

STATE OF NEW YORK

DIVISION OF TAX APPEALS

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In the Matter of the Petition	:	
of	:	DETERMINATION
<b>JEFFERSON PUB, INC.</b>	:	DTA NO. 823440
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, 2002 through May 31, 2005.	:	

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Petitioner, Jefferson Pub, Inc., filed a petition for revision of a determination or for refund of sales and use tax under Articles 28 and 29 of the Tax Law for the period March 1, 2002 through May 31, 2005.

A hearing was commenced before Catherine M. Bennett, Administrative Law Judge, at the offices of the Division of Tax Appeals, 183 East Main Street, Rochester, New York, on February 9, 2011 at 9:30 A.M. and was concluded at the same location on February 10, 2011 at 9:30 A.M., with all briefs to be submitted by August 5, 2011, which date began the six-month period for the issuance of this determination. The time for issuance of the determination was extended for three months pursuant to 20 NYCRR 3000.5(d). Petitioners appeared by Underberg & Kessler LLP (Scott D. Shimick, Esq., of counsel). The Division of Taxation appeared by Mark F. Volk, Esq. (Osborne Jack, Esq., of counsel).

## ***ISSUES***

I. Whether the audit method utilized by the Division of Taxation in its audit of Jefferson Pub, Inc., was reasonable or whether petitioner has shown error in either the audit method or the result.

II. Whether the Division properly imposed penalties against petitioner and whether reasonable cause exists to abate them.

## ***FINDINGS OF FACT***

1. Jefferson Pub, Inc., (petitioner) operates a bar and restaurant located in Rochester, New York, known as MacGregor's Grill and Tap Room (MacGregor's). Petitioner is owned by Richard Carvotta, who simultaneously operated several MacGregor's in other locations, all under different corporate names. The casual food menu was predominantly American cuisine served grill style, with very large portions. With beer as a main focus, petitioner has 150 different kinds of beer on tap. The most popular menu items are hamburgers, chicken sandwiches, chicken wings and wraps.

2. The Division of Taxation (Division) contacted petitioner by correspondence dated February 11, 2005, for the purpose of scheduling an appointment for a sales tax field audit of petitioner's records for the period March 1, 2002 through February 28, 2005. 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. This list requested the following documents, among others, for the audit period: sales tax returns, federal income tax returns, corporation tax returns, general ledger, sales invoices, exemption documents, fixed asset purchases, expense purchase invoices, bank statements, and cash receipts and disbursements journals.

3. A field audit appointment was held on April 20, 2005, at which time petitioner's then-representative, Gregg Genovese, CPA, met with the Division's auditors and provided the corporation's general ledger, sales tax returns, depreciation schedule, federal tax returns, expense invoices, bank statements, and canceled checks. He also provided a set of incomplete purchase invoices. Mr. Genovese did not produce any of petitioner's sales records at the meeting, and informed the Division that petitioner did not maintain register receipts. During the meeting, the Division requested that petitioner commence maintaining detailed sales records beginning with May 2005, and to provide those records to allow the Division to test the accuracy of petitioner's reported sales. Petitioner's sales records were not provided to the auditor by petitioner or his representative for May 2005 or any other month, during or after the audit.

4. Between 2002 and May 2005, the period subjected to audit, petitioner had its original point of sale<sup>1</sup> (POS) system in place. As a digital dining program designed to keep detailed sales records, petitioner used a POS system to keep track of items sold, their cost and the selling price. The system did not have a backup, hard copies were not kept by petitioner, and when the main computer in petitioner's office was destroyed by fire in May 2006, the sales records were no longer available for the audit period. Thereafter, petitioner replaced the system with a new one that he continues to use. No reports or other information available from either POS system were provided to the auditor or submitted into evidence during the hearing. No documents were provided to the auditor that would allow individual transactions to be traced to the sales tax returns.

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<sup>1</sup> The auditor mistakenly referred to the system as "point on sale."

5. On June 15, 2005, the auditor met with Mr. Genovese and Mr. Carvotta, petitioner's owner, at which time the parties discussed that, absent sales records, the Division would have to perform the audit using external indices. Mr. Genovese suggested the use of the markup method, to which Mr. Carvotta agreed, and Mr. Carvotta requested that the month of May 2005 be used to calculate the markup. The parties discussed that in order to compute the markup, petitioner needed to provide purchase records and specific information about the price and size of menu items.

