STATE OF NEW YORK

DIVISION OF TAX APPEALS

In the Matter of the Petitions	:	
of	:	
J. SAHANTADAM, INC. AND JOHN GORMEL	:	ORDER DTA NOS. 823328 AND 823329
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, 2005 through May 31, 2008.	:	

Petitioners, J. Sahantadam, Inc., and John Gormel, 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, 2005 through May 31, 2008.

On July 13, 2012, Administrative Law Judge Catherine M. Bennett issued a determination that granted the petitions of J. Sahantadam, Inc., and John Gormel as to the sales and use tax assessed, and cancelled the Notice of Determination issued to J. Sahantadam, Inc., dated September 2, 2008, and the Notice of Determination issued to John Gormel dated September 15, 2008, except for the portion of the assessment on capital and expense purchases conceded by petitioners.

Petitioners, appearing by Amigone, Sanchez & Mattrey LLP (B.P. Oliverio, Esq., of Counsel), brought an application for costs under Tax Law § 3030 on September 7, 2012. The Division of Taxation, appearing by Amanda Hiller, Esq. (Lori P. Antolick, Esq., of counsel), filed an affirmation in opposition to the application by its due date of October 8, 2012, which date began

the 90-day period for issuance of this order. Notice was provided to the parties of a 60-day extension for the issuance of this order.

Based upon petitioners' application for costs, the Division's affirmation in opposition, the determination issued July 13, 2012, and all pleadings and proceedings had herein, Catherine M. Bennett, Administrative Law Judge, renders the following order.

ISSUE

Whether petitioners are entitled to an award of costs pursuant to Tax Law § 3030.

FINDINGS OF FACT

1. Petitioners, J. Sahantadam, Inc. and John Gormel, operate a restaurant named The Retreat located in Liverpool, New York. John Gormel has been in the restaurant business since 1972. He purchased a former soda shop and turned it into a tavern known as The Retreat, occupying approximately 600 square feet. With various additions over 39 years, it is now a restaurant and bar business, occupying approximately 6,500 square feet, in a building owned by Mr. Gormel. The Retreat's sole shareholder is John Gormel, and his liability as its responsible officer is conceded by petitioners. The business was incorporated in New York State on August 5, 1985.

2. The Retreat has an American food menu, multiple rooms for seating and two bars, one inside the premises and one located outside, which is open seasonally. The restaurant seats 184 patrons, including seats at the bar, during the time when the outdoor patio is not open, and 244 during the warmer weather when the patio is open. The restaurant was described as a casual family restaurant, with the average dinner price at approximately $15.00. At any one time, the restaurant has about 25 wait staff and bartenders, with a few of them working full time. The restaurant has an older customer base and is not a late-night location.

3. The Division contacted The Retreat by correspondence dated February 4, 2008, for the purpose of scheduling an appointment for a sales tax field audit of its records for the period March 1, 2005 through December 31, 2007. Attached to the appointment letter was a Records Requested List, which set forth all of the books and records that were required to be made available for the audit.

4. The Division's first appointment with petitioners was on April 24, 2008. The auditor was provided boxes of invoices for capital purchases, depreciation schedules, the general ledgers, sales tax returns, sales invoices for exempt sales and corresponding exemption documentation, fixed asset purchase information, bank statements, and a disbursements journal. At the meeting the auditor identified the following documents that were needed for review: any and all point-of-sale reports, source documentation, and original guest checks for the audit period. The Division explained its need to review guest checks and cash register tapes, referred to as the "source documentation," in order to verify that all the sales were recorded in the general ledger, and ultimately reported on The Retreat's tax return. The Division sought to verify that the documents were sequentially numbered and that there were no missing guest checks.

5. During most of the period subjected to audit, petitioner had its original point-of-sale (POS) system in place. It was a digital dining program designed primarily to transfer the orders from the dining room into the kitchen. In or about January 2008, petitioners' new POS system replaced the old one. Under the new system, all orders must go through the computer system to the bartender or to the kitchen, or they do not get processed in order for the customers to be served. By the commencement of the audit, The Retreat had this more sophisticated POS system in place. When the Division requested to review petitioners' guest checks and cash register tapes

for the entire audit period, the Division was informed by petitioners that these items were not maintained, but instead petitioners had prepared a daily summary by server. The daily reports from petitioner's POS system were transcribed onto a handwritten daily summary, and the original documents were destroyed. The only records that were maintained for some period of time were the credit card transactions, which were maintained for a period of 18 months. Petitioners provided the Division with a year's worth of the daily handwritten sheets covering nearly all of 2007.

