

STATE OF NEW YORK

DIVISION OF TAX APPEALS

In the Matter of the Petition :
of :
DARMAN BUILDING SUPPLY CORPORATION : DETERMINATION
for Revision of a Determination or for Refund of Sales : DTA NO. 822058
and Use Taxes under Articles 28 and 29 of the Tax Law :
for the Period March 1, 2001 through February 29, 2004. :

Petitioner, Darman Building Supply Corporation, filed a petition for revision of a determination or for refund of sales and use taxes under Articles 28 and 29 of the Tax Law for the period March 1, 2001 through February 29, 2004.

A hearing was held before Arthur S. Bray, Administrative Law Judge, at the offices of the Division of Tax Appeals, 633 Third Avenue, New York, New York, on June 3, 2009 at 10:30 A.M., with all briefs to be submitted by October 30, 2009, which date began the six-month period for the issuance of this determination. Petitioner appeared by the Hopkins Law Group, LLC (Everett Hopkins, Esq., of counsel). The Division of Taxation appeared by Daniel Smirlock, Esq. (Osborne K. Jack, Esq.).

ISSUE

Whether the audit methodology was reasonably calculated to determine the amount of sales and use taxes due.

FINDINGS OF FACT

1. Petitioner, Darman Building Supply Corporation (Darman), was a supplier of building materials to contractors.

2. On February 24, 2004, the Division of Taxation (Division) sent an appointment letter to Darman stating that its sales and use tax records had been scheduled for a field audit for the period March 1, 2001 through February 29, 2004. The letter stated that “[a]ll books and records pertaining to the sales and use tax liability, for the audit period, must be available on the appointment date.” A schedule of books and records to be produced was attached to the letter.

3. On June 28, 2004, an audit was conducted at petitioner’s representative’s office. Initially, the only information provided was a general ledger for the period April 1, 2001 through March 31, 2004, the income tax returns for these periods and a series of exempt sales forms. The Division was not presented with any invoices or a description of the jobs that were performed.

4. In the course of the audit, the Division ascertained that it could not reconcile the gross sales per the books with the gross sales reported on the federal income tax returns. For the fiscal year ended March 31, 2002, sales per the general ledger were \$5,034,637.00 while the sales reported on the income tax returns for the year were \$8,671,687.00. Although asked, no explanation was offered by petitioner as to why the general ledger figure was so much lower than the income tax figure. From April 2002 through March 2004, the differences in the sales figures were not considered significant. Therefore, the sales amounts reported in the general ledger were used. For each fiscal year, the highest sales figures were used.

5. The Division gave petitioner the following list of those documents that it wished to examine on the next audit appointment: sales invoices with exemption certificates for nontaxable sales for the quarter ending August 31, 2003; materials purchase invoices for the quarter ending August 31, 2003; expense purchase invoices for repair and maintenance including auto repair, office expenses, warehouse cost and miscellaneous expenses for the quarter ending

August 31, 2003; the invoice for a motor vehicle purchased September 30, 2002; and sales journals for the fiscal year ending March 31, 2002.

6. On August 4, 2004, the audit was reassigned to a new auditor, who scheduled an audit appointment at the office of Darman's accountant. In a letter dated August 19, 2004, the new auditor requested that petitioner provide the records requested by the previous auditor. Written requests for these records were also made on February 7, 2005, April 21, 2005, November 29, 2005, February 24, 2006, March 13, 2006 and June 29, 2006.

7. On December 23, 2004, the auditor met with petitioner's accountant and reviewed the general ledger for the period April 1, 2001 through March 31, 2004. However, the items requested in the letter of August 19, 2004 were not provided. The auditor and the accountant then discussed the audit procedure, the documents which were still required and Darman's protest rights. Another appointment was scheduled.

8. After encountering difficulty in scheduling a subsequent audit appointment, the auditor advised petitioner's representative that unless additional documentation was produced, he would issue a statement of proposed audit change based upon the information that was available.

9. On May 23, 2005, an appointment was held at the accountant's office. During this meeting, petitioner's accountant presented a series of contractor exempt purchase certificates. No other records, such as sales invoices or contracts, which would have provided a description of the job that was performed, were presented. Consequently, the auditor concluded that the certificates did not substantiate the exempt sales.