6. On July 11, 2005, the auditor met with Mr. Genovese who provided copies of petitioner's purchase invoices for May 2005, along with petitioner's menu used during the same month, for the purpose of computing a markup on purchases.

7. Two menus were introduced into evidence. One was designated as the 2004 menu, and the other was referred to as the 2005 menu for petitioner's restaurants. The existence of the menus as of certain dates was identified in accordance with when certain MacGregor's locations were open and operating. The menu prices contained in the 2005 menu were used in the audit computations with the purchase invoices for May 2005 in order to perform the markup computations. One of the more significant differences noted between the 2004 and 2005 menus concerned a change in petitioner's business practice to discontinue the inclusion of steak fries with a purchased menu item, and substitute instead hot chips, a less costly item substitute. Additionally, the prices in the 2005 menu reflected price increases on many main menu items, which the auditor estimated to be approximately 15% higher in price.

8. The Division's auditor commenced a markup computation for food, and a separate markup for liquor and beer. In doing so, she created a spreadsheet of information taken from petitioner's May 2005 purchase invoices, particularly the quantity and the cost of certain items

purchased, and calculated the number of servings, and the cost per serving. The auditor selected primary menu food items to test, such as hamburgers, and utilized the purchase invoices to calculate the cost per serving. Sandwich items on the menu, including hamburgers, are accompanied by a roll, lettuce, tomato, onion, dressing and other condiments, and there is no separate charge for these accompaniments. In order to account for additional food products that accompanied any particular menu item, for example the roll and condiments served with a hamburger, the auditor estimated all of these additional costs by speaking to other people in her office who had performed similar markup audits, and added a lump sum 50 cents, to account for all the additional food items in the per serving computation.

After the auditor computed the cost per menu item, she then took the selling price per the menu and multiplied it by the number of servings calculated from the purchase invoices, to result in audited sales. The audited sales amount was divided by the total cost associated with each item, resulting in a markup percentage for each individual menu item tested. These markup percentages formed the basis for the final result, a single weighted average markup for food.

9. Petitioner buys its food and nonfood items from several main vendors: Michael T. Schlenker Produce, Inc., A&G Meat, DiPaolo Bakery Products, US Food Service and Dudley Poultry Co., Inc. The purchase invoices for May 2005 included purchases of food and nonfood items from each of these vendors. In cases where the purchase invoices were not clear, or the auditor could not determine from the information provided how many servings were derived from a purchase invoice, she contacted the vendor who sold the item to petitioner. For some pricing or explanatory information, the auditor contacted Sysco, a vendor from whom petitioner did not purchase any products.

10. The menu items considered in the initial markup computation included garden burgers, potato skins, chicken breasts, philly steaks, ground beef patties, strip steaks, one type of french fries, pizza fingers, mozzarella sticks, tortellini alfredo, chicken wings, soup and hotdogs. The weighted average markup on these select items was calculated to be 3.23. The 3.23 markup resulted in additional tax due of \$121,116.71.

11. Petitioner requested that additional items be considered in the markup to be more representative of petitioner's business. Information from petitioner's May 2005 purchase invoices was utilized. The auditor added markup calculations on clam chowder and a large variety of other soups, clam strips, shrimp, steak cut potatoes, additional chicken, ham, turkey breast, haddock, taco meat, and roast beef, among other items, to the first computation . The resulting average weighted markup using these additional items was 4.13, which resulted in additional tax due in the amount of \$205,878.81.

12. Using the May 2005 purchase invoices for beer and liquor, the auditor performed similar computations, first determining unit pricing. After allowing an estimated 15% for breakage, the auditor calculated a final markup of 4.485 on beer and liquor. This markup resulted in additional tax assessed on beer and liquor in the amount of \$78,973.11, which was combined with the second food markup calculation, and resulted in the Division's issuing a Statement of Proposed Audit Change dated November 2, 2007, showing an additional tax assessment in the amount of \$284,851.92, plus penalty and interest.

13. Throughout the audit, and subsequent thereto, the markup was changed numerous times by the auditor: when petitioner brought numerous errors to the attention of the auditor that required some adjustment; when petitioner provided additional information and substantiation that impacted the calculations; and when petitioner pointed out instances where petitioner's

purchase invoices were misinterpreted by the auditor resulting in computational errors. In addition, petitioner pointed out that often food had to be discarded as waste, and in the case of soup, sometimes large quantities were discarded at the end of the day. In response to this discussion with the taxpayer, the auditor allowed a 3% waste factor for food in general, and a 15% waste factor for soup.

