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 : ORDER
DTA NOS. 821181, 821182,

MARK SUPPLES AND AMY TAYLOR : 821183, 821290, 821291 AND 821859

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. :

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.	:

Petitioners 33 Virginia Place, Inc., and Mark Supples filed petitions for revision of determinations or for refund of sales and use taxes under Articles 28 and 29 of the Tax Law for the period September 1, 2001 through November 30, 2003.

Petitioner 33 Virginia Place, Inc., 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 December 1, 2003 through August 31, 2006.

Petitioners, 33 Virginia Place, Inc., Mark and Amy Taylor Supples, and Matthew J. and Melissa A. Conroy, filed petitions for revision of determinations or for refund of sales and use taxes under Articles 28 and 29 of the Tax Law for the period September 1, 2001 through November 30, 2003.

On November 13, 2008, Administrative Law Judge Brian L. Friedman issued a determination which: (1) granted the petitions of 33 Virginia Place, Inc., and Mark Supples as to the sales and use tax assessed except that which was assessed on petitioners' fixed asset acquisitions, and cancelled the balance of the assessment from the first sales tax audit, thereby modifying the Notice of Determination issued to 33 Virginia Place, Inc., dated December 1, 2004 and the Notice of Determination issued to Mark Supples dated December 27, 2004; (2) granted the petitions of 33 Virginia Place, Inc., with respect to the second sales tax audit and corporation franchise tax audit, cancelling the Notice of Determination dated May 31, 2007 and the Notice of Deficiency dated March 30, 2006; and (3) granted the petitions of Mark Supples and Amy Taylor Supples and the petition of Matthew J. Conroy and Melissa A. Conroy, cancelling the notices of deficiency dated April 17, 2006.

The Division of Taxation filed an exception to the November 13, 2008 determination of the Administrative Law Judge with the Tax Appeals Tribunal. Oral argument was heard in this matter on July 15, 2009. On December 23, 2009, the Tax Appeals Tribunal issued a decision which denied the exception of the Division of Taxation and affirmed the determination of the Administrative Law Judge.

Petitioners, appearing by Amigone, Sanchez, Mattrey & Marshall, LLP (B.P. Oliverio, Esq. Of Counsel), brought an application for costs under Tax Law § 3030 on January 19, 2010. The Division of Taxation, appearing by Daniel Smirlock, Esq. (James Della Porta, Esq., of counsel), filed an affirmation in opposition to the application on February 16, 2010, which date began the 90-day period for issuance of this order. This matter was assigned to Catherine M. Bennett, Administrative Law Judge, upon the retirement of Judge Friedman, and notice was provided to the parties of a 60-day extension for the issuance of this order.

Based upon petitioners' application for costs, the Division's affirmation in opposition, the determination issued November 13, 2008, the decision of the Tax Appeals Tribunal issued on December 23, 2009, and all pleadings and proceedings had herein, Catherine M. Bennett, Administrative Law Judge, renders the following order.

ISSUE

Whether petitioners are entitled to an award of costs pursuant to Tax Law § 3030.

FINDINGS OF FACT

1. Petitioner 33 Virginia Place, Inc. (petitioner or the Company) 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.[1]

2. The Division of Taxation (Division) issued a Notice of Determination dated December 1, 2004, 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. The Division issued another Notice of Determination to petitioner assessing additional sales and use taxes in the amount of $318,815.93, plus penalty and interest for a total due of $536,589.45 for the period of December 1, 2003 through August 31, 2006.

The Division issued a Notice of Determination dated December 27, 2004, to Mark Supples, which assessed tax in the amount of $127,688.20, plus penalty and interest, for a total

[1] "Petitioners" will refer to the Company and the individual petitioners collectively.

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.

The Division issued a Notice of Deficiency dated March 30, 2006, 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.

The Division issued a Notice of Deficiency dated April 17, 2006, 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.

The Division issued a Notice of Deficiency, dated April 17, 2006, 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.

