STATE OF NEW YORK

DIVISION OF TAX APPEALS

In the Matter of the Petition of **ALVIN'S WINE & LIQUOR, INC.** 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, 1994 through November 30, 1997.	:	
In the Matter of the Petition of **RAFAEL RODRIGUEZ** 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, 1994 through November 30, 1997.	:	DETERMINATION DTA NOS. 821638 AND 821639

Petitioners, Alvin's Wine & Liquor, Inc., and Rafael Rodriguez, each 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, 1994 through November 30, 1997.

A consolidated hearing was held before Frank W. Barrie, Administrative Law Judge, at the offices of the Division of Tax Appeals, 500 Federal Street, Troy, New York, on February 15, 2008 at 10:30 A.M., with all briefs to be submitted by July 11, 2008, which date began the six-month period for the issuance of this determination. Petitioners appeared by James H. Tully, Jr., Esq. The Division of Taxation appeared by Daniel Smirlock, Esq. (Lori Antolick, Esq., of counsel).

ISSUES

I. Whether the Division of Taxation (Division) has met its burden of proof to show that the corporate petitioner willfully and intentionally filed false sales tax returns so that the

Division's imposition of fraud penalty pursuant to Tax Law § 1145(a)(2) was proper and the notices of determination, issued more than eight years after tax returns were filed, were not barred by the period of limitations for assessment of additional tax.

II. Whether, if the notices of determination were timely issued, the audit method employed by the Division of Taxation was reasonable or whether petitioners have shown error in either the audit method or result.

III. Whether, if the notices of determination were timely issued, the corporate petitioner failed to show in excess of 25% of the amount of tax required to be shown on its sales tax returns so that penalty under Tax Law § 1145(a)(1)(vi) was properly imposed

FINDINGS OF FACT

1. Petitioner Alvin's Wine & Liquor, Inc., has operated a liquor store on the Grand Concourse in the Bronx since 1994 to date. During the audit period at issue, consisting of three years running from December 1, 1994 through November 30, 1997, petitioner[1] reported on its sales tax returns total gross sales and total taxable sales in the same amount of $406,018.00 as follows:

Sales tax quarter ending	Sales reported
02/28/95	$ 16,588.00
05/31/95	28,130.00
08/31/95	22,800.00
11/30/95	23,394.00
02/29/96	27,005.00
05/31/96	30,248.00
08/31/96	28,964.00

[1] Rafael Rodriguez filed a separate petition, as an individual responsible for the tax liabilities of the corporate petitioner, challenging the assessment at issue. Nonetheless, for purposes of this determination, references to "petitioner" are to the corporate petitioner, Alvin's Wine & Liquor, Inc. Any relief granted to the corporate petitioner would flow likewise to the benefit of Mr. Rodriguez (***see Matter of Mackiewicz***, Tax Appeals Tribunal, June 7, 2007).

11/30/96	37,753.00
02/28/97	36,428.00
05/31/97	27,753.00
08/31/97	27,633.00
11/30/97	99,322.00
Total	$406,018.00

2. By a Notice of Determination dated August 14, 2006, the Division of Taxation (Division) assessed sales tax due of $104,785.72, for the period December 1, 1994 through November 30, 1997, plus interest and penalties, including fraud penalty pursuant to Tax Law § 1145(a)(2) and penalty for omitting, from the taxes reported on its sales tax returns, an amount in excess of 25% of taxes required to be reported pursuant to Tax Law § 1145(a)(1)(vi), against Alvin's Wine & Liquor, Inc. A conforming Notice of Determination, also dated August 14, 2006, was issued against Rafael Rodriguez as "an officer/responsible person" of the corporate petitioner. By a Conciliation Order dated February 23, 2007, tax assessed was reduced to $94,311.35, after an adjustment based upon an increase in the liquor store's inventory.

3. Petitioner Rafael Rodriguez concedes that as the sole owner of the corporate petitioner, he is a person required to collect sales and use tax under Tax Law § 1131(1) on behalf of his Bronx liquor store. An unsophisticated immigrant with limited English language abilities, petitioner first operated a small grocery store where he obtained some business experience. He then opened his Bronx liquor store in 1994 as a new store and has had a substantial learning curve in establishing his operation, which remains in business at the same location to date. While petitioner has one other employee, he is usually alone in the store.

