

STATE OF NEW YORK
STATE TAX COMMISSION

In the Matter of the Petition	:
of	:
CHATEAU CHEMISTS, INC.	:
	:
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 December 1, 1975	:
through May 31, 1979.	:

DECISION

Petitioner, Chateau Chemists, Inc., c/o David Horowitz, 372 Eastwood Road, Woodmere, New York 11598, 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 December 1, 1975 through May 31, 1979 (File No. 34521).

A formal hearing was held before Robert A. Couze, Hearing Officer, at the offices of the State Tax Commission, Two World Trade Center, New York, New York, on May 10, 1982 at 10:15 A.M. and continued on September 14, 1982 at 9:30 A.M.; October 25, 1982 at 9:30 A.M.; October 27, 1982 at 9:30 A.M.; October 29, 1982 at 9:30 A.M.; November 1, 1982 at 10:00 A.M.; November 4, 1982 at 10:00 A.M.; November 5, 1982 at 10:00 A.M.; November 8, 1982 at 10:00 A.M.; November 9, 1982 at 10:00 A.M. and continued to conclusion on November 16, 1982 at 9:30 A.M.; with all briefs to be submitted by February 8, 1983. Petitioner appeared by Goldberg & Goldberg (Henry L. Goldberg, Esq., of counsel). The Audit Division appeared by Paul Coburn, Esq. (Robert Plautz, Esq., of counsel).

ISSUES

I. Whether the Audit Division used proper audit procedures in determining petitioner's additional sales and use taxes due.

II. Whether the Audit Division properly imposed the fraud penalty against petitioner for willfully filing false sales tax returns.

FINDINGS OF FACT

1. On September 20, 1980, as the result of a field audit, the Audit Division issued a Notice of Determination and Demand for Payment of Sales and Use Taxes Due against petitioner, Chateau Chemists, Inc., in the amount of \$22,242.90, plus a 50 percent fraud penalty of \$11,121.44 and interest of \$9,400.44, for a total due of \$42,764.78 for the period December 1, 1975 through February 28, 1978. On February 20, 1981, the Audit Division issued a Notice of Determination and Demand for Payment of Sales and Use Taxes Due against petitioner in the amount of \$10,820.43, plus a 50 percent fraud penalty of \$5,410.21 and interest of \$2,837.74, for a total due of \$19,068.38 for the period March 1, 1978 through May 31, 1979.

2. Petitioner, by its president, David Horowitz, executed consents extending the period of limitation for assessment of sales and use taxes for the period December 1, 1975 through August 31, 1978 to September 20, 1980.

3. Petitioner operated a drug store in Woodmere, Long Island. The store was located across the street from the commuter railroad station and, as a result, petitioner had many commuter customers during rush hours. Petitioner also had many regular customers from the neighborhood and it provided a delivery service to these customers, as well as extending credit to them. Petitioner carried some 50,000 items for sale in the store including prescription and non-prescription drugs, cigarettes and tobacco, candy, cosmetics and sundries. In 1979, due to losses incurred as a result of pilferage problems, petitioner closed the store and moved the operation to another location in the center of town.

4. On audit, the auditor examined petitioner's cash disbursements book, sales tax returns, income tax returns and a file of purchase invoices. Petitioner maintained no original sales documents such as sales invoices or cash register tapes; therefore, the auditor decided to perform a purchase markup audit of petitioner's purchase invoices for a test period of one year from June 1, 1977 through May 31, 1978. As the auditor examined the purchase invoices, he found an invoice with no check number indicating payment. Upon questioning petitioner's accountant and president, the auditor was advised that the invoice in question had been paid in cash as an accommodation purchase for a friend. The auditor went directly to the supplier, South Shore Tobacco Company ("South Shore") to verify the purchase. He found that, while petitioner's books reflected total purchases of \$9,256.54 from South Shore for the one year test period, South Shore's records indicated total purchases of \$72,863.09 for the year leaving \$63,606.55 in unexplained purchases. After conferring with his supervisor, the auditor referred the case to the Special Investigations Bureau ("SIB").

