

STATE OF NEW YORK

STATE TAX COMMISSION

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In the Matter of the Petition	:	
	:	
of	:	
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BAILO GRILL, INC.	:	DECISION
and LILLIAN STEIN	:	
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, 1977	:	
through August 31, 1978.	:	

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Petitioners, Bailo Grill, Inc. and Lillian Stein, 6101 Broadway, Lancaster, New York 14086, 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, 1977 through August 31, 1978 (File Nos. 34138 and 34722).

A hearing was held before Doris E. Steinhardt, Hearing Officer, at the offices of the State Tax Commission, State Office Building Campus, Albany, New York, on January 8, 1985 at 11:00 A.M., with all briefs to be submitted by April 16, 1985. Petitioners appeared by Boreanaz, Baker & Humann, Esqs. (Harold J. Boreanaz, Esq., of counsel). The Audit Division appeared by John P. Dugan, Esq. (Deborah J. Dwyer, Esq., of counsel).

ISSUES

I. Whether based upon markup tests performed of the purchases of Bailo Grill, Inc., the Audit Division properly determined that petitioners were liable for additional sales and use tax.

II. Whether the Audit Division properly assessed against petitioners a fraud penalty pursuant to Tax Law section 1145(a)(2).

FINDINGS OF FACT

1. On April 14, 1981, the Audit Division issued to petitioner Bailo Grill, Inc. ("Bailo Grill") a Notice of Determination and Demand for Payment of Sales and Use Taxes Due, assessing sales and use taxes for the period March 1, 1977 through August 31, 1978 in the amount of \$96,593.07, plus interest and a fraud penalty pursuant to section 1145(a)(2) of Tax Law Article 28. On April 14, 1981, the Audit Division issued to petitioner Lillian Stein, as president of Bailo Grill, a Notice of Determination and Demand for Payment of Sales and Use Taxes Due, assessing sales tax for the period March 1, 1977 through August 31, 1978 in the amount of \$95,138.75, plus interest, and similarly imposing a fraud penalty under section 1145(a)(2).

2. For several decades, prior to its destruction by fire in December, 1979, Bailo Grill was a popular restaurant and bar in the Buffalo area. It was open for business between the hours of 10:00 A.M. and 1:00 A.M., serving lunch and dinner. The restaurant was well-known for its roast beef sandwich on a Kummelweck roll. Mrs. Stein purchased the business in 1974 and was the sole officer and shareholder.

3. The sales tax audit which resulted in the assessments under consideration was precipitated by an examination of the books and records of one of Bailo Grill's suppliers; this latter examination revealed that Bailo Grill had issued a resale certificate to the supplier and was purchasing cleaning supplies and paper products without paying the sales tax thereon. Upon review of the sales and use tax returns filed by Bailo Grill, the Audit Division discovered that the restaurant failed to remit any use tax with its returns; the Division consequently assigned an examiner to audit the restaurant's books and records.

4. During the course of the audit, Mrs. Stein and the restaurant's accountant, Mr. Martin Saunders, provided the examiner with copies of Bailo Grill's federal corporation income tax returns, cancelled checks drawn on the corporate account and some purchase invoices. Bailo Grill apparently did not maintain either a sales journal or a purchases journal; cash register tapes and guest checks were unavailable, inasmuch as Mrs. Stein discarded these documents after recording the restaurant's receipts in a day book.

Mr. Saunders was responsible for preparing Bailo Grill's federal corporation income tax returns, using information regarding deposits to the corporate account and expenses paid by cash and by check. Mrs. Stein completed and submitted Bailo Grill's sales and use tax returns, relying on the day book. Before acquiring Bailo Grill, Mrs. Stein had been employed as its bookkeeper, in which position she prepared the payroll and certain other records, but not the sales and use tax returns. Based on this and other bookkeeping experience, she was aware of the statutory recordkeeping requirements, but nonetheless disposed of register tapes and guest checks because they were voluminous.

5. As one of his preliminary audit procedures, the examiner compared the restaurant's purchases of paper products during the fiscal year ended June 30, 1978 as reflected in an analysis prepared by Mr. Saunders and as reflected in the supplier's invoices. According to Mr. Saunders' analysis, these purchases totalled \$3,628.37, whereas the supplier's records evidenced purchases of approximately \$25,000.00. The examiner concluded that Bailo Grill's purchase records were incomplete and decided to perform markup testing, using the records of Bailo Grill's suppliers as the source of the restaurant's purchases. His markup methods are summarized below.

(a) Beer markup. The examiner reviewed and summarized the invoices of the restaurant's beer suppliers for the quarterly period March through May, 1978. Bailo Grill's purchases of kegs and bottles of beer during such period as shown by its check disbursements were reconciled with its purchases according to the invoices. With respect to draft beer, the examiner obtained the size of the glasses in which it was served from Mrs. Stein and allowed a 15 percent reduction to purchases to account for spillage and waste. He calculated a weighted markup for draft and bottled beer of 286.4 percent, using cost as shown in the invoices and selling price as shown in the menu, and applied such percentage to beer purchases during the fiscal year ended June 30, 1978. Audited beer sales totalled \$87,643.05.