4. A review of the photographs of petitioner's Bronx liquor store shows that a customer who enters the store is surrounded by bulletproof glass and is unable to touch any liquor. Small windows in the glass permit the purchase and exchange of liquor. Petitioner keeps inventory in three locations at the business premises: the basement, backroom, and selling area behind the

bulletproof glass. In addition, given the store's limited size, petitioner also utilizes a "buy and hold" option offered by his suppliers or liquor distributors, which enables petitioner to take advantage of discounts offered on the sale of larger amounts of liquor. The liquor is then held by the distributor for later delivery. Invoices show that petitioner pays monthly storage fees to his suppliers, ranging from $29.00 to $65.00, in order to take advantage of this option.

5. Petitioner admits that its sales tax returns as originally filed were not accurate. It blames its accountant, Manuel Vidal, who prepared the returns, which Mr. Rodriguez filed without reviewing. It was not until a meeting at the State Liquor Authority to contest the granting of a liquor license to a potential competitor for a business at a nearby location that Mr. Rodriguez fully understood that his store's sales tax returns, as prepared by Mr. Vidal, were not accurate. Mr. Rodriguez learned then that Mr. Vidal prepared petitioner's returns without consideration of the actual purchase invoices he provided. Petitioner concedes that it did not maintain any sales records from which its sales tax returns could be prepared. Nonetheless, Mr. Rodriguez thought Mr. Vidal could prepare the returns with sufficient accuracy by utilizing the store's actual purchase invoices and a reasonable markup. Mr. Rodriguez did not understand that the estimating of sales by a markup of purchases did not comport with the legal requirements of reporting actual sales which are accounted for by sales records.

The Audit

6. The auditor, by a letter dated December 4, 1997, notified petitioner that its sales tax records for the period March 1, 1995 through November 30, 1997 had been selected for field audit to begin on January 5, 1998. This letter specified that the following books and records should be made available for the auditor's review: financial statements, journals, ledgers, sales invoices, purchase invoices, cash register tapes, sales and use tax returns, federal income tax returns, and exemption certificates. The auditor followed up with a letter dated January 6, 1998 to petitioner's then representative, Manuel Vidal, which rescheduled the commencement of his field audit to January 13, 1998 and expanded the period under review to June 1, 1994

through November 30, 1997. This later letter also included a similar request for records as noted above in the earlier letter dated December 4, 1997.

7. Petitioner did not provide for audit review any cash register tapes, sales invoices, or any other source documents to establish its specific sales. Mr. Rodriguez candidly admits that his business did not maintain cash register tapes during the audit period but that he now understands this requirement and presently maintains such records.

8. In May of 1998, petitioner replaced its former accountant, Manuel Vidal, with a new accountant, Marty Liss. Mr. Vidal had reported petitioner's "purchases per records" of $319,142.00 while Mr. Liss presented "purchases per records" of $604,031.00. In contrast, the Division determined petitioner's "purchases per third party suppliers of $1,321,200.00." Petitioner's reported sales of $406,018.00, as noted in Finding of Fact 1, were substantially less than its purchases as indicated by Mr. Liss and dramatically less than what was determined by the Division from information obtained from petitioner's suppliers. As a result, on May 8, 2000, the matter was referred by the auditor to the Revenue Crimes Division for investigation and possible criminal prosecution.

9. With the referral to the Revenue Crimes Division, petitioner retained the representation of an attorney, James H. Tully, Jr. On October 31, 2000, Mr. Tully advised the Revenue Crime Division that petitioner had obtained purchase information from suppliers and would prepare amended sales tax returns based on those purchases, with allowances for nondelivery and breakage. Petitioner provided the Revenue Crime Division, which was located at the World Trade Center, with documents, notably its purchase invoices. These documents were later destroyed during the attack on the World Trade Center, and before such destruction, only some of the documents were photocopied and returned to petitioner. Photocopies of purchase invoices for 1995 and 1997 were provided by the Division to petitioner but none for 1996. Despite petitioner's cooperation at this stage of the audit and investigation, the Division referred the matter to the office of the Bronx District Attorney for criminal prosecution. It was

not until February of 2006 that the matter was referred back to the Division when the office of the Bronx District Attorney decided not to prosecute. The Division then completed the "civil audit" which resulted in the issuance of the notices of determination detailed in Finding of Fact 2. With the lapse of six years and the destruction of the World Trade Center, where the Revenue Crimes Division was located, petitioner had presumed that this matter had been rendered moot. Rather, to petitioner's surprise, the Division issued the Notice of Determination dated August 14, 2006 which asserted sales tax due of $104,785.72 as well as a penalty for fraud. By such date, petitioner no longer had in its possession the photocopies provided by the Division of its purchase invoices for 1995 and 1997, the originals of which were destroyed on September 11, 2001.

