

STATE OF NEW YORK

DIVISION OF TAX APPEALS

In the Matter of the Petitions	:	
of	:	
2720 HENRIETTA - BRIGHTON, INC.	:	DETERMINATION
AND WANG Y. HWANG, AS OFFICER	:	DTA NOS. 822750
	:	AND 822751
for Revision of Determinations or for Refund of	:	
Sales and Use Taxes under Articles 28 and 29 of the	:	
Tax Law for the Period March 1, 2004 through	:	
May 31, 2007.	:	

Petitioners, 2720 Henrietta - Brighton, Inc. and Wang Y. Hwang, as officer, 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 March 1, 2004 through May 31, 2007.

A consolidated hearing was held before Arthur S. Bray, Administrative Law Judge, at the offices of the Division of Tax Appeals, 183 East Main Street, Rochester, New York, on September 16, 2009 at 9:45 A.M., with all briefs to be submitted by December 3, 2009 which date commenced the six-month period for the issuance of this determination. Petitioners appeared by Petralia, Webb & O'Connell, P.C. (Arnold R. Petralia, Esq., of counsel). The Division of Taxation appeared by Daniel Smirlock, Esq. (Sarah Dasenbrock, Esq., of counsel).

ISSUES

I. Whether it was appropriate for the Division of Taxation to use an indirect audit methodology.

II. Whether, assuming the use of an indirect audit methodology was proper, petitioners have shown error in the audit method or result.

III. Whether petitioners have established any facts or circumstances warranting the reduction or abatement of the penalty.

FINDINGS OF FACT

1. Petitioner 2720 Henrietta - Brighton, Inc., was a full-service Japanese restaurant with a small bar. It served hibachi and sushi cuisine. Petitioner Wang Y. Hwang owned a controlling interest in the restaurant.

2. On January 11, 2007, the Division mailed an appointment letter to the restaurant stating that its sales and use tax records had been scheduled for a field audit for the period March 1, 2004 through November 30, 2006. 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 the books and records to be produced was attached to the letter. Subsequently, the audit period was amended to include the periods through May 31, 2007.

3. The Division found that the records that were subsequently produced were not sufficient to perform a detailed audit. The cash register tapes bore an erroneous year and did not show the day of the month. Nevertheless, the Division attempted to correlate the guest checks to the tapes for a particular month during the audit period. The Division found that there were guest checks on days where there were no entries on the tapes and there were days where there were cash register tapes but no guest checks. Its review led the Division to conclude that the tapes could not be used for an audit.

4. The Division also determined that there were numerous gaps and missing checks in the sequence of the guest checks. Further, there was a wide variation in the number of missing checks within a gap. There were days where the guest checks were completely missing. In some instances the restaurant was missing a large number of checks and in other instances it was

missing just a few checks. When the Division examined the guest checks, it found that it was of greater concern when the restaurant was missing a few checks within a book than when there was a gap of 100 or 500 checks, because this could be attributable to using a book of checks out of sequence. The audit workpapers show that most of the gaps in the sequence of checks, including large gaps, were of odd numbers.

5. The Division conducted an analysis of cash deposits and determined that the restaurant deposited only 5 to 13 percent of its cash receipts.

6. The one item that the Division believed that it had a clear record of was credit card sales. Therefore, the Division decided to use an observation test and from that observation test calculate a cash-to-credit ratio and apply it to credit card sales. The Division felt that by using credit card sales to estimate total sales, it would account for fluctuations in total sales during the audit period.

7. On September 15, 2007, which was a Saturday, the Division conducted an observation of the restaurant. On this day, the restaurant was open from 4:00 P.M. until approximately 10:00 P.M. The individuals conducting the observation watched the restaurant from approximately one-half hour before opening until approximately one-half hour after closing. During the observation, the auditors recorded every sale and noted whether the purchase was by cash or credit card. The sales information was then provided to the auditor and the auditor's supervisor for analysis. The auditor found that during the observation period, cash sales constituted 35.83 percent of sales and credit card sales constituted 64.17 percent of sales. The Division then subtracted the tips from the credit card sales to determine the credit card sales without tips or tax. This amount was then divided by the cash-to-credit ratio of 64.17 percent to calculate the audited total sales and then total sales per quarter. The Division subtracted the reported gross sales from

the audited gross sales to find the unreported gross sales. The remainder was then multiplied by the tax rate to calculate the amount of tax due. The sum of the amounts of tax due, for each quarter, was \$27,041.95.