(b) Liquor markup. The examiner found that Bailo Grill's liquor purchases for the quarterly period ended May 31, 1978 per its check disbursements were in agreement with purchases per its suppliers' records. Using serving sizes as provided by Mrs. Stein, and costs and selling prices in accordance with the purchase invoices and the menu, respectively, and granting a 15 percent allowance for spilling and breakage, the examiner arrived at a weighted markup for liquor of 417.7 percent. The application of this markup to liquor purchases for the fiscal year ended June 30, 1978 yielded audited liquor sales of \$57,587.00.

(c) Cigarette markup. The examiner secured the amount of Bailo Grill's cigarette purchases for the fiscal year ended June 30, 1978 from its supplier. Cigarettes were sold through a vending machine for 75 cents per package. The examiner subtracted the excise tax from the selling price and divided the net price by the cost (43 cents per pack). Purchases for fiscal

year 1978 were then multiplied by the resultant markup percentage of 40 percent to yield audited cigarette sales of \$4,568.00.

(d) Soft drink markup. Bailo Grill purchased syrup from its supplier in 5-gallon tanks and combined the syrup with water in a 1:5 ratio. As in the above-described tests, the examiner used the glass size as provided by Mrs. Stein, the cost as indicated by the supplier's records and the selling price listed on the menu. He reduced purchases for fiscal year 1978 by 15 percent for spillage and by 50 tanks for incorporation in mixed drinks. He then marked purchases up by 900 percent to produce audited soft drink sales of \$64,807.00.

(e) Food markup. Because purchases of beef accounted for approximately 90 percent of Bailo Grill's total food purchases, the examiner decided to conduct markup testing only of beef. He obtained the restaurant's purchases of beef for fiscal year 1978 from its three suppliers, and calculated an average cost per pound of \$1.41. He cooked a roast beef at home during the period of his audit and estimated shrinkage of approximately 20 percent. Further, he estimated a serving size of six ounces. He did not consult with Mrs. Stein respecting either his estimate of shrinkage or of serving portion. Thus, allowing a reduction to purchases of 20 percent for shrinkage, estimating a serving size of six ounces sold for \$1.90 as shown on the menu, and using an average cost of \$1.50 per pound, the examiner computed a markup of 169 percent. He marked up the restaurant's food purchases for fiscal year 1978 by such percentage, which computation resulted in audited food sales of \$832,177.00.

The final step in the examiner's methodology consisted of the calculation of an error rate of 228.2 percent; this rate resulted from dividing audited sales for fiscal year 1978 (\$1,046,782.00) by gross sales reported for the same period (\$244,462.00). He applied the error rate to gross sales reported for

the audit period to arrive at additional sales of \$1,359,125.00, upon which sales tax of \$95,138.75 was due.

A comparison of Bailo Grill's gross sales for the fiscal year ended June 30, 1978 as reflected in its federal corporation income tax return and its sales tax returns and as disclosed by audit follows:

	<u>GROSS SALES</u> <u>FYE 6/30/78</u>
Per federal corporation income tax return	\$ 312,831
Per sales tax returns	244,462
Per audit	1,046,782

Mrs. Stein paid certain suppliers in cash upon delivery of the merchandise, continuing the practice of the former owners of Bailo Grill. The Audit Division viewed these cash transactions, together with the magnitude of the margin of error and the inadequacy of the restaurant's records, to be indicative of fraud, and accordingly assessed against petitioners the penalty of Tax Law section 1145(a)(2).

6. At some point during the audit procedures, the examiner's supervisors referred the matter to the Special Investigations Bureau. Bureau personnel, in conjunction with the examiner, prepared certain schedules, including: a listing of the restaurant's suppliers contacted; an analysis of purchases for the period March, 1977 through August, 1978 and the tax payable on sales thereof, with no markup whatsoever; and a markup computation using the accrual method and a markup percentage of 227 percent. (The accrual method takes account of purchases when payment is remitted, in contrast to the cash method which considers purchases when made.) The analysis of purchases (without application of any markup) is summarized below.

<u>QUARTER ENDED</u>	<u>TAX DUE</u>	<u>TAX PAID</u>	<u>UNDERPAYMENT/ (OVERPAYMENT)</u>
5/31/77	\$5,446.10	\$5,868.00	\$ (421.90)
8/31/77	7,124.32	5,631.50	1,492.82
11/30/77	6,100.03	4,210.00	1,890.03
2/28/78	3,892.53	3,245.55	646.98
5/31/78	4,808.99	3,802.40	1,006.59
8/31/78	6,523.14	6,230.00	293.14

Petitioners did not offer in evidence the markup computation utilizing the accrual method.