14. Once the spoilage factor was taken into account, the auditor recalculated the average weighted markup for food, using the same expanded food items as in the second food markup. This resulted in the auditor's final average weighted markup on food of 4.07. The next step was the auditor's determination of purchases over the entire audit period. The auditor determined that petitioner's general ledger separated "food and (non-alcoholic) beverages" from "liquor." For each of the years that comprised the audit, the auditor determined the purchases as follows:

a. Petitioner did not provide the auditor with purchase records for 2002. For the months in the audit period that fell in 2002, the auditor extracted the cost of goods sold from petitioner's 2002 tax return and allocated a percentage to food and beverage, separate from liquor, based upon ratios from other years, where the general ledger records were available.

b. For 2003, 2004 and January and February 2005, petitioner provided purchases from its general ledger, where petitioner separated purchases for liquor from that of food and other beverages.

c. In the case of March, April and May 2005, the auditor estimated the purchases based on the auditor's claim that petitioner either did not have purchase records available for those months, or petitioner had not provided them to her. The estimates appear to be proportionately based upon the actual records submitted for January and February 2005.

15. The purchases were adjusted for nonfood items included in petitioner's general ledger under food and beverage, and were determined to be 8% of the total. Liquor purchases remained a separate computation. The result of applying the 4.07 markup to the adjusted food and beverage purchases was audited food sales in the amount of \$4,648,931.21. Taking into consideration the sales reported by petitioner for the same time period in the amount of \$2,204,735.83, resulted in additional audited sales of \$2,444,195.38, and additional tax due on food in the amount of \$199,358.68. Combining this with the additional tax assessed on beer and liquor in the amount of \$78,973.11, resulted in the original Notice of Determination issued to petitioner.

16. The Division issued Notice of Determination Assessment No. L-030080748-2, dated May 22, 2008, to petitioner, assessing additional sales and use taxes in the amount of \$278,331.80 plus penalty and interest, for a total of \$628,132.00, for the tax period March 1, 2002 through May 31, 2005. Based upon verbal requests for records for the quarter ending May 2005, the auditor had considered the audit period updated to include the sales tax quarter March 1, 2005 through May 31, 2005.

17. After the issuance of the notice, during the Bureau of Conciliation and Mediation Services (BCMS) conference in this matter, petitioner demonstrated that the auditor had overstated the quantity of beer available for sale, had misinterpreted information on purchase invoices that was used in the computation of the assessment, and had mischaracterized certain liquor that was used in cooking or as an ingredient in a drink, as opposed to an individual alcoholic beverage. Once these corrections were made, the Division reduced the tax due on the liquor and beer portion of the audit to zero.



Also after the issuance of the notice, several adjustments were made by the Division affecting the food and beverage assessment, after discussions with petitioner, who explained why the calculations were erroneous without them. For example, petitioner noted that oil was used in much of the food preparation, and oil was included in food purchases. However, the auditor had not taken into account the cost of oil as an additional per item cost, upon which all the food markups were calculated. In response the auditor reduced the food purchased by all of the oil purchases so they would not affect the markup computation.

Another correction made to the assessment concerned the calculation of purchases for partial tax years, 2002 and 2005. The audit period commenced on March 1, 2002, and the auditor had erroneously included purchases for full year instead of 10 months. The same error was made for 2005, another year where all 12 months were not part of the audit period. The correction for the two partial years reduced the assessment against petitioner.

The BCMS conciliation order (CMS No. 225589) reflected these changes, and the assessment was reduced to \$179,475.80, plus penalty and interest.

18. After BCMS, another type of correction made by the auditor was, for example, for items like Virginia baked ham, where the auditor misunderstood the invoice, and included more servings than were available in the amount purchased, distorting the calculation of the markup.

The corrections made both before and after BCMS ultimately reduced the markup percentage from 4.07 to 3.82, and resulted in a reduction of the tax assessed on food and beverages from \$179,475.52 to \$157,909.52.

19. At the hearing, the Division conceded that the tax assessed for the quarter March 1, 2005 through May 31, 2005 should be cancelled since the Division did not properly request books and records for that quarter. Cancellation of the tax assessed for that quarter reduced the

amount of tax due from \$157,909.52 to \$142,731.17, plus penalties and interest.

