

STATE OF NEW YORK

STATE TAX COMMISSION

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| In the Matter of the Petition | : | |
| | : | |
| of | : | |
| | : | |
| RAINBOW RESTAURANT BLVD., LTD. | : | DECISION |
| | : | |
| 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, 1976 | : | |
| through May 31, 1979. | : | |

Petitioner, Rainbow Restaurant Blvd., Ltd., One East Bedford Park Boulevard, Bronx, New York 10468, filed a petition for revision of a determination or for refund of sales and use taxes under Articles 28 and 29 of the Tax Law for the period March 1, 1976 through May 31, 1979 (File No. 29414).

A formal hearing was commenced before Robert Couze, Hearing Officer, at the offices of the State Tax Commission, Two World Trade Center, New York, New York, on December 2, 1982 at 3:15 P.M. and continued on March 8, 1983 at 10:45 A.M.; it was further continued before Doris E. Steinhardt, Hearing Officer, at the same offices on July 14, 1983 at 1:15 P.M. and on July 15, 1983 at 1:30 P.M., and concluded on July 20, 1983 at 11:00 A.M., with all briefs to be submitted by September 22, 1983. Petitioner appeared by William Paul Jacobs, Esq. The Audit Division appeared at the December 2, 1982 hearing by Paul B. Coburn, Esq. (Barry M. Bresler, Esq., of counsel) and at all further hearings by John P. Dugan, Esq. (Deborah Dwyer, Esq., of counsel).

ISSUE

Whether the Audit Division properly determined petitioner's sales tax liability for the period under consideration by an observation test conducted from outside the business premises.

FINDINGS OF FACT

1. On September 20, 1979, following a field audit (described in detail infra), the Audit Division issued to petitioner, Rainbow Restaurant Blvd., Ltd. ("Rainbow"), a Notice of Determination and Demand for Payment of Sales and Use Taxes Due, assessing sales and use taxes under Articles 28 and 29 of the Tax Law for the period March 1, 1976 through May 31, 1979 in the amount of \$70,233.04, plus interest of \$13,855.25 and penalty of \$13,578.14, for a total due of \$97,666.43.

2. Rainbow is a small restaurant, situated at the intersection of Jerome Avenue and Bedford Park Boulevard, in a commercial neighborhood. Rainbow employs approximately five persons: one waitress for the hours of 7 A.M. to 11 A.M.; two waiters, one serving customers during the 11 A.M. to 9 P.M shift and the other during the 9 P.M. to 7 A.M. shift; and two broilermen. The restaurant has a seating capacity of approximately 30: there is a counter with 10 stools and 10 four-seat booths, but five of the booths are in such disrepair that they are not utilized. The busiest hours are at breakfast time, and the most frequently served items are coffee, soft drinks and pastry.

3. For the period March 1, 1976 through November 30, 1978, petitioner submitted sales and use tax returns, reflecting taxable sales and services and sales tax due thereon, scheduled as follows:

| <u>PERIOD ENDED</u> | <u>TAXABLE SALES AND SERVICES</u> | <u>SALES TAX</u> |
|---------------------|-----------------------------------|--------------------|
| 5/31/76 | \$ 17,222.23 | \$ 1,377.78 |
| 8/31/76 | 18,333.33 | 1,466.67 |
| 11/30/76 | 20,833.33 | 1,666.67 |
| 2/28/77 | 13,611.11 | 1,088.89 |
| 5/31/77 | 18,148.15 | 1,451.85 |
| 8/31/77 | 13,038.89 | 1,043.11 |
| 11/30/77 | 18,171.30 | 1,453.70 |
| 2/28/78 | 20,272.22 | 1,621.78 |
| 5/31/78 | 24,537.04 | 1,962.96 |
| 8/31/78 | 17,870.37 | 1,429.63 |
| 11/30/78 | 21,562.04 | 1,724.96 |
| | <u>\$203,600.01</u> | <u>\$16,288.00</u> |

Petitioner's accountant prepared the returns from his worksheets, which summarized on a fiscal year basis (June 1 through May 31) sales, disbursements by cash and by check, and deposits (among other things). The accountant accumulated disbursements by reference to bills and invoices; bills paid by check were retained, whereas those paid by cash were discarded. Petitioner's president, Peter Nikolakakos, furnished the accountant with the daily sales figure on a plain sheet of paper. Mr. Nikolakakos never turned over to him the daily guest checks and cash register tapes, but bound these records together and stored them in the basement of the restaurant. Mr. Nikolakakos also kept, for his own use, a daybook for recordation of daily sales, expenses and profit. The accountant thus never reviewed the daybook nor reconciled the guest checks with the register tapes or his worksheets, in preparing the returns.

