This is better than the external indices in that the results of the data collected is localized.” Finally, the manual states, in bold print: “**Major point to stress: The more you use the vendor’s records, the stronger the case will be.**”

18. The auditor’s supervisor, the sales tax section head of the Buffalo District Office, supervised this audit. He stated that petitioner’s markup per its books was approximately 92 to 93% above cost which, in his opinion, was a low markup based on his audit experience. As a result of the use of the 2002 edition of the Restaurant Industry Operations Report, the markup calculated for petitioner was 181% above cost for food and 185% above cost for beverages which the section head stated was reasonable based on his audit experience.

Because petitioner made cash purchases and a cash disbursements journal was not provided, the section head could not be certain that the purchase records were complete. He stated that a markup test based on petitioner’s records was not performed because, due to the fact that there were many daily specials offered, he had no idea what was being sold and at what price. As a result thereof, the section head directed the auditor to use the 2002 Restaurant Industry Operations Report and he also determined which exhibit within the report to use to determine petitioner’s markup percentage. He never compared the 2002 edition with the 2001 or 2003 editions to determine if the results varied markedly.

The section head made the decision to assess penalties in this matter based on an almost 50% understatement of gross receipts and, in addition, on the fact that required records were not kept by petitioner.

The section head also made the decision to refer the audit results to the personal income tax and corporation franchise tax sections for possible assertions of income tax and franchise tax deficiencies.

19. On cross examination, the section head stated that Exhibit C-12 of the 2002 Restaurant Industry Operations Report, which was the exhibit used by the auditor to determine petitioner's markup, indicates that the median per seat total sales was \$10,887.00. Multiplying this per seat figure by the total seats in petitioner's restaurant (approximately 80 including the bar stools) equals \$870,960.00. Multiplying this amount by 3 (total years in the audit period) equals \$2,612,880.00. For the audit period, petitioner reported sales of \$3,714,329.00; however, based upon the markup percentage determined by the auditor using Exhibit C-12, the Division increased petitioner's sales by approximately \$1.7 million, resulting in audited sales which were approximately \$2.9 million over the per seat amount set forth in Exhibit C-12.

In Exhibit C-2, Average Daily Seat Turnover for Full Service Restaurants (Average Check Per Person \$25 and Over), the same category as Exhibit C-12, which was used to calculate petitioner's markup percentage, the median average daily seat turnover was 0.9, or less than one turn per day. The section head admitted that the results of the audit would require substantially more than one turn per day to achieve the level of sales computed by the Division.

In Exhibit C-8, Statement of Income and Expenses for Full Service Restaurants (Average Check Per Person \$25 and Over), the median profit before income taxes is \$200.00 per seat. Pursuant to the results of the audit, the additional \$1.7 million, divided by 3 (the years in the audit period), divided by the seats in petitioner's restaurant (approximately 80), results in a profit per seat of more than \$7,000.00.

On cross examination, the section head conceded that the markup computed per the Restaurant Industry Operations Report ignored the number of seat turns per day and amount of profit per seat. On direct examination, the section head indicated that the hours of operation for Mother's was 4:00 P.M. until 4:00 A.M and, when asked why an observation test was not performed for Mother's, he stated that an observation test is not normally performed when an establishment is "open to the middle of the night."

Second Sales Tax Audit

20. A second sales tax audit of petitioner was performed for the period December 1, 2003 through August 31, 2006. While the section head was the same for the second audit, a different auditor conducted the audit.

By letter dated October 10, 2006, petitioner was advised that its sales and use tax records were scheduled for audit. Attached to the letter was a Records Requested List which set forth all of the records required to perform the audit. Pursuant to the letter, the auditor received some guest checks which were in a box separated on a per day basis. Petitioner began keeping the guest checks in January 2005. The guest checks were prenumbered but were not in sequential order. Some end-of-day register tapes were available for the period January 25, 2006 through August 31, 2006, although some tapes were missing.

By a letter dated November 21, 2006 to Mark Supples, petitioner was advised that the following records were missing and needed for review:

End of day register cash out tapes were available from 1/25/06 - 8/31/06 however [*sic*] there are numerous tapes missing during this period. The missing tapes will need to be presented for review by the date below. See included transcript.

End of day register cash out tapes or guest checks were not provided prior to 1/25/06 please [*sic*] provide these records for review.

Cash register journal tapes for the entire period were not made available.

On January 30, 2007, another letter was sent to Mark Supples which requested the same records previously requested in the November 21, 2006 letter. In addition, this letter also asked for daily cash out sheets for the months of December 2003 and February 2006.

21. Guest checks were provided for petitioner's credit card sales only; guest checks for cash sales were not made available to the auditor. The guest checks were not sequentially numbered; they were not in books but were loose. In addition, Z tapes (end-of-day register tapes which list all daily transactions) were missing for many Fridays and Saturdays. Based upon the records presented, the auditor could not determine what petitioner's sales were for any given day.

22. For the audit period, petitioner's book markup was approximately 90% which, based upon the auditor's experience, was "a little bit low." The auditor determined that he could not perform a food markup because he could not verify what was being sold and in what portions since he did not have the daily specials menu for all of the days in the audit period.

The auditor stated that he considered an observation test, but "the way it was set up, it didn't lend itself to an observation." This was because Mother's had two small registers behind the counters which had small displays and "we would have had to basically sit right next to the register behind the counter, which was quite small, and watch the register in order to see that everything was being rung in." The credit card machine was located at one end of the bar and to perform an observation would have caused "major disruption in the business."

23. The auditor decided to use the 2006/2007 edition of the Restaurant Industry Operations Report by the National Restaurant Association and Deloitte & Touche LLP. In computing petitioner's markup, the auditor used Exhibit C-16, Statement of Income and Expenses - Ratio to Total Sales for Full Service Restaurants (Average Check Per Person \$25 and

Over). The auditor utilized the median ratios of cost to total sales for restaurants with sales of \$2,000,000.00 and over (the auditor stated that while the heading at the top of the page states \$2,000 and over, it actually is \$2,000 times 1,000 which equals \$2,000,000.00) which, using this exhibit, were 31.7% for food and 29.8% for beverages. The auditor then divided 100 by the 31.7 to arrive at a 315% markup for food and divided 100 by the 29.8 to arrive at a 336% markup for beverages. These markup percentages were applied to petitioner's purchases for food and beverages which the auditor obtained from general ledger reports supplied by petitioner's accountant.