10. On May 24, 2005, the Division issued a Statement of Proposed Audit Change for Sales and Use Tax asserting a deficiency of sales and use taxes in the amount of \$2,098,491.43 plus penalties and interest. The statement was based on information that was available at that time,

which consisted of a general ledger for the period April 1, 2001 to March 31, 2004, the income tax returns for those periods and a series exempt sales forms. Invoices or a description of the job that was performed were not available. The asserted deficiency was calculated by disallowing all of the exempt sales which were reported on Darman's sales and use tax returns because no documentation was presented to substantiate the exemptions. In addition, the Division concluded that there was one fixed asset transaction, which the Division determined was taxable and which resulted in additional taxes due of \$657.77.

11. On June 21, 2005, the Division received the Statement of Proposed Audit Change from petitioner's accountant with an explanation that petitioner needed additional time to produce invoices and tax exemption certificates. The Division replied that petitioner could have approximately 30 more days to provide documentation, and thereafter, the audit would be closed as a disagreed case. Following a series of unsuccessful attempts by the Division and petitioner's accountant to contact each other, the parties agreed to meet on November 7, 2005 at the office of petitioner's accountant.

12. On November 7, 2005, the auditor went to the office of the taxpayer's accountant and reviewed additional documentation including sales invoices for the period June 1, 2003 through August 31, 2003, sales transaction details by account for the same period of time and contractor exempt purchase certificates. At the end of the meeting, they agreed to schedule another appointment on December 29, 2005.

13. On November 29, 2005, the auditor sent a letter, which again listed the items required and confirmed the appointment in December. At the December meeting, the auditor was advised that petitioner did not have any additional records. Upon returning to his office, the auditor

prepared a Test Period Audit Method Election form and cover letter and mailed them to Darman and Darman's accountant.

14. On March 10, 2006, a meeting was held at the Division's Queens District Office. During the meeting, petitioner's accountant, at that time, signed the test period election form with regard to sales.

15. The assessment which followed was based on the following review of four discrete areas: sales, disallowed exempt sales, expenses and fixed assets.

(a). In order to determine the amount of tax due on petitioner's sales, petitioner's accountant provided a document titled Transaction Detail by Account. The document set forth a list of each customer and the amount of the sale to that customer for the period June 1, 2003 through August 31, 2003. Next to each transaction, petitioner's accountant made a notation showing whether the sale was taxable or exempt. The Division noted that according to the schedule, there were taxable sales of \$882,552.00, while petitioner reported taxable sales of \$495,519.00 during the same period of time. The Division subtracted the reported taxable sales of \$495,519.00 from the taxable sales per the schedule of \$882,552.00 in order to determine that there were additional taxable sales during the test period of \$387,033.00. The Division then divided the additional taxable sales by the reported taxable sales to calculate an error rate of 78.1066 percent. The error rate was multiplied by the reported taxable sales for each quarter during the audit period to find the additional taxable sales for each quarter. The additional taxable sales were, in turn, multiplied by the tax rate in effect during that particular quarter, to calculate the amount of additional tax due. The sum of the additional tax due for each sales tax quarter during the audit period was \$483,219.25.

(b). The Division also computed an error rate based upon the exempt sales that were not substantiated. Since sales were made in New York City and Suffolk County, which had different sales tax rates, different calculations were performed for each location. With respect to the sales in New York City, the Division disallowed claimed exempt sales in the amount of \$98,808.72. The total amount of exempt sales, \$2,035,805.50, was divided by the amount of disallowed exempt sales to calculate an error rate of 4.8535 percent. The error rate was then applied to the audited exempt sales during the audit period to determine additional taxable sales of \$1,010,369.00 and additional tax due of \$84,639.44.

For Suffolk County, the disallowed exempt sales were \$18,118.98. This amount was divided by the amount of exempt sales during the test period of \$2,035,805.50 resulting in an error rate of 0.89 percent. The Division multiplied the error rate by the amount of reported exempt sales during the audit period resulting in disallowed exempt sales of \$185,274.00.