10. Sales tax asserted due of $104,785.72 was computed as follows. Petitioner's purchases for the audit period totaling $1,298,941.00 were calculated by the auditor's review of purchase invoices obtained from 12 different third-party suppliers, including petitioner's three main suppliers, Charmer, Peerless and Premier. Based on petitioner's federal tax returns, an inventory adjustment was allowed for "ending inventory buildup" of $35,163.51. Deducting this allowance from the purchases resulted in purchases available for sale of $1,263,777.49. A markup percentage of 32.63% was then applied to such purchases available for sale resulting in audit period gross sales of $1,676,148.00. The Division relied upon a Robert Morris Associates 1995 Retailer Liquor (SIC#5921) study to calculate a markup percentage of 32.63%. A close review of this study, which was based upon an analysis of financial statements for 142 retail liquor businesses, shows that it is applicable to liquor retailers in general without any differentiation based upon location. Rather, the liquor retailers are categorized only by their volume of sales. The auditor's starting point for calculating petitioner's markup percentage was gross profit of 24.6%, as shown in the study for liquor retailers with annual sales of up to $1,000,000.00. This compared to gross profit amounts shown for liquor retailers with greater annual sales as follows:

Amount of sales	Gross profit percentage
$0.0 to $1,000,000.00	24.6
$1,000,000 to $3,000,000	21.5
$3,000,000 to $5,000,000	21.2
$5,000,000 to $10,000,000	19.0
$10,000,000 to $25,000,000	21.6

The auditor then computed a markup percentage of 32.63% by dividing the gross profit percentage by cost of goods sold percentage, i.e., 24.6% divided by 75.4%.[2]

11. On January 11, 2006, the Division received a so-called "squeal letter" claiming that petitioner Rafael Rodriquez "continues to make a mockery of the government for having avoided prosecution of tax evasion and fraud" as the result of the death of the Division's investigator and destruction of documents in the September 11th attacks. This letter, mailed on November 28, 2005, had been addressed to the New York City Department of Finance, which forwarded it to the Division for review. The envelope shows a sender's name and address in the Bronx.

12. An audit performed by an accountant, Stewart Buxbaum, on behalf of petitioner resulted in a calculation of unreported sales of $157,036.00, in contrast with the Division's determination of unreported sales of $1,270,130.00. Mr. Buxbaum utilized the larger amount of $500,000.00 for petitioner's inventory and "bill and hold" purchases,[3] an allowance of 15% for pilferage and breakage, and a markup percentage of only 10% since "this was a beginning store," which had to attract customers. Mr. Buxbaum in his report further suggested that it would have been reasonable to use an even lower markup since "in the beginning much of the

[2] The cost of goods sold percentage was calculated by subtracting the gross profit percentage shown in the study from 100%. For example, gross profit of 24.6% subtracted from 100.0% is 75.4%.

[3] An affidavit of a salesman for one of petitioner's distributors, Peerless Importers, Inc., confirmed that, "It was the practice, when delivering to [petitioner], to include in the bill product that is paid for but not actually delivered because of insufficient storage space at the premises, this is called 'bill and hold'."

product was sold at cost." An inventory of petitioner's premises conducted on May 10, 2004 showed an inventory value of $577,045.00. Further, Mr. Buxbaum did not consider "short" deliveries which Mr. Rodriguez complained was a part of doing business in the Bronx and which he estimated amounted to 15% to 20% of his purchases. Drivers would not deliver all of the items shown on purchase invoices, retaining items to sell themselves for personal profit. An allowance for "short" deliveries would reduce even further Mr. Buxbaum's estimate of unreported sales.

SUMMARY OF THE PARTIES' POSITIONS

13. Petitioner maintains that it did not willfully fail to pay sales tax. Rather, it relied upon its accountant, Manuel Vidal, who, without its knowledge, prepared its sales tax returns by apparently making up numbers and failed to utilize the liquor store's actual purchase records as provided. In addition, petitioner contends the auditor's estimate of the store's sales was unreasonable. The auditor did not take into consideration the nondelivery of inventory shown on purchase invoices. Petitioner complains that its liquor distributors reported goods that were shipped and received by it when in fact they were not. In addition, the markup used was grossly excessive given the newness of his business and the nature of an inner-city liquor store, which is not accounted for in the Robert Morris studies used to estimate its markup. According to petitioner, the Robert Morris studies should not be applicable to a new store where the vendor is attempting to build up its trade by selling items sometimes at cost to attract customers.

