STATE OF NEW YORK

DIVISION OF TAX APPEALS

In the Matter of the Petition of **MAD DEN, INC.** for Revision of a Determination or for Refund of Sales and Use Taxes under Articles 28 and 29 of the Tax Law for the Period June 1, 2004 through May 31, 2007.	:	DETERMINATION DTA NOS. 823251 AND 823252
In the Matter of the Petition of **BRIAN MADDEN** 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, 2005 through May 31, 2007.	:	

Petitioners, Mad Den, Inc. and Brian Madden, 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 periods June 1, 2004 through May 31, 2007 and March 1, 2005 through May 31, 2007,[1] respectively.

A hearing was begun before Joseph W. Pinto, Jr., Administrative Law Judge, at the offices of the Division of Tax Appeals, 500 Federal Street, Troy, New York, on September 23, 2010 at 12:00 P.M., and continued to conclusion on January 18, 2011 at 11:00 A.M., with all briefs to be submitted by May 2, 2011, which date began the six-month period for the issuance of this

[1]No explanation was provided for the different audit periods.

determination. Petitioner Mad Den, Inc., appeared by its president, Brian Madden, and Mr. Madden appeared pro se. The Division of Taxation appeared by Mark F. Volk, Esq. (Anita K. Luckina, Esq., of counsel).

ISSUES

I. Whether the Division was warranted in resorting to an indirect audit methodology in this matter.

II. If the Division was correct in utilizing an indirect audit methodology, whether said methodology had a rational basis and was reasonably calculated to determine sales tax due from Mad Den, Inc., and Brian Madden, as officer, for the respective audit periods.

III. Whether petitioners' production of books and records at the hearing established that there were adequate records for a detailed audit and that the additional sales tax determined by the Division of Taxation using an external index was incorrect.

IV. Whether petitioners have demonstrated reasonable cause for the abatement of the penalty asserted.

FINDINGS OF FACT

1. During the period June 1, 2004 through May 31, 2007 (audit period), petitioner Brian Madden was the president and sole owner of Mad Den, Inc. (Mad Den). At the time he purchased the business in May 1999, Mr. Madden had no background in restaurant operations, having operated only a lawn maintenance business prior to that time. Mr. Madden has not contested his responsibility for taxes determined to be due from Mad Den, Inc.

2. Mad Den operated a restaurant, known as Café Strega, at 2 Broadway in Pleasantville, New York, until it closed for substantial renovations on September 30, 2006, when leased space next door at 6 Broadway was used to more than double its patron seating capacity from 38 to 85

seats, excluding seating for a bar. Thereafter, the restaurant was operated by unrelated third parties.

3. The Division of Taxation (Division) began its audit of Mad Den on June 25, 2007 by mailing an appointment letter to the business at 2 Broadway, Pleasantville, New York, in which it requested a meeting and the production of various documents by the taxpayer with regard to its sales and use tax liability for the period June 1, 2004 through May 31, 2007. The records requested included sales and use tax returns and federal income tax returns for the audit period; sales invoices, guest checks and cash register tapes; the general ledger; fixed asset and expense purchase records; the cash receipts and cash disbursement journals; financial statements, leases and utility bills.

4. After a second written request for records, dated July 11, 2007, the auditor, Arnold Green, met with Mr. Madden and his representative at the restaurant on August 21, 2007, where the records available for inspection were produced. They consisted of federal income tax returns, a check book, bank statements and sales figures written on envelopes. From the information received, Mr. Green prepared a reconciliation of the sales tax and federal income tax returns filed, noting several unexplained discrepancies, most obvious of which were the larger gross sales figures on the federal income tax returns for 2004, 2005 and 2006. At this time, Mr. Madden indicated to the auditor that the restaurant had been sold and indicated to him that he was the owner during the period prior to October 1, 2006 and no longer had access to the restaurant or the point of sale computer system that recorded sales at the restaurant.

