

STATE OF NEW YORK

DIVISION OF TAX APPEALS

In the Matter of the Petitions	:	
of	:	
JEROSAL RESTAURANT, INC. AND	:	DETERMINATION
ROCCO PANETTA	:	DTA NOS. 822430 AND
	:	822431
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, 2002 through August 31, 2005.	:	

Petitioners, Jerosal Restaurant, Inc. and Rocco Panetta, 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, 2002 through August 31, 2005.

A hearing was held before Joseph W. Pinto, Jr., Administrative Law Judge, at the offices of the Division of Tax Appeals, 500 Federal Street, Troy, New York, on April 29, 2009 at 10:30 A.M., with all briefs to be submitted by November 16, 2009, which date began the six-month period for the issuance of this determination. Petitioners appeared by David R. Dolan, CPA. The Division of Taxation appeared by Daniel Smirlock, Esq. (Lori P. Antolick, Esq., of counsel).

ISSUE

Whether the Division of Taxation properly determined additional sales and use taxes due from Jerosal Restaurant, Inc., and Rocco Panetta for the period September 1, 2002 through August 31, 2005 using an estimated audit methodology.

FINDINGS OF FACT

1. Jerosal Restaurant, Inc. (petitioner¹) operated an Italian restaurant called La Stazione Ristorante & Wine Bar at 5 Main Street, New Paltz, New York, between September 1, 2002 and August 31, 2005 (the audit period) making sales of food and drink .

2. An audit appointment letter, dated September 12, 2005, was mailed to petitioner's representative, John J. Pezzo, CPA, confirming an appointment at Mr. Pezzo's office for the performance of a sales and use tax audit of petitioner's records for the period September 1, 2002 through August 31, 2005. The appointment was scheduled for November 1, 2005 and requested that specific records pertinent to the audit period be made available at that time, including: sales tax returns; federal income tax returns; New York State corporation tax returns; the general ledger; general journal and closing entries; all exemption documentation to support nontaxable sales; chart of accounts; fixed asset purchase and sales invoices for the audit period; recurring expenses for 2004; bank statements, canceled checks and deposit slips for all bank accounts maintained by petitioner; cash receipts journal; cash disbursement journal; the corporate book; depreciation schedules for the audit period; State Liquor Authority license in effect for the audit period; guest checks and cash register tapes for the period 6/1/2004 through 8/31/2004.

3. On October 31, 2005, Mr. Pezzo requested that the field audit be postponed to November 28, 2005. The auditor obliged and confirmed the postponement to November 28, 2005 in a letter to Mr. Pezzo, dated October 31, 2005. The letter once again requested the documentation required by the Division for the audit.

¹Petitioners, Jerosal Restaurant, Inc., and Rocco Panetta, will be referred to throughout this determination in the singular as petitioner.

4. At the meeting on November 28, 2005, the auditor reviewed petitioner's federal income tax returns, forms 1120, and the general ledger. He also learned that the restaurant had a computerized register and ordering system, which had been installed in November or December 2003. This system tracked sales, purchases, and cash and credit card sales for each day the business was in operation. It also totaled these items by month.

After determining that there were discrepancies between the taxable sales indicated by the receipts listed in the general ledger divided by 1.08 (tax rate) and the reported gross sales, the auditor made a list of additional records he wished to review and gave it to Mr. Pezzo. The list included the daily sales reports from the year 2004 through August 31, 2005; disbursement invoices for 2004; the general ledger information for the period January 1, 2005 through August 31, 2005; a menu; and certain fixed asset invoices. The auditor made it clear that if he did not receive the daily sales reports he would resort to a markup analysis.

5. The auditor made a third written request for the information on August 29, 2006 and warned that he would directly contact the corporate officer if the information was not forthcoming by September 15, 2006. In fact, the auditor received no further information from Mr. Pezzo and wrote to Mr. Rocco Panetta on October 2, 2006, seeking the information requested in the letter to Mr. Pezzo of August 29, 2006.

6. On November 8, 2006, the auditor received a packet of information from Mr. Pezzo that included the general ledger for the period September 1, 2004 through November 30, 2004; computer system sales detail for the single day of November 24, 2005; bank statements for a Bank of New York account for the period September 1, 2004 through November 30, 2004; and a sample of purchases for resale for the period September 1, 2004 through November 30, 2004.