6. On or about July 22, 2008, the Division issued a subpoena to petitioners to request the production of guest checks and cash register tapes for the entire audit period, as well as detailed transaction POS reports from the POS system for the full audit period, at the Sales Tax Unit in Syracuse, New York, on July 30, 2008. The Division did not receive the records requested in accordance with the demands of the subpoena.

7. The Division updated and amended the original audit period to cover 39 quarters, from March 1, 2005 thorough May 31, 2008.

8. The Division's auditors asked to perform a test-period audit on a period after the audit period. Petitioners' representative provided detailed guest checks and other documents for a two-week period covering the end of July 2008 and the beginning of August 2008. Petitioners' bookkeeper provided the auditors with all the pertinent documents. The auditors briefly reviewed the information at the office of Mark Hettler, petitioners' CPA, and, after a couple of hours, did not attempt to perform a test-period audit and concluded the records were inadequate because the guest checks were not in sequential order. This was the only reason provided by the auditors for determining the records to be inadequate.

9. Once the auditor determined that there was inadequate source documentation to verify petitioners' sales for the audit period with a detailed audit, the auditor considered other audit methods. An observation test was considered but dismissed after the auditor noted that the size of the business, the layout of the POS terminals and the number of areas that would need to be under observation would not only be difficult for the Division's auditors, but likewise, be intrusive to petitioners' business operations. A markup test was considered, but not used, because the Division could not determine how the cost of goods sold was calculated by petitioners, and because the Division believed petitioners commingled purchases of The Retreat and The Cobblestone, Mr. Gormel's other bar.

10. After Mr. Tienken, the Division's auditor, determined that he could not calculate the correct amount of sales tax due without the source documentation and dismissed the use of an observation or markup test, he resorted to the Almanac of Business and Industrial Financial Ratios, 2008 Edition (the almanac), to identify different ratios that might be used to estimate the sales tax due for the audit period. The auditor explained that he chose the almanac because it summarized information from 243,000 businesses, and banks and lending institutions use the information contained in the almanac as a benchmark, upon which lending is based. He claimed to have identified the type of business in the almanac, then identified various ratios that would apply to this business, and determine the estimated sales tax due from the vendor. The auditor chose the data to be used by first identifying the category most like petitioners' principal business activity. The table he chose was entitled Food Services and Drinking Places (#722115), and the auditor narrowed his choice within this business category to the factors contained specifically in Table I from the almanac, which represented "Corporations with and without Net Income," and

from Table I, compared petitioners' restaurant to those with assets ranging from $1,000,000.00 to $5,000,000.00. Also, under the business category entitled Food Services and Drinking Places, there existed Table II, which represented "Corporations with Net Income." This table was not used by the auditors in any of their computations of estimated sales, but was referred to by the parties at various times.

11. During the period in issue, The Retreat had assets ranging from $1,043,919.00 to $1,463,722.00, and net income of $49,597.00, $84,581.00, $147,183.00 and $208,134.00 for the years 2004 through 2007, respectively. At the time the auditor chose Table I, the 2007 return had not yet been filed; however, the years 2004, 2005 and 2006 showed a net income. The auditor chose Table I, Corporations with and without Net Income, when calculating petitioners' estimated sales, because he did not know whether there would be income or loss for the business in the year 2007.

12. At the time Mr. Tienken calculated petitioners' estimated sales, he estimated the actual operating margin for 2007 because it was not yet available to him. As a part of his calculations, he assumed that, on the basis of federal tax returns for 2004, 2005 and 2006 showing net profit, 2007 would result in a similar growth pattern and profit, and, accordingly, calculated an estimated operating margin for 2007 in the amount of $253,560.00. For his estimated calculation of officers' compensation for 2007, Mr. Tienken took an average of the three prior years.

13. The Retreat's tax returns for 2007 were filed and available, and revealed actual net income from The Retreat in the amount of $208,134.00, the Division's auditors did not alter their choice of the almanac table from which the indices were applied, or recalculate the tax due using the actual amount.

14. Mr. Tienken, the auditor, examined five indices from Table I of the almanac and compared them to the information he had gathered from petitioners' records. The first was officer wages, which Mr. Tienken dismissed as a good choice by explaining that The Retreat has only one shareholder, who also derives income from other sources. The next index considered was wages, and this was dismissed as a good index to use because the auditor believed that the restaurant industry is notorious for underreporting wages, and he did not believe he could place his confidence in wages being accurately reported. Mr. Tienken did not recall whether he asked petitioners for the information necessary to determine proper wages and did not recall whether in making a determination not to utilize wages he reviewed payroll or other records.