5. Given the lack of sales records produced and the discrepancies noted between the sales tax returns and federal income tax returns, by August 31, 2007 the auditor had determined that the records produced were inadequate to perform a detailed sales audit. Gross sales reported on Mad

Den's federal returns totaled $1,556,628.00 for the years 2004, 2005 and 2006, while the gross sales reported on the sales tax returns filed during the audit period only totaled $445,796.00. The auditor noted in his field audit record on August 31, 2007 that he was already reviewing rent factor applications, a methodology used to estimate a taxpayer's sales where records are inadequate for doing so.

6. After meeting with his section head, the auditor called Mr. Madden on September 7, 2007, requesting copies of leases, a certificate of occupancy, additional asset bills, utility bills for the period June 2006 to June 2007 and missing bank statements. Prior to receiving the information, however, he met with his team leader and Mr. Madden at the Division's Westchester District Office on September 11, 2007, and attempted to determine audited taxable sales and the tax due thereon using the differences between the sales reported on the federal income tax returns and the sales tax returns. At this meeting, Mr. Madden stated that he believed the resulting sales figures were too high.

7. Mr. Madden met with the Mr. Green at the District Office again on October 12, 2007, but no further sales documentation was produced, only copies of the leases were supplied. At this juncture, the auditor explained taxpayer rights, penalties and the appeal process, and noted Mr. Madden's stated belief that the sales reported on the federal returns may have been erroneous.

8. Based on the records produced by petitioners, the auditor determined that they were not adequate to perform a detailed audit and continued his calculation of gross sales for the audit period utilizing the rent factor. His choice of the rent factor as an indirect audit methodology was approved by the section head on November 26, 2007.

9. The rent factor used was a ratio of restaurant occupancy costs (rent, taxes and insurance) to total sales as calculated and published in the 2006-2007 Restaurant Industry Operations Report

published by the National Restaurant Association and Deloitte & Touche LLP and based on financial and operating data for 2005 as reported by 996 restaurant operators. The report presents operating results as amounts per restaurant seat and as ratios to total sales.

10. The auditor determined Mad Den's total sales using the aforementioned 2006-2007 Restaurant Industry Operations Report. He determined the occupancy costs for each of the years 2004, 2005 and 2006 by looking to the rent expense stated by Mad Den on its federal income tax returns for those years. Line 11 of the returns for 2004, 2005 and 2006 stated an annual rent expense of $78,493.00, $82,869.00 and $74,010.00, respectively, which the auditor divided by 12 to establish a monthly rent and then multiplied by 3 to arrive at a quarterly figure. The auditor made an adjustment for the months between October 2006 and January 2007, when the restaurant was closed for renovations. Each quarter was divided by the ratio, 7.9%, set forth in the 2006-2007 Restaurant Industry Operations Report for full service restaurants with average checks per patron of $25.00 and over for establishments in the upper quartile. The report defined the upper quartile as the boundary of the upper 25% of the responses for the category item from the lower 75%. The auditor chose the upper quartile percentage of 7.9 because it yielded the lowest number of gross sales, which he believed, from office experience in the Westchester District Office, best matched petitioners' business.

11. The auditor took the total of the three annual rent expenses, $208,843.00, and divided it by 7.9% to arrive at gross sales of $2,643,562.00. After allowing for reported gross sales of $445,796.00, additional gross sales were $2,197,766.00 for the audit period, yielding additional tax due of $151,255.15.

12. A Statement of Proposed Audit Change for Sales and Use Tax was issued to Mad Den, dated November 30, 2007, which set forth additional tax due of $151,255.15 plus penalty and

interest. However, subsequent to the issuance of this first statement, in March 2008, Mad Den filed amended sales tax returns for the period June 1, 2004 through May 31, 2007, that reflected an increase in taxable sales from the $445,796.00 originally reported to $1,004,867.00. This new total of gross sales, determined by Mad Den from credit card receipts, resulted in revised additional taxable sales of $1,638,715.00 for the audit period, or additional tax due of $121,534.09 plus penalty and interest. Mad Den remitted no tax payment with its amended returns.

13. Utilizing the new gross sales figures reported by petitioner on its amended sales tax returns, the Division issued a second Statement of Proposed Audit Change for Sales and Use Tax, dated March 8, 2008, setting forth additional tax due of $121,534.09 plus penalty and interest for a total due of $213,968.07. The statement was returned to the Westchester District Office on March 13, 2008 indicating Mad Den's disagreement with the tax, penalty and interest determined to be due.