3. The basis for the Division's notices was two sales tax audits of petitioner's business, a corporation franchise tax assessment issued to the Company and personal income tax assessments to the individual petitioners, all flowing from the results of the sales tax audits. As to the first sales tax audit, after a proper request for books and records, and a production of some records (more fully set forth in the determination of the administrative law judge), a determination was made by the Division that petitioner failed to maintain records that were required of petitioner as a vendor.[2] In an attempt to verify sales, since there were no guest checks

[2] Later, at the hearing, petitioners stipulated to the fact that they failed to maintain records as required.

or cash register tapes for the audit period, the Division attempted to use petitioner's selling prices to determine a markup of items sold. As to wine, liquor and food, there were too many menu variables and information not provided to the Division for a markup to be done reliably. Thus, the Division turned to the 2002 edition of the Restaurant Industry Operations Report by the National Restaurant Association and Deloitte & Touche (2002 Report). The auditor chose an exhibit for Full Service Restaurants (Average Check Per Person $25 and Over), Statement of Income and Expenses - Amount Per Seat. Using the median figures in the exhibit, the auditor calculated markup percentages for food and beverages at 181% and 185%, respectively, above cost. Third-party verification was used to verify purchases per petitioner's books, and the markup percentages were then applied to petitioner's purchases from its own disbursements journal. Additional tax due was calculated to be $140,369.88 on sales of food and beverages; additional tax on fixed asset acquisitions in the amount of $9,299.79 (not in dispute) was added to this amount, for a total tax due by petitioner of $149,669.69, for the period March 1, 2001 through November 30, 2003.

The Division's auditor could not articulate her reasoning for using the figures in this schedule to compute the markup, as opposed to other schedules in the publication, and never considered using the total sales per seat amount, a component of the schedule used, in computing the tax due. Had the auditor used the median sales per seat of $10,887.00, the Division would have computed taxable sales of $2,612,880.00 (compared to petitioner's reported sales for the same period of $3,714,329.00); however, based upon the markup percentage calculated by the Division, petitioner's sales were estimated to be $1.7 million over that which it reported, and $2.9 million over the per seat amount set forth in the same schedule used by the Division.

Although another schedule of the 2002 Report allowed a calculation to be made that considered the number of times a seat turned over in the restaurant, the Division ignored the information that calculated the number of seat turns per day and amount of profit per seat.

4. The second sales tax audit, performed by a different auditor, spanned the period December 1, 2003 through August 31, 2006. Again, the Division made a proper request for records and received some records, but too insufficient to determine whether petitioner had properly reported its sales. The auditor made a determination to use the 2006/2007 edition of the Restaurant Industry Operations Report by the National Restaurant Association and Deloitte & Touche LLP (2006/2007 Report) in order to compute petitioner's markup on items sold. The auditor chose a different schedule from the report than was used in the prior audit. This time the exhibit entitled Statement of Income and Expenses - Ratio to Total Sales for Full Service Restaurants (Average Check Per Person $25 and Over), with sales of $2 million and over was used. Using the median ratios of cost to total sales from this schedule, the auditor arrived at a 315% markup for food and 336% markup for beverages, which were applied to petitioner's purchases from its general ledger. This calculation resulted in additional taxable sales of $3,797,508.69, with tax due thereon in the amount of $318,815.94.

The auditor handling the second audit was aware that the markup percentages that 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 attributed the difference to the fact that different indices from different exhibits of the two reports were used. He could not recall, however, whether the other exhibits in the report were examined and why they were not used.

5. Upon referral from the Sales Tax Audit Bureau, the Division advised petitioner that its corporation franchise tax returns for the years 2001 through 2003 had been selected for audit. The Division 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. Since January and February 2001 were outside the sales tax audit period, those months were estimated. To compute the additional franchise tax due from petitioner, the auditor used additional gross receipts from the results of the first sales tax audit and applied it to the years at issue. The result was franchise tax due on the entire net income base for 2001 in the amount of $4,976.00. For 2002, the franchise tax due on the same entire net income base was $3,614.00.[3]

As to the personal income tax ramifications that flowed through from the sales tax audits, the Division asserted the following additional liabilities:

a. For 2001, Mark Supples was the owner of 100% of the shares of petitioner. Thus, the additional gross receipts computed for 2001 in the amount of $594,611.00 were attributed to him, resulting in additional tax due of $41,165.00 after payments for which he received credit.

b. For 2002, Mark Supples was a 45% shareholder, Amy Taylor (Mark Supples's wife) was a 45% shareholder and Matthew Conroy was a 10% shareholder. Thus the additional gross receipts in the amount of $556,011.00 were attributed to them in accordance with their percentage of ownership. For Mark Supples and Amy Taylor, who filed a joint return, the resulting tax due for tax year 2002 was $35,501.00. For Matthew Conroy, who filed jointly with his wife Melissa A. Conroy, the resulting personal income tax was $3,902.00 for the 2002 tax year.

