

STATE OF NEW YORK

STATE TAX COMMISSION

---

In the Matter of the Petition

of

CHARLES AND JOSEPH COSTA

D/B/A INTERNATIONAL HOUSE OF PANCAKES #4639

for Revision of a Determination or for Refund  
of Sales and Use Taxes under Articles 28 and 29  
of the Tax Law for the Period June 1, 1976  
through May 31, 1978.

---

In the Matter of the Petition

of

INTERNATIONAL HOUSE OF PANCAKES

for Redetermination of a Deficiency or for  
Refund of Unincorporated Business Tax under  
Article 23 of the Tax Law for the Year 1976.

---

DECISION

In the Matter of the Petition

of

JOSEPH COSTA

for Redetermination of a Deficiency or for  
Refund of New York State Personal Income Tax  
under Article 22 of the Tax Law and New York  
City Nonresident Earnings Tax under Chapter 46,  
Title U of the Administrative Code of the City  
of New York for the Year 1976.

---

In the Matter of the Petition

of

CHARLES AND ARLENE COSTA

for Redetermination of a Deficiency or for  
Refund of New York State Personal Income Tax  
under Article 22 of the Tax Law and New York  
City Nonresident Earnings Tax under Chapter 46,  
Title U of the Administrative Code of the City  
of New York for the Year 1976.

---

Petitioners Charles and Joseph Costa, doing business as International House of Pancakes #4639, 155-17 Northern Boulevard, Flushing, New York 11354, 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 June 1, 1976 through May 31, 1978 (File No. 32563).

Petitioner International House of Pancakes, 155-17 Northern Boulevard, Flushing, New York 11354, filed a petition for redetermination of a deficiency or for refund of unincorporated business tax under Article 23 of the Tax Law for the year 1976 (File No. 30965).

Petitioner Joseph Costa, 508 Tether Lane, Paramus, New Jersey 07652, filed a petition for redetermination of a deficiency or for refund of New York State personal income tax under Article 22 of the Tax Law and New York City nonresident earnings tax under Chapter 46, Title U of the Administrative Code of the City of New York for the year 1976 (File No. 30764).

Petitioners Charles and Arlene Costa, 8 Glen Court, Hawthorne, New Jersey 07506, filed a petition for redetermination of a deficiency or for refund of New York State personal income tax under Article 22 of the Tax Law and New York City nonresident earnings tax under Chapter 46, Title U of the Administrative Code of the City of New York for the year 1976 (File No. 30885).

A consolidated formal hearing was held before Doris E. Steinhardt, Hearing Officer, at the offices of the State Tax Commission, Two World Trade Center, New York, New York, on September 13, 1984 at 10:00 A.M., with all briefs to be submitted by November 29, 1984. Petitioners appeared by Gerald M. Cotter, Esq. The Audit Division appeared by John P. Dugan, Esq. (William Fox, Esq., of counsel).

ISSUE

Whether in the conduct of a sales tax audit of International House of Pancakes, the Audit Division properly utilized guest checks and register readings for one day to make projections for the entire period June 1, 1976 through May 31, 1978.

FINDINGS OF FACT

1.(a) Subsequent to the conduct of a field examination, the Audit Division issued to petitioners Charles and Joseph Costa, doing business as International House of Pancakes #4639 ("IHOP #4639"), two notices of determination and demands: the first, dated December 27, 1979, covered the period June 1, 1976 through May 31, 1977 and was in the amount of \$97,053.53, plus penalty and interest; the second, under date September 8, 1980, covered the period June 1, 1977 through May 31, 1978 and assessed taxes in the sum of \$100,589.76, plus penalty and interest. On July 30, 1979, Joseph Costa had executed on behalf of IHOP #4639 a consent extending the period of limitations for assessment of tax for the period June 1, 1976 through May 31, 1979 to and including December 31, 1979.

(b) The Audit Division treated the additional sales found by the sales tax examination as additional gross receipts realized by the partnership, International House of Pancakes. Consequently, on April 11, 1980, the Audit Division issued a Notice of Deficiency to the partnership, asserting unincorporated business tax under Article 23 of the Tax Law for the year 1976 in the amount of \$64,270.61, plus penalty and interest.

(c) Finally, the Audit Division augmented the taxable income of the partners, Joseph Costa and Charles Costa, to take account of their alleged

additional distributive shares of partnership income. On April 11, 1980, the Audit Division issued to petitioner Joseph Costa ("Joseph") a Notice of Deficiency, asserting New York State personal income tax under Article 22 of the Tax Law and New York City nonresident earnings tax under Chapter 46, Title U of the Administrative Code of the City of New York in the amount of \$92,126.27, plus penalty and interest. On the same date, the Audit Division issued to petitioners Charles and Arlene Costa a Notice of Deficiency, asserting personal income tax and nonresident earnings tax of \$90,830.02, plus penalty and interest.