Next, Mr. Tienken considered an index that utilized rent paid, and this index too was disregarded as invalid. He explained that since the building is owned by Mr. Gormel, who is also the owner of The Retreat, he is effectively paying himself rent, and that number could easily be inflated, reducing the actual wages he would pay himself, and would not be an accurate representation of the business. The fifth index that Mr. Tienken considered but disregarded was one dealing with the cost of goods sold. He could not determine how petitioners calculated cost of good sold on their federal return, he was unsure if catering fees were included, was unable to determine if cash purchases were being reported, and he could not determine what was being sold and in what portions due to the lack of guest checks.

The last index, operating margin before officers' compensation, was the index used to estimate petitioners' revenues. Edward Martorana, the audit supervisor, indicated that he directed the use of this index because he believed it essentially represents the profit of a single-owner business and would be a conservative approach to the estimate.

15. At some point during the audit, in an attempt to broaden his horizons with respect to ratios that might be used to estimate petitioners' sales, Mr. Tienken located a professional article by Richard Williams, a restaurant industry expert and president of HVS Food and Beverage Services, where the relationship between gross sales and rent paid was discussed. Mr. Tienken contacted Mr. Williams for his advice concerning this case in order to determine a rent factor for 2008, expressed in terms of a percentage of gross sales, that might be applied herein. The response was that the rent factor usually falls between 5% and 8% for a business of this kind. Petitioners' rent paid for the years 2004 through 2007 was consistently 6.9% to 7% of sales. Despite the fact that the percentages fell within the suggested range, the auditor dismissed their usefulness since the building was owned by the owner of the business, and he believed it may not represent fair market rent.

16. On or about April 29, 2008, petitioner J. Sahantadam, Inc., executed a consent extending the period of limitations for assessment of sales and use taxes for the period March 1, 2005 through August 31, 2005, until September 20, 2008. On or about May 21, 2008, petitioner John Gormel executed a consent extending the period of limitations for assessment of sales and use taxes for the period March 1, 2005 through August 31, 2005, until September 20, 2008.

17. In order to calculate The Retreat's estimated sales, Mr. Tienken first examined its federal returns for the years 2004 through 2006 and determined the operating margin before officer's compensation (OMBOC). For 2007, Mr. Tienken calculated an estimated operating margin using the percentage of growth and profit margins from the previous three tax years. He applied the 4.9% index corresponding to the operating margin before officer's compensation on Table I of the almanac to the OMBOC from the returns or as calculated (for 2007) to achieve

estimated sales. His calculation for 2004 included only the seven months (3/1/05 to 9/30/05) contained in the audit period, and the calculation for 2007 included only the eight months (10/1/07 through 5/31/08) contained in the audit period. Finally, the auditor subtracted from the estimated sales figure the amount of sales tax that was reported and paid by petitioners for the years in issue. This resulted in underreported estimated sales in the amount of $6,658,106.88[1] and additional sales tax due in the amount of $533,117.58.

18. The auditor performed a review of The Retreat's capital records and expense purchases during the audit, and determined there were additional taxable items for which sales tax had not been remitted. The amounts assessed for both capital records and expense purchases, $1,147.20 and $19,111.11, respectively, were conceded as owed by petitioners.

19. The Division issued Notice of Determination, Assessment No. L-030621765-4, dated September 2, 2008, to petitioner J. Sahantadam, Inc., assessing additional sales and use taxes in the amount of $553,375.89 plus penalty and interest for the tax period March 1, 2005 through May 31, 2008. This represents tax determined on The Retreat's sales, capital expenditures and expense purchases. The amount that remained in issue was $533,117.58, plus penalties and interest, representing tax due on sales. The Division issued Notice of Determination Assessment No. L-030651205-8, dated September 15, 2008, to petitioner John H. Gormel, as an officer or responsible person of J. Sahantadam, Inc., assessing the same additional sales and use taxes for

[1] This amount is $9,500.00 greater than the result calculated in the audit work paper that was reviewed in detail at the hearing. No explanation is provided for the discrepancy. However, there is no dispute as to the final corresponding sales tax assessed based upon sales. Other work papers and some of the discussion during the hearing made reference to $6.9 million as the underreported estimated sales. This amount appears to include an additional month ending 6/30/08 that was never assessed. During the hearing, the auditor confirmed that the audit period ended with 5/31/08.

the tax period March 1, 2005 through May 31, 2008, based on the same computations as those forming the basis for the assessment against the business.