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[3] After a change in the Tax Law that eliminated the differential between the franchise tax rate and the personal income tax rate, no franchise tax deficiency was asserted for the 2003 tax year.

c. For 2003, as with 2002, Mark Supples was a 45% shareholder, Amy Taylor was a 45% shareholder and Matthew Conroy was a 10% shareholder. Thus, the additional gross receipts in the amount of $772,868.00 were attributed to them in accordance with their percentage of ownership. For Mark Supples and Amy Taylor, who filed a joint return, the resulting tax due for tax year 2003 was $54,774.00. For Matthew Conroy, who filed jointly with his wife Melissa A. Conroy, the resulting personal income tax was $6,020.00 for the 2003 tax year.

6. A hearing before an administrative law judge was held on January 9 and 10, 2008, at which time petitioners provided testimony and documents explaining what they believed were the deficiencies in the audit by the Division. In addition, petitioners put forth the testimony and analysis of Dave Gross, a certified sales tax specialist, who, among other observations, performed an analysis based on table turnover rates. Mr. Gross concluded, based upon his table turnover analysis and the amount of profit that would have to have been generated if the Division's audit results were accurate, that the Division's calculation of markup percentages based upon the select information used from 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.

Additionally, Brendan McCafferty, an attorney specializing in sales and use taxation, reviewed the work performed by David 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. Further, Mr. McCafferty offered the opinion 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 in this case. Mr. McCafferty reviewed the reports and stated that, in his opinion, they were not the most reasonable studies to use because their express purpose was to be used as a benchmark in the industry for comparing management operations and to provide an informational resource. Particularly with respect to the second audit, Mr. McCafferty noted that the auditor selected the incorrect category for petitioner because 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. In addition, 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 petitioner to achieve a seat turnover of 4 to 4.5 turns per day, which he deemed unreasonably high.

7. On November 13, 2008, Administrative Law Judge Brian L. Friedman addressed this matter and issued his determination. He summarized the issues as follows:

> 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.

Judge Friedman, cancelling all assessments other than the tax assessed on petitioner's fixed asset acquisitions in the amount of $9,299.79 (plus applicable penalty and interest), concluded as follows:

> 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.***).
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> 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. . . . 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.
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> 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.
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> 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.

8. Judge Friedman's determination was appealed to the Tax Appeals Tribunal, and on December 23, 2009, the Tribunal issued its decision. After first setting forth the standards for conducting a sales and use tax audit, the Tribunal affirmed the conclusions of the administrative law as follows:

> There is a distinction to be made between determining whether or not it was rational for the Division to use particular external indices, such as the 2002 and 2006/2007 Reports, as the basis for its audit and whether the audit methodology resulting from the use of these Reports was reasonably calculated to reflect taxes due. We find that in this case, it was rational for each auditor to rely on the Restaurant Industry Operations Report as the basis for calculating petitioners' sales and use tax liability, notwithstanding each auditor's inability to testify as to the quality of the data contained in the report.
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> That being said, however, the manner in which these indices were used resulted in audit methodologies that cannot be said to have been reasonably calculated to reflect petitioners' tax liability.
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> * * *
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> Had the Division used the median portion of Exhibit C-12 appropriately in calculating petitioners' taxable sales, it would have estimated petitioners' tax liability for the period by calculating the sales price of food and beverages sold "per seat," based on the number of seats in petitioners' restaurant. As pointed out by the Administrative Law Judge, this calculation, if performed, would have shown that audited sales were significantly lower than sales actually reported by petitioners, and resulted in no additional tax due by petitioners. In fact, even if the auditor had considered petitioners' business to be in the upper quartile of Exhibit C-12 instead of in the median range, a "per seat" analysis would still have shown petitioners' taxable sales to have been lower than what it had previously reported.
>
> Rather, what the Division did was to extract numbers from Exhibit C-12 of the report and use those numbers in a manner for which they were not intended. Whatever information was used to compile the cost of beverages and food and the sales of beverages and food contained in Exhibit C-12 of the report was necessarily modified by the number of seats in the restaurants that contributed to their cost and sales figures.

Ignoring this component of Exhibit C-12, the Division used the Restaurant Report to create its own external index, which it identified as a "markup percentage." The term "markup percentage" is not contained in Exhibit C-12.

The Division is correct that its auditors are not required to explain the basis of the data underlying the external indices used, nor the method in which the data was formulated. We believe, however, that this does not give the Division carte blanche to simply extract convenient numbers from an index and use them in a manner for which they were never intended to be used. Having chosen to use the median portion of Exhibit C-12 of the 2002 Report, the Division should have used it for the purposes for which it was intended, and not randomly selected numbers from the exhibit that supported an increased tax liability for petitioners. While there is no question that petitioners' lack of records opened the door for the Division to use an external index to estimate petitioners' taxable sales, it must be pointed out that a lack of records does not equate to a presumption that taxable sales have been underreported.