Based on these markup percentages, audited taxable sales were determined to be \$8,564,102.69. Petitioner reported gross sales on its returns filed for the audit period in the amount of \$4,766,594.00; therefore, additional taxable sales were \$3,797,508.69, with tax due thereon in the amount of \$318,815.94. Penalties were imposed by the auditor because of "gross understatement of tax" and because petitioner, despite being advised during the prior audit as to what records were required to be kept, failed to keep such records.

24. On May 31, 2007, the Division issued a Notice of Determination to petitioner which assessed additional sales and use tax in the amount of \$318,815.93, plus penalty and interest, for a total amount due of \$536,589.45 for the period December 1, 2003 through August 31, 2006.

25. The audit was conducted at the restaurant, which the auditor visited four or five times. An investigator employed by the Division visited Mother's with another employee of the Division on February 15, 2007 and prepared a report which stated, among other things, that:

It was estimated that the food traffic was primarily by Credit Card, and that the Servers were using a bank. This will be a very difficult inside observation for several reasons. The locations to scrutinize are each of two cash registers, the credit card station, and the kitchen/wait station.

With five servers, each moving quite rapidly, identifying their activities will be difficult.

26. The auditor did not perform a markup using petitioner's records because he did not have sufficient information regarding sales. Upon cross examination, the auditor stated that he was somewhat familiar with the prior audit and the method of computing the markup in the prior audit. When asked whether he had read the 2006/2007 edition of the Restaurant Industry Operations Report, the auditor replied that he had not read the entire publication. The auditor stated that he had not read page 15 of the publication, entitled "Introduction To Analysis of Data and Explanatory Notes," where it stated that more than 1,370 restaurants throughout the United States responded to the survey and, after a careful review for accuracy and completeness, 996 were used for the report. Page 15, under "Explanatory Notes," stated, in part, as follows:

Readers should be aware that the operators who participated in this study are not identical with those who participated in prior years' studies. This makes comparisons with previous data difficult, because reporting ratios can be vastly different. However, comparisons of the information in past reports may be useful in identifying certain financial trends.

27. The auditor was aware that the markup percentages which he calculated (315% for food and 336% for beverages) were different from the percentages calculated in the prior audit (281% for food and 285% for beverages), but he attributed that difference to the fact that different indices (or exhibits) were used. However, he stated that he thought that the use of Exhibit C-16 from the 2006/2007 edition of the Restaurant Industry Operations Report "was more representative of the taxpayer's business." The auditor stated that he did not realize that the category (exhibit) which he selected from the report was going to result in a higher markup percentage than was computed in the prior audit.

The auditor, when asked during cross examination why he selected Exhibit C-16 rather than any of the other exhibits contained in Section C of the Report, stated that he did not remember which of the other exhibits were examined and why these other exhibits were not used.

During cross examination, Exhibit C-11 from the 2006/2007 edition of the Restaurant Industry Operations Report was introduced into evidence by petitioners. This exhibit was the 2006/2007 equivalent of Exhibit C-12 of the Restaurant Industry Operations Report from the 2002 edition which was used in the first audit. If Exhibit C-11 from the 2006/2007 edition had been used in the second audit, the markup percentages would have been 297% for food and 289% for beverages, as opposed to the 315% for food and 336% for beverages derived from Exhibit C-16.

Petitioners also introduced into evidence Exhibit C-18 from the 2006/2007 edition of the Restaurant Industry Operations Report . Use of this exhibit, entitled “Full Service Restaurants (Average Check Per Person \$25 and Over), Statement of Income and Expenses - Ratio to Total Sales,” would have yielded still different markup percentages, to wit, 294% for food and 313% for beverages.

On cross examination, the auditor was asked if he would agree that if his markup was reasonable, that it should also require reasonable seat turns per day and the auditor responded: “I would think so.” When asked if, during his audit, he had noticed in the Restaurant Industry Operations Report a schedule relating to daily seat turnover, he replied: “I just saw it now. I don’t remember if I reviewed it, you know, which schedules I actually reviewed.”

The auditor also agreed, during cross examination, that because Mother's credit card sales were verifiable by audit, any additional sales determined on audit (in this instance, \$3,797,508.69) would have to have been cash sales.

Corporation Franchise Tax and Personal Income Tax Audits

28. A letter dated March 3, 2005 was sent by the Division to petitioner advising it that its corporation franchise tax returns for the years 2001 through 2003 had been selected for audit based upon a referral from the Sales Tax Audit Bureau.

29. Petitioner filed its franchise tax returns on a calendar year basis. A letter was sent to petitioner scheduling an appointment for March 22, 2005; however, petitioner did not appear. Mark Supples telephoned the auditor on March 23, 2005, and when asked if he wished to schedule another appointment, he indicated that he did not wish to since he disagreed with the sales tax audit findings and intended to contest such findings. The auditor explained to Mr. Supples that as a result of the sales tax audit findings, there would be franchise tax and personal income tax deficiencies asserted by the Division. The auditor further explained that since the months of January and February 2001 were outside the sales tax audit period, the additional income attributable to these months would have to be estimated unless Mr. Supples wished to provide the auditor with actual sales figures. Mr. Supples stated that he did not wish to do that and told the auditor to go ahead and bill him. Petitioner's previous representative asked that the matter be placed on hold pending a decision from the Division's Bureau of Conciliation and Mediation Services (BCMS) regarding the sales tax assessments. The auditor stated that the case would be placed on hold if a waiver extending the statute of limitations was executed.

