

STATE OF NEW YORK

DIVISION OF TAX APPEALS

In the Matter of the Petitions :
of : DETERMINATION
BOK HUI NAM : DTA NOS. 821515 AND 822016
for Redetermination of Deficiencies or for Refund of :
Personal Income Tax under Article 22 of the Tax :
Law for the Years 2000 through 2003. :

Petitioner, Bok Hui Nam, filed petitions for redetermination of deficiencies or for refund of New York State personal income tax under Article 22 of the Tax Law for the years 2000 through 2003.

On September 5 and 13, 2007, respectively, and on January 9 and 11, 2008, respectively, the Division of Taxation, appearing by Daniel Smirlock, Esq. (Michele W. Milavec, Esq., of counsel), and petitioner, appearing by Pfeiffer & Pfeiffer, PC (Raymond M. Pfeiffer, Esq., of counsel), waived a hearing and submitted these matters for determination based on documents and briefs to be submitted by April 11, 2008, which date commenced the six-month period for issuance of this determination (Tax Law § 2010[3]). After due consideration of the documents and arguments submitted, Thomas C. Sacca, Administrative Law Judge, renders the following determination.

ISSUES

I. Whether the Division of Taxation properly determined additional income tax due by using the results of a previous sales tax audit.

II. Whether petitioner demonstrated reasonable cause to justify abatement of penalties asserted with respect to the income tax deficiencies.

FINDINGS OF FACT

1. Petitioner, Bok Hui Nam, owned and operated the Korean Express Restaurant, which was located on the campus of the University of Buffalo, Amherst, New York. During the years at issue, petitioner filed New York State resident income tax returns, Form IT-201, reporting income from Korean Express on the included Schedule C of her federal income tax return for each of the years at issue.

2. Petitioner's business operation was the subject of a sales tax audit for the period September 1, 2000 through August 31, 2003 by the Division of Taxation (Division). Due to the business's failure to maintain complete and accurate records of its sales, costs and expenses, the Division resorted to an observation audit which was conducted on April 15, 2004. The auditor calculated an error rate based on the observation of the business operation, multiplied it by the total sales for that day and divided the result by the number of hours the business was open to determine an average amount of sales per hour. The auditor then multiplied the average sales per hour times the number of hours the restaurant was open for the quarter ended May 31, 2004 to compute the taxable sales for that quarter.

3. The taxable sales computed for the quarter ended May 31, 2004 were compared to the taxable sales as reported on that quarter's sales tax return to calculate an error rate of 2.397. This error rate was then applied to the taxable sales as reported for each quarter of the audit period at issue in order to calculate audited taxable sales. The taxable sales reported on the sales tax returns were subtracted from audited taxable sales to arrive at additional taxable sales for the tax period September 1, 2000 through August 31, 2003. On August 20, 2004, petitioner

executed a Consent to the Statement of Proposed Audit Change for Sales and Use Tax, dated August 12, 2004, for the period September 1, 2000 through August 31, 2003.

4. By letter dated September 15, 2004, the Division advised petitioner that her New York State personal income tax returns for the years 2000, 2001, 2002 and 2003 had been selected for audit based upon a referral from the Sales Tax Audit Bureau. The Division further advised that information received from the Sales Tax Audit Bureau indicated that gross receipts as reported on Schedule C of petitioner's New York State personal income tax return might be understated. The Division further advised that this information would be incorporated into the results of the income tax audit.

5. On October 20, 2004, the Division informed petitioner that the previous sales tax audit revealed that gross receipts as reported on Schedule C of the New York State income tax returns were understated and a personal income tax audit adjustment resulted in an increase in petitioner's tax liability for tax years 2000, 2001, 2002 and 2003. The statements of personal income audit changes accompanying the Division's letter of October 20, 2004 indicated additional personal income tax liability of \$8,207.00 for year 2000, \$8,058.00 for year 2001, \$10,433.00 for year 2002 and \$13,138.00 for year 2003.