While it is advisable to do so, auditors are not required by law to confirm the reasonableness of the results of their chosen methodology. However, the failure to do so here proved fatal to the Division's choice of audit methodology. The choices of exhibits were the Division's to make and, having made them, the Division is responsible for the outcome.

* * *

While the Division is not under an obligation to use an external index in such a way as to minimize petitioners' tax liability, as stated above, the index chosen must be "reasonably calculated to reflect the taxes due" (***see***, ***Matter of W.T. Grant Co. v. Joseph***, ***supra***). Had consideration been given to other exhibits in that Report, it would have appeared obvious that petitioners may not have underreported sales in any respect. With no articulated basis having been provided for using one exhibit over another, and given the divergent range of results depending on the choice of exhibits within the same external index, we find that, in this instance, the use of Exhibit C-16 of the Report by the auditor to calculate petitioners' taxable sales was not "reasonably calculated to reflect the taxes due" by petitioners.

9. Petitioners' January 19, 2010 application for costs seeks an award of costs in the amount of $126,024.74, consisting specifically of the following items:

a) $18,822.50 for expert witnesses
   (i) Sales Tax Solutions and Consulting ($5,255.00) and
   (ii) Brendan McCafferty ($13,567.50)

b) $97,556.00 for attorneys fees
(i) Amigone, Sanchez, Mattrey & Marshall, LLP ($53,707.50)
(ii) Hodgson Russ LLP ($43,848.50)

c) $3,271.24 for disbursements
(i) Amigone, Sanchez, Mattrey & Marshall, LLP ($2,059.50)
(ii) Hodgson Russ LLP ($1,211.74)

d) $6,375.00 for legal fees and disbursements associated with this application
(i) Amigone, Sanchez, Mattrey & Marshall legal fees ($6,300.00)
(ii) Amigone, Sanchez, Mattrey & Marshall disbursements ($75.00)

10. Accompanying petitioners' application for costs were voluminous and detailed itemized statements of each of the attorneys and expert witnesses listed, setting forth the actual time expended and the rate at which their fees and other expenses were computed.

11. Also accompanying petitioners' application for costs were the following:

a) The affidavit of Mark Supples, as president of 33 Virginia Place, Inc. and a 45% shareholder, set forth the following information:

i. A listing of the costs for which petitioners are seeking reimbursement.
ii. A statement that the Company's net worth at the time the proceeding was commenced was less than $7 million.
iii. A statement that the most recent Balance Sheet and Statement of Profit & Loss of the Company showed a book value of $12,000.00 as of December 31, 2009.
iv. A statement that at the time the proceeding was commenced, the Company had fewer than 50 full time and part time employees.
v. A statement that at the time the proceeding was filed, his net worth was substantially less than $2 million, and although it has increased, it still remains so.
vi. A statement that the joint net worth of Mark Supples and his wife, Amy Taylor, is substantially less than $2 million as evidenced by an attached joint financial statement.

b)The affidavit of Amy Taylor, an officer of 33 Virginia Place, Inc. and a 45% shareholder, set forth the following information:

i. A statement that at the time the proceeding was filed, her net worth was substantially less than $2 million, and although it has increased, it still remains so.

ii. A statement that the joint net worth of Amy Taylor, and her husband, Mark Supples, is substantially less than $2 million as evidenced by an attached joint financial statement.

c) The affidavit of Matthew J. Conroy, stating that at the time the proceeding was filed his net worth was less than $2 million. Attached to his affidavit was a personal financial statement dated January 11, 2010, showing his total net worth was less than $2 million at that time.

d) The affidavit of Melissa A. Conroy, stating that at the time the proceeding was filed her net worth was less than $2 million. Attached to her affidavit was a personal financial statement dated January 11, 2010, showing her total net worth was less than $2 million at that time.

SUMMARY OF THE PARTIES' POSITIONS

12. Petitioners maintain that they are the prevailing parties and should be awarded the full amount of the costs they are seeking. Further, petitioners argue that the Division's assertion that its position was substantially justified is completely without merit.

13. In opposition to petitioners' application, the Division maintains that petitioners' application for costs should be denied because the Division's position in this matter was substantially justified. However, the Division asserts, even if the Division's position is not substantially justified, petitioner has overstated the costs for which it is entitled to reimbursement.

