STATE OF NEW YORK

DIVISION OF TAX APPEALS

In the Matter of the Petition	:	
of	:	
J & L DONUT SHOP, INC.	:	DETERMINATION DTA NO. 823143
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 September 1, 2005 through February 28, 2009.	:	

Petitioner, J & L Donut Shop, Inc., 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 September 1, 2005 through February 28, 2009.

A hearing was held before Thomas C. Sacca, Administrative Law Judge, at the offices of the Division of Tax Appeals, 500 Federal Street, Troy, New York, on June 16, 2010, at 11:00 A.M., with all briefs to be submitted by December 20, 2010, which date commenced the six-month period for issuance of this determination. Petitioner appeared by Michael J. Buxbaum, CPA. The Division of Taxation appeared by Daniel Smirlock, Esq. (Robert A. Maslyn, Esq., of counsel).

ISSUES

I. Whether the audit methodology utilized by the Division of Taxation in its audit of J & L Donut Shop, Inc., had a rational basis and was reasonably calculated to reflect the taxes due.

II. Whether penalties asserted against petitioner should be abated.

FINDINGS OF FACT

1. Petitioner, J & L Donut Shop, Inc., was established in 1983 and registered to do business in New York State in April 1984. Petitioner operated under the name Galaxy Restaurant, and was located at 1 Palisade Avenue, Yonkers, New York. Its business hours were 6:00 A.M. to 5:00 P.M., Monday through Saturday, and 7:00 A.M. to 3:00 P.M. on Sunday.

2. On July 31, 2008, the Division of Taxation (Division) sent a letter to petitioner stating that the business's sales and use tax records had been scheduled for a field audit for the period June 1, 2005 through May 31, 2008. 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. Among other things the letter requested sales invoices, cash register tapes and guest checks for the entire audit period.

3. On November 25, 2008, the Division's auditor visited the business premises and ordered two items, a muffin and a cup of tea. According to the menu, the muffin cost $1.50 and the tea cost $1.25. The auditor received a guest check showing $3.00 due. The cashier collected the guest check and $3.00, and upon request the auditor received a receipt showing only the total of $3.00. The receipt did not separate the items purchased, the amount of tax due or the name of the business.

4. On December 25, 2008, the taxpayer's representative informed the auditor by letter that petitioner was not in possession of original sales invoices or cash register tapes for the audit period. In response, the auditor sent a letter dated January 16, 2009 requesting guest checks, cash register tapes, sales journal, general ledger and purchase invoices for the months of December 2008 and January 2009. In response to the Division's request, petitioner provided to the auditor cash register tapes and guest checks for the period January 8, 2009 through January 28, 2009.

The cash register tapes did not detail the items sold and the guest checks did not separately state the tax due or the items sold.

5. On April 8, 2009, an investigator of the Division entered the business premises and ordered a coffee and a muffin. The guest check listed the two items purchased and the total amount due of $4.35. There was no separate amount charged for each item and no separate statement of the tax due. On April 9, 2009, the investigator purchased for take-out a coffee and muffin and was charged $3.00. The receipts received by the investigator on both days showed only the total collected, with no separately stated tax or business identification.

6. On April 21, 2009, the Division sent a second letter to petitioner stating that the audit period had been amended and expanded to the period September 1, 2005 through February 28, 2009. The letter stated that in addition to the records already requested, all books and records pertaining to the sales and use tax liability for the updated period be made available. A schedule of books and records to be produced was attached to the letter. Among other things the letter requested sales invoices, cash register tapes and guest checks for the entire audit period.

7. Except for the period January 8, 2009 through January 28, 2009, petitioner did not provide any source documentation such as guest checks or cash register tapes, a day book or any type of tax accrual account. The guest checks and cash register tapes that were provided either did not indicate the items sold, failed to separately state the amount of tax collected, or both. After reviewing the few records provided, the auditor decided to employ an indirect audit method to calculate the amount of taxable sales. The indirect audit method chosen was a rent factor.

8. The auditor employed an industry index entitled Restaurant Industry Operations Report, 2007-2008 edition, to compute the gross sales of petitioner. The publication contains data on restaurant operations in various categories, was commonly used in the auditor's office

and he was familiar with the use of the index. The index is based on financial and operating data for 2006 provided by members of the National Restaurant Association and members of various state restaurant associations. The data processing contained in the report was performed by Deloitte & Touche LLP.