8. On the basis of the forgoing audit, the Division issued a Notice of Determination (L-029603255-9), dated January 17, 2008, to the restaurant that assessed sales and use tax in the amount of \$27,041.95 plus penalty and interest for a balance due of \$43,631.94. On January 18, 2008, the Division also issued a Notice of Determination to petitioner Young Hwang Wang (L-029607362-3) that assessed the same amount of tax plus penalty and interest. Each notice imposed a penalty pursuant to Tax Law 1145(a)(1)(i) for failure to timely pay the tax imposed by Articles 28 and 29 of the Tax Law.

9. The sales volume on the day selected for the audit was very high. The Division felt that a high sales volume would lead to a more accurate statistical sampling for the credit-to-cash analysis. The observation was limited to one day because it was also the team leader's understanding that it was audit policy to conduct an observation test for one day rather than a more extended period.

10. The restaurant kept guest checks stacked in a closet at the front of the restaurant. When a party was seated, the host would leave a check at the table. In general, one guest check was used for each party. The restaurant did not try to keep guest checks in any particular order except to the extent that it tried to keep the last two numbers on the guest checks in order.

11. There are several reasons why a gap in the sequence of the guest checks might occur. The gaps of 100 or 500 probably arose from the way the guest checks were removed from the box and stacked. If the restaurant ran out of checks, the bookkeeper would go to an office supply store and purchase more checks for the restaurant. Consequently, the checks were not always

from the same supplier. If the guests at a particular table requested separate checks, the server would sign a sheet and bring the additional checks to the table. The original check would be voided and might be thrown away. On other occasions, a customer might ask to keep the check for his records. The bookkeeper felt that once a guest check was processed by a credit card machine, it was no longer needed and the customer was welcome to retain it.

12. The bookkeeper kept the guest checks in separate monthly piles, and whenever she had a chance, she would write the total sales for each day in a journal that allocated the sales into different categories such as food, liquor, beer and wine and soda. In order to prepare the sales tax returns, the bookkeeper sent a facsimile of a spreadsheet with the daily sales to the restaurant's accountant, Mr. Nacca. Thereafter, these amounts were reported by the accountant on the sales tax returns.

13. It is the bookkeeper's impression that there were relatively more credit card transactions during the week compared to the weekends because there are more business people eating out during the week and they tend to use credit cards. There are more couples and families on weekends.

14. The restaurant kept a certain amount of cash in the register in order to operate. The amount of cash varied from time to time but it would have at least \$500.00. Only cash sales were rung up on the cash register. The cash register was operated by the hostess and, if the hostess was busy, by the bartender. The reason the restaurant followed this practice is that there were frequently new people working at the restaurant and it tried to keep its procedures as simple as it could for them.

15. On occasion, the restaurant would cash a check for an employee and then deposit the check into the restaurant's account. This was done as a courtesy for employees who did not have

bank accounts or for employees whose bank was closed when they received their check. On credit card sales, the restaurant also cashed tips for its servers.

16. The restaurant's sales tax returns were prepared by Joseph Nacca, CPA. Before a return was due, Mr. Nacca's office contacted the restaurant to make sure that the restaurant either dropped off or faxed the information needed to prepare the return before the due date. After the returns were prepared, they were submitted to the client for signature and payment before the due date. In this case, Mr. Nacca received a daily sales journal for each month of the sales tax quarter from the restaurant which, in turn, was used to prepare the sales tax returns.

17. In addition to the sales journal, Mr. Nacca's office also received, on a quarterly or semiannual basis, the disbursements journal and bank statements, which might include cancelled checks depending upon the bank involved. Mr. Nacca's office reconciled the bank statements in order to obtain a cash balance. When he reviewed the bank balance, he did not examine any of the credit card deposits.

18. Using the guest checks for the dates of September 9, 2007 through September 14, 2007, Mr. Nacca performed an analysis of guest checks and found that credit card sales comprised 71.72 percent of total sales during this period of time and the balance of 28.28 percent were cash sales. These percentages would have resulted in an underpayment of sales tax of \$9,600.00. Mr. Nacca opined that if the test were expanded to a longer period of time, it would have shown that even less tax was due. When this analysis was presented to the Division, Mr. Nacca was told that since the Division did not observe the restaurant on these days, it could not use the analysis.