20. In 2007, Steven Chatwin, CPA, was hired as petitioner's accountant, replacing Gregg Genovese, the CPA who initially represented petitioner. Mr. Chatwin raised numerous issues during the audit and the hearing concerning mistaken assumptions made by the auditor in her estimation of the assessment. Some of those resulted in the reduction of the assessment to \$142,731.17, as noted above. The calculation of additional adjustments was prepared by Mr. Chatwin on the basis of petitioner's records and the audit methodology employed, taking into account errors and mistaken assumptions as identified both during the hearing and in the post-hearing brief presented by petitioner's attorney, as follows:

a. Mr. Chatwin identified that, although petitioner's actual purchase invoices were used for the markup calculation, resulting in the assessment in issue, the auditor's selective choice of food products and the incomplete cost analysis of certain menu items used to perform this calculation did not result in a reasonably accurate estimate as could be obtained from the available records. Mr. Chatwin analyzed in great detail each of the purchase invoices supplied to the Division for the test period, and interviewed petitioner's owner and primary chef concerning recipes and the ingredients used therein. He recalculated the cost of individual menu items to include substantially all major menu items and all the components of menu items whether or not accounted for by the auditor, as was represented by the available purchase invoices, such as condiments, sauces, and spices used in their preparation and service. He then took the same mathematical approach as the auditor for the actual computation of the markup, and resulting assessment. His newly calculated average markup was 3.01 and the resulting tax \$56,369.89.

b. During the audit, Mr. Chatwin raised questions about the appropriateness of using May 2005 as the test month, given the defined audit period, particularly since some purchase invoices

for 2004 were reviewed, and others relied upon, i.e. in the review of petitioner's expense and capital purchases. Mr. Chatwin suggested a change to the Division in the audit posture to a review of 2004 invoices, and expressed his bewilderment of the choice made by the Division and petitioner's former CPA to use May 2005 as the test month. No changes were made to the choice of the test period. Given that May 2005 would remain the test month, Mr. Chatwin agreed that using the 2005 menu was the correct menu to use. However, he stood firm in his belief that using May 2005 pricing was not representative of the entire 39 months (which was ultimately reduced to the original 36).

Mr. Chatwin next suggested that since the menu prices significantly increased on or about April 2005, after the audit period, but just before the test period, and the 2004 menu prices are more representative of the audit period, the Division's calculations should be revised to reflect the sales prices of the earlier menu. In order to reflect this change, Mr. Chatwin performed the same set of calculations, using the earlier 2004 menu prices, where those items were actually a part of the earlier menu. The calculation amounted to \$26,565.43, resulting in a reduced assessment of \$29,804.46.

c. Petitioner established that one of the other changes made along with the menu price increases in early 2005 was the discontinuance of french fries served as part of the sandwich and burger menu items, and replacement of the fries with chips, at a lesser cost to petitioner. The cost of the french fries was calculated to be \$.41 per serving, compared to the cost of chips at \$.29 per serving. Mr. Chatwin recalculated the assessment by adding \$.12 differential cost (fries over chips) to the cost of those menu items that included fries during the audit period, when the 2004 menu was in place. This \$6,275.38 adjustment resulted in a reduction of the liability to \$23,529.08.

d. Mr. Chatwin noted that the purchase invoices used to formulate the markup included nonfood items and other food items that were not properly accounted for in the auditor's computation. These miscellaneous food items include, for example, cottage cheese, marinades, numerous sauces, nuts, garlic, olives, jalapenos, vinegar and seasonings. Mr. Chatwin suggests that such costs were included overall, but not accounted for in the calculation of the markup percentages of the individual menu items. According to Mr. Chatwin, a reduction has already been made for the nonfood items in the amount of \$3,075.04. The amount of the miscellaneous food items from the May 2005 purchase invoices that have not been properly accounted for total \$1,826.51. As a percentage of the total invoices, Mr. Chatwin adds together \$3,075.04 for nonfood items and \$1,826.51 for the miscellaneous food items, divides that sum by the total food and nonfood purchases for May 2005, \$33,385.07, and determines that these items represent 14.7% of the total. After he takes these items into account in the recalculation, the result is an \$11,688.70 reduction in the liability to \$11,840.38.

21. Petitioner's two managers are permitted to eat at the restaurant at no cost, and other employees are permitted to eat at a 50% reduction. The auditor was presented with this information during the audit in 2005. There were no computations regarding employee meals submitted to the auditor or as part of the hearing record. Employee meals were not taken into account in the auditor's calculation.