The income tax deficiency was determined by applying the error rate of 2.397 to the taxable sales as reported by petitioner on her Schedule C for each year to arrive at audited taxable sales. For the January/February period and the December period, taxable sales were estimated by taking the total taxable sales reported for the year, as indicated on the Schedule C, less the taxable sales reported for the period March 1 through November 30, as indicated on the filed sales tax returns, and dividing the total by two. From audited taxable sales, the auditor subtracted taxable sales previously reported, resulting in additional taxable sales per audit for each of the tax years at

issue. In determining the additional tax due for the period January 1, 2000 through August 31, 2000, a period not covered by the sales tax audit, the Division applied the sales tax error rate to taxable sales as reported by petitioner for such period.

6. In a letter dated January 24, 2005, petitioner proposed that as the sales tax audit of the business was based upon estimated sales, it would be appropriate to allow additional estimated costs on the increased sales. The Division rejected petitioner's proposal, stating that an adjustment to costs would be made should documentation supporting such an increase be provided.

By facsimile dated July 19, 2005, petitioner forwarded to the Division copies of unsigned amended resident income tax returns, Form IT-201X, for the tax years 2000, 2001, 2002 and 2003. In response to the Division's inquiry of August 5, 2005 as to whether the amended returns had been filed and what specific adjustments were made for each year, petitioner stated in a letter dated August 8, 2005 that the amended returns had not been filed and that the returns reflected the cost of goods for each year in question being increased by 50% to conform to the increased estimate of sales determined in the sales tax audit.

7. On February 6, 2006, the Division issued to petitioner a Notice of Deficiency for the year 2000 asserting personal income tax due of \$8,207.00, plus penalty and interest. On the same date, the Division issued a second Notice of Deficiency for the years 2001, 2002 and 2003 asserting personal income tax due of \$31,629.00, plus penalty and interest. Penalties were assessed for each year pursuant to Tax Law § 685(b)(1) and (2) for negligence and Tax Law § 685(p) for the substantial understatement of income.

8. Petitioner immigrated to the United States from Korea in 1986. In 1999, she came to Buffalo from Las Vegas, Nevada, and opened the Korean Express Restaurant. Petitioner

operated the business from space she rented on the State University of New York at Buffalo campus from U.B. Commons, Inc. As most of the business's customers were University of Buffalo students, petitioner's business earnings were greater when the university was in session during the months of September, October, November, early December, February, March, April and early May.

Petitioner purchased a home in the Buffalo area on December 20, 2002, at a purchase price of \$235,000.00. Petitioner received a mortgage in the amount of \$211,500.00 and made a down payment of \$20,000.00, an amount she received from her father to purchase the house. During the period 2001 through 2003, petitioner deposited a total of \$103,497.00 into her personal checking account maintained at the M & T Bank.

CONCLUSIONS OF LAW

A. Petitioner's personal income tax liability is derived from a sales tax audit of the Korean Express Restaurant, of which Bok Hui Nam was the sole owner. Petitioner admittedly failed to keep books and records of her sales, costs and expenses, and without such records the Division properly performed an observation audit to determine petitioner's taxable sales for the sales tax audit period. The error rate which resulted was applied to the taxable sales as reported by the business, resulting in additional audited taxable sales and additional sales tax due. Petitioner consented to the determination of the sales tax audit, and the additional gross receipts were added to petitioner's gross receipts as reported on her federal schedule C, increasing her personal income liability for the years 2000, 2001, 2002 and 2003. For the year 2000, the sales tax audit covered only the period September 1, 2000 through December 31, 2000. For that portion of the year 2000 prior to the sales tax audit period, the Division determined additional income by applying the sales tax error rate to taxable sales reported by petitioner during this period.

Petitioner contends that the method used to reconstruct her income was erroneous in that the auditor simply added the estimated additional gross sales as determined on the sales tax audit to her taxable income to arrive at an income tax deficiency for the years at issue. According to petitioner, it was unreasonable to fail to estimate the cost of goods sold applicable to the increased additional gross sales, and suggests that the income tax assessment be reduced by 50% as attributable to increased costs. In addition, petitioner claims that the audit method employed to determine the income tax deficiency for the earlier portion of the tax year 2000 was unreasonable.