Accordingly, on May 25, 2005, consents were executed whereby it was agreed that franchise taxes due from petitioner for the period January 1 through December 31, 2001 could be

determined or assessed at any time on or before September 15, 2006 and personal income taxes due from Mark Supples and Amy Taylor for the period January 1, 2001 through December 31, 2002 and due from Matthew J. and Melissa A. Conroy for the period January 1, 2002 through December 31, 2002 could be determined or assessed at any time on or before September 15, 2006.

30. To compute the additional franchise tax due from petitioner, the auditor used the additional gross receipts from the results of the first sales tax audit and applied it to the years at issue. For the months of January and February 2001, which were not part of the sales tax audit, the auditor utilized the audited sales for the period March 1, 2001 through December 31, 2001, divided the results by 10 (to get an average monthly sales figure) and then multiplied the monthly figure by 12 to get a yearly total for 2001. For the month of December 2003, which was not a part of the first sales tax audit, a similar method was used by taking audited sales for January 1, 2003 through November 30, 2003, dividing the results by 11 (to get an average monthly sales figure) and then multiplying the monthly figure by 12 to arrive at a yearly total for 2003.

Pursuant to the first sales tax audit of petitioner, the total audited sales were \$5,457,157.38 (*see* Finding of Fact 10) which, on a yearly basis, were as follows: \$1,482,935.00 for March 1 through December 31, 2001; \$1,824,665.00 for 2002; and \$2,149,557.00 for January 1 through November 30, 2003. Using the method set forth above to estimate the months that were not part of the sales tax audit (January and February 2001 and December 2003), the auditor determined the following:

Year	Audited Gross Receipts	Gross Sales Reported	Additional Gross Receipts
2001	\$1,779,522.00	\$1,184,911.00	\$594,611.00
2002	\$1,824,665.00	\$1,268,654.00	\$556,011.00
2003	\$2,344,971.00	\$1,572,103.00	\$772,868.00

Federal taxable income per audit was computed as follows:

Year	Federal Taxable Income Reported	Additional Gross Receipts	Federal Taxable Income Per Audit
2001	\$20,562.00	\$594,611.00	\$615,173.00
2002	\$37,423.00	\$556,011.00	\$593,434.00
2003	\$125,265.00	\$772,868.00	\$894,133.00

For 2001, the franchise tax due on the entire net income base was determined to be \$5,076.00. Petitioner had previously paid the sum of \$100.00; therefore, the balance due for 2001 was \$4,976.00. For 2002, the franchise tax due on the entire net income base was determined to be \$3,858.00. Petitioner had previously paid the sum of \$244.00; therefore, the balance due for 2002 was \$3,614.00.

31. On March 30, 2006, the Division issued a Notice of Deficiency to petitioner which asserted a corporation franchise tax deficiency of \$8,590.00 (\$4,976.00 for 2001 and \$3,614.00 for 2002), plus interest, for a total amount due of \$11,082.95 for the years 2001 and 2002.

Since petitioner is an S corporation and the franchise tax rate was higher than the personal income tax rate for 2001 and 2002, deficiencies of corporation franchise tax were asserted for those years. Due to a change in the law, which eliminated the differential between the franchise tax rate and the personal income tax rate, the tax flowed through to the corporate shareholders, so all that was due on the S corporation's return for the year 2003 was the minimum tax of \$225.00

which had already been paid by petitioner. Therefore, no corporation franchise tax deficiency was asserted against petitioner for the 2003 tax year.

32. For the year 2001, Mark Supples was the owner of 100% of the shares of petitioner. Therefore, the additional gross receipts of \$594,611.00 (*see* Finding of Fact 30) were attributable to him, thereby increasing his New York State adjusted gross income to \$781,193.00 which, after the standard deduction, resulted in New York State taxable income of \$767,793.00, with tax due thereon of \$52,741.00. Mr. Supples had previously paid the sum of \$11,429.00 (penalty of \$147.00 had also been paid), leaving a balance of \$41,165.00. No adjustments for other expenses or deductions were made because Mr. Supples did not provide any information to the auditor.

33. For the year 2002, Mark Supples was a 45% shareholder of petitioner. Amy Taylor, the wife of Mark Supples, was also a 45% shareholder and Matthew Conroy was a 10% shareholder. Therefore, the additional gross receipts of \$556,011.00 (*see* Finding of Fact 30) were attributable as follows: \$250,205.00 to Mark Supples; \$250,205.00 to Amy Taylor; and \$55,601.00 to Matthew Conroy.

Since Mark Supples and Amy Taylor filed a joint return, the \$500,410.00 was added to their adjusted gross income for the year. Accordingly, after the subtraction of the standard deduction, their New York State taxable income was \$658,656.00, with tax due thereon of \$45,118.00. After credit for tax previously paid of \$9,617.00 (penalty of \$250.00 had also been paid), tax due for the 2002 year was \$35,501.00.

34. For 2003, as was the case for 2002, Mark Supples and Amy Taylor were each owners of 45% of the shares of petitioner while Matthew Conroy owned 10% of the shares. Therefore,

the additional gross receipts of \$772,868.00 (*see* Finding of Fact 30) were attributable as follows: \$347,791.00 to Mark Supples; \$347,791.00 to Amy Taylor; and \$77,287.00 to Matthew Conroy.

Since Mark Supples and Amy Taylor filed a joint return, the \$695,582.00 was added to their adjusted gross income for the year. Accordingly, after the subtraction of the standard deduction, their New York State taxable income was \$986,394.00, with tax due thereon of \$75,952.00. After credit for tax previously paid of \$21,178.00 (penalty of \$267.00 had also been paid), tax due for the 2003 year was \$54,774.00.

35. As a result of Matthew Conroy's 10% ownership of petitioner's stock in 2002, \$55,601.00 was added to the adjusted gross income of Matthew J. Conroy and Melissa A. Conroy, his wife, with whom he filed a joint return. After subtraction of the standard deduction, their New York State taxable income was \$93,203.00, with tax due thereon of \$5,708.00. Since the Conroys had previously paid tax in the amount of \$1,806.00, the balance due for the 2002 tax year was \$3,902.00.