7. Although additional requests for records were made to Mr. Pezzo and Mr. Panetta, the Division only received general ledgers, cash disbursements and previously submitted invoices. Petitioner also submitted a spreadsheet with a breakdown of daily sales of food, beverages and other items, but was unable to produce any cash register tapes, guest checks or invoices, despite the fact that the new computerized register and ordering system had been installed in November or December 2003. In sum, no source documentation was submitted.

8. After 19 months of requests for records, the Division concluded that the likelihood of receiving the books and records required for a detailed audit was not substantial. A rough estimate of petitioner's markups was gleaned from an analysis of cost of goods sold over gross sales as reported on the federal tax returns, and were as follows:

Year	Markup %
2002	120.30
2003	114.20
2004	91.40
2005	172.73

Based on the auditor's experience doing numerous audits of restaurants in the region, it was determined that these markup percentages were low. In fact, the auditor had performed six to seven hundred sales tax audits in his 35 years with the Division, of which approximately 50 were Italian restaurants.

9. The auditor's analysis of the cash receipts journals and bank statements provided by petitioner indicated that the bank deposits were in excess of the gross sales reported on the sales tax returns for every one of the quarters in the audit period and for the years 2003 and 2004 on the federal forms 1120. The same documents indicated that only 12% of deposits for the audit period

were cash while the remaining deposits were ascribed to credit cards, a result which conflicted with the auditor's experience with restaurant audits. Combined with the failure of petitioner to produce adequate books and records for 19 months, the cash receipts journals and bank statements analysis led the auditor to determine that petitioner's books and records could not be used in a detailed audit and that he would have to estimate the amount of sales and use taxes due for the audit period.

10. On January 11, 2007, the Division issued to petitioner a statement of proposed audit change, form AU-346, which informed petitioner that the Division had computed additional sales and use taxes due for the audit period in the sum of \$67,677.52 plus penalty and interest. The liability was determined using information taken from petitioner's records and the application of a financial ratio.

11. Without the requested records, the auditor was forced to use an external index to determine audited taxable sales and chose to utilize the Almanac of Business and Industrial Financial Ratios, 2006 edition. This Almanac was compiled to help determine a company's true measure of performance and value. Using the section of the Almanac dealing with the accommodation and food services industry, the auditor took the cost of goods sold (referred to in the Almanac as the cost of operations) as reported by petitioner on its federal income tax returns (forms 1120) for the years in issue, and applied (divided by) a percentage, 39.4%, which expressed the ratio of operating costs over operating income for companies with a money and asset value of between \$250,000,000.00 and \$500,000,000.00.²

²Since the parties discussed and asked questions with regard to the asset value of the business during the audit period, and never suggested a value in excess of \$500,000.00, it is assumed they failed to notice that the chart contained in the Almanac specified that the values stated were "in Thousands of Dollars." The correct column, with which the parties' suggested values are consistent, was "under 500" or \$500,000.00. The applicable percentage to be divided into costs of goods sold was 40.6% for the period July 2002 to June 2003.

It is noted that the 2006 edition of the Almanac provided a percentage of operating costs over operating income for the period July 2002 through June 2003. Petitioner submitted the same table from the later editions of the Almanac, which covered the periods July 2003 through June 2004 and July 2004 through June 2005.³

12. The auditor took the cost of goods sold from the federal income tax returns for the business and divided by 12 to get a monthly figure. This was then multiplied by three to get a quarterly cost of goods sold number and then divided by the percentage from the Almanac. When totaled, this yielded audited taxable sales for the audit period, from which reported taxable sales were subtracted to arrive at additional taxable sales. The appropriate tax rate was applied to each quarter and resulted in additional tax due of \$67,677.52.

13. On March 23, 2007, the Division issued to Jerosal Restaurant, Inc., a Notice of Determination, which set forth additional sales and use taxes due of \$67,677.52 plus penalty and interest. Subsequently, on June 11, 2007, the Division issued to Rocco Panetta, as a person responsible for the collection and payment of sales and use taxes on behalf of Jerosal Restaurant, Inc., a Notice of Determination, which asserted additional tax of \$67,677.52 plus penalty and interest.