4.(a) The sales tax examiner commenced his audit by visiting the office of petitioner's accountant to review the worksheets, federal corporation income tax returns, sales and use tax returns, and check disbursements. He was able to reconcile petitioner's reported taxable sales and petitioner's check disbursements (for the test period March through May, 1977) with the accountant's worksheets, and also petitioner's purchases as reflected on its corporation income tax returns with purchases as shown on the worksheets. Comparison of purchases per books to reported taxable sales revealed a markup of 407.8 percent. Finally, he found that for the period March, 1976 through May, 1978, the sum of total cash payouts and bank deposits (\$193,589) exceeded reported taxable sales (\$164,168) plus sales tax (\$13,133) by \$16,288.

(b) Because Mr. Nikolakakos discarded bills paid by cash, it was impossible for the examiner to conduct a purchase markup test. The examiner directed Mr. Nikolakakos to provide him with guest checks and register tapes

for a certain three-month test period and further, to retain all guest checks and tapes thenceforward. Mr. Nikolakakos delivered to the Bronx District Office two cartons containing guest checks and tapes used over a three-month period. He testified that the records were delivered in specific accordance with the examiner's instructions. The examiner testified, on the other hand, that the records furnished were outside the audit period and were therefore not examined or utilized in arriving at the assessment.

(c) The Audit Division determined that in view of the lack of complete purchase invoices and the alleged lack of sales records, it was necessary to conduct an observation test to verify petitioner's reported taxable sales. Mr. Nikolakakos consented to have one examiner stationed at the cash register for the purpose of recording sales, but the Audit Division insisted on stationing at least two examiners on the premises. Discussions deteriorated, the parties were unable to agree upon a method for conduct of an on-premises observation test, and as a result, the Audit Division decided to conduct a test from outside the business premises. The Audit Division assigned four auditors (two auditors from 8 A.M. to 8 P.M. August 29, 1979, and two from 8 P.M. August 29 to 8 A.M. August 30, 1979) to sit in an automobile outside Rainbow and count the persons leaving. The results of the count are set forth below.

| | <u>TIME</u> | <u>NUMBER OF PERSONS LEAVING</u> |
|---------|-------------------|--------------------------------------|
| 8/29/79 | 8 A.M. - 9 A.M. | 51 |
| | 9 A.M. - 10 A.M. | 33 |
| | 10 A.M. - 11 A.M. | 16 |
| | 11 A.M. - 12 noon | 33 |
| | 12 noon - 1 P.M. | 27 |
| | 1 P.M. - 2 P.M. | 12 |
| | 2 P.M. - 3 P.M. | 30 |
| | 3 P.M. - 4 P.M. | 11 |
| | 4 P.M. - 5 P.M. | 21 |
| | 5 P.M. - 6 P.M. | 18 |

| | | |
|---------|-----------------------|------------|
| 8/30/79 | 6 P.M. - 7 P.M. | 24 |
| | 7 P.M. - 8 P.M. | 25 |
| | 8 P.M. - 9 P.M. | 22 |
| | 9 P.M. - 10 P.M. | 16 |
| | 10 P.M. - 11 P.M. | 19 |
| | 11 P.M. - 12 midnight | 20 |
| | 12 mid. - 1 A.M. | 20 |
| | 1 A.M. - 2 A.M. | 11 |
| | 2 A.M. - 3 A.M. | 26 |
| | 3 A.M. - 4 A.M. | 19 |
| | 4 A.M. - 5 A.M. | 25 |
| | 5 A.M. - 6 A.M. | 23 |
| | 6 A.M. - 7 A.M. | 26 |
| | 7 A.M. - 8 A.M. | 65 |
| | | <u>593</u> |

This count was turned over to the sales tax examiner originally assigned to the matter. None of the auditors who participated in the test were produced at the hearing to offer testimony. It is unknown whether any allowance was made for non-patrons entering the restaurant solely to use the public telephone, the restroom or the cigarette machine.

(d) The sales tax examiner had requested Mr. Nikolakakos to retain the guest checks and register tape for the same 24-hour period. These records indicated total sales of \$186.45 to 132 customers. The examiner determined the average check ($\$186.45/132 = \1.4125) and multiplied that amount by the number of persons counted (593) to arrive at audited taxable sales of \$837.61. He subsequently calculated an "error rate" by dividing audited sales by reported sales ($\$837.61/\$186.45 = 349\%$) and applied such rate to reported taxable sales for the entire period under consideration.