The auditor obtained a rent factor of 8.8% representing rent as a percentage of gross sales. This rent factor was the median quartile for limited service restaurants. For the years 2005, 2006 and 2007, the rent factor chosen was applied to the rent amount taken from petitioner's U.S. corporation income tax return, Form 1120. The monthly rent determined to be paid by petitioner as claimed on the returns was $7,898.00 for the year 2005, $7,458.00 for the year 2006 and $7,528.00 for the year 2007. As the auditor did not have in his possession petitioner's U.S. corporation income tax returns for the years 2008 and 2009, he projected the rent claimed to have been paid in 2007 to the last two years. As a result the auditor determined for the audit period gross sales of $3,600,414.62, additional taxable sales of $2,632,809.62, and additional sales tax due of $220,497.98.

The auditor did not make an adjustment for nontaxable sales because the auditor did not observe a specific take-out sales area, the restaurant did not appear to be set up for take-out sales, petitioner had not provided any records of nontaxable sales and the investigator had been charged sales tax on her purchase of a nontaxable item, the muffin for take-out.

9. Petitioner executed two consents extending the period of limitations for assessment of sales and use taxes under Articles 28 and 29 of the Tax Law that collectively extended the period in which to assess sales and use taxes due for the period September 1, 2005 through November 30, 2006 to December 20, 2009.

10. On the basis of the audit performed, the Division issued a Notice of Determination (Assessment # L-032254703-6), dated June 29, 2009, to petitioner, which assessed sales and use tax for the period September 1, 2005 through February 28, 2009 in the amount of $220,497.98, plus penalty and interest. The penalty was imposed pursuant to Tax Law § 1145(a)(1) because of the inadequacy of the business's records and the amount of the underreporting of tax.

11. On September 15, 1997, petitioner signed a lease with the then landlord that in its last year, 2004, provided for monthly rent in the amount of $4,200.00. On June 26, 2003, petitioner executed an extension of the lease with a new landlord that provided for monthly rent for each of the fiscal years ended June 30, 2004 through June 30, 2009 of $7,500.00, $7,762.50, $8,034.18, $8,315.38 and $8,606.42, respectively.

CONCLUSIONS OF LAW

A. Tax Law § 1105(a)(i) imposes a sales tax on the receipts from every sale of food or drink of any nature when sold in restaurants for consumption on the premises.

B. Tax Law § 1135(a) provides that "[e]very person required to collect tax shall keep records of every sale . . . and of all amounts paid, charged or due thereon and of the tax payable thereon, in such form as the commissioner of taxation and finance may by regulation require." Such records include a copy of "each sales slip, invoice receipt, statement or memorandum upon which subdivision (a) of section eleven thirty-two requires that the tax be stated separately." (***Id.***; 20 NYCRR 533.2[b][1].)

C. 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 . . ." (Tax Law § 1138[a][1]). When acting

pursuant to section 1138(a)(1), the Division is required to select an audit methodology reasonably calculated to reflect the tax due. The burden then rests upon the taxpayer to demonstrate that the audit methodology or the amount of the assessment was erroneous (***see Matter of Your Own Choice, Inc.***, Tax Appeals Tribunal, February 20, 2003).

D. The standard for reviewing a sales tax audit where an indirect audit methodology has been employed in the determination of sales tax liability is well established, and was set forth in ***Matter of AGDN, Inc***. (Tax Appeals Tribunal, February 6, 1997), as follows:

> a vendor . . . is 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 (***see***, Tax Law §§ 1138[a]; 1135; 1142[5]; ***see, e.g.***, ***Matter of Mera Delicatessen***, Tax Appeals Tribunal, November 2, 1989). Specifically, such records required to be maintained 'shall include a true copy of each sales slip, invoice, receipt, statement or memorandum' (Tax Law § 1135). It is equally well established that where insufficient records are kept and it is not possible to conduct a complete audit, 'the amount of tax due shall be determined by the commissioner of taxation and finance from such information as may be available. If necessary, the tax may be estimated on the basis of external indices . . .' (Tax Law § 1138[a]; ***see, Matter of Chartair, Inc. v. State Tax Commn.***, 65 AD2d 44, 411 NYS2d 41, 43). 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).