19. In Mr. Nacca's opinion, he provided everything that the Division requested.

SUMMARY OF PETITIONERS' POSITION

20. In their brief, petitioners argue that a complete audit could have been performed with the guest checks but that the Division failed to properly analyze them. Petitioners submit that the large gaps in checks were due to breaks in sequence in which no checks were issued. Other gaps could have been due to the way voided checks were handled. According to petitioners, the facts presented herein are analogous to the situation in *Matter of King Crab Rest. v. Chu* (134 Ad2d 51) where the Division failed to conduct an adequate investigation to determine if it could have conducted a complete audit. Petitioners further argue that the Division's analysis of the restaurant's handling of cash was flawed because it failed to take into account the fact that the missing cash was due to the restaurant's practice of paying the tips on the credit card sales. Petitioners maintain that this practice reduced the amount of cash that was available for deposit and had an effect on the assessment because the audit methodology was based on the percentage of cash-to-credit sales. Petitioners next argue that the use of a single day observation was flawed. In this regard, petitioners submit that the restaurant had a higher proportion of cash-to-credit card sales on Saturdays, which was the day chosen for the observation. In conclusion, petitioners contend that, if the audit was proper, the amount of the deficiency should correspond to the amount found by the restaurant's accountant and, further, the penalty should be cancelled.

In their reply brief, petitioners maintain that the spreadsheet relied upon by the Division to show the number of missing checks was not identifiable on its face and that petitioners must have an opportunity to cross examine a witness on the document. Petitioners contend that when the Division's representative argued in the brief that the gaps varied widely including odd numbers of various lengths, with few numbers being divisible by 50 or 100, she was testifying. According to petitioners, the record of missing checks was not admissible since there was no witness who

could testify as to its accuracy. In addition, petitioners submit that the Division's reports lack any probative value since they were submitted without a proper foundation.

Petitioners maintain that if they had been asked, Mr. and Mrs. Hwang could have explained the missing guest checks. Petitioners also reiterate their argument that the observation on a Saturday which was not representative of other days and that the cases cited by the Division are not on point.

CONCLUSIONS OF LAW

A. It is well established that any person making taxable sales is a "vendor" under Tax Law § 1101(b)(8). As such, petitioners were "required to maintain complete, adequate and accurate books and records regarding its sales tax liability and, upon request, to make the same available for audit by the Division" (*Matter of AGDN, Inc.*, Tax Appeals Tribunal, February 6, 1997). The records required to be maintained "include a true copy of each sales slip, invoice, receipt, statement or memorandum." (Tax Law § 1135[a]). Recently, in *Matter of Krystallos, Inc.* (Tax Appeals Tribunal, May 13, 2010) the Tribunal reiterated the following standard, set forth in *Matter of Your Own Choice* (Tax Appeals Tribunal, February 20, 2003), for reviewing a sales tax audit where external indices are employed:

To determine the adequacy of a taxpayer's records, the Division must first request (*Matter of Christ Cella, Inc. v. State Tax Commn., 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).

B. Relying upon *King Crab*, petitioners argue that the Division could have conducted a complete audit using its guest checks but failed to properly analyze them. In *King Crab*, the Division conducted an audit of a restaurant that did not maintain cash register tapes. After a brief review, the auditor noted that the guest checks were not in chronological order. Based upon the lack of cash register tapes and his brief review of the guest checks, the auditor determined that the records were inadequate to conduct a complete audit. Upon review, the Court concluded that the use of a test period was inappropriate because the auditor did not conduct a sufficient investigation to justify the conclusion that the records were not capable of supporting a complete audit.

C. In this case, the record shows that the Division conducted a through examination of the guest checks that were provided by the restaurant and found numerous gaps which were both

large and small. Although there were gaps in the checks, which might be explained by taking whole books of checks out of order or purchasing checks from a different supplier, there were other large gaps of checks that were not divisible by 100 as well as gaps within books of a smaller number of checks. At the hearing, petitioners explained that voided checks were discarded and that it was common for customers to take checks home with them for their records. The difficulty with petitioners' practice of not adhering to a pattern of maintaining consecutively numbered checks, discarding voided checks and permitting a customer to leave with the only original record of the sale is that it became impossible for the Division to conduct an investigation to independently verify the restaurant's taxable sales and receipts. It follows that petitioners' reliance upon *King Crab* is misplaced, petitioners' records were not adequate and the Division's use of an external index was appropriate (*see Matter of Giordano v. State Tax Commn.*, 145 AD2d 726 [3d Dept 1988]; *Matter of Chartair, Inc. v. State Tax Commn.* (65 AD2d 44 [3d Dept 1978])). Contrary to the argument in petitioners' brief, the Division is not required to speculate as to the cause or nature of the undocumented sales and then use another indirect source, such as bank records, to determine the amount of such sales. Petitioners' position is the anthesis of the requirement that there be independently verifiable records of sales.¹

Petitioners' contention that the Division improperly presented an argument based upon the Division's workpapers regarding the number of missing checks is completely without merit. The workpapers in issue were included in the file, which was received in evidence. Moreover, said workpapers were available to petitioners for their own examination and questioning of the Division's witness at the hearing, if desired. Clearly, the Division may avail itself of the

¹ Petitioners have not argued that the cash register tapes were sufficient for the conduct of an audit. If it had been presented, it would not have been given any credence because they bore incorrect dates and only recorded cash sales.

documents in its possession (State Administrative Procedure Act § 306 [2]). If petitioners thought that these pages were unclear or that additional questions were warranted, they could have pursued these concerns at the hearing. Under the circumstances, petitioners' objections to the Division's comments on the schedule of missing checks is without any merit.