14. By an order of the Bureau of Conciliation and Mediation Services (BCMS), dated May 2, 2008, the additional taxes due set forth in the Notices of Determination were reduced to \$39,663.00 (penalty and interest were unchanged), due to a modification in the amount of cost of goods sold determined by the auditor.

³The percentage for companies with asset values under \$500,000.00 for July 2002-June 2003 was 40.6%; for July 2003-June 2004 it was 41.8%; and for July 2004-June 2005 it was 42.4%.

15. Penalties were asserted due to petitioner's negligence in not paying the correct amount of tax due in a timely fashion, for failing to take the necessary actions to pay the proper amount of tax due after a deficiency was determined in a prior audit period and for underreporting tax in excess of 25% for the quarters ended February 28, 2003, February 29, 2004, May 31, 2004, and November 30, 2004.

16. Petitioner Rocco Panetta did not appear at the hearing. However, his representative conceded that he was a person responsible for the collection and payment of sales and use taxes on behalf of Jerosal Restaurant, Inc.

17. Mr. Pezzo's bookkeeper, Ms. Michell Schupner, testified that she was directed by Mr. Pezzo how to enter items on the general ledger and how to classify cash receipts from the business. She was directed to enter the charges from credit card purchases as food or beverage purchases without obtaining the credit card statements to reconcile cash receipts or disbursements with the bank statements. She testified that Mr. Pezzo would sometimes tell her to allocate a hundred dollars or more from the credit card purchases to auto expense or supplies without explanation.

SUMMARY OF PETITIONER'S POSITION

18. Although conceding that the Division was given very little in the way of books and records during the audit, petitioner contends that an analysis of the American Express account used by the business and Mr. Panetta reflects a more accurate accounting of petitioner's costs of goods sold for the audit period. Petitioner argues that the American Express statements reveal purchases which, when added together, give the actual cost of goods sold figure and that if this number had been used by the auditor, it would have resulted in no additional sales and use taxes due. Essentially, petitioner urges this forum to ignore the cost of goods sold supplied by

petitioner on its forms 1120 and accept the American Express bills with Mr. Dolan's choice of purchases as a substitute.

19. Petitioner contends that his prior accountant, Mr. Pezzo, did not provide the necessary information to the auditor and did not use due diligence in his determination of petitioner's costs of goods sold, thus overstating them on the federal income tax returns.

20. At hearing, petitioner's representative conceded that the auditor did what was appropriate given the lack of records presented to him on audit.

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. A "retail sale" is "a sale of tangible personal property to any person for any purpose, other than . . . for resale as such . . ." (Tax Law § 1101[b][4][i]). Tax Law § 1138(a)(1) provides, in relevant part, that if a sales tax return was not filed, "or if a return when filed was incorrect or insufficient, the amount of tax due shall be determined [by the Division of Taxation] from such information as may be available. If necessary, the tax may be estimated on the basis of external indices. . . ." (Tax Law § 1138[a][1].) When acting pursuant to section 1138(a)(1), the Division is required to select a method reasonably calculated to reflect the tax due. The burden then rests upon the taxpayer to demonstrate that the method of audit or the amount of the assessment was erroneous (*see Matter of Your Own Choice, Inc.*, Tax Appeals Tribunal, February 20, 2003).

B. The standard for reviewing a sales tax audit where external indices were employed was set forth in *Matter of Your Own Choice, Inc.*, as follows:

To determine the adequacy of a taxpayer's records, the Division must first request (*Matter of Christ Cella, Inc. v. State Tax Commn.*, [102 AD2d 352, 477 NYS2d 858] *supra*) and thoroughly examine (*Matter of King Crab Rest. v. Chu*,