E. In this case, the record establishes the Division's clear and unequivocal written request for books and records of petitioner's sales, as well as petitioner's failure to produce such books and records. Based on the lack of records provided and petitioner's representative's letter stating that petitioner did not possess cash register tapes or guest checks for the audit period, the

Division reasonably concluded that petitioner did not maintain or have available books and records that were sufficient to verify gross and taxable sales for the audit period including, most tellingly, any records of sales. Having established the unavailability of required books and records, the Division was clearly entitled to resort to the use of indirect methods, including the use of a rent factor, to determine petitioner's sales and sales tax liability. In fact, the Division's authority to do so has been consistently sustained (***see Matter of Del's Mini Deli, Inc. v. Commissioner of Taxation and Finance***, 205 AD2d 989, 613 NYS2d 967 [1994]; ***Matter of Vebole Edibles v. Tax Appeals Tribunal,*** 162 AD2d 765, 557 NYS2d 678 [1990]; ***Matter of Sarantopoulos v. Tax Appeals Tribunal***, 186 AD2d 878, 589 NYS2d 102 [1992]) and the use of a rent factor has been specifically addressed and approved (***see Matter of Constantini,*** Tax Appeals Tribunal, January 10, 2008; ***Matter of Your Own Choice, Inc.,*** Tax Appeals Tribunal, February 20, 2003; ***Matter of Bitable on Broadway, Inc.,*** Tax Appeals Tribunal, January 23, 1992). In view of the foregoing, the only questions presented in this case are whether petitioner has established that the audit method employed was unreasonable and whether the amount of tax assessed as the result of the application of the method used in this case was erroneous (***Matter of Surface Line Operators Fraternal Organization v. Tully***).

F. Addressing first the years 2005, 2006 and 2007, petitioner has not established that the audit method was unreasonable or that the amount of tax determined by application of such method was erroneous. For the period in question, petitioner admittedly did not maintain any records of sales as required by the Tax Law. Petitioner presented no invoices, cash register tapes, guest checks or other source documentation that could be used to establish the correct amount of sales tax due. Having established the inadequacies of a taxpayer's records, the Division is under no obligation to utilize one indirect method of audit as opposed to another, but rather must only

select a method of audit reasonably calculated to determine the amount of tax due (***Matter of Grant Co. v. Joseph***). Petitioner presented no evidence to show that the rent factor utilized by the Division was unreasonable. Under these circumstances, the Division's resort to a rent factor for the years 2005, 2006 and 2007 to determine sales was entirely reasonable (***cf. Matter of Fokos Lounge, Inc.***, Tax Appeals Tribunal, March 7, 1991 [where taxpayer proved through an expert witness that the utilities factor was without a rational basis as applied to its business]). Furthermore, as a general proposition, any imprecision in the results of an audit arising by reason of a taxpayer's own failure to keep and maintain records of all of its sales as required by Tax Law § 1135(a)(1) must be borne by that taxpayer (***Matter of Markowitz v. State Tax Commission; Matter of Meyer v. State Tax Commission***).

G. As to the years 2008 and 2009, it is petitioner's position that a review of the entire record in this matter establishes that the Division's use of the rent factor methodology to estimate taxable sales lacked a rational basis and was therefore not a reasonable method to estimate petitioner's sales. Petitioner contends that the rent amounts used by the Division were excessive as the amounts were not actually paid throughout the audit period. In addition, petitioner posits that the rent amounts were higher than the local real estate market could bear, forcing petitioner out of business. In support of its position, petitioner introduced into the record an invoice from petitioner's landlord dated December 1, 2008 that indicated petitioner owed past rent due on October 31, 2008 of $31,104.79, and had failed to pay the monthly rent for November and December 2008 in the amount of $8,907.00. A second invoice dated June 1, 2010 from petitioner's landlord indicated petitioner owed $55,796.56 in back rent as of April 30, 2010. Finally, petitioner introduced into the record a letter from a commercial real estate company

located in Yonkers, New York, dated November 26, 2008, that stated that the real estate market was asking $25.00 per square foot for available retail space.