D. Petitioners contend that the Division erred in determining that the cash sales were not being deposited in the bank. According to petitioners, the flawed cash analysis was a ground for the use of external indices.

E. The forgoing position is not supported by the record. Petitioners are correct that the Division conducted an analysis of the handling of cash and found that only a small proportion of the cash sales was being deposited in the bank. However, the testimony of the Division's witness is clear that the basis for the use of external indices was the restaurant's inadequate records and not the handling of the cash (Transcript, p. 40). Moreover, when it performed its audit analysis of cash-to-credit card sales, the Division subtracted the amount of tips from the credit card sales before calculating the cash to credit ratio. It follows that petitioners' arguments regarding the Division's analysis of cash are irrelevant to the audit or the amount of tax assessed.

F. Petitioners object to the use of a one-day observation period. According to petitioners, it is inconceivable that an inflexible policy of a single day could result in an accurate result where the evidence shows that the day chosen, Saturday, is not representative of other days. It is also noted that the uncontradicted evidence was that the ratio of cash sales to credit card sales was higher on Saturdays. Petitioners posit that the refusal to expand the audit beyond a single day violated the holding in *King Crab* where the Division erroneously conducted an estimated markup because it was too time consuming to perform a complete audit. It is submitted that the

Division had no basis for concluding that the percentage of people using a credit card on a Saturday would not be different than the percentage of people using a credit card on a weekday.

G. The forgoing argument is without merit. The extrapolation of the results of a one-day observation test to a multi-year audit period has been sustained on repeated occasions (*see Matter of Del's Mini Deli v. Commr. of Taxation and Finance*, 205 AD2d 989 [3d Dept 1994], *Matter of Lombard v. Commr. of Taxation and Finance*, 197 AD2d 799, 602 NYS2d 972 [3d Dept 1993]; *Matter of Sarantopoulos v. Tax Appeals Tribunal*, 186 AD2d 878 [3d Dept 1992]).

H. At the hearing, petitioners presented their own analysis of guest checks, which covered a period of several days, in order to establish that the Division's one-day observation test produced an erroneous assessment. This analysis is not accepted because it is based on the same inadequate record of sales, that is, an incomplete set of guest checks, which initially prompted the use of an external index. It is noted that exactness in the outcome of the audit method is not required when it is the taxpayer's failure to maintain proper records which prevents it (*Matter of Markowitz v. State Tax Commn.*, 54 AD2d 1023 [3d Dept. 1976], *affd* 44 NY2d 684 [1978]).

I. The Division asserted penalty herein pursuant to Tax Law § 1145(a)(1)(i). This section states that any person failing to file a return or pay over any sales or use tax shall be subject to a penalty. The penalty may be canceled if the failure was due to reasonable cause and not due to willful neglect (Tax Law § 1145[a][1][iii]). Consistent with this statute, the Division regulations provide that penalty imposed under Tax Law § 1145(a)(1)(I) must be imposed unless it is shown that such failure was due to reasonable cause and not due to willful neglect (20 NYCRR 2392.1[a][1]).

J. In establishing reasonable cause for abatement of a penalty, the taxpayer faces an onerous task (*Matter of Philip Morris, Inc.*, Tax Appeals Tribunal, April 29, 1993). Referring to

the mandatory language of Tax Law § 1145(a)(1)(i), the Tribunal stated that “the Legislature evidenced its intent that filing returns and paying tax according to a particular timetable be treated as a largely unavoidable obligation” (*Matter of MCI Communications Corp.*, Tax Appeals Tribunal, January 16, 1992). In this case, petitioner failed to maintain the records needed to verify its taxable sales. Accordingly, penalties and interest imposed herein are properly sustained.

K. The petitions of 2720 Henrietta-Brighton, Inc. and Hwang Y. Wang are denied, and the notices of determination dated January 17, 2008 and January 18, 2008, respectively, are sustained together with such penalty and interest as may be lawfully due.

DATED: Troy, New York
June 3, 2010

/s/ Arthur S. Bray
ADMINISTRATIVE LAW JUDGE