The total amount of tax due arising from disallowed exempt sales was \$100,512.15.

(c). According to petitioner's general ledger, the total of all expenses for the sales tax quarter June 1, 2003 through August 31, 2003 was \$119,560.00. The expenses included such items as an automobile lease, building maintenance, equipment rental, office repairs, supplies, utilities and an expense for the warehouse. The auditor had previously requested expense invoices for the period. However, none were provided. The Division also determined that the expense purchase records did not allow the Division to trace any transactions back to the original source or forward to the final total. Since no invoices were presented, the Division projected the expenses throughout the audit period and then multiplied the expenses, broken down by the applicable sales tax quarter, by an error rate of 100 percent. The product was then multiplied by the sales tax rate in effect for the quarter in issue, which resulted in tax due of \$10,005.08.

(d). In regard to fixed assets, the Division assessed sales and use tax in the amount of \$657.77 on petitioner's purchase of a motor vehicle because petitioner was unable to produce an invoice to substantiate that it had paid tax on this purchase. The Division did not review any registration material in determining whether to assess tax.

16. On the basis of the forgoing audit findings, the Division issued a Notice of Determination to petitioner assessing sales and use tax in the amount of \$594,394.25 plus penalty and interest for a balance due of \$1,270,513.38. Both statutory and omnibus penalties were assessed pursuant to Tax Law § 1145(a)(1)(i) and (vi) because the additional tax due was more than 25 percent of the audited tax due.

17. In order to determine the amount of tax due, it was the practice of petitioner's principal, Mr. Green, to examine all of the deposits for a sales tax quarter and determine which ones were taxable. He calculated the tax due on the total amount of taxable receipts. Mr. Green based his conclusion of whether a job was taxable on his intimate knowledge of the business and of the jobs performed.

SUMMARY OF THE PARTIES' POSITIONS

18. At the hearing, petitioner presented the testimony of Mr. Jeffrey Terry, an accountant who was retained by petitioner after the period in issue. Mr. Terry reviewed the audit findings and prepared the following analysis:

(a). Mr. Terry maintained that the Division's calculation of tax due on additional taxable sales was erroneous because petitioner believes that it mistakenly classified two transactions as taxable sales when they were exempt: Almar GA Atl Term 03102 for \$31,356.83 and Aspro Solco

JC Penny for \$890.71.¹ Mr. Terry subtracted the total of the two sales from the original taxable sales amount of \$882,552.00 to calculate revised taxable sales for the test period of \$850,304.00. The amount was further reduced by the taxable sales collected during the test period of \$196,136.00 and by the amount of taxable sales collected in subsequent periods of \$609,426.00.² As a result of these calculations, Mr. Terry found that there were additional taxable sales during the test period of \$44,743.00. Mr. Terry's computations resulted in a revised error rate of 5.5542 percent and a finding that the amount of additional tax due on sales was \$34,362.21.

(b). Relying upon five exemption certificates and the understanding that two other customers were exempt from sales tax, Mr. Terry recalculated the error rate on disallowed exempt sales in New York City from 4.85 percent to .44 percent. The proposed revised error rate resulted in tax due in the amount of \$9,798.00. With respect to disallowed exempt sales in Suffolk County, Mr. Terry found that there was one sale to a police organization in Suffolk County. Petitioner treated this sale as exempt. This reduced the error rate and the amount of tax due to zero.

(c). Mr. Terry also recalculated the amount of tax due on petitioner's expenses over the test period. Mr. Terry submits that tax should not have been assessed on the motor vehicle lease because a well-established company such as Ford would have charged sales tax. Mr. Terry supported this argument with proof that the registration on this vehicle was due for renewal.

¹ Mr. Terry's conclusion that these sales were not taxable was based solely on the memory and representation of petitioner's principal. Mr. Terry did not review the actual invoices or supporting documentation.