Petitioner further argued in its reply brief that the Division's use of a rent factor methodology in determining the amount of gross sales was in error because it could have used the actual rent amounts paid as shown on its U.S. corporation income tax returns. Petitioner stated in its reply brief that it had paid rent in the amount of $103,374.00 in 2008 and $78,000.00 in 2009. Although not substantiated, these allegations undermine petitioner's own position that it was unable to pay its rent, and that the high rent payments caused it to go out of business. The allegations also bring into question the validity of the landlord invoices showing past amounts of rent due, as petitioner's tax returns state that it fully paid the rent required to be paid by the lease extension. Under these circumstances, the landlord invoices are given no weight in this determination. In addition, the letter from the commercial real estate company was also given no weight in this determination as there was no explanation, except anecdotal statements, for the letter's conclusions.

H. Addressing the years 2008 and 2009, petitioner has not established that the audit method was unreasonable or that the amount of tax determined by application of such method was erroneous. For this period, the only records presented on audit were the guest checks and cash register tapes for the period January 8, 2009 through January 28, 2009, which did not identify the items sold or the amount of tax collected. Petitioner presented no invoices, cash register tapes, guest checks or other source documentation that could be used to establish the correct amount of sales tax due. Having established the inadequacies of a taxpayer's records, the Division must only select a method of audit reasonably calculated to determine the amount of tax due (***Matter of Grant Co. v. Joseph***). Having rejected the landlord invoices and commercial real

estate company letter, it is determined that petitioner presented no evidence to show that the rent factor utilized by the Division was unreasonable. Under these circumstances, the Division's resort to a rent factor for the years 2008 and 2009 to determine sales was entirely reasonable (***cf. Matter of Fokos Lounge, Inc.***)

I. Petitioner contends that the failure of the Division to consider some of its sales as nontaxable, in light of the Division's knowledge that petitioner made take-out nontaxable sales, renders the audit determinations erroneous and unreasonable, citing ***Matter of Bernstein-On-Essex St.*** (Tax Appeals Tribunal, December 3, 1992). In ***Bernstein-On-Essex St.***, the Division assessed sales tax on all sales, despite having knowledge that the taxpayer made both taxable and nontaxable, over-the-counter sales. The Tribunal held that because the Division was aware of the nontaxable, over-the-counter sales, its assumption that all sales were subject to tax was flawed, and the audit method was unreasonable, lacking a rational basis.

Here, the Division was aware of petitioner's over-the-counter sales as its investigator purchased a muffin and coffee for take-out. The Division was also aware, however, that petitioner charged sales tax on this nontaxable purchase. Contrary to petitioner's claim, the sales tax collected was on both the muffin and coffee, not just the coffee, as it was the same tax amount charged by petitioner on the earlier purchase by the auditor of the same items. Since the only knowledge the Division had at the time of the audit was that petitioner improperly charged sales tax on a nontaxable, over-the-counter sale, and petitioner had not produced any records establishing nontaxable sales, the Division properly concluded that all sales were subject to sales tax (Tax Law § 1105[a]). As petitioner has failed to produce any evidence establishing nontaxable sales, it is concluded that petitioner has failed to meet its burden of establishing that the audit method employed was unreasonable or that the amount of tax assessed as the result of

the application of the method used in this case was erroneous (***Matter of Surface Line Operators Fraternal Organization***).

J. In establishing reasonable cause for the abatement of penalty, the taxpayer faces an onerous task (***Matter of Philip Morris, Inc.***, Tax Appeals Tribunal, April 29, 1993). In ***Philip Morris*** it was explained that "[b]y first requiring the imposition of penalties (rather than merely allowing them at the Commissioner's discretion), the Legislature evidenced its intent that filing returns and paying the tax according to a particular timetable be treated as a largely unavoidable obligation [citations omitted]" (***Matter of MCI Telecommunications Corp.***, Tax Appeals Tribunal, January 16, 1992, ***confirmed*** 193 AD2d 978, 598 NYS2d 360 [1993]). Here, petitioner failed to make adequate books and records available for audit and substantially underreported and underpaid the tax due. Under these circumstances, the waiver of penalties would not be justified.

K. The petition of J & L Donut Shop, Inc. is denied, and the Notice of Determination dated June 29, 2009 is sustained together with such penalties and interest as may be lawfully due.

DATED: Troy, New York
April 28, 2011

/s/ Thomas C. Sacca
ADMINISTRATIVE LAW JUDGE