134 AD2d 51, 522 NYS2d 978) the taxpayer's books and records for the entire period of the proposed assessment (*Matter of Adamides v. Chu*, 134 AD2d 776, 521 NYS2d 826, *lv denied* 71 NY2d 806, 530 NYS2d 109). The purpose of the examination is to determine, through verification drawn independently from within these records (*Matter of Giordano v. State Tax Commn.*, 145 AD2d 726, 535 NYS2d 255; *Matter of Urban Liqs. v. State Tax Commn.*, 90 AD2d 576, 456 NYS2d 138; *Matter of Meyer v. State Tax Commn.*, 61 AD2d 223, 402 NYS2d 74, *lv denied* 44 NY2d 645, 406 NYS2d 1025; *see also, Matter of Hennekens v. State Tax Commn.*, 114 AD2d 599, 494 NYS2d 208), that they are, in fact, so insufficient that it is "virtually impossible [for the Division of Taxation] to verify taxable sales receipts and conduct a complete audit" (*Matter of Chartair, Inc. v. State Tax Commn.*, 65 AD2d 44, 411 NYS2d 41, 43; *Matter of Christ Cella, Inc. v. State Tax Commn.*, *supra*), "from which the exact amount of tax due can be determined" (*Matter of Mohawk Airlines v. Tully*, 75 AD2d 249, 429 NYS2d 759, 760).

Where the Division follows this procedure, thereby demonstrating that the records are incomplete or inaccurate, the Division may resort to external indices to estimate tax (*Matter of Urban Liqs. v. State Tax Commn.*, *supra*). The estimate methodology utilized must be reasonably calculated to reflect taxes due (*Matter of W.T. Grant Co. v. Joseph*, 2 NY2d 196, 159 NYS2d 150, *cert denied* 355 US 869, 2 L Ed 2d 75), but exactness in the outcome of the audit method is not required (*Matter of Markowitz v. State Tax Commn.*, 54 AD2d 1023, 388 NYS2d 176, *affd* 44 NY2d 684, 405 NYS2d 454; *Matter of Cinelli*, Tax Appeals Tribunal, September 14, 1989). The taxpayer bears the burden of proving with clear and convincing evidence that the assessment is erroneous (*Matter of Scarpulla v. State Tax Commn.*, 120 AD2d 842, 502 NYS2d 113) or that the audit methodology is unreasonable (*Matter of Surface Line Operators Fraternal Org. v. Tully*, 85 AD2d 858, 446 NYS2d 451; *Matter of Cousins Serv. Station*, Tax Appeals Tribunal, August 11, 1988). In addition, "[c]onsiderable latitude is given an auditor's method of estimating sales under such circumstances as exist in [each] case" (*Matter of Grecian Sq. v. New York State Tax Commn.*, 119 AD2d 948, 501 NYS2d 219, 221).

C. In this matter, the Division made a proper request for petitioner's books and records by its numerous letters, telephone calls and meetings with Mr. Pezzo over a 19-month period beginning in September 2005. During that period, petitioner never supplied the books and records requested, and the auditor was left without the material needed to do a detailed audit. Thus, the auditor was justified in resorting to an estimated audit methodology to determine petitioner's tax liability for the audit period. (*Matter of Urban*

Liqs. v. State Tax Commn.) In fact, petitioner's representative conceded this in his summation at hearing, lamenting that the auditor did not have the requisite books and records to perform a detailed audit and was justified in resorting to an estimated methodology.

Of the records that were supplied, petitioner's federal income tax returns, the forms 1120, supplied a cost of goods sold figure that the auditor used in his chosen methodology. Using the Almanac of Business and Industrial Financial Ratios, a publication compiled to help determine a company's true measure of performance and value from statistics gathered from 118,000 accommodation and food service companies, the auditor was able to obtain a ratio expressed as a percentage for businesses like petitioner and apply it to cost of goods sold to ultimately determine taxable income. Use of such ratios is specifically provided for under the second sentence of Tax Law § 1138(a)(1) and has long been accepted by the Tax Appeals Tribunal and confirmed by the courts. (*See e.g. Matter of A & J Gifts Shop v. Chu*, 145 AD2d 877, 536 NYS2d 209 [3d Dept 1988], *lv denied*, 74 NY2d 603 [1989]).

Petitioner's only defense was an attack on the validity of its own reported cost of goods sold. It tried to identify specific items on the American Express bills for the audit period, which it argued were the only record of purchases for the business. This analysis was buttressed by the assertion of Ms. Schupner, Mr. Pezzo's bookkeeper, that he was careless with the attribution of certain expenses to cost of goods sold. Petitioner's attack must fail for several reasons.