² Mr. Terry maintained that reliance upon the transactions detail report was misplaced because petitioner reported sales tax when payment was received not when the sales took place. A review of the transaction detail report led Mr. Terry to the conclusion that some of the sales within the test period were actually received by petitioner after the test period. Mr. Terry did not perform a reconciliation to determine if the tax was actually collected and remitted to New York. Nor did he perform a test to ascertain if the procedure described by petitioner's principle was actually followed.

According to Mr. Terry, it would not have been possible to register the vehicle unless sales tax was paid. A second category of expense that was challenged by Mr. Terry was characterized as payments to the owner. Mr. Terry maintained that no tax was due because these payments were repayments of loans to the owner for specific expense items. The third category was utilities. Mr. Terry submitted that the utilities would have charged sales tax and therefore sales tax was already paid on the utilities. Mr. Terry's analysis resulted in disallowed expenses of \$2,966.90. The disallowed expenses were divided by the expenses tested of \$7,339.90 resulting in an error rate of 40.4215 percent and tax due of \$4,044.33. Prior to making these calculations, Mr. Terry did not review the lease from Ford, the utility bills or any supporting documentation regarding payments to the owner.

(d). With respect to fixed assets, Mr. Terry concluded that no tax was due. As explained in petitioner's brief, petitioner maintains that a responsible company would have charged sales tax.

19. On the basis of Mr. Terry's calculations, petitioner believes that the revised amount of tax due is \$48,204.65.

20. In its brief, the Division agreed to reduce the amount of additional tax due from disallowed exempt sales in New York City from \$84,639.44 to \$9,798.00, which is the amount proposed by petitioner. The Division also agreed to reduce the amount of tax assessed on the basis of disallowed exempt sales in Suffolk County from \$15,872.71 to zero. On the basis of the forgoing, the amount of tax asserted to be due is revised from \$594,394.25 to \$503,680.82. Except for the concession regarding the amount of disallowed exempt sales, the Division argues that petitioner has not presented sufficient evidence warranting any additional adjustments and that, as adjusted, the notice should be sustained.

CONCLUSIONS OF LAW

A. Tax Law § 1105(a) imposes a sales tax on the receipts from every “retail sale” of tangible personal property except as otherwise provided in Article 28 of the Tax Law. Tax Law § 1138(a)(1) provides, in relevant part, that if a sales tax return is 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” When acting pursuant to section 1138(a)(1), the Division is required to select a method reasonably calculated to reflect the tax due. The burden then rests upon the taxpayer to demonstrate that the method of the audit or the amount of the assessment was erroneous (*see Matter of Your Own Choice, Inc.*, Tax Appeals Tribunal, February 20, 2003).

B. Initially, petitioner notes that the Division utilized a test period for the months of June through August of 2003 in order to determine the amount of tax due on sales for the period March 1, 2001 through February 29, 2004. According to petitioner, the Division has not provided a basis by which a three-month test period can reasonably assess three years of activity. Petitioner submits that it supplies contractors in the construction industry who have inconsistent payments and commitments to pay. As such, petitioner maintains that there is no rational relationship to its liability for a three-year period. In this regard, petitioner contends that it had records which were sufficient to perform an audit.

C. There were two elements to the Division’s audit of sales, additional taxable sales and disallowed exempt sales. Here, the record shows that a representative of petitioner signed an audit method election agreement consenting to a test period method audit for its review of petitioner’s sales. Contrary to the underlying premise of petitioner’s argument, this agreement was not based upon the inadequacy of petitioner’s records. Rather, the agreement states “[i]f the

auditor determines that my books and records are both complete and adequate, I agree that the audit should be conducted using a Test Period Method Audit.” There is no evidence in the record to support the contention that his waiver was not knowingly and voluntarily made. If there was an objection to the use of the audit method election form, it should have been raised at the hearing (*Matter of Barton*, Tax Appeals Tribunal, December 28, 1989). Accordingly, it is found that having signed an audit method election form, the right to a complete audit was waived (*cf. Matter of James Kennedy & Co., Inc. v. Chu*, 125 AD2d 773 [3d Dept. 1986]; *Matter of Barton*).³

D. Although an audit method election form was not executed with respect to expenses, it is clear that the inadequacy of petitioner’s records warranted the use of an indirect audit method. The record shows that although requested, petitioner was unable to produce any expense invoices. Moreover, the expense purchase records did not allow the Division the opportunity to trace any transactions back to the original source or forward to a final total. The absence of the records contravenes Tax Law § 1135(a)(1), which directs persons required to collect sales tax to maintain records sufficient to verify all transactions, in a manner suitable to determine the correct amount of tax due. The records required to be maintained “include a true copy of each sales slip, invoice, receipt, statement or memorandum.”