For 2003, as a result of Matthew Conroy's 10% stock ownership of petitioner, \$77,287.00 was added to the adjusted gross income of Matthew J. Conroy and Melissa A. Conroy, his wife, with whom he filed a joint return. After subtraction of the standard deduction and one exemption, their New York State taxable income was \$123,459.00, with tax due thereon of \$8,283.00. After an adjustment due to a reduction in their New York State child and dependent care credit as a result of the increased income, the balance due for 2003 was \$6,020.00.

36. On April 17, 2006, the Division issued a Notice of Deficiency to Mark Supples and Amy Taylor which asserted a personal income tax deficiency in the amount of \$131,440.00 (\$41,165.00 for 2001, \$35,501.00 for 2002 and \$54,774.00 for 2003), plus interest and penalty, for a total amount due of \$172,260.75 for the years 2001, 2002 and 2003.

37. On April 17, 2006, the Division issued a Notice of Deficiency to Matthew J. Conroy and Melissa A. Conroy which asserted a personal income tax deficiency in the amount of \$9,922.00 (\$3,902.00 for 2002 and \$6,020.00 for 2003), plus interest and penalty, for a total amount due of \$12,625.63 for the years 2002 and 2003.

38. During cross examination, when posed with the question of whether he asked or requested that the auditors conduct an observation of the business to determine the sales, Mark Supples indicated that during both the first and second sales tax audits, he “begged them to do it.” He stated:

I went so far as to offer to pay the auditors to sit at my bar during any night of their choice, sit in front of the registers, sit in front of the credit card machine, sit in my kitchen. I would pay double time to the auditors to do this, to disprove their ridiculous claims. I made that offer every single time we met.

39. For the week of Friday, November 9 through Thursday, November 15, 2007, Mark Supples kept a record of his total sales with tax (\$40,687.01), charge sales without tips (\$25,092.55), total food without tax (\$19,108.25), number of customers who dined (963), and average amount of check per person including tax (\$32.20).

40. David E. Gross, is a certified sales tax specialist, a CMI (Certified Member of the Institute of the Institute of Professionals in Taxation), which is a designation of achievement, knowledge and distinction in sales and use tax. He has provided services to numerous clients, from Fortune 500 to family owned operations for approximately 15 years. He possesses a Bachelor of Science Degree in accounting from Medaille College and also attended the University of Buffalo School of Management. Mr. Gross currently is the owner of Sales Tax Solutions of North Tonawanda, New York, which represents companies and clients in state sales and use tax audits. He was formerly employed: as a senior tax accountant at Lumsden &

McCormick, LLP of Buffalo, New York; as a senior sales tax accountant at Allegis Group, Inc. of Baltimore, Maryland; as a sales tax consultant at Freed Maxick & Battaglia, CPA of Buffalo, New York; as a senior accountant at Sodexo Marriott Services of Williamsville, New York; and as a sales and property tax supervisor and sales tax analyst at Delaware North Companies, Inc. of Buffalo, New York.

Mr. Gross reviewed the operating records of Mother's and opined that the sales tax assessments were considerably high for a restaurant of the type and size of Mother's. He performed a food cost analysis for the year 2006 for the restaurant after reviewing the Division's assessments by taking a full year of purchases, targeting approximately 20 or so menu items and calculating a cost percentage per unit.

Mr. Gross also performed a cost markup comparison for each of the two audit periods. He utilized petitioner's costs (purchases) which, as noted in the audit report for the first audit, reconciled to petitioner's books. For the first audit period, petitioner's liquor purchases were \$741,808.29 and its food purchases were \$1,189,681.05 (total purchases were \$1,931,489.34). Sales reported for the period were in the amount of \$3,719,518.00. Using the auditor's calculations and utilizing the markup percentages, per the 2002 edition of the Restaurant Industry Operations Report of 285% for liquor and 281% for food, petitioner would have liquor sales of \$2,114,413.93 and food sales of \$3,341,800.70, or total sales of \$5,455,214.63. If the Division's audit results are correct, petitioner underreported its sales by \$1,735,696.63. Petitioner's bank deposits for this audit period were \$3,890,460.99 which amount was greater than reported sales by \$170,942.99, which Mr. Gross indicated was likely the sales tax collected (petitioner had reported tax due in the amount of \$297,466.00 for the audit period.).

According to a cost markup comparison for the second audit period, petitioner's liquor purchases were \$1,018,250.21 and its food purchases were \$1,632,629.20 (total purchases were \$2,650,879.41). Sales reported for the period were in the amount of \$4,766,594.00. Using the auditor's calculations and utilizing the markup percentages, per the 2006/2007 edition of the Restaurant Industry Operations Report of 336% for liquor and 315% for food, petitioner would have liquor sales of \$3,421,320.71 and food sales of \$5,142,781.98, or total sales of \$8,564,102.69. If the Division's audit results are correct, petitioner underreported its sales by \$3,797,508.69. Petitioner's bank deposits for the audit period were \$5,150,404.00 which amount was greater than reported sales by \$383,810.00, which Mr. Gross indicated was likely the sales tax collected (petitioner had reported sales tax due in the amount of \$397,162.11 for the audit period).

41. For the first audit period, December 1, 2001 through November 30, 2003, Mr. Gross examined the number of table turns. According to the figures reported by petitioner, the turning rate would have been approximately 1.9 while, if the Division's audit figures were used, the turn rate would have been approximately 3.6, or nearly twice as much as petitioner's figures. Mr. Gross observed the operation of Mother's and stated that base upon his experience, it is not physically possible for this restaurant to turn each seat more than three times per night. Exhibit C-2 of the 2002 edition of the Restaurant Industry Operations Report indicates that the median turn rate of a steak and seafood restaurant is 0.9 while the upper quartile turn rate is 1.4.

For the second audit period, the Division's audit results indicate that petitioner's sales were \$8,564,102.69. Per the 2006/2007 edition of the Restaurant Industry Operations Report, the median turn rate for steak and seafood restaurants is 0.7 and the upper quartile is 1.0. Therefore,

Mr. Gross stated that to achieve the sales which the Division asserts were made by petitioner, a seat turn rate of more than four times the average would have been required.