14. The Division issued to Mad Den, Inc. a Notice of Determination, dated April 21, 2008, which asserted additional tax due for the period June 1, 2004 through May 31, 2007 in the sum of $121,534.09, penalty of $46,816.82 and interest of $46,589.99. Penalties imposed included both statutory penalty and additional penalty for underreporting in excess of 25% of the amount required to be reported. A second Notice of Determination was issued to Brian Madden on the same date for the truncated period March 1, 2005 through May 31, 2007, which asserted tax of $92,069.80, penalty of $35,031.38 and interest of $29,100.42, for a total due of $156,201.60.

15. The auditor, Arnold Green, represented the Division through the Bureau of Conciliation and Mediation Services conference on November 19, 2008, but retired prior to hearing. His team leader, Mr. Jethin Kanakkassery, appeared at the hearing in his place. However, as noted in Mr.

Green's field audit record, Mr. Kanakkassery only appeared at conferences with Mr. Madden during the audit on September 11, 2007 and January 10, 2008.

16. The lease for the premises at 2 Broadway, the Café Strega operated by Mad Den and Mr. Madden, was assigned to Mad Den on May 2, 1999 and specified monthly rents applicable to the audit period as follows:

June 1, 2004 - December 31, 2004	$4,573.39
January 1, 2005 - March 31, 2005	$4,573.39
April 1, 2005 - December 31, 2005	$4,710.59
January 1, 2006 - March 31, 2006	$4,710.59
April 1, 2006 - December 31, 2006	$4,851.91
January 1, 2007 - March 31, 2007	$4,851.91

17. The auditor's field audit record indicated that he was aware of the second lease for the premises at 6 Broadway in Pleasantville, New York, adjacent to the restaurant and ultimately used for expansion of the restaurant. The lease, provided to him pursuant to his request on October 12, 2007, was dated February 15, 2006 and stated a monthly rent of $1,465.22 for the period February 1, 2006 through January 1, 2007 (prior to completion of the renovations) and rent of $1,538.48 for the period February 1, 2007 through January 1, 2008.[2]

18. Although Mad Den signed a lease for the storefront at 6 Broadway on February 15, 2006, it began to rent the space on a month-to-month basis sometime in 2003 or 2004 with the intent of expanding its adjacent location at 2 Broadway (the existing Café Strega) when it had the capital to do so. It paid rent for the space in 2004 of $1,329.00 per month and $1,395.45 per month in 2005. The payments were made to Frances Beja by check. Frances Beja was the

[2]It is noted that the lease inexplicably omitted the month of January 2007.

president of Laured Realty Corp., the owner of 6 Broadway and also landlord of the property at 2 Broadway.

19. On September 30, 2006, Mad Den closed Strega to begin renovations for expansion of the restaurant. At the same time, Mr. Madden received an inquiry from John and Gina Vaccarino concerning the sale of the business, to which he was receptive.

20. On December 5, 2006, Brian Madden entered into a binding contract with the Vaccarinos for the sale of the restaurant business known as Strega for $300,000.00. Ten thousand dollars ($10,000.00) was paid to Mr. Madden at the time of the contract with the remaining terms to be determined by closing. However, the contract provided that Mr. Vaccarino, who undertook to complete the renovations to the property, would be credited with the cost of his work.

21. On March 19, 2007, Mr. Madden and the Vaccarinos signed an addendum to the contract that further delineated the terms and acknowledged the payment therewith of $50,000.00 by the Vaccarinos. The addendum also provided that all construction costs incurred by Mr. Vaccarino, to the extent substantiated by receipts, would be credited against the $300,000.00 purchase price. The closing was to take place after the Vaccarinos received a liquor license.

22. Neither Mr. Madden nor Mad Den operated the restaurant business at Strega after it closed for renovations on September 30, 2006, but the extent to which he or Mad Den continued to play a role in the business is not clear. When the expanded restaurant reopened in February of 2007, it was operated by the Vaccarinos.