CONCLUSIONS OF LAW

A. Tax Law § 3030(a) provides, generally, as follows:

> In any administrative or court proceeding which is brought by or against the commissioner in connection with the determination, collection, or refund of any tax, the prevailing party may be awarded a judgment or settlement for:
>
> (1) reasonable administrative costs incurred in connection with such administrative proceeding within the department, and
>
> (2) reasonable litigation costs incurred in connection with such court proceeding.

Reasonable administrative costs include reasonable fees paid in connection with the administrative proceeding, but incurred after the issuance of the notice or other document giving rise to the taxpayer's right to a hearing (Tax Law § 3030[c][2][B]). The statute also provides that fees for the services of an individual who is authorized to practice before the Division of Tax Appeals are treated as fees for the services of an attorney (Tax Law § 3030[c][3]).

B. A prevailing party is defined by the statute as follows:

> [A]ny party in any proceeding to which [Tax Law § 3030(a)] applies (other than the commissioner or any creditor of the taxpayer involved):
>
> (i) who (I) has substantially prevailed with respect to the amount in controversy, or (II) has substantially prevailed with respect to the most significant issue or set of issues presented, and
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> (ii) who (I) within thirty days of final judgment in the action, submits to the court an application for fees and other expenses which shows that the party is a prevailing party and is eligible to receive an award under this section, and the amount sought, including an itemized statement from an attorney or expert witness representing or appearing in behalf of the party stating the actual time expended and the rate at which fees and other expenses were computed . . . and (II) is an individual whose net worth did not exceed two million dollars at the time the civil action was filed . . . .
>
> (B) Exception if the commissioner establishes that the commissioner's position was substantially justified.
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> (i) General rule. A party shall not be treated as the prevailing party in a proceeding to which subdivision (a) of this section applies if the commissioner establishes that the position of the commissioner in the proceeding was substantially justified.

(ii) Burden of proof. The commissioner shall have the burden of proof of establishing that the commissioner's position in a proceeding referred to in subdivision (a) of this section was substantially justified, in which event, a party shall not be treated as a prevailing party.

(iii) Presumption. For purposes of clause (i) of this subparagraph, the position of the commissioner shall be presumed not to be substantially justified if the department, inter alia, did not follow its applicable published guidance in the administrative proceeding. Such presumption may be rebutted.

* * *

(C) Determination as to prevailing party. Any determination under this paragraph as to whether a party is a prevailing party shall be made by agreement of the parties or (i) in the case where the final determination with respect to tax is made at the administrative level, by the division of tax appeals, or (ii) in the case where such final determination is made by a court, the court (Tax Law § 3030[c][5]).

C. Petitioners succeeded, based upon their production of extensive testimony and documentary evidence at hearing, in meeting their burden of proving by clear and convincing evidence that the results of both sales tax audits were erroneous and that the audit methods were unequivocally unreasonable. Consequently, with the exception of the sales tax on fixed assets, the notices of determination for sales tax liability, and the notices of deficiency for corporation franchise tax liability and personal income tax liability, were canceled in their entirety. Notwithstanding this result, however, petitioners were not the prevailing party within the meaning and intent of Tax Law § 3030 because the Division was substantially justified in issuing the notices based upon the information in its possession at the time the notices were issued.

D. Tax Law § 3030 is clearly modeled after Internal Revenue Code § 7430. It is proper, therefore, to use Federal cases for guidance in analyzing this state law (***see Matter of Levin v. Gallman***, 42 NY2d 32, 396 NYS2d 623 [1977]; ***Matter of Ilter Sener***, Tax Appeals Tribunal, May 5, 1988). A position is substantially justified if it has a reasonable basis in both fact and law (***see Information Resources, Inc. v. United States***, 996 F2d 780, 785, 93-2 US Tax Cas ¶ 50,519

[1993]), with such determination properly based "on all the facts and circumstances surrounding the case, not solely upon the final outcome" (***Phillips v. Commissioner***, 851 F2d 1492, 1499, 88-2 US Tax Cas ¶ 9431 [1988]; ***Heasley v. Commissioner***, 967 F2d 116, 120, 92 US Tax Cas ¶ 50,412 [1992]). The fact that the notices were cancelled by the administrative law judge and his determination affirmed by the Tax Appeals Tribunal, is a factor to be considered (***Heasley***). However, this outcome does not preclude a finding that the Division's position was substantially justified at the time the notices were issued, since the finding must be made in view of what the Division knew at the time its position was taken (Tax Law § 3030[c][8][B]; ***see DeVenney v. Commissioner***, 85 TC 927, 930 [1985]).