Mr. Gross performed a turnover rate analysis for each audit period. In performing his analysis, he used a \$25.00 average sale per meal and a \$5.00 average sale per drink. The number of seats used in the analysis were 58, consisting of 13 tables with 4 seats and 3 tables with 2 seats. Noting that the restaurant was open seven days per week, his analysis assumed, after discussions with Mark Supples, that the prime diner hours were Monday through Saturday from 5:00 P.M. to 10:00 P.M. and Sunday from 3:00 P.M. to 10:00 P.M. To calculate the turnover time, Mr. Gross used the five hour dining period for Mondays through Saturdays and the seven hour period for Sundays. For the first audit period, his analysis concluded as follows:

Based on the average meal sale plus the average drink sale, and the number of tables, Mother's restaurant would have to turn a table of two over every 65 minutes in order to produce the sales as indicated by the New York State audit. This estimate is nearly double the calculated meal time of 90 minutes. This would indicate Mother's is turning over each seat at an average rate of 2.8 times a day which is .9 more than Mother's calculation.

For the second audit period, Mr. Gross's analysis concluded:

Based on the average meal sale plus the average drink sale, and the number of tables, Mother's restaurant would have to turn a table of two over every 40 minutes in order to produce the sales as indicated by the New York State audit. This estimate is nearly double the average meal time of 60 to 75 minutes. This would indicate that Mother's is turning over each seat at an average rate of 4.3 times a day.

42. Mr. Gross concluded, based upon his table turnover analysis and the amount of profit which would have to have been generated if the Division's audit results were accurate, that the Division's use of selected exhibits (markup percentages) within the 2002 Restaurant Industry Operations Report for the first audit period and the 2006/2007 Restaurant Industry Operations

Report for the second audit period were not consistent with the other exhibits within the reports which were ignored by the Division during the performance of the audits.

Mr. Gross also noted that on the first page of Section C - Full Service Restaurants (Average Check Per Person \$25 and Over), the 2006/2007 Restaurant Industry Operations Report, under "Highlights," it states that median food sales are \$8,595.00 per seat and the median beverage sales are \$3,174.00 per seat, or roughly \$11,769.00 in total sales per seat. Using his calculations of approximately 2 turns per seat per day on a yearly basis, the result would be \$23,538.00 per seat times 58 seats times 3 years, or \$4,095,612.00 in sales. For the second audit period, petitioner reported sales of \$4,766,594.00. Using the Division's audit findings of sales of \$8,564,102.69, dividing by 3 years, then dividing by 58 seats, results in median sales per seat of \$49,218.00, more than 4 times the median sales per the 2006/2007 Restaurant Industry Operations Report.

43. Brendan McCafferty holds a Bachelor's Degree from St. John Fisher College, a Master's Degree from Rochester Institute of Technology and a law degree from the University of Buffalo. He worked as a financial auditor for Price Waterhouse and then worked for a smaller CPA firm as an auditor. Upon completion of law school, Mr. McCafferty practiced with the law firm of Damon & Morey with a specialty in tax. Thereafter, he entered into a consulting practice specializing in multistate taxation, primarily sales and use tax. He also worked as a consultant to Ernst & Young and Deloitte & Touche. In total, Mr. McCafferty worked as a tax accountant and consultant for approximately 20 years.

Mr. McCafferty reviewed the work performed by David E. Gross and determined that his assumptions and premises were reasonable. When he reviewed the audit materials pertaining to the second sales tax audit, he saw no evidence that the Division considered the results of the first

audit. For the first audit, the Division used markup percentages obtained from the 2002 edition of Restaurant Industry Operations Report by Deloitte & Touche which were 281% for food and 285% for liquor. In the second audit, the Division used markup percentages from the 2006/2007 Restaurant Industry Operations Report which were 315% for food and 336% for liquor.

Mr. McCafferty stated that observation tests are frequently used by the Division in food service or cash-type businesses and, in his opinion, an observation test would have been useful in determining whether the Division's assessments were reasonable.

44. Mr. McCafferty reviewed the Division's Indirect Audit Methods Trainer's Manual (*see* Finding of Fact 17). In the section pertaining to External Indices on page 4-3 thereof, it states: "The last method we can use if there is nothing else are external indices." This section also sets forth some of the more well known examples of published data which include: Risk Management Association f/k/a Robert Morris Associates (RMA); Troy's Almanac of Business Ratios; and Dun & Bradstreet. Mr. McCafferty stated that the RMA study is from a consortium of creditors, banks and other lenders that compile information from businesses which have applied for loans. The information is typically broken out by size of business, by type of business and by standard industrial code (SIC) which identifies the specific business. Mr. McCafferty indicated that the SIC code, as it pertains to restaurants, is broken down into the various types of restaurants which can be further broken down by the size and geographical location (by region) of the restaurants.

Mr. McCafferty indicated that the financial information provided in the RMA report is based on a credit application which is usually backed up by audit and financial statements of the business. Usually an external CPA firm has input into the financial information as opposed to the Restaurant Industry Operations Report which contains information that was basically self-

prepared by the members of the industry itself, i.e., voluntary information provided for that particular survey.

The Dun & Bradstreet service is similar to the RMA study in that it provides information used by creditors and, like the RMA study, is sortable by business category. The Troy's Almanac of Business Ratios is a compilation which is primarily derived from federal income tax returns.

Mr. McCafferty reviewed the Deloitte & Touche Restaurant Industry Operations Report and stated that, in his opinion, it was not the most reasonable study to use because its express purpose is that it is to be used as a benchmark in the industry for comparing management operations and to provide an informational resource. Moreover, the source of the information was voluntary information provided by members of the restaurant management association.