Petitioner also complains that the auditor did not consider petitioner's use of "bill and hold" due to the small size of its premises. It paid for inventory it did not take physical possession of, in order to take advantage of discounts for larger volume purchases. Petitioner also notes that its actual purchase invoices, provided to the auditor, were destroyed on September 11, 2001, which made it impossible to defend against an assessment issued many years later because it kept track of nondelivery of items on the invoices. Further, petitioner argues that it cooperated during the investigation which should be viewed as a mitigating factor and that it continues to operate its business to date in conformance with its sales tax obligations. Most important, according to petitioner, any tax due for the years at issue is no longer assessable based upon the expiration of the period of limitations for assessment.

14. The Division maintains that it has proven that petitioner's failure to file returns and pay sales tax was due to fraud. It contends that it has introduced adequate circumstantial evidence to prove fraud: petitioner's underreporting was "substantial and is a clear indicia of fraud." The Division emphasizes that "[t]he continuous underreporting of sales [tax] due over twelve sales tax quarters obviates any claim of inadvertent mistake." In addition, the Division points out that, "[a]t no point during the Hearing was petitioner able to explain how he paid for the $1.3 million in purchases reported by his third party suppliers" and suggests that the purchases were paid "with cash that was never deposited or reported."

CONCLUSIONS OF LAW

A. In general, no assessment of additional sales tax may be made after the expiration of more than three years from the date of the filing of a return (Tax Law § 1147[b]). As detailed in Finding of Fact 2, the notices of determination dated August 14, 2006, contested by petitioners in this proceeding, were issued more than three years from the date of the filing of the sales tax returns for the 12 sales tax quarters at issue, spanning December 1, 1994 through November 30, 1997. However, Tax Law § 1147(b) also provides for an *exception* to this period of limitation for assessment of three years "in the case of a *willfully* false or fraudulent return with *intent* to evade the tax . . . [emphasis added] . " Furthermore, as noted in Finding of Fact 2, the Division has imposed fraud penalty pursuant to Tax Law § 1145(a)(2)[4] against petitioner.

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[4]Tax Law former § 1145(a)(2), as in effect during the years at issue, provides, in pertinent part: "If the failure to pay or pay over any tax to the commissioner of taxation and finance within the time required by this article is due to fraud . . . there shall be added to the tax (i) a penalty of fifty percent of the amount of the tax due, plus (ii) interest on such unpaid tax at the rate of twelve percent per annum or the underpayment rate of interest . . . whichever is greater, for the period beginning on the last day prescribed by this article for the payment of such tax . . . and ending on the day on which such tax is paid, plus (iii) . . . an amount equal to fifty percent of the interest payable under subparagraph (ii) of this paragraph, on that portion of the unpaid tax which is attributable to fraud."

Consequently, it must be concluded that petitioner's sales tax returns were *willfully* false or fraudulent and filed with the *intent* to evade tax, not only to find an exception to the three-year period of limitation for assessment, but also to support the imposition of fraud penalty.

B. The Division must shoulder the burden of proving that petitioner's sales tax returns were *willfully* false or fraudulent and filed with the *intent* to evade tax (***see Matter of Cinelli***, Tax Appeals Tribunal, September 14, 1989). In ***Cinelli***, the Tribunal provided the following guidance in determining whether a taxpayer may be subject to the imposition of a penalty for fraud:

> The burden of showing fraud under § 1145(a)(2) has consistently been interpreted to reside with the Division [citations omitted]. The standard of proof necessary to support a finding of fraud requires 'clear, definite and unmistakable evidence of every element of fraud, including willful, knowledgeable and intentional wrongful acts or omissions constituting false representations, resulting in deliberate nonpayment or underpayment of taxes due and owing.' (***Matter of Ilter Sener d/b/a Jimmy's Gas Station***, Tax Appeals Tribunal, May 5, 1988, citing, ***Matter of Walter and Gertrude Shutt***, State Tax Commn., July 13, 1982).
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> For a taxpayer to be subject to a civil fraud penalty, willful intent is a critical element; the individual . . . must have acted deliberately, knowingly, and with the specific intent to violate the Tax Law (***Matter of Cousins Service Station, Inc.***, Tax Appeals Tribunal, August 11, 1988). Fraud need not be established by direct evidence, but can be shown by surveying the taxpayer's entire course of business and drawing reasonable inferences therefrom [citation omitted].