Mr. Panetta, the person who presumably made the charges on the American Express bills, did not appear at the hearing and therefore there was no testimony containing personal knowledge of the purchases made and whether they were indeed properly characterized as cost of goods sold or expenses, business or personal. More importantly, the charges on the American

Express bills were not supported by any source documentation, a recurring problem with this entire audit. Petitioner has simply not provided a demonstrable audit trail capable of explaining its alleged sales, purchases and, thus, its taxable sales reported.

Additionally, without Mr. Panetta's testimony or documentation, it could not be determined if the business maintained other accounts for the purchase of goods or how many goods were purchased in cash. The auditor noted that the bank records only revealed 12% cash deposits, which, in his experience with these types of restaurants, was a low figure and called into question the validity of deposits as an accurate depiction of the cash part of the business.

Petitioner was the subject of a previous audit which resulted in additional taxes due. However, it was not able to produce sales invoices, cash register tapes, guest checks or any other source documentation. It produced no accurate sales or purchase information despite its installation of a new computerized register and ordering system in 2003 that had the capability to track sales, purchases, and cash and credit sales for each day the business was in operation. Petitioner produced only one day's report from the system despite numerous requests from the auditor for more.

Petitioner's failure to address these issues is not overcome by an analysis of the American Express bills for the audit period. It may well be that the costs of goods sold are not reflected as accurately as petitioner now wishes they had been when it prepared its forms 1120, but the failures are petitioner's, and the Division was justified in relying on information supplied by petitioner on its returns in performing its estimate. Reliance on petitioner's American Express account alone would not be prudent for the reasons stated above.

As noted in the cases cited above, the Division used an accepted methodology to reasonably calculate the taxes due, understanding that such an estimate might not be as exact as a

detailed audit. However, its use of such a method was the fault of petitioner, which did not produce the records necessary to do such an audit. The Division's methodology was reasonably calculated to reflect taxes due. It is of no import that the result was not precise. (*Matter of Markowitz v. State Tax Commn.*)

D. Petitioner has not produced any credible evidence to demonstrate that the Division's assessment was erroneous and has therefore not met its burden of proof. (*Matter of Scarpulla v. State Tax Commn.*)

E. As noted in footnote 2 above, the parties appear to have misread Table II in the Almanac of Business and Industrial Financial Ratios where it specified that the values listed for the asset value of businesses was to be read in the "thousands of dollars." Since neither party ever asserted that the value of the business was in excess of \$500,000.00, either at hearing or in post-hearing submissions, the Division is directed to recalculate the additional taxes due using the correct percentages as set forth in footnote 3 above for the applicable periods. The computation should utilize the modified cost of goods sold value as determined at the BCMS conference and incorporated in the BCMS order of May 2, 2008.

F. Tax Law § 1145(a)(1)(i) authorizes the imposition of a penalty for the failure to file a return or to pay or pay over the sales and use tax due within the time required. Tax Law § 1145(a)(1)(vi) authorizes the imposition of a penalty upon a taxpayer for his omission from the total amount of sales and use taxes required to be shown on a return an amount which is in excess of 25 percent of the amount of such taxes required to be shown on the return. Such penalties may be abated, pursuant to Tax Law § 1145(a)(1)(iii) and (vi), when the taxpayer establishes that such omission was due to reasonable cause and not due to willful neglect. Reasonable cause includes any cause for delinquency which would appear to a person of ordinary

prudence and intelligence as reasonable cause for the delay in filing a sales tax return and paying the tax imposed under Articles 28 and 29 of the Tax Law (*see* 20 NYCRR 2392.1[d][5]).

Petitioner has not presented any evidence or argument warranting the waiver of the penalties asserted.

However, the Division is directed to determine if the penalty asserted pursuant to Tax Law § 1145(a)(1)(vi) is applicable to any of the quarters in the audit period after the recomputation using the cost of goods sold amounts determined after the BCMS conference and the application of the correct percentage from the Almanac as directed in Conclusion of Law E.

G. The petitions of Jerosal Restaurant, Inc., and Rocco Panetta are granted to the extent set forth in Conclusions of Law E and F, but in all other respects the notices of determination, dated March 23, 2007 and June 11, 2007, as modified by the Conciliation Order, dated May 2, 2008, are sustained.

DATED: Troy, New York
May 13, 2010

/s/ Joseph W. Pinto, Jr.
ADMINISTRATIVE LAW JUDGE