Particularly with respect to the second audit, Mr. McCafferty opined that the auditor selected the incorrect category for petitioner since he used the median ratios of cost to total sales for restaurants with sales over \$2,000,000.00, when petitioner's total sales for the nearly three year period were \$4,766,594.00, or less than \$2,000,000.00 per year. When comparing the audit results with the table turn analysis performed by David Gross, Mr. McCafferty stated that in order to generate the sales as assessed, it was necessary for Mother's to achieve a seat turnover of 4 to 4.5 turns per day which is not reasonable. Based on industry standards, turnover is substantially lower than that. Even with respect to the first audit period, Mr. Gross's analysis revealed that to generate the sales as assessed, a turnover rate of 2.8 per evening was required which Mr. McCafferty stated was not reasonable for this restaurant.

CONCLUSIONS OF LAW

A. In the present matter, two sales tax audits of petitioner were conducted by the Division. As a result of assessments of additional sales and use tax against petitioner resulting from these audits, the Division assessed additional sales and use tax against Mark Supples, as an officer or responsible person of petitioner for a portion of the first audit period, i.e., September 1, 2001 through November 30, 2003, asserted personal income tax deficiencies against petitioner's shareholders, Mark Supples and Amy Taylor and Matthew J. Conroy (Melissa A. Conroy was also named in the Notice of Deficiency by virtue of having filed jointly with her husband) and also asserted a deficiency of corporation franchise tax against petitioner for the period January 1, 2001 through December 31, 2002. Since the determination as to whether the assessment of sales and use tax against Mr. Supples and the personal income and franchise tax deficiencies against petitioner, Mr. Supples and Ms. Taylor, and the Conroys were proper depends upon whether the sales tax assessments are upheld, modified or canceled, the propriety of the sales tax audits and the results derived therefrom will first be addressed.

B. 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 of audit 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).

C. 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).

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).

D. In the present matter, it is conceded that for each of the two sales tax audits conducted, petitioner did not maintain and, upon request by the Division, did not provide sufficient books and records to the Division's auditors to enable the auditors to perform a detailed audit. Accordingly, there is no dispute that for each of the sales tax audits at issue, the Division was within its rights to resort to external indices to determine whether, for each of the periods, petitioner owed additional sales and use taxes. What is at issue, however, is whether the external indices selected, the 2002 edition of the Restaurant Industry Operations Report in the first audit and the 2006/2007 edition of the Restaurant Industry Operations Report in the second audit were reasonable audit methodologies or whether the results derived therefrom were erroneous.

E. In *Matter of Basileo* (Tax Appeals Tribunal, May 9, 1991), the Tribunal stated:

While it is true that 'considerable 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), certain limitations have been placed on this principle. It is necessary that the record contain sufficient evidence to allow the trier of fact to determine whether the audit has a rational basis (*Matter of Grecian Sq. v. New York State Tax Commn.*, *supra*) and, further, that the record contain specific information identifying the external index employed by the Division in estimating the taxpayer's liability (*Matter of Fashana*, Tax Appeals Tribunal, September 21, 1989).

* * *

We also conclude that the Division must at hearing, through witnesses or documents, be able to respond meaningfully to inquiries regarding the nature of the audit performed. Such information is necessary in order to provide petitioner with an opportunity to meet its burden of proving such methodology unreasonable (*Matter of Fokos Lounge*, Tax Appeals Tribunal, March 7, 1991).

Petitioner asserts that there was no attempt on the part of the Division to utilize the taxpayer's pricing information since menus were readily available. However, a review of this case reveals that because of the abundance of daily specials and the lack of daily special menus,

guest checks and register tapes for most of the audit periods, a markup test utilizing petitioner's selling prices was not feasible. Because wine was sold by the glass and by the bottle and liquor was sold in shots, mixed drinks and cocktails requiring different amounts therein, absent guest checks and register tapes for most of the audit periods, an alcoholic beverage markup using petitioner's selling prices could not be performed.

Therefore, since the Division's resort to the use of external indices was proper, absent adequate books and records, the critical issue to be resolved with respect to both sales tax audits was whether the audit method selected, or in these audits, the particular indices selected had a rational basis and, accordingly, were reasonably calculated to reflect tax due.

As will hereinafter be shown, neither the auditors nor their section head were able to adequately describe and explain the rationale behind the selection of the particular exhibit in the Restaurant Industry Operations Report. That fact, when combined with their failure to make even a cursory examination of the other exhibits within the section of the Report pertaining to full service restaurants with an average check per person of \$25.00 and over (the category which the auditors selected as being applicable to petitioner), to ascertain whether their audit results were reasonable, and the independent evidence presented by petitioner's witnesses, David E. Gross and Brendan McCafferty, results in a determination that petitioner has proven, by clear and convincing evidence, that the sales tax assessments at issue were erroneous and that the audit methodology was arbitrary and patently unreasonable.

F. In the first audit, the auditor testified that she selected the 2002 edition of the Restaurant Industry Operations Report because the year 2002 was the one full year within the audit period. However, she indicated that she did not compare the data in the 2002 edition with the 2001 or 2003 editions to determine if there was consistency. Inasmuch as page 15 of the

Report alerted users of the publication that the operators who participated in the 2002 study were not identical with those who participated in previous years' studies, a comparison with other years would, at the very least, be prudent. During direct examination, she indicated that she used Exhibit C-10 to compute the markup percentage to be used in her audit; later, on cross examination, she corrected herself and stated that she had, in fact, used Exhibit C-12 instead. When asked by petitioners' representative why she had selected the figures set forth in Exhibit C-12, as opposed to any of the other schedules set forth in Section C - Full Service Restaurants (Average Check Per Person \$25 and Over), she indicated that Exhibit C-12 seemed to be an average of some of the other schedules or exhibits. She stated that "we didn't have that type of information pertaining exactly to that category, so this seemed as though it was just an average." Obviously, the auditor was confused as to the reason that Exhibit C-12 rather than any of the other exhibits was selected. Despite the fact that Exhibit C-12 is an amount per seat analysis, the auditor, when asked why she did not use the numbers therein to compute total sales per seat, she simply replied that she did not know. Clearly, Exhibit C-12 was not utilized in the manner for which the data was presented. At the very least, doing these calculations to determine total sales might well have caused the auditor some reason to rethink her use of this exhibit to determine a markup percentage.