5. The SIB agent obtained all of petitioner's books and records and then sent letters to petitioner's suppliers requesting purchase amounts for the period June, 1977 through August, 1979. Of the suppliers canvassed, 12 to 14 responded with purchase amounts which did not agree with petitioner's books and records. All but four of the discrepancies were either satisfactorily explained by petitioner or were so minimal as to have no effect on the audit. The SIB agent, therefore, included unreported purchases from four suppliers in conducting the audit. The prior auditor had performed a detailed analysis of purchases for the month of June, 1977. The agent used the analysis as a basis for conducting a one month test period audit. The agent applied a taxable ratio determined by the auditor for each supplier for the test month and determined

reported taxable purchases for June, 1977. He then added the unreported purchases totalling \$7,825.21 for the month of June, 1977 to the taxable purchases as determined and arrived at a total taxable purchases figure for the test month of \$13,998.24. The agent does not appear to have taken into account that a portion of the unreported purchases were not taxable. The agent marked up the \$13,998.24 to \$15,096.18 using markup percentages which he obtained by contacting members of the Audit Division and requesting markup percentages from audits of similar businesses. The agent did not perform a markup test based on invoices and selling prices nor did he perform an observation test to determine markups or taxable ratios. In fact, the agent never visited petitioner's premises. The audited taxable sales figure of \$15,096.18 was divided by reported taxable sales of \$7,303.58 to arrive at an error factor of 107 percent. The agent applied the error rate to reported taxable sales for the 42 month audit period to obtain additional taxable sales.

6. The Attorney General filed criminal charges against petitioner and its president, David Horowitz, in the District Court of Nassau County for willfully filing false sales and use tax returns in violation of section 1145(b) of the Tax Law for the period March 1, 1978 through November 30, 1978. On December 15, 1980, petitioner pled guilty to three counts of filing false returns for the aforesaid period and all charges against David Horowitz were dismissed. The court imposed a fine of \$375.00 on petitioner and granted a conditional discharge on condition that petitioner pay all taxes, penalties and interest found to be due after exhausting all of its administrative remedies.

7. Following the filing of criminal charges, the Audit Division never returned to petitioner's premises to continue the audit. Instead, the SIB findings for June, 1977 were projected over 42 months and assessments were

issued. The Audit Division's reason for not completing the audit was that it did not want to give petitioner the idea that the civil matter would be resolved while criminal proceedings were taking place. The Audit Division further assumed that, because petitioner pled guilty to fraud for a nine month period, fraudulent returns were filed for the entire period and, therefore, the fraud penalty was imposed for the full 42 months of the audit period.

8. Petitioner's method of determining sales tax due consisted of its accountant determining total sales by adding daily sales and confirming the results by checking bank statements on a monthly basis. In order to determine taxable sales, the accountant multiplied gross sales by a taxable ratio percentage of approximately 25 percent. Petitioner claimed that this figure had been suggested by an Audit Division representative during a prior audit. The 25 percent ratio was adjusted seasonally so that the actual average percentage of taxable sales utilized was 23.6 percent. The taxable sales as determined were filed on the tax returns. Petitioner argues that its sales tax returns were computed based on sales per its books and records. The fact that some of petitioner's purchases were not recorded in its books would have no effect on the amount of taxable sales reported. Thus, petitioner argues, there was no fraudulent filing. Other than petitioner's guilty plea of filing false returns for nine months and the unreported purchases from four suppliers, the Audit Division offered no evidence of willful filing of false returns.

9. Petitioner argued that the Audit Division failed to perform a complete audit based on all of petitioner's available books and records and that the results were, therefore, inaccurate. Petitioner performed its own reaudit using as a base the audit originally begun by the first auditor assigned to this matter and completing the audit using records and information not utilized

by the SIB. Petitioner took the purchases recorded in its books for June, 1977 of \$33,170.38 and added the unreported purchases for the month of \$7,825.21, as determined by the Audit Division, to arrive at total purchases for June, 1977 of \$40,995.59. Petitioner used all of the auditor's taxable ratios for the various suppliers except in three instances where it used an average taxable ratio for several months and applied it to the June, 1977 purchases to determine taxable purchases from those three suppliers. The result was \$10,494.40 in total taxable purchases.

10. Petitioner then broke down its purchases into five categories: cigarettes, tobacco and candy, cosmetics, sundries and taxable pharmaceuticals. With respect to tobacco and candy and taxable pharmaceuticals, petitioner used markups as determined by the Audit Division of 50 percent and 20 percent, respectively. With respect to cigarettes, petitioner sold cartons at cost and individual packs at a 20 percent markup. Therefore, an observation test was conducted to determine the number of cartons and individual packs sold and petitioner found that 93 percent of cigarette sales were by carton and the resulting overall markup was computed to be 1.4 percent. With respect to cosmetics and sundries, markup tests were conducted using purchase invoices and selling prices determined from "pennysaver" ads and window signs from the audit period. The result was a 25 percent markup on cosmetics and a 13 percent markup on sundries. Petitioner marked up the purchases by category to arrive at taxable sales for June, 1977 of \$11,753.11. The latter amount was compared to June, 1977 purchases to arrive at an average weighted markup for the audit period of 12 percent. Taxable purchases for June, 1977 were compared to total purchases for the month to arrive at a 25.6 percent taxable ratio for the entire audit period.