E. Since an indirect audit method was not utilized with respect to the capital acquisitions and the amount of disallowed exempt sales are no longer in issue, the forgoing argument does not pertain to the remaining portions of the audit.

³ In view of the repeated requests for books and records and the apparent inability to completely comply with this request, it is clear that the Division would have been permitted to utilize an estimated audit method without first obtaining a signed consent (Tax Law § 1138[a]; *see Matter of Chartair, Inc. v. State Tax Commn.*, 65 AD2d 44 [3d Dept 1978]).

F. Petitioner next argues that the testimony offered by the Division establishes that there is no standard in using available documents for the test period and that it penalizes petitioner with whatever documents are available. Petitioner notes that for the period April 2001 through March 2002 an assessment was made by the Division using the federal income tax return instead of the general ledger. It then points out that the Division chose to use the federal return rather than the general ledger because there was a substantial difference between the general ledger and the federal return, but did not define how substantial is defined or how it was rationally related to the Division's ability to obtain an accurate assessment. Petitioner next points out that for the next two periods the Division used the general ledger rather than the federal return despite the fact that the Division had the same documents for all of the time periods. Petitioner surmises that the Division employed whatever documents were available to create the greatest tax deficiency as opposed to accurately assessing petitioner.

G. Petitioner's contention that there is no standard to be used in deciding what figures to use in conducting an audit is rejected. The standard was summarized in *Matter of AGDN, Inc.* (Tax Appeals Tribunal, February 6, 1977) as follows:

When estimating sales tax due, the Division need only adopt an audit method reasonably calculated to determine the amount of tax due (*Matter of Grant Co. v. Joseph*, 2 NY2d 196, 159 NYS2d 150, *cert denied* 355 US 869); exactness is not required (*Matter of Meyer v. State Tax Commn.*, 61 AD2d 223, 402 NYS2d 74, *lv denied* 44 NY2d 645, 406 NYS2d 1025; *Matter of Markowitz v. State Tax Commn.*, 54 AD2d 1023, 388 NYS2d 176, *affd* 44 NY2d 684, 405 NYS2d 454). The burden is then on the taxpayer to demonstrate, by clear and convincing evidence, that the audit method employed or the tax assessed was unreasonable (*Matter of Meskouris Bros. v. Chu*, 139 AD2d 813, 526 NYS2d 679; *Matter of Surface Line Operators Fraternal Org. v. Tully*, 85 AD2d 858, 446 NYS2d 451).

H. The record shows that upon reviewing the sales tax returns and the federal corporate income tax returns for the period in issue, the Division ascertained that for the fiscal year ended

March 31, 2002, sales per the general ledger were \$5,034,637.00 while the sales reported on the corporate income tax returns were \$8,671,687.00. Although asked, petitioner did not present any explanation for the differences in the sales figures. From April 2002 through March 2004, the differences in the sales figures were not considered significant and therefore the amounts reported in the general ledger were used. Therefore, in determining adjusted gross sales for the entire audit period, the Division utilized the amounts reported on the federal corporate income tax for the period April 1, 2001 through March 31, 2002 and the amounts reported on petitioner's general ledger for the remainder of the period in issue.

I. Given the lack of any explanation as to why the income tax return for the period ended March 31, 2002 reported over \$3,000,000.00 more in sales than the general ledger, it was entirely reasonable to utilize the amount reported on the return rather than the general ledger to calculate gross sales. Furthermore, in the absence of any explanation as to why a lower amount would be more accurate, it was reasonable to utilize the highest sales figure for each fiscal year. Exactness is not required where it is the taxpayer's own failure to maintain proper records which prevents exactness in the determination of sales tax liability (*Matter of Meyer v. State Tax Commn.*, 61 AD2d 223 [3d Dept 1978]; *Matter of Markowitz v. State Tax Commn.*, 54 AD2d 1023 [3d Dept 1976], *affd* 44 NY2d 684 [1978]).