22. The auditor performed a review of petitioner's capital records during the audit. The capital records were deemed adequate and allowed the Division to trace transactions back to the source or forward to a final total. It was noted in the Field Audit Report that there were also adequate internal control procedures in this portion of the business operations.

23. The auditor performed a review of expense purchase records during the audit. The test period used was the year 2004 because the auditor deemed this period representative of business activity. The expense records were deemed adequate and allowed the Division to trace any transaction back to the original source or forward to a final total. The Division found adequate internal controls in this aspect of the business.

### ***SUMMARY OF THE PARTIES' POSITIONS***

24. Petitioner argues that the determination must be annulled because the audit methodology did not have a rational basis and was therefore unreasonable because the auditor could not substantiate her methodology, did not use a representative test period, and arbitrarily applied the methodology. Alternatively, petitioner asserts that even if the determination is not annulled, the liability under the methodology used would be zero if it had been properly applied. Some of the Division's failures asserted by petitioner are as follows:

a. Petitioner maintains that the auditor performed the audit in an incomplete manner by not accounting for the less primary components of prepared menu items, or by reducing overall purchases by a total of these items, having had the information to do so readily available on the invoices provided.

b. Petitioner argues that the 2004 menu prices are far more representative of the entire audit period than those from the 2005 menu, and if the audit methodology were applied using such pricing, a significant reduction would occur.

c. Petitioner asserts that along with the suggested use of the 2004 menu prices, the 12 cent increased cost of french fries as a component of a menu item (over chips served beginning in 2005) must be factored into adjustments to the liability.

d. Petitioner maintains that less prominent food items used in either the preparation or service of menu items, totaling \$1,823.51 in the May 2005 invoices alone, must be accounted for in the computations to avoid distortion.

e. Petitioner argues that the auditor should have taken into account an amount representing exempt purchases made by personnel from an Internal Revenue Code § 501(c)(3) organization.

f. Petitioner maintains that the spoilage of 3% allowed by the auditor was an insufficient allowance, and such amount does not adequately cover spoilage, let alone the return of meals.

g. Petitioner asserts that since its two managers are permitted to eat at the restaurant at no cost, and other employees are permitted to eat at a 50% reduction, the items consumed are not available for sale or are only partially sold, and thus should be taken into account to reduce the assessment.

25. Petitioner argues that if the test period audit calculations take into account all of the foregoing suggested revisions, the assessment for food and beverage sales would be reduced to zero tax due, as was the assessment based upon liquor sales.

Lastly, petitioner asserts that it is entitled to an abatement of penalties, since any failure to remit was due to reasonable cause and not willful neglect.

26. The Division maintains that the audit methodology it used was reasonable and that petitioner has not adequately sustained its burden of proof to show that the audit was unreasonable and the results erroneous. The Division also asserts petitioner has failed to show reasonable cause for abatement of penalties.

### ***CONCLUSIONS OF LAW***

A. Tax Law § 1105(a) imposes a sales tax on the receipts from every “retail sale” of tangible personal property except as otherwise provided in Article 28 of the Tax Law. A “retail

sale” is “[a] sale of tangible personal property to any person for any purpose, other than . . . for resale as such . . .” (Tax Law § 1101[b][4][i]). Tax Law § 1138(a)(1) provides, in relevant part, that if a sales tax return was not filed, “or if a return when filed 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 . . . .”

When acting pursuant to section 1138(a)(1), the Division is required to select a method of audit 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]) 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. Tax Commn.*, 119 AD2d 948, 501 NYS2d 219, 221).

C. In the present matter, it is clear that petitioner, though requested to do so by the Division, did not provide the sales records for the audit period in order to enable the auditor to perform a detailed audit. Although petitioner’s original POS system likely had the capability to deliver the sales records sought by the Division for the audit period until its destruction in May 2006, those records were not produced. It appears as though petitioner’s initial representative, Gregg Genovese, had his own strategy for handling the audit, and did not request from petitioner’s owner, or otherwise produce, the requested sales records. Mr. Genovese’s influence as to the choice of the markup method and the use of May 2005 as a test month, may have also played a large role in what thereafter took place in the context of the audit. Nonetheless, petitioner remains responsible for the omission of the sales records, the acquiescence in the test month decision, and must bear what flows from those choices. Accordingly, since it is clear that complete records were not available to the Division to perform a detailed audit, the Division was within its rights to resort to an estimated methodology to determine whether petitioner had properly remitted sales and use taxes for the audit period. In view of the foregoing, the only questions presented in this case are whether petitioner has established that the audit method employed, including the period tested, 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*).