11. Petitioner took its total purchases per its books for the 42 month audit period amounting to \$1,369,500.71 and added the unreported purchases of \$151,739.44 determined by the Audit Division to arrive at total purchases. The unreported purchases, however, only encompassed a 29 month period and were not the total unreported purchases for the entire 42 month period. Petitioner applied the taxable ratio and average markup to the taxable purchases to arrive at taxable sales of \$436,169.00.

12. The Audit Division did not make any allowance for pilferage; however, the auditor testified that there had to be some pilferage occurring in the store. Petitioner submitted diagrams of the store which showed several "blind spots" which could not be observed for pilferage. There were numerous children from a nearby school who created pilferage problems in the store and petitioner's employees often found empty merchandise boxes scattered around the store indicating pilferage. Petitioner, therefore, used a pilferage allowance of 2.5 percent which it deducted from taxable sales to arrive at a total taxable sales figure of \$425,265.00 which, when compared to reported taxable sales of \$424,817.00, resulted in additional taxable sales of \$448.00.

13. Petitioner further argued that even using the taxable ratio of 29.6 percent and average markup of 24.2 percent as determined by the Audit Division and applying those percentages to the total purchases for the audit period results in additional taxable sales of \$120,458.00 for a tax due of approximately \$8,472.00 rather than the \$33,063.33 determined by the Audit Division using the 107 percent error factor.

14. With its brief, petitioner submitted proposed findings of fact for the Commission's consideration. The following proposed findings have been adopted by the Commission: 1, 4, 7, 8, 13-22, 24-27, 29, 30, 32-36, 38-44, 46-50,

53-55, 68, 70-77, 86, 89, 90, 94, 95, 98, 100, 101, 103, 107-112 and 115. The following proposed findings were unsupported by the evidence: 9, 10, 23, 51, 58, 59, 61-67, 81, 85, 93 and 97. The following proposed findings were irrelevant or unnecessary for a determination of this matter: 79, 80, 82, 83, 87, 88, 91, 92, 96, 99, 102, 105, 113 and 114. The following proposed findings were conclusory in nature rather than factual: 2, 3, 5, 6, 11, 12, 28, 31, 37, 45, 52, 56, 57, 60, 69, 78, 84, 104 and 106.

CONCLUSIONS OF LAW

A. That section 1135 of the Tax Law, in effect during the period in issue, requires every person required to collect sales tax to keep records of every sale and of the tax payable thereon. "Such records shall include a true copy of each sales slip, invoice, receipt, statement or memorandum...". Section 1138(a) provides that if a sales tax return "is not filed, or if a return when filed is incorrect or insufficient, the amount of tax due shall be determined by the tax commission from such information as may be available. If necessary, the tax may be estimated on the basis of external indices...". "When records are not provided or are incomplete and insufficient, it is [the Tax Commission's] duty to select a method reasonably calculated to reflect the taxes due. The burden then rests upon the taxpayer to demonstrate...that the method of audit or the amount of the tax assessed was erroneous" (Surface Line Operators Fraternal Organization, Inc. v. Tully, 85 A.D.2d 858).

B. That, inasmuch as petitioner failed to maintain any original sales documents, the Audit Division was justified in resorting to an indirect audit method using external indices to determine the tax due. However, the audit method adopted must be "reasonably calculated to reflect the taxes due" (W. T. Grant Co. v. Joseph, 2 N.Y.2d 196). The reaudit by petitioner using all

available records for the audit period, as well as observation tests on the store premises, more accurately reflects the actual taxes due than the limited margin of error method used by the Audit Division. The fact that there were ongoing criminal proceedings was not a sufficient reason for the SIB agent to refrain from visiting the store location and availing himself of all available records.