C. The Division has not shouldered its burden to show that the fraud penalty was properly asserted against petitioner and that the fraud exception to the general period of limitation of three years for assessment is applicable. The Division's evidence does not provide clear and convincing proof that petitioner willfully, deliberately, and intentionally sought to evade paying sales tax that was legally due.

D. As noted in Finding of Fact 9, the office of the Bronx District Attorney decided not to prosecute petitioner, and the matter was referred back to the Division, which then decided to complete the civil audit. Consequently, this proceeding does not simply seek to impose civil fraud penalty after a criminal conviction (***compare Matter of T. Management,*** Tax Appeals Tribunal, April 12, 2001; ***Matter of Alteri***, Tax Appeals Tribunal, August 20, 1998).

Furthermore, petitioner did not fail to file returns prepared by his accountant and remit tax (***compare Matter of Alteri***). Rather, petitioner was an unsophisticated taxpayer with limited English language ability, who, as noted in Finding of Fact 5, relied on his accountant, Manuel Vidal, to prepare his returns. When Mr. Rodriguez understood that Mr. Vidal had filed clearly erroneous returns, he replaced him.

E. As detailed in paragraph 18, petitioner has presented a variety of explanations why the estimate of sales tax due calculated by the Division is in error: (1) use of an unreasonable markup percentage given the newness of the business, (2) failure to account for "buy and hold" purchases, (3) breakage, (4) nondelivery of items shown on purchase invoices, and (5) the need to build up the inventory of a new business. In addition, as noted in Finding of Fact 12, petitioner's own rational estimate of its sales is dramatically less than the Division's calculation.

F. Petitioner has also countered the Division's contention that it acted willfully and with intent to underreport its sales during the period at issue by noting the inexperience in the liquor business and lack of sophistication of its sole shareholder and officer, Rafael Rodriguez. Mr. Rodriguez appeared and testified at the hearing, and on cross-examination, the Division was not able to establish that he acted willfully and with intent to underreport his store's sales. He never was budged off his vigorously asserted position that any underreporting of sales was *not* the result of a willfullness or intent to evade tax, but rather resulted from the many explanations noted above. Carelessness, negligence or inadvertence does not equal fraud (***Matter of Cousins Service Station, Inc.***, Tax Appeals Tribunal, August 11, 1988). In sum, the Division's attempt to shoulder its burden of proving such willfulness and intent to underreport sales by pointing to its own estimate of *gross* underreporting of sales has been undermined by the petitioner's countervailing explanations which were bolstered by the testimony of Mr. Rodriguez at hearing, as well as accountant Buxbaum's reasonable estimate of unreported sales.

G. Furthermore, the Division has not offered any other adequate proof to sustain its heavy burden of establishing that Mr. Rodriguez acted "deliberately, knowingly and with the specific intent to violate the Tax Law" (***Matter of Cousins Service Station, Inc.***). Notably, the squeal letter, detailed in Finding of Fact 11, is not sufficient to meet this burden. Petitioner "categorically denies ever making such a statement, and believes that the letter is the result of a dispute he had with a relative regarding family matters." It is noted that there is no evidence in the record to show any attempt by the Division to locate the sender of the letter in order to overcome the hearsay objection by petitioner to the squeal letter. Although hearsay evidence is admissible in administrative proceedings like those held in the Division of Tax Appeals, it does not rise to the level of proof necessary for the Division to meet its burden of proving fraud (***see Matter of Georgian Motel Corp. v. New York State Liq. Auth.***, 184 AD2d 853, 584 NYS2d 673 [1992]). Similarly, no witnesses from any of petitioner's distributors were presented at hearing to counter petitioner's claims of nondelivery of purchases.

H. Consequently, the notices of determination dated August 14, 2006 are time-barred by the three year period of limitation for assessment (Tax Law § 1147[b]).

I. The petitions of Alvin's Wine & Liquor, Inc. and Rafael Rodriguez are granted, and the notices of determination dated August 14, 2006 are cancelled.

DATED: Troy, New York
November 20, 2008

/s/ Frank W. Barrie
ADMINISTRATIVE LAW JUDGE