2. IHOP #4639 is a restaurant operated under a franchise granted by International House of Pancakes, Inc. ("IHOP, Inc."). The restaurant is open for business from 7:00 A.M. until midnight Sunday through Thursday and from 7:00 A.M. until 2:00 A.M. on Friday and Saturday, and has a seating capacity of 84. Pursuant to the franchise agreement, IHOP #4639 remits a monthly rental, service fee and national advertising fee to IHOP, Inc., with each payment computed as an established percentage of the restaurant's gross volume. To ensure compliance with the franchise agreement, IHOP, Inc. engages independent examiners to audit the franchised restaurants.

3. The sales tax examination which resulted in the assessments and the deficiencies under consideration was precipitated by an anonymous letter, informing the Audit Division that guest checks totalling \$8.00 or more were not rung up on the cash register on Saturdays, Sundays and holidays and checks in excess of \$20.00 were never rung up. In an effort to verify this information, eleven Audit Division employees patronized the restaurant for breakfast on May 14, 1979, a Saturday; the guest check inclusive of sales tax totalled \$32.62 and was not rung up on the register in the presence of the Audit Division employees.

4. On or about May 17, 1979, the Audit Division forwarded a notification to IHOP #4639, to the attention of Joseph, advising that a multi-tax examination was to be conducted commencing June 14, 1979 and requesting access to the following records, among others: purchase invoices, sales invoices, expense invoices, guest checks, register tapes and bank statements for the quarterly period March 1 through May 31, 1979; the general ledger; and the cash receipts and cash disbursements journals. Petitioners' accountant requested postponement of the appointment because of Joseph's unavailability on the scheduled date.

5. The examination was rescheduled for and the examiners began the audit on July 30, 1979. Records available on that date consisted of the cash receipts and cash disbursements journals. Joseph also demonstrated for the examiners the operation of the "documentor", which accumulates daily sales. Guest checks list menu items available (e.g., sausage and eggs, steak sandwich) followed by numbers in brackets; upon a customer's order, the waiter or waitress draws a line through the appropriate item (e.g., one order of buttermilk pancakes). At the end of the meal, the customer presents the guest check to the cash register operator who inserts the check into the documentor twice: once to read the lined-out items and the second time for the printing out of the sale amount, sales tax amount and total amount due. The total amount due is then rung up on the cash register. At regular intervals, 11:30 A.M., 2:30 P.M., 5:00 P.M., 8:30 P.M., 10:00 P.M. and midnight (and also at 3:00 A.M. on Fridays and Saturdays), using the documentor, Joseph takes readings of the restaurant's gross sales and records the readings on daily register reading report forms submitted to IHOP, Inc., along with a tape produced by the documentor during the addition operation. IHOP, Inc. relies on these reports and tapes in

preparing IHOP #4639's sales and use tax returns. Joseph also furnished the examiners with samples of guest checks and documentor summary reports.

The examiners specifically requested completed guest checks for the test period selected (March 1 through May 31, 1979) but were informed that guest checks were forwarded to the IHOP, Inc. principal office in North Hollywood, California.

During the July 30, 1979 appointment, the examiners obtained carbon copies of transmittal sheets which recapitulate the restaurant's weekly activities, including sales, purchases, payroll and franchise payments; the originals are forwarded to IHOP, Inc.

By letter to IHOP, Inc. dated July 31, 1979, the Audit Division requested the guest checks of IHOP #4639 for the test period.

6. When the examiners learned from IHOP, Inc. that guest checks were in fact retained by the individual restaurants, they renewed their request of Joseph for such documents. The examination then continued on September 4 and again on October 2 and November 18, 1979. On September 4, Joseph provided the examiners guest checks bound by rubber bands in sequential batches of fifty and stored in no particular order in a carton. The examiners attempted to arrange the guest checks in chronological order. Because the largest number of guest checks were used on August 18, 1979, the examiners concluded that the checks were complete for that date. (The guest checks were in actuality dated September 18, 1979 but Joseph advised the examiners that the documentor had dated them erroneously.) On October 2, Joseph provided the examiners with carbon copies of transmittals for the years 1976 and 1977 which the examiners referred to in endeavoring to arrive at purchases for the test quarter. On November 18, the examiners obtained the bank records of the partnership and from IHOP, Inc., the

register reading report forms and the documentor-generated tapes for the test period.