J. In its brief, petitioner's representative takes issue with the following findings of the Division:

(1) Petitioner maintains that in determining the amount of tax due on expenses, the Division imposed tax on the utilities because the Division assumed that petitioner could have been using a private home as opposed to a business address. Petitioner submits that this position

is arbitrary because it was located in a commercial establishment and the auditor never visited the location.

A careful reading of the transcript shows that while the auditor did make reference to the possibility that petitioner could have been located in a residence, the true reason that tax was imposed on the utility expenses was that invoices for the utilities showing that tax was paid were not presented (Transcript, p. 36). In view of petitioner's failure to comply with Tax Law § 1135(a)(1), the Division's position was justified.

(2) Petitioner contends that the Division arbitrarily decided whether petitioner's sales were tax exempt. According to petitioner, most of its sales were for municipal projects and that practically 100 percent of the jobs completed by petitioner were tax exempt. Petitioner notes that it presented a Contractor Exempt Purchase Certificate for the New York City School Construction Authority and for the Hudson River Park. It also notes that other exempt work listed in petitioner's general ledger include City University of New York, the Federal Court in New York, the Museum of Modern Art in New York City and Suffolk County Police Department.

The record in this matter shows that the exemption documents noted above were offered and received in evidence at the hearing. In its brief, the Division acknowledged the receipt of these documents and reduced the assessment accordingly. Petitioner's argument with respect to the remaining sales is rejected because it is contrary to Tax Law § 1132(c) which creates a presumption that all receipts are taxable unless the vendor obtains a certificate from the purchaser indicating an exemption (*see Matter of Lefkowitz*, Tax Appeals Tribunal, May 31, 1990).

K. In the concluding section of the brief, petitioner argues that petitioner's principal was a small businessman who reported sales based on collections and not based on invoices. It is submitted that petitioner was not in a position to prepay sales tax based on billing. It is further noted that the accountant pointed out that petitioner would include invoices in his gross sales that were never actually collected. Petitioner also calls attention to the fact that Mr. Terry calculated an error rate on taxable sales of approximately 5.5 percent.

20 NYCRR 532.1(a)(2) provides as follows:

Where a vendor makes a sale for which payment is not received at the time of delivery, such sale must be reported on the return covering the period in which the sale is made. *Thus, if the sale is a taxable sale, the full amount of tax must be remitted with the return whether or not any money was collected at the time of sale.* (Emphasis added.)

It follows from the forgoing that petitioner did not have the option of waiting until the customer made a payment before remitting the tax due.

With respect to the item denominated as payments to owner, petitioner contends that there is no evidence that sales tax was due on any of these items. This argument is without merit since it erroneously places the burden of proof on the Division. Contrary to the premise of petitioner's argument, Tax Law § 1132(c)(1) creates a presumption that all receipts are subject to tax. The burden of proof is upon petitioner to show that the assessment is erroneous (*Matter of Meskouris Bros. v. Chu*, 139 AD2d 813 [3d Dept 1988]).

Petitioner also reiterates its argument regarding the tax assessed on the purchase of a motor vehicle and tax assessed on the utilities. The same principle that is applicable to the lease of an automobile also applies to the purchase of a motor vehicle. In the absence of any evidence showing that sales tax was paid on the purchase, the Division correctly concluded that sales tax

was due (Tax Law § 1135[a][1]). Petitioner's argument with respect to the utilities has already been addressed and does not warrant further attention.

L. The Division is directed to modify the Notice of Determination in accordance with Finding of Fact 20.

M. The petition of Darman Building Supply Corporation is denied and the Notice of Determination, as modified by Conclusion of Law L, is sustained together with such penalties and interest as are lawfully due.

DATED: Troy, New York
April 29, 2010

/s/ Arthur S. Bray
ADMINISTRATIVE LAW JUDGE