5. On March 27, 1980, a conference was held at the Bronx District Office for the purpose of discussing the results of the observation test. In attendance were Mr. Nikolakakos, petitioner's accountant, the sales tax examiner and various Audit Division representatives, including the district office sales tax administrator. Discussions regarding conduct of an on-premises observation

test again degenerated. An argument ensued over the cartons of guest checks and tapes provided to the Audit Division by Mr. Nikolakakos; Mr. Nikolakakos refused to remove them from the district office and directed that they be discarded.

6. Petitioner disputes the amount of audited taxable sales, characterizing such amount as excessive. In support of its position, petitioner offered the testimony of the day waiter and broilerman that they served an average of 100 customers during their shift, and the testimony of Mr. Nikolakakos and of a third party who had contemplated purchasing Rainbow in May, 1977 that average daily sales were approximately \$200.00. Furthermore, respecting the discrepancy between reported taxable sales and expenses plus deposits, Mr. Nikolakakos stated that, from time to time as the need arose, he loaned funds to the corporation.

CONCLUSIONS OF LAW

A. That Tax Law section 1135, subdivision (a) imposes on every person required to collect tax the duty to maintain records of every sale and the tax payable thereon. Where a taxpayer maintains comprehensive records and furnishes them to the Audit Division for examination, the taxpayer has the right to expect they will be used to determine his liability under Articles 28 and 29. Where such records are not maintained or are not furnished, the Audit Division may resort to use of outside indices. Tax Law section 1138(a). Petitioner's president testified that guest checks and cash register tapes were retained and stored in the basement of the business premises. Petitioner nonetheless elected not to offer any such records into evidence at the hearing. Mr. Nikolakakos's testimony, standing alone, is insufficient to carry petitioner's burden to establish the existence of complete and adequate records.

B. That since petitioner failed to prove the adequacy of its record keeping, the Audit Division was authorized to rely upon such information as it had available. The examiners, however, were under a "duty to select a method of audit reasonably calculated to reflect the taxes due". Matter of Urban Liquors, Inc. v. State Tax Comm., 90 A.D.2d 576. It is our conclusion that the audit methodology employed was not so "reasonably calculated". The Audit Division had the consent of Mr. Nikolakakos to situate one sales tax examiner on the business premises for the purpose of verifying sales, but neglected to avail itself of this opportunity. The Audit Division had in its possession three months of guest checks and register tapes yet totally disregarded these records, neglecting even to inspect them for completeness (whether the records fell within or without the audit period). Finally, the Audit Division failed to produce at the hearing, for direct testimony or cross-examination, any of the four examiners who actually took part in the outside-the-premises observation test, so that many procedural details of such test are unknown.

C. That by reference to the average check amount determined by the examiner from petitioner's records (Finding of Fact "4(d)") and to the testimony of petitioner's employees regarding the average number of customers served (Finding of Fact "6"), it is apparent that petitioner underreported taxable sales. Petitioner's waiter and broilerman estimated that they served 100 customers during their 10-hour shift, from 11 A.M. to 9 P.M. It is thus reasonable to conclude that at least 10 customers were served each hour, and 240 each day. It is possible that fewer customers patronized the restaurant during the very early morning hours, but if so, this factor would be counter-balanced by the larger number of patrons during breakfast which according to the testimony, was the most frequently served meal. Multiplying the dollar

amount of the average check by the average number of customers yields daily taxable sales of \$339.00. Comparison of the amount of daily reported taxable sales (as indicated by the guest checks and cash register tape for a 24-hour period) with daily recomputed sales establishes an underreporting of taxable sales on petitioner's part.

$$\frac{\$339.00 \text{ recomputed taxable sales}}{\$186.00 \text{ reported taxable sales}} = 1.82$$

The Audit Division is hereby directed to recompute the assessment, increasing petitioner's reported taxable sales by 82 percent.

D. That the petition of Rainbow Restaurant Blvd., Ltd. is granted to the extent indicated in Conclusion of Law "C", and the notice of determination and demand, with full penalty and interest, is to be modified accordingly.

DATED: Albany, New York

STATE TAX COMMISSION

MAY 17 1985

Richard Arden
PRESIDENT

Francis R. K. King
COMMISSIONER

Mark J. Hall
COMMISSIONER