7. Given that the extension of the period of limitations for assessment was due to expire on December 31, 1979, the examiners requested Joseph to execute a further extension of one year. On the advice of his accountant, he refused to so extend the statute. The examiners concluded that they had no alternative but to employ the records they had in their possession to arrive at an estimated assessment.

(a) The examiners reconciled sales per books to the partnership returns for the years 1977 and 1978.

(b) Purchases as reflected in the cash disbursements journal from June 1, 1976 through December 31, 1977 and in the general ledger for 1978 were compared with purchases disclosed on the partnership returns; purchases per books exceeded purchases on the 1978 return by 41.89 percent.

(c) Fixed asset acquisitions were ascertained from the partnership returns and cash disbursements journal. Tax of \$511.85 was found due on purchases of \$10,857.00. Tests of expense purchases could not be completed due to time constraints.

(d) The examiners compared the guest checks dated August 18, 1979 with the documentor-generated tape for the same date and calculated an understatement of taxable sales of 199.55 percent ( $\$11,322.28/\$3,779.80$ ). Application of this rate to taxable sales reported during the period under consideration resulted in sales tax due of \$197,131.44. The examiners also verified that the meals purchased by the Audit Division employees on May 14, 1979 for \$32.62 did not appear on the documentor tape for that date.

8. In opposition to the assessments and deficiencies, petitioners maintain that: (a) the Audit Division's use of a test period was unwarranted in view of "the volume and availability of detailed documentation" concerning the restaurant's business activities; (b) taxable sales of \$11,322.38 as reflected in the guest checks for August 18, 1979 actually represented a full week's receipts; and (c) this restaurant has never been cited by IHOP, Inc. for underreporting income even though "thorough, frequent and detailed examinations" have been performed. Petitioners offered in evidence a letter from IHOP, Inc. which stated, "[T]he average IHOP sales in the month of August 1979 were \$9,128, and in September 1979 \$8,289"; it cannot be determined from the letter or its attachment whether the figures recited are daily, weekly or monthly averages. Petitioners also offered a letter from W. M. Murray & Associates, Inc. under date August 21, 1980, stating that the firm of management examiners had scheduled an audit on August 29, 1980 to verify the reported gross sales of a franchisee, referred to as "IHOP #46-" with a blank space following the two digits and hyphen. (A spot of correction fluid appears after "#46-".)

#### CONCLUSIONS OF LAW

A. That the inadequacy of the record keeping procedures of the restaurant is clearly established by the evidence. Restaurant personnel did not ring up on the cash register a sale made to Audit Division employees in the course of an observation test, and petitioners were unable to produce for the verification of taxable sales guest checks for the audit period, or even, for that matter, guest checks for any quarter falling within the audit period. Furthermore, petitioners failed to demonstrate any error in the audit methodology, which relied directly upon guest checks and documentor readings for August 18, 1979.



Petitioners' claim that such guest checks represented a week's receipts is unsupported by either the guest checks themselves or the letter from IHOP, Inc.

B. That inasmuch as the sales tax examination and its results were proper and correct, the use of such results as a basis to assert an unincorporated business tax deficiency against the partnership International House of Pancakes and to assert New York State personal income tax and New York City nonresident earnings tax deficiencies against the partners was likewise appropriate. (See Matter of William T. Kelly, State Tax Commission, December 31, 1984; Matter of Carmen and Adelia Garzia, State Tax Commission, June 29, 1983.)

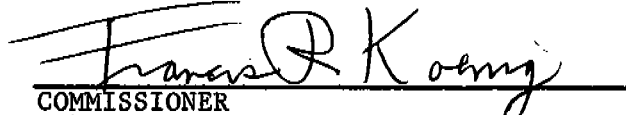
C. That the petition of Charles and Joseph Costa doing business as International House of Pancakes #4639 is denied, and the assessments issued on December 27, 1979 and September 8, 1980 are sustained. The petition of International House of Pancakes is denied, and the Notice of Deficiency issued on April 11, 1980 is sustained. The petition of Joseph Costa is denied, and the Notice of Deficiency issued on April 11, 1980 is sustained. The petition of Charles and Arlene Costa is denied, and the Notice of Deficiency issued on April 11, 1980 is sustained.

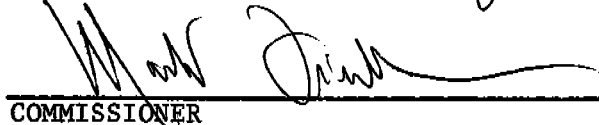
DATED: Albany, New York

STATE TAX COMMISSION

JUN 28 1985

  
PRESIDENT

  
COMMISSIONER

  
COMMISSIONER