D. In *Matter of Basileo* (Tax Appeals Tribunal, May 9, 1991), the Tribunal stated:

While it is true that ‘considerable 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), certain limitations have been placed on this principle. It is necessary that the record contain sufficient evidence to allow the trier of fact to determine whether the audit has a rational basis (*Matter of Grecian Sq. v. New York State Tax Commn.*, *supra*) and, further, that the record contain specific information identifying the external index employed by the Division in estimating the taxpayer’s liability (*Matter of Fashana*, Tax Appeals Tribunal, September 21, 1989).

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We also conclude that the Division must at hearing, through witnesses or documents, be able to respond meaningfully to inquiries regarding the nature of the audit performed. Such information is necessary in order to provide petitioner with an opportunity to meet its burden of proving such methodology unreasonable (*Matter of Fokos Lounge*, Tax Appeals Tribunal, March 7, 1991).

In similarly strong language in *Matter of Abbasi* (Tax Appeals Tribunal, June 12, 2008), the Tribunal criticized the Division’s use of estimates that were referred to as “habits of mind,” and where such estimates have as their basis the Division’s “experience” with little or no substantiation for their use, virtually incapable of a fair challenge by a taxpayer. Citing many of the cases previously mentioned, the Tribunal warned:

As a general principle, the conduct of government proceedings based on secret information, which the individual citizen has no opportunity to challenge or even examine, strongly suggests the absence of fairness. Accordingly, in order to impose on petitioner the heavy burden of proving by clear and convincing evidence that the audit methodology is unreasonable, it is not sufficient for the Division simply to present an estimated dollar amount of sales and to state that it is based on the Division’s “experience.” Instead, the record must contain sufficient evidence to enable the trier of fact to determine whether the audit has a rational basis, as well as specific information identifying the external index employed by the Division in estimating tax liability (*see, Matter of Grecian Sq. v. New York State Tax Commn.*, 119 AD2d 948 [3d Dept 1986]; *Matter of Spallina*, Tax Appeals Tribunal, February 27, 1992; *Matter of Fokos Lounge*,

Tax Appeals Tribunal, March 7, 1991; *Matter of Fashana*, Tax Appeals Tribunal, September 21, 1989; *Matter of Savino*, Tax Appeals Tribunal, September 22, 1988).

It is well established that the Division's resort during an audit to outside indices, such as purchase invoices, in order to determine the amount of tax due is proper, where, as here, the sales records were absent (*Matter of Urban Liquors*). The more narrow issue to be resolved with respect to the audit methodology in this case is not whether the markup method utilizing the purchase invoices was a reasonable choice of methods, but whether the execution of the audit methodology was reasonable, and reached a rational result.

E. Petitioner maintains that the assessment determination must be annulled because the audit methodology did not have a rational basis, and was therefore unreasonable for the following reasons: the auditor could not substantiate her methodology, she failed to use a representative test period, and she arbitrarily applied the test period methodology. The Division disagrees and argues that the audit methodology was reasonable, and that petitioner has not carried its burden of showing that the audit was unreasonable and the results erroneous.

The methodology chosen in this case, the markup of purchases to determine sales, is an accepted estimated sales tax audit methodology in cases without adequate sales records. However, the execution of various computations and assumptions within the methodology as applied in this case were flawed, and each must be addressed. As will hereinafter be shown, the auditor struggled to adequately explain portions of the audit, such as the rationale behind a portion of the markup test that added a lump sum to the cost of menu items based upon "office experience," and the omission of other costs that should have been included, that were identifiable on the purchase invoices presented.

Even though the flaws within the audit were not insignificant, particularly when multiplied over the entire audit period, and under other circumstances might lead to a different result, under these facts they do not render the audit results nullified, but necessitate adjustments to better reflect the proper sales tax computations. Case law provides that such adjustments are appropriate where supported by testimony and evidence (*see Matter of Vebol Edibles, Inc.*, Tax Appeals Tribunal, January 12, 1989, *confirmed* 162 Ad2D 765 [1990], *affd* 77 NY2d 803 [1991]; *Matter of Markowitz v. State Tax Commn.*, 54 AD2d 1023 [1976]; 388 NYS2d 176 [1976], *affd* 44 NY2d 684, 405 NYS2d 454 [1978]).