23. The Vaccarinos operated Strega from February 2007 to sometime in the summer of 2008. During that period, they failed to undertake certain actions in performance of their duties under the contract, namely: they failed to apply for a liquor license; they failed to obtain an

assignment of the lease; and they failed to pay the balance of the purchase price. In addition, they removed items from the restaurant that belonged to Mad Den.

24. On September 20, 2010, after a jury trial in New York Supreme Court, Westchester County, Hon. Alan D. Scheinkman presiding, petitioners were awarded damages against the Vaccarinos for breach of their contract for the purchase of Strega in the sum of $216,875.00.

25. After the Vaccarinos began operation of Strega in February 2007, Mr. Madden's access to the restaurant was at first curtailed and then totally precluded. In particular, his access to the sales records that were ultimately produced at hearing was prohibited. Hence, as of the date the audit was commenced, Mr. Madden did not have access to the records. These records had been kept in the basement of 2 Broadway, the original restaurant location, and were moved on occasion to avoid hazards such as water damage.

26. During the period under audit, Mad Den had a point of sale system to track its sales. Orders were placed on one of two computer terminals and transmitted to the kitchen or the bar. There was only one cash register. The system also recorded payments. Only three managers were authorized to void or delete transactions: petitioner Brian Madden; Michael Madden, his brother; and Adrienne Godino. However, voided and deleted transactions were rare because they were usually caused by inaccuracies in orders or the input of incorrect table numbers, which were uncommon occurrences.

27. At the end of each night, the point of sale system generated a report, called the snapshot report, which indicated how many guests had been served, the total sales, breakdown of sales by category, a breakdown of sales by order number and a breakdown of the type of payment used. The category delineated order numbers reflected the actual checks for the evening along with the

name of the server. The snapshot reports were bundled with the guest checks, credit card receipts and other documentation and kept in boxes in the basement at the 2 Broadway location.

28. Despite retaining the snapshot reports, guest checks, credit card receipts and other documentation, Mad Den chose to prepare its original sales and use tax returns from bank statements, using a system of estimating gross sales from bank deposits. In March of 2008, during the course of the audit, Mad Den submitted amended returns for which it relied upon credit card receipts for the period June 1, 2004 through September 30, 2006. At this time, Mr. Madden had not regained access to the restaurant and his sales records.

29. It was not until the summer of 2008, when the Vaccarinos vacated the restaurant premises, that Mr. Madden regained entry into the basement and recovered the sales records, i.e., the snapshot reports, guest checks, credit card receipts and other sales documentation.

30. During the course of the hearing in this matter, petitioner submitted into evidence the snapshot reports, checks and credit card receipts for most of the audit period. However, discrepancies remained unresolved. For the quarter ended August 31, 2004, petitioner's original sales tax return set forth $74,187.00 in gross sales. Its amended return, dated March 13, 2008, set forth gross sales of $117,639.00. The snapshot reports for the same quarter indicated total sales of $188,813.72. Further, although Mr. Madden recollected that most sales were credit card sales, the section of the snapshot reports entitled "payment summary" on many of the reports indicated that a significant amount was cash sales. During the quarter ended August 31, 2004, $39,171.64 were cash sales.

SUMMARY OF THE PARTIES' POSITIONS

31. Petitioners argue that the Division's use of an estimated audit methodology produced an inaccurate or unreasonable tax liability for the audit period. Petitioners contend that their

production of sales records for the audit period establish that the estimated tax liability was incorrect and that they have carried their burden of proving the correct amount of tax due. In the alternative, petitioners believe that the Division erred in its use of the rent expense figure from the federal returns because that amount included rent for nonpatron space during the audit period.

Petitioners contend that penalties should be abated because they have demonstrated reasonable cause for their failure to properly report and pay the correct amount of tax due. Petitioners claim the flaws in their accounting caused their underpayment of sales taxes and that they have attempted to correct these flaws as witnessed by Mad Den's amended returns and subsequent explanation at the BCMS conference.

32. The Division counters that its use of an indirect, estimated audit methodology was proper given petitioners' failure to supply, upon its request, complete books and records, on which a detailed audit could be performed. Further, it contends that penalty should be sustained given the fact that petitioners did not attempt to properly report and remit sales tax during the audit period, choosing instead to estimate the sales tax due from available bank statements.