20. Guy Hibbert, Adam Gormel and Wynonna McGarry, all long-time employees of The Retreat, provided credible testimony at the hearing that given the size of the restaurant, the ordering they were responsible for, and the number of staff available, it was not feasible for the business to have sustained the increased amount of sales suggested by the audit results. Their duties, separated for internal control, were set forth in great detail at the hearing. The Division's auditors did not speak directly with these individuals about their roles with The Retreat.

21. Petitioners provided photos of the restaurant, its cold storage, freezer and dry goods space, in addition to the kitchen area. The Division's auditors did not request to see, nor did they review, the space in these areas.

22. Mr. Gormel paid interest to The Retreat in amounts of approximately $20,000.00, $29,000.00 and $37,000.00 a year during the years 2005 through 2007, respectively, on money he borrowed from the corporation, according to his CPA, Mr. Hettler. When the Division's audit calculations were performed, the interest income was not taken into account. Mr. Hettler calculated the affect this had on the Division's computation, since the interest income would affect the use of the Almanac's operating margin before officer's compensation. He determined that using an annual average of $30,000.00 of interest paid, not having taken this into account would overstate the sales calculated by approximately $612,000.00 for each year of the audit, or approximately $2 million dollars for the audit period.

23. Mark Hettler, the CPA who has assisted petitioners with accounting matters for the past 32 years, testified as to intimate familiarity with petitioners' facility, operations and tax

returns. In the course of his involvement with this matter, Mr. Hettler was familiar with the material petitioners provided to the Division. After the assessment was made against petitioners, Mr. Hettler had a chance to review the Tax Field Audit Record and the Field Audit Report. In preparation for the hearing in this case, Mr. Hettler undertook an audit of the petitioners' sales for the period October 11, 2010 to October 17, 2010. His report, entitled "Independent Accountant's Report on Applying Agreed-Upon Procedures" represented the steps he took to analyze The Retreat's records for the one-week period and an agreement between the CPA and John Gormel as to the enumerated procedures that were followed in doing so. Mr. Hettler collected the daily guest checks from petitioners for one week, and by server, and listed them on a spreadsheet. The spreadsheet was reconciled to the daily summary that is printed from the POS system for the same time frame. Since petitioners also create a hand-posted daily summary, the daily summary printed from the system was compared and reconciled to the hand-posted daily summary. Totals from the daily summary that represent cash and credit card amounts were compared to cash and credit card postings on the bank statements. The deposits on the bank statements were then traced to petitioners' general ledger for the corresponding month. Those monthly numbers were then traced to petitioners' sales tax report for the month. Any discrepancies found by Mr. Hettler were classified by him as "very immaterial" and in some cases, merely differences of cents. The final step in Mr. Hettler's analysis was to trace and verify that all the guest checks were accounted for each day. The guest checks are in sequential order at the time a customer enters and the check is opened. However, they do not necessarily remain in numerical order as they are listed on the daily register tape, because the daily summary lists the guest checks in the order they are closed or cashed out. Every guest check in the numerical

sequence could be located and was accounted for in this analysis. After spending several days working on this analysis, Mr. Hettler concluded that petitioners' POS system was a system able to be audited.

24. The sales for the week that Mr. Hettler analyzed the POS system were approximately $67,000.00, which if equated to an annual amount, would result in annual sales of slightly less than $3.5 million. He compared this amount to the annual sales figures on The Retreats' federal tax returns for 2004, 2005 and 2006, where the reported sales were approximately $3.3 million, $3.6 million and $3.9 million, respectively.

25. Mr. Hettler recalled interacting with the Division's auditors with respect to the test period audit that they were going to conduct in August 2008, and confirmed that the 2008 test period used by the Division would have involved the exact same information that he had available to him during the week of testing that he performed in October 2010, including all the tapes with the copies of the guest checks. He stated that the Division never completed the test-period audit, and after a less than two-hour review, concluded that they would not complete it because in examining the cash register tapes, the guest checks were not in sequential order. The Division did not seek assistance from Mr. Hettler to explain any aspects of petitioners' records on the day of this review.

Mr. Hettler's overall conclusion was, based upon his knowledge and interaction with petitioners and his access to their books and records, that it was not possible for an additional $6.6 million in sales to exist compared to what had already been reported. He also firmly stated that petitioners' records were sufficient for the Division to conduct a detailed audit using petitioners' records.