During cross examination of the sales tax section head, he admitted that he directed the auditor to use Exhibit C-12 rather than any of the other exhibits contained within Section C of the Report. Perhaps it was because she did not actually select Exhibit C-12 that the auditor was confused as to the reason for its utilization in the audit. However, the section head's justification and explanation seemed similarly unclear.

On cross examination, the section head, when asked why the 2002 edition of the Report was used, stated that he wanted to use the mid year of the audit. Yet he admitted that the 2002 edition was published in 2002 and contained data from 2001, so that if he wanted data from 2002, he should have used the 2003 edition.

The section head acknowledged that the title of Exhibit C-12 was "Statement of Income and Expenses - Amount per Seat." The median numbers under the heading "Single Unit - Independent" represent cost of food and beverage and sales of food and beverage per seat. These were the numbers which the auditor used to calculate petitioner's markup percentages. While acknowledging that these figures represented amounts *per seat*, he stated that, despite knowing the number of seats in Mother's, he never multiplied the median numbers in Exhibit C-12 by the number of seats in the restaurant to determine if the calculations were reasonable. When asked by petitioners' counsel to multiply the total sales per seat figure in the median column of Exhibit C-12 (\$10,887) by the number of seats in the restaurant (approximately 80 which includes bar seating), the result equals \$870,960.00 which, when multiplied by 3 (years in the audit period), yields the amount of \$2,612,880.00, an amount which is significantly less than the sales reported by petitioner. Reported sales during this audit period were \$3,714,329.00, an amount which was approximately \$1.1 million greater than the data indicated.

Again, during cross examination by petitioners' counsel, the section head conceded that the markup computed per the Restaurant Industry Operations Report ignored the number of seat turns per day and amount of profit per seat (*see* Finding of Fact 19) despite the fact data relating to these factors was readily available in other exhibits within Section C of the Report.

Exhibit C-8 of the Report reveals that the median per seat profit (before income taxes) is \$200.00 while the upper quartile per seat profit is \$860.00. Using the upper quartile figure and

multiplying it by the approximate 80 seats (including seats in the bar) in Mother's would yield a profit of \$68,800.00. Pursuant to the results of the audit, additional taxable sales (and, therefore, additional profit since expenses were reviewed) were determined to be \$1,742,828.38, an amount which exceeds the Report's profitability prognostication by more than \$1.5 million.

David E. Gross, a certified sales tax specialist, performed a table turn analysis for the first audit period (*see* Finding of Fact 41) which revealed that according to the sales figures reported by petitioner, its turn rate would have been approximately 1.9 which exceeds the median (0.9) and upper quartile (1.4) turn rates set forth in Exhibit C-2 of the 2002 Restaurant Industry Operations Report. If the Division's audited sales figures are used, the turn rate would have to have been approximately 3.6, which based upon Mr. Gross's experience and his observation of the operation of Mother's, is not physically possible.

G. With respect to the second audit, the auditor stated that he was somewhat familiar with the first audit and the method of computing the markup employed by that auditor. He stated that he decided to use the 2006/2007 edition of the Restaurant Industry Operations Report to calculate petitioner's markup percentages for the second audit. In this case, the auditor selected Exhibit C-16, Statement of Income and Expenses - Ratio to Total Sales for Full Service Restaurants (Average Check Per Person \$25 and Over). He decided to use the median ratios of cost to total sales for restaurants with sales of \$2,000,000.00 and over, but offered no explanation as to why that exhibit was selected or why the median was chosen over lower or upper quartiles.

During cross examination, the auditor admitted that he had not read the entire publication and, specifically, he had not read the portion of the publication entitled "Introduction To Analysis of Data and Explanatory Notes," where the method of obtaining and reviewing the data is set forth. He indicated that he was aware that the markup percentages which he calculated from

Exhibit C-16 were different from the markup percentages calculated in the prior audit, but he attributed it to the use of a different exhibit.

Clearly, this auditor offered no rational basis for his utilization of Exhibit C-16 of the 2006/2007 Restaurant Industry Operations Report. While he admitted only to a cursory review of the prior audit, it must be assumed that his use of the Report was more than a mere coincidence. Yet, while the auditor chose to use the same external index, he did not use the same exhibit contained within and offered no valid explanation for his deviation from the prior auditor's methodology. He simply stated that he thought that the use of Exhibit C-16 "was more representative of the taxpayer's business."

As was the case with the first sales tax audit, this auditor also failed to take any steps to determine if his markup calculations were reasonable. Despite the availability, within Section C of the Report, of seat turn ratios and profitability indexes, this auditor chose to do nothing more. Petitioner's witness, David E. Gross, performed a cost markup comparison for this audit period (*see* Finding of Fact 40) and also performed a table turn analysis (*see* Finding of Fact 41). The cost markup analysis showed that petitioner's bank deposits of \$5,150,404.00 were greater than its reported sales for the period of \$4,766,594.00 by \$383,810.00 which likely represented sales tax collected since petitioner reported and paid sales tax for the period in the amount of \$397,162.11. If the Division's audit results are to be believed, petitioner's sales for the period were \$8,564,102.69, meaning that sales were underreported by \$3,797,508.69. Since the auditor agreed that credit card sales were verifiable and, in fact, guest checks were provided for credit card sales (*see* Finding of Fact 21), the audit results mean that this additional \$3,797,508.69 represented profit resulting from cash sales which petitioner did not deposit. Mr. Gross stated that a restaurant of the type and size of Mother's could not generate that amount of profit.

Mr. Gross's table turn analysis showed that to achieve the sales which the Division asserts were made during the audit period, \$8,564,102.69, a seat turn rate of more than four times the average would have to have been accomplished. According to the 2006/2007 edition of the Restaurant Industry Operations Report by the National Restaurant Association and Deloitte & Touche LLP, the same external index which the Division chose as the source of its markup percentage, the median turn rate for steak and seafood restaurants was 0.7 and the upper quartile was 1.0. Clearly, a turn rate of more than 4 (Mr. Gross's analysis concluded that a turn rate of 4.3 per day would be required to attain the sales asserted by the Division), is not in any way reasonable. Had the auditor taken the time to analyze the table turn information contained in the Report, perhaps he would have reconsidered his audit findings.