B. The Tax Appeals Tribunal has spoken to petitioner's arguments in its decision in *Matter of R & J Automotive, Inc.* (Tax Appeals Tribunal, June 15, 1989), where it said:

In a sales and use tax audit, resort to external indices as a method of computing sales tax liability must be founded upon a determination of the insufficiency of the taxpayer's record keeping which makes it virtually impossible to verify sales receipts and conduct a complete audit (*Chartair, Inc. v. State Tax Commn.*, 65 AD2d 44, 411 NYS2d 41 [1978]). This standard, requiring demonstrably inadequate records before an indirect auditing technique may be used, has been explicitly rejected in audits of income for personal income, non-resident earnings and unincorporated business taxes (*Matter of Giuliano v. Chu*, 135 AD2d 89, 521 NYS2d 883 [1987]; *Matter of Hennekens v. State Tax Commn.*, 114 AD2d 599, 494 NYS2d 208 [1985]). The distinction between an income tax audit and a sales tax audit centers on the type of tax being imposed (*Hennekens v. State Tax Commn.*, *supra*). While sales tax audits seek recovery of taxes imposed directly upon verifiable receipts as evidenced by books and records which are required to be maintained (*Matter of Licata v. Chu*, 64 NY2d 873, 874, 487 NYS2d 552 [1985]), audits involving the imposition of tax on income concern the receipt of income which cannot easily be verified by reference to books and records (*Matter of Hennekens v. State Tax Commn.*, *supra*). The standard articulated by the courts of New York concerning audits of income is that indirect auditing methods are proper where the taxpayer's income is not accurately reflected in his books and records (*see, Matter of Giuliano v. Chu, supra; Matter of Hennekens v. State Tax Commn., supra; Matter of Checho v. State Tax Commn.*, 111 AD2d 470, 488 NYS2d 859 [1985]).

The New York State reconstruction of income cases have their genesis in the Federal law and cases. In particular, the case of *Holland v. United States*, (348

US 121) is recognized as the cornerstone of the law concerning reconstruction procedures. In *Holland* the Court recognized that reconstruction methods in income tax cases serve two primary purposes. First, they serve as a means of testing the accuracy of the books and records that have been presented. Second, they are cogent evidence of the amount of income which has been unreported. Further, *Holland* gave rise to the well settled principle that the fact that books and records appear to be adequate on their face does not preclude the use of reconstruction methods (*see, Schwarzkopf v. Commr.*, 246 F2d 731, *citing Holland v. United States, supra*, at 131-132).

Petitioner's argument that the Division erroneously computed her income does not recognize the Division's right to utilize an indirect auditing method in the case of personal income tax, where receipt of the income cannot easily be verified by reference to books and records (*see Hennekens v. State Tax Commn.*). Petitioner admittedly failed to keep accurate books and records of her sales, costs and expenses relating to the operation of her business. Due to the lack of books and records, the Division conducted an observation audit which resulted in a determination of additional sales tax due, to which petitioner consented. Given that petitioner signed the consent to the Statement of Proposed Audit Adjustments for the sales tax assessment, indicating agreement with the figures contained therein, the Division's use of these figures to determine the amount of additional unreported income for income tax purposes was clearly proper and appropriate (*Matter of Rosemellia*, Tax Appeals Tribunal, March 12, 1993). The determination of additional sales provided a factual basis for the Division to decide that the income reported by petitioner on her personal income tax returns was not accurate, and it was entirely appropriate for the Division to use the additional sales to determine petitioner's income for the years at issue (*Matter of Bonanno*, Tax Appeals Tribunal, December 13, 1990; *Matter of Bruno*, Tax Appeals Tribunal, May 13, 1993). The application of the *R & J Automotive* principles to the instant matter supports the audit methodology chosen and utilized by the Division to compute the additional personal income tax due. As the income tax deficiency

determined by the Division was proper under the circumstances, the taxpayer bears the burden of proving by clear and convincing evidence that the deficiency and the method used to determine the additional amount of tax due were erroneous (*Matter of Leogrande v. Tax Appeals Tribunal*, 187 AD2d 768, 589 NYS2d 383 [1992], *lv denied*, 81 NY2d 704, 595 NYS2d 398 [1993]).