7. Lillian Stein and Bailo Grill, Inc. were indicted by an Erie County grand jury on six counts of grand larceny in the second degree in violation of section 155.35 of the Penal Law, and on four counts of filing a false and fraudulent sales and use tax return in violation of section 1145(b) of the Tax Law. Each count of grand larceny in the second degree charged that on the prescribed date for filing sales and use tax returns for the period March 1, 1977 through August 31, 1978, Mrs. Stein and the corporation withheld monies in excess of the sum of \$1,500.00 from the State of New York and failed to remit the monies to the state, in execution of a general fraudulent scheme and with intent to deprive the state of money and to appropriate it to their own use. After trial before the Honorable William J. Flynn, Jr., Mrs. Stein and the corporation were found not guilty on all counts.

8. Petitioners maintain that the audit methods upon which the assessments are predicated were deficient or erroneous in a number of respects, which are outlined below.

(a) Petitioners maintain that the audit failed to adequately consider employee theft. During the audit period, Mrs. Stein dismissed employees for theft and made one telephone complaint to the Sheriff's Department. (The Sheriff was unwilling to investigate her complaint due to lack of proof.)

(b) Petitioners maintain that the allowance for spillage and waste of draft beer was insufficient. Bailo Grill's beer distribution system, purchased many years ago, was incapable of maintaining a constant temperature so as to permit the proper drawing of beer.

(c) Petitioners maintain that the serving size of beef estimated by the examiner was insufficient. The portion of beef served on a Kummelweck roll was very generous, approximately eight ounces.

(d) Petitioners maintain that the allowance for shrinkage of beef was insufficient, and the beef markup procedure in general failed to consider waste. In order to prevent burning, each roast had a layer of fat about two inches in thickness; thus, shrinkage amounted to approximately 30 percent. Further, the principals of one of the restaurant's beef suppliers visited the premises to ascertain the reason(s) for an allegedly excessive amount of waste; as a result of their inspection, restaurant personnel were instructed on the proper methods for cooking the meat and in addition, the steam tables were replaced.

(e) Finally, petitioners maintain that the examiner failed to consider the drop in business which ensued from construction nearby and the days during which the restaurant was closed.

9. On questioning by her representative, Mrs. Stein testified that she prepared the sales and use tax returns of Bailo Grill for the period March 1, 1977 through August 31, 1978 to the best of her ability and without any intention to commit fraud with respect to the returns.

#### CONCLUSIONS OF LAW

A. That in light of the inadequacy of the corporation's recordkeeping, in particular the absence of cash register tapes and guest checks, the Audit



Division's employment of markup techniques to verify taxable sales was warranted and necessary. Through the testimony of Mrs. Stein, petitioners have established that the following adjustments to the food markup testing are appropriate: serving size should be increased to eight ounces, and the allowance for shrinkage should be increased to 30 percent.

B. That respecting the imposition of the fraud penalty, in order to prevail the Audit Division must show by clear and convincing evidence every element of fraud, including willful, knowledgeable and intentional wrongful acts or omissions constituting false representation by petitioners and resulting in deliberate nonpayment or underpayment of taxes due and owing (Matter of Walter Shutt, State Tax Comm., June 4, 1982). As an initial matter, petitioners' acquittal on the criminal charges of filing false and fraudulent returns does not foreclose a finding of fraud in a subsequent civil proceeding; this principle arises from the difference in degree of the burden of proof in criminal and civil cases. (Helvering v. Mitchell, 303 U.S. 391.) After weighing the evidence presented herein, however, it is our conclusion that the Audit Division did not meet its burden. The discrepancies in the corporation's sales as reported on its federal return, as reported in its sales and use tax returns and as revealed by the audit, though not insubstantial, did not persist over such a length of time as to indicate a pattern or scheme. Furthermore, Mrs. Stein's explanation that the restaurant's suppliers were paid in cash as a continuation of the former owner's business practice was reasonable and credible. The remaining evidence is insufficient to sustain the imposition of the fraud penalty.

C. That the petition of Bailo Grill, Inc. and Lillian Stein is granted to

the extent indicated in Conclusions of Law "A" and "B"; the assessments issued on April 14, 1981 are to be modified accordingly; and except as so granted, the petition is in all other respects denied.

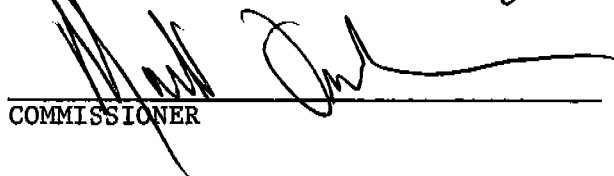
DATED: Albany, New York

STATE TAX COMMISSION

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COMMISSIONER

  
COMMISSIONER