Mr. Gross pointed out that on the first page of Section C- Full Service Restaurants (Average Check Per Person \$25 and Over), the 2006/2007 Restaurant Industry Operations Report, under "Highlights," it states that the median food sales are \$8,595.00 per seat and that the median beverage sales are \$3,174.00 per seat, or roughly \$11,769.00 in total sales per seat. It must be pointed out that the auditor admitted that he had not read the entire publication and, therefore, likely failed to become familiar with these per seat figures. Using his calculations of approximately 2 turns per seat per day on a yearly basis, the result would be \$11,769.00 times 2, or \$23,538.00 times 58 seats, times 3 years, or \$4,095,612.00 in sales.² For the second audit period, petitioner reported sales of \$4,766,594.00. Using the Division's audit findings of sales of \$8,564,102.69, dividing by 3 years, then dividing by the 58 seats in the restaurants, results in

² Previously, it was noted that including bar seating, there are 80 seats in the restaurant. However, for purposes of this analysis, to assume that all bar patrons consumed food while at the bar or to assume that none of the bar patrons were later seated in the dining room, would skew the analysis. Therefore, only dining room seating (58) was used.

median sales per seat of \$49,218.00, more than 4 times the median sales per the 2006/2007 Restaurant Industry Operations Report.

Brendan McCafferty, an attorney and financial auditor whose practice specialized in multistate taxation, primarily sales and use taxes, stated that, in his opinion, the auditor in the second audit selected the wrong category within Exhibit C-16 of the Report, since he used the median ratios of cost to total sales for restaurants with sales over \$2,000,000.00, when petitioner's total sales for nearly three years totaled \$4,766,594.00, or less than \$2,000,000.00 per year. Mr. McCafferty also compared the audit results with Mr. Gross's table turn analysis and concluded that in order for Mother's to generate the sales as assessed, it would be necessary to achieve a seat turnover of 4 to 4.5 turns daily which is substantially greater than industry standards.

H. In summary, it is undisputed that Mother's did not maintain and, therefore, produce for audit, the books and records necessary to perform a detailed audit. Case law holds that, as a general proposition, any imprecision in the results of an audit arising by reason of a taxpayer's own failure to maintain adequate and accurate records of all of its sales as required by Tax Law § 1135(a)(1) must be borne by that taxpayer (*Matter of Meyer v. State Tax Commn.*; *Matter of Markowitz v. State Tax Commn.*).

What resulted from the two sales tax audits at issue in this matter is far more than imprecision, however. Both auditors chose to utilize data contained in a Restaurant Industry Operations Report by the National Restaurant Association and Deloitte & Touche LLP. The first auditor used the 2002 edition; the second auditor used the 2006/2007 edition. While prior Tax Appeals Tribunal decisions have sustained the use of this Report, it must be pointed out that in a number of these cases, the only data utilized was a rent factor. Obviously, the editors of the

Report have provided sufficient warning as to its year-to-year reliability and its use for anything more than a management tool (*see* Finding of Fact 15). Since these auditors nevertheless chose the Report as a means by which to compute sales tax liability, they must be sufficiently familiar with the Report to be able to respond meaningfully to inquiries regarding its use (*see Matter of Fokos Lounge*) and, clearly, such familiarity was lacking herein.

The auditors could not explain why this particular report was chosen, and they did not sufficiently familiarize themselves with the contents so as to be certain that the chosen data was applicable to petitioner's business. Each auditor attempted to calculate a markup percentage which was applied to petitioner's purchases. Neither auditor bothered to check the reasonableness of their markup percentage by comparing the resulting audited taxable sales with other data which was set forth in the same section of the report that was utilized in computing the markup percentage.

Petitioner, while clearly negligent in its record keeping, was most diligent in analyzing the audit results in both sales tax audits. Its witnesses, most notably, David E. Gross and Brendan McCafferty, visited the business premises, reviewed the reports used by the auditors and performed independent analyses of the data contained in the reports which, in total, leads to the conclusion that the methods selected were not reasonably calculated to reflect tax due. By clear and convincing evidence, petitioner has shown that the results of both sales tax audits were erroneous and, clearly and unequivocally, that the audit methods employed were unreasonable.

I. Accordingly, other than the tax assessed on petitioner's fixed asset acquisitions, \$9,299.79 (*see* Finding of Fact 11), plus applicable penalty and interest, the balance of the assessment from the first sales tax audit must be canceled. As a result, the Notice of Determination issued to Mark Supples, as an officer or responsible person of petitioner must be

modified accordingly. The assessment derived from the second sales tax audit is canceled in its entirety since no tax was assessed on fixed assets. Mr. Supples was not personally assessed as a result of the second sales tax audit.

As to the corporation franchise tax and personal income tax deficiencies, they, too, must be canceled, since additional gross receipts from the sales tax audits were the bases for the corporation franchise tax deficiency asserted against petitioner and for the personal income tax deficiencies asserted against Mark Supples and Amy Taylor and Matthew J. Conroy and Melissa A. Conroy.

J. (a) The petitions of 33 Virginia Place, Inc. and Mark Supples are granted to the extent indicated in Conclusion of Law I; the Division of Taxation is directed to modify the Notice of Determination issued to 33 Virginia Place, Inc. on December 1, 2004 and the Notice of Determination issued to Mark Supples on December 27, 2004 accordingly;

(b) The petitions of 33 Virginia Place, Inc. with respect to the second sales tax audit and the corporation franchise tax audit are granted and the Notice of Determination issued May 31, 2007 and the Notice of Deficiency issued March 30, 2006 are hereby canceled;

(c) The petition of Mark Supples and Amy Taylor and the petition of Matthew J. Conroy and Melissa A. Conroy are granted and the notices of deficiency issued on April 17, 2006 are hereby canceled.

DATED: Troy, New York
November 13, 2008

/s/ Brian L. Friedman
ADMINISTRATIVE LAW JUDGE