CONCLUSIONS OF LAW

A. Tax Law § 1105(a) imposes 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][A]). Tax Law § 1138(a)(1) provides, in relevant part, that if a sales tax return was 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 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. It is clear from the record that the Division made a proper written request for books and records on more than one occasion and then thoroughly examined what was produced. Unfortunately, those records fell woefully short of what would have been required to perform a full and detailed audit.

The Division mailed two appointment letters to petitioners, on June 25 and July 11, 2007, both with exhaustive lists of sales tax records it requested be produced for the period June 1, 2004 through May 31, 2007. In response, petitioners only produced copies of federal income tax returns, a check book, some bank statements and sales figures written on envelopes. Notably, no guest checks, receipts or other source documentation was available for review, and there was an obvious, large discrepancy between the gross sales listed on the federal returns and the sales tax returns filed.

Although there was some discussion between the Division and petitioners about using the differences between the federal returns and sales tax returns as a basis for an assessment, it was clear that the records produced made a detailed audit an impossibility. The Division made the decision to resort to an external index that it believed was reasonably calculated to reflect taxes due.

The rent factor, or the method by which occupancy costs are used to estimate a taxpayer's gross sales, is a method that has been considered by the Tax Appeals Tribunal on several occasions. In ***Matter of Your Own Choice, Inc.***, the Tribunal approved the use of a rent factor in conjunction with a publication entitled Cost of Doing Business - Corporations published by Dun & Bradstreet Corporation. In that case, the Division utilized the method to determine sales of a

convenience store, referring to the Dun & Bradstreet index and its own knowledge of a number of factors bearing on the volume of that petitioner's business, including its location in a commercial neighborhood with plenty of competition that served to reduce traffic in the store and the Division's inability to rule out that that petitioner's gross sales included Lottery commissions.

In ***Matter of Bitable on Broadway*** (Tax Appeals Tribunal, January 23, 1992, ***confirmed*** 199 AD2d 633 [1993]), the Tribunal approved the use of a rent factor in the absence of adequate records. In that case, the Division used a rent factor obtained from the National Restaurant Association's Restaurant Industry Operations Report for 1987, the same report used herein. In approving the use of the rent factor, the Tribunal concluded that it was sufficient for the Division to identify the statistical report on which its calculations were based since the report was publicly available and the taxpayer would thus be able to introduce evidence challenging the soundness or applicability of the report. The decision specifically distinguishes "those cases where the audit methodology is based on facts that are peculiarly within the knowledge of the Division, e.g., audits of similar establishments, where the Division has the obligation to describe these facts in response to the petitioner's inquiries at hearing (***see Matter of Basileo***, Tax Appeals Tribunal, May 9, 1991)." (***See also Matter of Abbasi***, Tax Appeals Tribunal, June 12, 2008.)

D. Application of the rent factor in this matter, based upon the 2006-2007 Restaurant Industry Operations Report published by the National Restaurant Association and Deloitte & Touche LLP, using financial and operating data for 2005 as reported by 996 restaurant operators, was appropriate given the report's acceptance by the Tribunal and its use in many other cases where the Division was faced with a lack of records to perform a detailed audit. Further, petitioners have not raised any objections to the index per se, only the fact that the resulting tax liability did not appear to be accurate.

Accuracy is not a requirement imposed on the Division when it is forced to rely on estimated audit methodologies due to a taxpayer's failure to produce adequate books and records. (***Matter of Markowitz v. State Tax Commn***.) However, there are two adjustments to the application and results of the estimated methodology that are warranted. The first involves the occupancy cost used by the Division in its calculation of petitioners' gross sales and the second is the length of the audit period in light of petitioners' sale of the restaurant business.