26. A hearing before an administrative law judge was held on March 30 and 31, 2011, at which time petitioners presented a great deal of testimony by employees, its CPA and a sales tax specialist, David Gross. Petitioners maintained their position that they had adequate books and records for a direct audit, and that given the POS system and the controls in place, petitioners had maintained an audit trail that could have been utilized by the Division. Thus, they argued, the use of a methodology based upon an external index was improper. In addition, petitioners argued that the methodology used was not reasonably calculated to reflect the correct tax due from the corporation.

The Division maintained it was authorized to estimate sales tax due, that the audit methodology was reasonable, and petitioners had not adequately sustained their burden of proof that the audit was unreasonable and the results erroneous.

27. On July 13, 2012, a determination was issued by Catherine M. Bennett, Administrative Law Judge. It was concluded that petitioners did not provide actual guest checks or cash register tapes from the original POS system for the audit period as required. Though a post-audit period sample analyzed by Mr. Hettler led him to conclude that petitioners' records were in auditable condition, and should have served to eliminate any estimates by the Division, the Division was not under any obligation to use records outside the audit period to satisfy the question as to whether petitioners were remitting proper amounts of sales and use taxes. Thus, having determined that petitioners did not provide sufficient sales records for the audit period to enable the auditors to perform a detailed audit, the determination found that the Division was within its rights to resort to an estimated audit methodology to determine if petitioners had properly remitted sales and uses taxes for the audit period. The only questions presented in this matter

were whether petitioners had established that the audit methodology employed was unreasonable and whether the amount of tax assessed as the result of the application of the method used was erroneous.

The determination reviewed the standard for reviewing a sales tax audit where external indices were employed. In addition, the determination specifically scrutinized the 2008 Edition of the Almanac of Business and Industrial Financial Ration, Food Services and Drinking Places category, Table I Corporations with and without New Income, and the Operating Margin before Officer's Compensation factor of 4.9%. These indices were used to determine petitioners' estimated sales, and the determination reviewed whether the methodology resulting from the use of those indices was reasonably calculated to reflect the taxes due, and whether the results derived therefrom were erroneous. The determination concluded that the use of the almanac from which the indices were taken to perform the estimate was a rational approach to estimating sales absent complete records. However, citing ***33 Virginia Place*** (Tax Appeals Tribunal, December 23, 2009), it was found that the manner in which the almanac was employed bore fatal flaws that did not result in a methodology reasonably calculated to reflect taxes due, and thus, erroneous results. The determination contained the following discussion:

> In this case, the Division choice [sic] of the use of the almanac and the business category within the publication, entitled " Food Services and Drinking Places," were well-reasoned choices. However, . . . what decisions the Division made from this point forward did not illustrate a methodology reasonably calculated to reflect the taxes due and, accordingly, the results derived therefrom were erroneous. Within the Food Services and Drinking Places business category, there were two tables available to the Division; Table I depicted Corporations with and without Net Income; and Table II set forth comparative data for Corporations with Net Income. At the time the auditors were choosing which table to use, the information available to them consisted of three of the four tax years that were all or part of the subject of this audit. Tax years 2004 through 2006 showed reported net income of $49,597.00, $84,581.00 and $147,183.00,

respectively. When the auditors were estimating net income for 2007, in order to compute estimated operating margin before officers compensation, they made a valid assumption and projected that petitioners were likely to also have a profit in 2007, based upon petitioners' growth pattern of the three prior years . . . . But even having projected net income for 2007, the auditors ignored the use of Table II to be applied to Corporations with Net Income, and instead used the indices in Table I, those meant for Corporations with and without Net Income, resulting in a much higher calculation of estimated sales. The reason that the auditor's [sic] gave for choosing Table I over Table II was because the 2007 return had not been filed at the time the computations were being made. Clearly the choice of Table I was not consistent with the Division's assumption that petitioners' would have a net profit margin for 2007. Even after the filing of the 2007 return, where petitioners' reported actual net income of $208,134.00, the Division never altered its choice of table used in the computation, or its methodology in any manner. The Division's actions were not merely inconsistent, but clearly in error, and the Division failed to articulate a reasonable explanation for its choices. The auditor's choice of Table I over Table II was a significant part of the methodology used, and it contributed to a conclusion that the manner in which these indices were used resulted in an audit methodology that was not reasonably calculated to reflect the taxes due by petitioners. This was the first of several fatal flaws in the Division's estimated calculations, though notably the most significant.