C. Indirect auditing methodologies are proper in audits of income where the taxpayer's income is not accurately reflected in his books and records (*see Matter of Giuliano v. Chu*, 135AD2d 89, 521 NYS2d 883 [1987]; *Matter of Hennekens*; *Matter of Checho v. State Tax Commn.*, 111 AD2d 470, 488 NYS2d 859 [1985]). In this matter, there was no dispute by either party that the business's books and records were inadequate and its returns inaccurate. To this end, the distinction between audit standards for sales and use tax audits and franchise/income tax audits is not in issue. (*See Matter of R.J. Automotive, Inc.*; *Matter of Mountain Star Company, Inc.*, Tax Appeals Tribunal, March 13, 2008 [which noted the inapplicability of the standards in sales tax audits to franchise tax audits].)

D. Petitioner's suggestion that the business's cost of goods sold be increased by 50% was unsupported by any contemporaneous, corroborating documentary evidence, as petitioner had failed to maintain any records of individual sales during the audit period, and the claimed costs associated with such sales. At best, the statements in the affidavits presented by petitioner represent only another estimate of petitioner's tax liability. An alternative estimate does not establish that the Division's audit methodology was wrong and is clearly insufficient to establish by clear and convincing evidence that the amount assessed was erroneous (*see Matter of Meskouris Bros. v. Chu*, 139 AD2d 813, 526 NYS2d 679 [1988], citing *Matter of Surface Line Operators Fraternal Org. v. Tully*, 85 AD2d 858, 446 NYS2d 451, 452 [1981]; *Matter of Rosemellia*; *Matter of Pizza Works*, Tax Appeals Tribunal, March 21, 1991). On the other hand,

the auditor's testimony was supported by compelling documentary evidence, i.e., petitioner's consent to the results of the sales tax audit at the conclusion of the audit. Given petitioner's agreement with the audit results, the sales tax audit methodology was not unreasonable and the sales tax figures provided a proper basis for the income tax assessment. As petitioner failed to introduce any evidence of additional operating expenses or other increased costs, no adjustment to the audit findings is warranted.

E. Petitioner's argument that the Division's use of the audit method employed in determining the income tax deficiency for the portion of the year 2000 which was not covered by the sales tax audit is unpersuasive. In determining the additional tax due for the period January 1, 2000 through August 31, 2000, a period not covered by the sales tax audit, the Division applied the sales tax error rate to taxable sales as reported by petitioner for such period. This projection of the sales tax error rate to the period January 1, 2000 through August 31, 2000 is a proper method for calculating income earned and the applicable income tax by indirect audit method (*Matter of Bruno*).

F. Petitioner's contention that the Tax Appeals Tribunal decision in *Matter of Rosemellia* supports her position that the Division erred in not computing a cost of goods sold for the additional business income determined by the sales tax audit is not supported by the record of this matter. In *Rosemellia*, "[t]he Division used petitioner's 1986 purchases as indicated by his records to determine petitioner's markups on liquor, beer and food (snacks)." In the present matter, petitioner failed to keep any records of the business's income, costs or expenses. Unlike the factual circumstances contained in the *Rosemellia* case, the Division herein had no books and records to use to compute a cost of goods sold figure or to determine additional operating expenses for the business.

G. Penalties were assessed based on petitioner's failure to pay the tax liability in a timely manner due to negligence or intentional disregard of the statute and regulations (Tax Law § 685[a][1];[b][1], [2]) and for the substantial understatement of income tax (Tax Law § 685[p]). Such penalty may be waived upon a showing of reasonable cause for the understatement and a that the taxpayer acted in good faith.

Petitioner's admitted failure to maintain records of the business's sales, costs and expenses and admission that she had additional sales to that reported on her Schedule C for each of the years at issue support the imposition of penalty. Further, given the tax determined to be due for these years and petitioner's failure to pay it, this failure was due to petitioner's negligence. Petitioner has failed to demonstrate reasonable cause for the failure to file and pay the taxes due, and the imposition of penalties by the Division was justified (*Matter of Miller v. State Tax Commission*, 94 AD2d 841, 843, 463 NYS2d 306, 307 [1983]).

H. The petitions of Bok Hui Nam are denied, and the notices of deficiency dated February 6, 2006 are sustained.

DATED: Troy, New York
October 2, 2008

/s/ Thomas C. Sacca
ADMINISTRATIVE LAW JUDGE