The Tax Court in ***Oak Knoll Cellar v. Comm. of Internal Revenue*** (68 TCM 412 [1994]) reviewed the legislative history of Internal Revenue Code § 7430 pertaining to the guidelines for determining whether the conduct of the government was unreasonable, as follows:

> The committee intends that the determination by the court on this issue [of reasonableness] is to be made on the basis of the facts and legal precedents relating to the case as revealed in the record. Other factors the committee believes might be taken into account in making this determination include, (1) whether the government used the costs and expenses of litigation against its position to extract concessions from the taxpayer that were not justified under the circumstances of the case, (2) whether the government pursued the litigation against the taxpayer for purposes of harassment or embarrassment, or out of political motivation, and (3) such other factors as the court finds relevant ***(H. Rept. 97-404, at 12*** [1981]).

E. There is no dispute that petitioners in this case did not maintain books and records sufficient for the Division to perform a detailed audit and verify that sales had been properly reported. In fact, even after being informed of what was required of them after the first audit, petitioners did not comply with the level of record keeping required of them. Accordingly, for both sales tax audits, because of the failure by petitioners to maintain sufficient records, the Division was clearly entitled to resort to external indices to determine whether petitioners owed

additional sales tax. Petitioners argued, however, that the Division should have conducted an observation test or a markup test rather than resort to the external indices that it chose. On appeal, the Tax Appeals Tribunal (December 23, 2009) reminded us that eliminating the feasibility of such alternate estimation methodologies is not a mandatory prerequisite to selecting another estimated method, such as the one used herein. In addition, the Tribunal confirmed the Division's latitude to choose the method it feels best accomplished its goal of reasonably estimating petitioners' tax liability, despite the existence of its Indirect Audit Methods training manual prescribing a hierarchy of estimated methods to be employed. Thus, the latitude employed by the Division in choosing the reports, and the choice of the markup methodology, though executed with errors, did not exceed its authority.

Whether the Division was substantially justified in its position at the time the notices were issued hinges on two key facts of this case: the appropriateness of its decision to estimate due to the absence of books and records, and whether the choice of the particular indices, the 2002 and 2006/7 reports, was rational. It has already been established that the Division was justified in estimating petitioners' tax liability. The Tax Appeals Tribunal drew an important distinction as to the second point. Although the Tribunal affirmed that the use of the reports was rational, notwithstanding each auditor's inability to testify as to the quality of the data contained therein, it was critical of the manner in which the indices were used, yielding audit methodologies that did not result in a reasonable calculation of petitioners' tax liability. Simply, although the use of the reports was acceptable, the manner in which the statistics from the exhibits were used, was in error. The Division's additional failure to use common sense in checking on its concluding calculations proved fatal. However, the position that the Division took as to its decision to estimate petitioners' tax liability and the reports so employed to do so

was substantially justified. There is no evidence that, when the Division employed the estimated method used in this case, it did so to extract excessive tax revenue from petitioners that was not justified under the circumstances, or for purposes of harassment or embarrassment, or out of political motivation. (***see*** H. R. Rep. 97-404, at 12 [1981]). Nor is there any evidence that Division's position in this case was inconsistent with the position it has taken in other similar cases. The Tax Court in ***Reliable Credit Association, Inc. v. Comm.*** (73 TCM 1948 [1997]) similarly denied an award of costs to a corporation that failed to maintain books and records, though required to do so, and affirmed the reasonableness of the IRS's determination of corporate income by any method that clearly reflected income. In responding to that taxpayer's claims that the IRS failed to employ certain auditing procedures that would have enabled it to easily ascertain the correct amount of the deficiencies, the Court responded: "when the taxpayer has defaulted in . . . [its] task of supplying adequate records, . . . [the taxpayer] is not in a position to be hypercritical of the Commissioner's labor." The fact that errors resulted in this case from the way the reports were used by the auditors simply does not support an award of costs to petitioners. It was petitioners' failure that fueled a process they were forced to defend. Petitioners would have been in the same position challenging the reasonableness of the audit method and its result, regardless of the erroneous application of the indices chosen.

F. Since a determination has been made that the Division was substantially justified in its position, and thus, petitioners are not entitled to an award of costs, it is unnecessary to determine whether the costs claimed are reasonable.

G. Petitioners' application for costs and fees is denied.

DATED: Troy, New York
July 22, 2010

/s/ Catherine M. Bennett
ADMINISTRATIVE LAW JUDGE