* * *

Even after the estimated sales computation, had the Division's auditors performed some due diligence, this distortion would have even been more obvious. However, none was done. For example, the Division's research on the rent factor showed that for a business of this type and size, the industry expert indicated the rent should fall between 5% and 8% of gross sales. Consistently, for all the years in issue, petitioners' corporate rent was between 6.9 and 7% of its gross sales. However, although Mr. Tienken testified that he did take this information info consideration, he eventually chose to ignore this factor, even though it was a strong indicator that petitioners' reported sales were in line with a company in this industry with these amounts of reported rent paid.

The Tax Appeals Tribunal has stated, "[w]hile it is advisable to do so, auditors are not required by law to confirm the reasonableness of the results of their chosen methodology" (***Matter of 33 Virginia Place***). However, the failure to do so has proven fatal (***id.***), and certainly would have shed valuable light on the estimated results in this case. The Division could have easily determined how unreasonable an additional $6.6 million of sales over the audit period was in relation to the size of kitchen space, food storage space, geographic location, traffic, number of servers, chefs and bartenders. Another test of reasonableness that was completely ignored by the Division is Mr. Hettler's analysis. Though his detailed review took place two years after the audit, the Division's auditors had the same records used by him available to them in August 2008, two months after

> the end of the audit period. Prematurely, the auditors dismissed the usefulness of those records. The Division may not have been obligated to use test period records to estimate petitioners' sales for the assessment in this case, but once they had records that could have provided some indication as to the level of sales being produced by petitioners', it was error by the Division not to at the very least use those sales records from the test period as a guideline or benchmark of petitioners' sales, and compare it to its calculated result.
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> In summary, the Division simply did not meet its obligation to chose an [*sic*] method that is reasonably calculated to reflect the taxes due, and it further failed to test whether its resulting estimated sales were remotely reasonable. When the Division fails to meet its obligation in this regard, and the estimates of petitioners' sales are so skewed that a calculation of taxes due cannot possibly be reasonably calculated, the assessment must be cancelled (***Matter of 33 Virginia Place***). Accordingly, the assessments against both The Retreat and John Gormel, except as modified [as to amounts conceded by petitioners], are cancelled.

28. Petitioners' September 7, 2012 application for costs seeks an award of costs in the amount of $200,770.03, consisting specifically of the following items:

a) $152,690.25 for attorney's fees and disbursements in the following amounts:

i. Amigone, Sanchez & Mattrey, LLP	$86,859.50
ii. Magavern, Magavern Grimm LLP	$50,489.50
iii. Hancock Estabrook	$ 7,151.25
iv. Amigone, Sanchez & Mattrey, LLP	$ 8,190.00

b) $40,960.00 for expert witness services in the following amounts:

i. Sales Tax Solution and Consulting (D. Gross)	$ 3,275.00
ii. Mark P. Hettler, CPA	$37,685.00

c) $7,119.78 disbursements associated with the matter in the following amounts:

i. Amigone, Sanchez & Mattrey, LLP	$ 1,451.19
ii. Magavern, Magavern Grimm LLP	$ 5,618.59
iii. Amigone, Sanchez & Mattrey, LLP	$ 50.00

29. Accompanying petitioners' application for costs was the affidavit of petitioner John Gormel attesting to the payments of the fees and administrative disbursements, that The Retreat's

net worth was less than $7 million at the time the proceeding was commenced, remaining under $7 million at all pertinent times, and that the company had substantially less than 100 employees. Attached to the affidavit were voluminous invoices representing the legal fees, expert fees, and disbursements paid, the balance sheet as of September 30, 2009 and income statement of Sahantadam, Inc., for the year ended September 30, 2009, in addition to its balance sheet as of July 31, 2012, and the income statement for the year ended July 31, 2012. Also attached was a chart of the consumer price index for years 1997 through 2012.

30. Petitioners made a request that the full cost of legal services be reimbursed on the basis that Tax Law § 3030 was enacted in 1997, with a significant increase in the cost of living since that time, and there are a limited number of attorneys, consultants and experts sufficiently versed in litigating the sales tax matter of a food service business before the Division of Tax Appeals.

SUMMARY OF THE PARTIES' POSITIONS

31. Petitioners maintain that they are the prevailing parties and should be awarded the full amount of the costs they are seeking.

32. In opposition to petitioners' application, the Division maintains that petitioners' application for costs should be denied because the Division's position in this matter was substantially justified, that the litigation and administrative costs sought to be recovered by petitioners are unauthorized and unreasonable.