With respect to the occupancy cost used by the Division, it utilized the rent expense listed on Mad Den's federal income tax returns for the years 2004, 2005 and 2006. However, the auditor was provided with the lease for the premises at 6 Broadway and was aware from conversations with Mr. Madden that the restaurant had been closed for the period October 2006 to February 2007 in order to expand the restaurant. It is also clear that he knew the space at 6 Broadway was vacant or solely used for storage prior to that time. In addition, although the Division argues that Mr. Green was not aware that Mad Den leased 6 Broadway throughout the audit period, Mr. Madden's account of his conversations with the auditor and the lease for 6 Broadway, which was executed a year before occupancy, should have alerted Mr. Green to the fact that the federal rent expense figure included more than the occupancy costs for 2 Broadway and was not accurate for purposes of projecting sales using the 2006-2007 Restaurant Industry Operations Report.

The auditor's own report indicated that he knew the restaurant had more than doubled in seating capacity after the renovation and that seating capacity was central to the projection of gross sales in the Restaurant Industry Operations Report. The data collected by the National Restaurant Association regarding full service restaurants with average checks per person of $25.00 and over speaks to median values for food and beverage sales *per seat* and total sales *per*

square foot. Further, of the restaurants responding to the survey, 73% had fewer than 200 *seats*. The focus on seating in the report mandates that the Division utilize an occupancy expense that accurately represents the establishment to which it wishes to apply a rent factor.

However, when presented with evidence that the seating at Café Strega had doubled and that the lease for 6 Broadway was in effect a year before occupancy, the auditor chose to ignore the possibility that 6 Broadway was not occupied or used as patron seating for, at the very least, part of the audit period, especially since the rent expense figures he took from the federal returns were fairly consistent for 2004, 2005 and 2006. If petitioners had not been leasing both premises for all three years, there should have been a spike in rental expense in 2006. Since that did not occur, the prudent investigator would have questioned the pattern. Instead, the auditor did not investigate whether Mad Den had rented the space prior to signing the lease with full knowledge that the rent factor would determine sales based on an erroneous occupancy cost that distorted two factors the Restaurant Industry Operations Report relied heavily upon: seating capacity and square footage.

Mr. Madden credibly testified that he had begun renting the space at 6 Broadway prior to the audit period with an eye towards expanding the restaurant when he had the capital to do so. He presented checks paid to Laured Realty and Frances Beja to buttress this testimony. The space at 6 Broadway was not utilized as part of the restaurant until February 2007, at which time it began contributing to the seating capacity and earnings potential of Café Strega. Seating capacity as representative of earnings potential is the essence of utilizing occupancy costs to project gross sales. Until 6 Broadway was incorporated into the restaurant operations its

occupancy expense had no bearing on gross sales. For this reason, the Division is directed to recompute Mad Den's gross sales using only the occupancy costs for 2 Broadway.[3]

E. The Division's claim that it did not have knowledge of the sale of the business is neither genuine nor credible. It is true that Mr. Green did not note the sale or the fact that the restaurant was operated by someone other than Mr. Madden. However, he never mentioned in his log or report that he ever attempted to observe the operations of the business, from which Mr. Madden had been divorced since September 30, 2006. Mr. Madden credibly testified that he had sold the business to the Vaccarinos and produced the two executed contract documents that expressed the parties' desire to sell and purchase the business for $300,000.00. The contract also noted that the Vaccarinos would be credited with substantiated expenditures incurred by them in the renovation of the restaurant, which included the expansion of seating.

The court documents, including the jury verdict rendered after seven days of trial in Westchester County Supreme Court, support the fact that the business was sold pursuant to a valid contract that was subsequently breached. Further, Mr. Madden credibly testified that when the Vaccarinos began operating the restaurant or shortly thereafter, he was prohibited from entering the premises and using the computer system. Therefore, it is determined that Mad Den transferred the business operations to the Vaccarinos in December 2006. However, Mad Den and Mr. Madden ended their operation of Café Strega as of September 30, 2006, when it closed for renovations. The Division is directed to recompute the tax due as a result of its estimated audit methodology to reflect this change in the end of the audit period.

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[3]Since the occupancy costs for 6 Broadway are not apparent from the record, the Division is directed to subtract the known monthly rent amounts for 6 Broadway listed in Finding of Fact 18 from the monthly occupancy cost it calculated using the federal rent expense.