F. During the audit, the auditor selectively chose menu items, and created a spreadsheet with some of the costs associated with these menu items, from the purchase invoices provided to her by petitioner for May 2005. Those computations contained a considerable number of errors, and when multiplied over the course of the audit period of 36 months (the finally determined audit period), had a significant impact on the assessment calculations. In order to account for additional food products that accompanied any particular menu item, for example, the roll, lettuce, tomato and condiments served with a hamburger, the auditor estimated all of the additional costs associated with serving the burger, choosing a cost that she could not substantiate, and without considering the information available to her on the purchase invoices. Instead, the auditor spoke to other people in her office who had performed similar markup audits, in order to add a lump sum cost, a flat 50 cents, to account for all the additional food items in the per serving computation. The auditor could not describe other restaurants to which petitioner's was compared, the details of other comparable audits or identify any other basis upon which this number was derived. She could not meaningfully respond to this portion of the audit or provide

petitioner with sufficient information to challenge the reasonableness of the calculation or the result.

Through credible testimony, Mr. Chatwin identified items not incorporated into the cost of the menu items as calculated by the auditor, and focused on the primary, though smaller, components to the per serving calculations. In addition to using the same May 2005 invoices available to the auditor, Mr. Chatwin spoke with petitioner's owner and primary chef to clarify how purchased items were actually employed in petitioner's operations. Thereafter, incorporating these items and using the identical computational approach as did the auditor, Mr. Chatwin concluded that a more accurately estimated markup percentage is 3.01, which would reduce the sales tax liability to \$56,369.89.

If an auditor's selection of a number or calculation based on "office experience" is the basis for an entire audit computation, such that a taxpayer would be prohibited from examining any source for that calculation, and no other alternative exists, a conclusion that the methodology should be disregarded, and the result nullified, might be inevitable (*see Matter of Abbasi*). In this case, since only a portion of the audit calculations consisted of a component that could not be substantiated, and the calculation could be more reasonably estimated by the modifications offered and substantiated by Mr. Chatwin, such modifications will be allowed to adjust the assessment results, and the liability is reduced to \$56,369.89 (*see Matter of Vebol Edibles, Inc.; Matter of Markowitz v. State Tax Commn.*).

G. Petitioner asserts that the 2004 menu prices are far more representative of the entire audit period, given an approximate 15% increase in prices and the increased cost during that same period of adding french fries to many of the primary menu items. The Division's position

is that petitioner's former CPA and owner made the suggestions as to the markup method and the test month. The auditor agreed, then simply paired that information with the 2005 menu prices.

In order to quantify petitioner's theory supporting the use of the 2004 menu prices, Mr. Chatwin recalculated the assessment using the auditor's same computational approach, substituting the 2004 menu prices for those from 2005, and making an adjustment to the cost of menu items that included french fries in 2004, with the differential between the cost of fries and chips of \$.12 per serving. These two calculations resulted in a further reduction in the liability in the respective amounts of \$26,565.43 and \$6,275.38.

On the basis of all the testimony provided, and careful review of the record, I am convinced that the 2004 menu prices are clearly more representative of petitioner's business. Petitioner's owner, Mr. Carvotta, testified that he made significant menu pricing and serving adjustments to the 2005 menu in response to a profitability analysis of his business. The entire audit period falls before May 2005. It appears with the able assistance of Mr. Carvotta's mother, petitioner's bookkeeper, the purchase invoices from 2004 could have been located for use by the auditor. Nonetheless, the Division's price and cost comparison period will sustained for two reasons: 1) petitioner and his former representative suggested a markup method, and chose May 2005 as the test month; and 2) it would be not be proper to now pair 2004 menu prices with 2005 costs. The Division's audit log and the auditor's testimony revealed that petitioner directed the choice of the 2005 items. Petitioner's owner may have been misinformed by the former CPA, or he may have thought the period closer in time would be simpler for compliance reasons. Regardless of the reason, petitioner had a hand in deciding what purchase invoices would be reviewed, and perhaps indirectly, what menu prices would be paired with those costs for the purpose of computing the estimated markup on food and beverages. The entire computation

begins and ends with the May 2005 purchase invoices. Even Mr. Chatwin acquiesced that “the right menu was used for this audit period” qualifying that statement by indicating that he did not believe it to be representative of the entire 39 months. In consideration of the foregoing, an adjustment for 2004 prices will not be permitted.