CONCLUSIONS OF LAW

A. Tax Law § 3030(a) provides, generally, as follows:

> In any administrative or court proceeding which is brought by or against the commissioner in connection with the determination, collection, or refund of any tax, the prevailing party may be awarded a judgment or settlement for:

> (1) reasonable administrative costs incurred in connection with such administrative proceeding within the department, and
>
> (2) reasonable litigation costs incurred in connection with such court proceeding.

Reasonable administrative costs include reasonable fees paid in connection with the administrative proceeding, but incurred after the issuance of the notice or other document giving rise to the taxpayer's right to a hearing (Tax Law § 3030[c][2][B]). The statute also provides that fees for the services of an individual who is authorized to practice before the Division of Tax Appeals are treated as fees for the services of an attorney (Tax Law § 3030[c][3]).

B. A prevailing party is defined by the statute as follows:

> [A]ny party in any proceeding to which [Tax Law § 3030(a)] applies (other than the commissioner or any creditor of the taxpayer involved):
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> (i) who (I) has substantially prevailed with respect to the amount in controversy, or (II) has substantially prevailed with respect to the most significant issue or set of issues presented, and
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> (ii) who (I) within thirty days of final judgment in the action, submits to the court an application for fees and other expenses which shows that the party is a prevailing party and is eligible to receive an award under this section, and the amount sought, including an itemized statement from an attorney or expert witness representing or appearing in behalf of the party stating the actual time expended and the rate at which fees and other expenses were computed . . . and (II) is an individual whose net worth did not exceed two million dollars at the time the civil action was filed . . . , or any . . . corporation . . . the net worth of which did not exceed seven million dollars at the time the civil action was filed . . . .
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> (B) Exception if the commissioner establishes that the commissioner's position was substantially justified.
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> (i) General rule. A party shall not be treated as the prevailing party in a proceeding to which subdivision (a) of this section applies if the commissioner establishes that the position of the commissioner in the proceeding was substantially justified.
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> (ii) Burden of proof. The commissioner shall have the burden of proof of establishing that the commissioner's position in a proceeding referred to in

> subdivision (a) of this section was substantially justified, in which event, a party shall not be treated as a prevailing party.
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> (iii) Presumption. For purposes of clause (i) of this subparagraph, the position of the commissioner shall be presumed not to be substantially justified if the department, inter alia, did not follow its applicable published guidance in the administrative proceeding. Such presumption may be rebutted.
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> * * *
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> (C) Determination as to prevailing party. Any determination under this paragraph as to whether a party is a prevailing party shall be made by agreement of the parties or (i) in the case where the final determination with respect to tax is made at the administrative level, by the division of tax appeals, or (ii) in the case where such final determination is made by a court, the court (Tax Law § 3030[c][5]).

C. Petitioners succeeded, based upon their production of testimony and documentary evidence at hearing, in meeting their burden of proving by clear and convincing evidence that the result of the sales tax audit was erroneous and that the audit method was unreasonable. Consequently, the notices of determination for sales tax liability were canceled in their entirety. Notwithstanding this result, however, petitioners' cost application fails.

D. Petitioners were not the prevailing party within the meaning and intent of Tax Law § 3030 because the Division was substantially justified in issuing the notices based upon the information in its possession at the time the notices were issued.

Tax Law § 3030 is clearly modeled after Internal Revenue Code § 7430. It is proper, therefore, to use Federal cases for guidance in analyzing this state law (***see Matter of Levin v. Gallman***, 42 NY2d 32, 396 NYS2d 623 [1977]; ***Matter of Ilter Sener***, Tax Appeals Tribunal, May 6, 1988). A position is substantially justified if it has a reasonable basis in both fact and law (***see Information Resources, Inc. v. United States***, 996 F2d 780, 785, 93-2 US Tax Cas ¶ 50,519 [1993]), with such determination properly based on all the facts and circumstances surrounding

the case, not solely upon the final outcome (***Phillips v. Commissioner***, 851 F2d 1492, 1499, 88-2 US Tax Cas ¶ 9431 [1988]; ***Heasley v. Commissioner***, 967 F2d 116, 120, 92 US Tax Cas ¶ 50,412 [1992]). The fact that the notices were cancelled by the administrative law judge is a factor to be considered (***Heasley***). However, this outcome does not preclude a finding that the Division's position was substantially justified at the time the notices were issued, since the finding must be made in view of what the Division knew at the time its position was taken (Tax Law § 3030[c][8][B]; ***see DeVenney v. Commissioner***, 85 TC 927, 930 [1985]).