F. At hearing, petitioners submitted what they represented to be accurate records of all sales made by Mad Den at the Café Strega during the audit period. These records contained a snapshot or summary of each day's sales, the guest checks for each order and a credit card receipt where the sale was charged to a credit card. After reviewing the records submitted for the quarter ending May 31, 2005, the Division concluded that the totals on the snapshots did not match the sales invoices (guest checks); that credit card information was missing in snapshot reports; that voided sales were missing from the snapshots and daily receipts; that lunch sales were sporadically reported; total guests listed on the snapshots and guest checks differed; that the snapshots were missing pages; and guest checks produced could not be tied into any other documentation received on audit.

My own detailed review of the quarter ended August 31, 2004, the first quarter in the audit period revealed similar discrepancies, which deem the records unreliable and their acceptance for purposes of proving petitioners' true tax liability for the audit period impossible.

Total sales for the quarter ending August 31, 2004 as listed on the snapshot reports were $188,813.72. The snapshot reports often reported sales on Sundays and Mondays, even though Mr. Madden stated that the restaurant was closed on those days during the audit period. Of the total sales reflected on the snapshots, the reports listed cash sales of $39,171.64, a fact that Mr. Madden disputed in his testimony, saying that almost all sales were credit card sales. This raises the distinct possibility that cash sales were not accurately accounted for or, at the very least, were without a valid audit trail and not subject to internal controls.

The sales total is startling considering that Mad Den's original sales tax returns for the same quarter reported gross sales of $74,187.00 and its amended return listed only $117,639.00. Further, Mad Den's federal income tax return for the year 2004 stated gross sales of $703,904.00,

underscoring the Division's concern about the discrepancy between Mad Den's sales reported on its sales tax returns and federal income tax returns. A simple extrapolation of the quarterly sales for the quarter ended August 31, 2004 from the snapshot reports indicates a yearly figure more in line with the federal returns.

Given these substantial discrepancies, the records submitted are not deemed accurate or adequate to substantiate what petitioners urge is their true tax liability for the audit period. In fact, petitioners never utilized the snapshot reports or the underlying guest checks and other documentation to reconstruct accurate sales tax returns for the entire audit period, believing in error that merely submitting voluminous documentation would carry their burden of proof.

G. Having concluded that the Division properly utilized an estimated audit methodology and that petitioners were unable to demonstrate that the results were erroneous, it must be determined if petitioners have established reasonable cause to abate the penalties imposed. Tax Law § 1145(a)(1)(i) provides for penalty to be imposed where a person fails to pay over tax within the time required by law. Tax Law § 1145(a)(1)(vi) provides for an additional penalty when tax is understated by more than 25 percent. The Division assessed penalty under these sections. Tax Law § 1145(a)(1)(iii) and (vi) provide that the Division can remit the penalty if the failure to pay over the tax was due to reasonable cause.

In establishing reasonable cause for penalty abatement, 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 said 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 Telecommunications Corp.***, Tax Appeals Tribunal, January 16, 1992.) In the instant matter, petitioners neither maintained nor

produced records as required when requested on audit. However, at hearing, petitioners demonstrated that Mad Den did have a point of sale computerized recordkeeping system that generated daily snapshot summaries for each day of operation. These reports were maintained with guest checks and other sales documentation that petitioners contend accurately reflected their sales tax liability. Notwithstanding the availability of these records, petitioners have not put forward a valid reason for not using them when filing their original returns. Inexplicably, petitioners ignored these records and used bank statements to estimate their original returns and credit card receipts to estimate their amended returns. Neither of these methods came close to the gross sales they claimed on their federal income tax returns filed during the audit period or the sales reflected on their own snapshot for the quarter ended August 31, 2004. The result was a substantial discrepancy between reported sales and audited sales as evidenced by the tax paid with the returns during the audit period and the tax found due as a result of the audit. For all of these reasons, penalties must be sustained.[4]

H. The petitions of Mad Den, Inc., and Brian Madden are granted consistent with Conclusions of Law D and E above, but in all other respects the petitions are denied and the notices of determination, dated April 21, 2008, are sustained.

DATED: Troy, New York
September 22, 2011

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

[4]Imposition of the penalty under Tax Law § 1145(a)(1)(vi) will be determined after recomputation of the tax as directed in Conclusions of Law D and E above. If still warranted, it should be imposed.