H. Petitioner argues that nonfood items should not be a part of the calculation of the markup on food and beverages, and miscellaneous food items need to be properly accounted for in the computation. The Division maintains that its computation need not be exact, and petitioner was allowed adjustments for all items that it substantiated or explained to the auditor’s satisfaction.

The auditor made adjustments for nonfood items during the audit, including janitorial and other supplies. Petitioner’s posthearing brief suggests that an adjustment has already been made for nonfood items in the amount of \$3,075.04. It is unclear what additional items should be subject to adjustment. Although I agree that nonfood items should not be a part of the markup on food and beverages, petitioner has not carried its burden of proof to support a further modification in this regard. However, as to \$1,826.51 for miscellaneous food items, representing items purchased during May 2005 that are substantiated by the purchase invoices available to the auditor, an adjustment should be made to reduce the liability. These items, being too difficult to apportion over each and every menu item, can simply be the subject of a single entry that will ultimately carry over within the calculation.

I. Petitioner additionally maintains that the test period did not reflect the existence of exempt sales to employees of a local college who presented exemption certificates, that the auditor’s spoilage allowance of 3% is too low, and that employee meals that are permitted at either a reduced or at no cost have not properly been considered. The Division again responds

that it provided consideration to all adjustments for which there was substantiation or, at the very least, a plausible explanation.

As to these items, petitioner simply did not carry its burden of showing entitlement to the adjustments sought, including providing the appropriate documentation and quantifying the adjustment in some fashion. No exemption certificates were provided. Petitioner's dissatisfaction with the 3% spoilage allowance was not previously raised, nor was an alternative percentage substantiated. No calculations were submitted as to the cost of employee meals. It is undisputed that petitioner did not maintain and, therefore, produce for audit, the books and records necessary to perform a detailed audit. Case law holds that, as a general proposition, any imprecision in the results of an audit arising by reason of a taxpayer's own failure to maintain adequate and accurate records of all of its sales as required by Tax Law § 1135(a)(1) must be borne by that taxpayer (*Matter of Meyer v. State Tax Commn.*; *Matter of Markowitz v. State Tax Commn.*).

J. Tax Law § 1145(a)(1)(i) imposes a penalty upon persons who fail to timely file a return or timely pay the tax imposed by Articles 28 and 29 of the Tax Law. The penalty and additional interest may be waived if "such failure or delay was due to reasonable cause and not due to willful neglect" (Tax Law § 1145[a][1][iii]). In determining whether reasonable cause and good faith exist, the regulations provide several specific grounds, none of which apply to this matter, and also a catchall provision, which provides for a finding of reasonable cause based upon any ground for delinquency that would appear to a person of ordinary prudence and intelligence as a reasonable cause for delay, demonstrating an absence of willful neglect (20 NYCRR 2392.1[d][5]). The taxpayer bears the burden of establishing that the actions were based upon reasonable cause and not willful neglect (*see Matter of Philip Morris*, Tax Appeals Tribunal,

April 29, 1993; *Matter of MCI Telecommunications Corp.*, Tax Appeals Tribunal, January 16, 1992, *confirmed* 193 AD2d 978, 598 NYS2d 360 [1993]; 20 NYCRR 3000.15[d][5]).

Petitioner presented evidence that it initially hired Gregg Genovese, a CPA, and relied upon his expertise to represent him in the audit of Jefferson Pub. Mr. Carvotta testified that when Mr. Genovese requested records or documents for the audit, Mr. Carvotta provided them, and that Mr. Genovese never asked him to produce the sales records. However, when Mr. Carvotta was party to a meeting with the auditor in June 2005, it was made abundantly clear that sales records needed to be produced, or an estimation would result. Having firsthand knowledge of what records were required to be produced, and without an adequate explanation as to why these records were never brought forth, petitioner fails to prove that its actions were based upon reasonable reliance on professional advice, as opposed to willful neglect. Accordingly, the penalties on the adjusted assessment are upheld.

K. The petition of Jefferson Pub, Inc., is granted to the extent indicated in Conclusions of Law F and H; the Division of Taxation is directed to modify the Notice of Determination dated June 12, 2008, and except as so modified, the notice is otherwise sustained.

DATED: Albany, New York  
April 26, 2012

/s/ Catherine M. Bennett  
ADMINISTRATIVE LAW JUDGE