The Tax Court in ***Oak Knoll Cellar v. Comm. of Internal Revenue*** (68 TCM 412 [1994]) reviewed the legislative history of Internal Revenue Code § 7430 pertaining to the guidelines for determining whether the conduct of the government was unreasonable, as follows:

> The committee intends that the determination by the court on this issue [of reasonableness] is to be made on the basis of the facts and legal precedents relating to the case as revealed in the record. Other factors the committee believes might be taken into account in making this determination include, (1) whether the government used the costs and expenses of litigation against its position to extract concessions from the taxpayer that were not justified under the circumstances of the case, (2) whether the government pursued the litigation against the taxpayer for purposes of harassment or embarrassment, or out of political motivation, and (3) such other factors as the court finds relevant (HR Representative 404, 97th Cong, [1981]).

E. Whether the Division was substantially justified in its position at the time the notices were issued hinges on two key facts of this case: the appropriateness of its decision to estimate due to the absence of books and records and whether the choice of the particular methodology was rational. Petitioners did not provide the actual guest checks or cash register tapes from the original POS system for the audit period. Such records were required to be retained as either traditional paper documentation or in an electronic format (***see*** Tax Law § 1135[g]; 20 NYCRR 533.2[a][2]; 20 NYCRR 2402.2[c][1]). These records were not maintained as required, and

although they were requested by the Division on numerous occasions, they were never produced. Petitioners rely upon the analysis performed by their CPA, Mr. Hettler, with post-audit records approximately two years after the audit. Mr. Hettler's analysis was quite telling about petitioners' operations and records, and although he may have had to take a circuitous route to show the records could in fact seemingly meet petitioners' record retention obligation, because these were post-audit records, the Division was under no obligation to utilize them. As noted in the determination, at the very least what the Division should have done is utilize such an analysis as a benchmark of petitioners' reporting. But this is not the same as requiring the Division to accept the records as representative of those from the audit period, and without that obligation, the Division was well within its rights to resort to an estimated methodology. The Tribunal has confirmed the Division's latitude to choose the method it feels best accomplished its goal of reasonably estimating petitioners' tax liability, and the latitude employed by the Division in choosing this methodology, though executed with errors, did not exceed its authority. The cancellation of the assessments resulted from a determination that although a valid methodology was employed, its execution was fatally flawed. These flaws, however, do not erase the Division's position as being substantially justified at the time of the assessment. There is no evidence that, when the Division employed the estimated method used in this case, it did so to extract excessive tax revenue from petitioners that was not justified under the circumstances, or for purposes of harassment or embarrassment, or out of political motivation (***see*** HR Rep 404, 97th Cong, [1981]). Nor is there any evidence that the Division's position in this case was inconsistent with the position it has taken in other similar cases. The Tax Court in ***Reliable Credit Association, Inc. v. Comm.*** (73 TCM 1948 [1997]) similarly denied an award of costs to a corporation that failed to maintain books and records, though required to do so, and affirmed

the reasonableness of the IRS's determination of corporate income by any method that clearly reflected income. In responding to that taxpayer's claims that the IRS failed to employ certain auditing procedures that would have enabled it to easily ascertain the correct amount of the deficiencies, the Court responded: "when the taxpayer has defaulted in . . . [its] task of supplying adequate records, . . . [the taxpayer] is not in a position to be hypercritical of the Commissioner's labor." The fact that errors resulted in this case from the way the almanac tables were chosen and used by the auditors simply does not support an award of costs to petitioners. It was petitioners' failure that fueled a process they were forced to defend. Petitioners would have been in the same position of challenging the reasonableness of the audit method and its result, regardless of the errors committed.

F. Tax Law § 3030(c)(5)(A)(ii) requires the parties seeking costs establish that their net worth does not exceed certain statutory limits. The net worth of J. Sahantadam, Inc., is established by documentation and affirmed by Mr. Gormel. However, Mr. Gormel makes no mention, let alone a sworn statement, that his individual net worth does not exceed $2 million, as is also required. This application for costs, absent such information, is defective for this reason as well.

G. Since a determination has been made that the Division was substantially justified in its position and that the application lacks the necessary net worth information, and thus, petitioners are not entitled to an award of costs, it is unnecessary to determine whether the fees and disbursements claimed are reasonable and substantiated.

H. Petitioners' application for costs and fees is denied.

DATED: Albany, New York
January 17, 2013

/s/ Catherine M. Bennett
ADMINISTRATIVE LAW JUDGE