C. That, although petitioner's reaudit was more accurate than the Audit Division's audit, there were several erroneous assumptions made by petitioner in determining the tax due. In determining the taxable ratios for each supplier for the month of June, 1977, petitioner used average taxable ratios from several months and applied them to the June purchases of three suppliers. This procedure was improper in that the June purchase invoices, on their face, accurately stated the June taxable ratio. To apply the taxable ratios of other months to the June purchases only serves to distort the actual June taxable ratio. Therefore, petitioner should have used the actual June, 1977 taxable ratios as determined by the auditor using the June, 1977 invoices. Use of the original taxable ratios results in additional taxable purchases for June of \$1,020.07, which when added to petitioner's determination of \$10,494.40 results in taxable purchases for June, 1977 of \$11,514.47. The increase in taxable purchases causes an increase in taxable sales of \$1,207.81 using petitioner's markup percentages. The taxable sales for June, 1977 are, thus, \$12,960.92. When taxable sales are compared to taxable purchases, there is a 12.56 percent overall weighted average markup to be used for the entire audit period. When taxable purchases for June, 1977 of \$11,514.47 are compared to total purchases for June of \$40,995.59, including unreported purchases, the result is an overall taxable ratio of 28 percent to be used for the entire audit period.

D. That petitioner also erred in determining total purchases for the entire 42 month audit period. Petitioner added unreported purchases for a 29 month period to reported purchases for 42 months. It is clear from the record that the practice of omitting purchases from the books and records occurred throughout the audit period; therefore, the unreported purchases should be projected throughout the 42 months as follows:

Unreported purchases for 29 months	\$151,739.44	=	\$5,232.39
Number of months	29		Unreported per month

\$ 5,232.39	Unreported per month
x 42	Months in audit period
<u>\$219,760.38</u>	Unreported purchases for entire audit period

Petitioner's purchases per books for the audit period were \$1,369,500.71. Adding \$219,760.38 in unreported purchases results in total purchases for the 42 months of \$1,529,261.09. Applying the 28 percent taxable ratio and the 12.56 percent markup results in a taxable sales figure as follows:

\$1,529,261.09	Total purchases
x .28	Taxable ratio
<u>\$ 444,993.08</u>	Taxable purchases
x .1256	Markup percentage
<u>\$ 55,891.13</u>	Markup
+ 444,993.08	Taxable purchases
<u>\$ 500,884.21</u>	Taxable sales

E. That petitioner adequately demonstrated that there was a pilferage problem in the store. The auditor even conceded that there had to be pilferage in the store, yet no allowance was made for this problem. Under the circumstances, therefore, a 2.5 percent pilferage allowance is reasonable and should have been included in the Audit Division's determination. Applying the pilferage allowance to the \$500,884.21 taxable sales results in a total taxable sales figure for the entire audit period of \$488,362.11. The taxable sales figure when compared to taxable sales reported of \$424,817.00 indicates additional taxable sales of \$63,545.11. The Audit Division is, therefore, directed to

recompute the sales tax due based on the latter additional taxable sales figure.

F. That section 1145(a)(2) of the Tax Law provides,

"[i]f the failure to file a return or to pay or pay over any tax to the tax commission within the time required by this article is due to fraud, there shall be added to the tax a penalty of fifty percent of the amount of the tax due...".

The standard of proof necessary to support a finding of fraud requires "clear, definite and unmistakeable evidence of every element of fraud, including willful, knowledgeable and intentional wrongful acts or omissions constituting false representations, resulting in deliberate nonpayment or underpayment of taxes due and owing" (Matter of Cardinal Motors, Inc., State Tax Commission, July 8, 1983; Matter of Walter Shutt and Gertrude Shutt, State Tax Commission, June 4, 1982). The only bases for imposition of the fraud penalty put forth by the Audit Division were petitioner's guilty plea to filing of false returns for three taxable quarters and the large amount of unreported purchases. Petitioner has shown that its accountant used sales figures from the cash receipts book confirmed by bank deposit statements; thus, whether petitioner recorded all of its purchases is irrelevant to the issue of whether there was fraud in the preparation of the sales tax returns. Petitioner may have chosen an arbitrary and inaccurate means to complete its tax returns, but this is not clear and convincing evidence of fraud. Moreover, petitioner's plea of guilty to filing false returns for a nine month period collaterally estops petitioner from contesting the civil fraud penalty for that nine month period only (Matter of Cardinal Motors, supra; Matter of Shutt, supra). The Audit Division has failed to sustain its burden of proof of fraud for the remaining 33 months of the audit period and the penalty provided for in section 1145(a)(1)(i) of the Tax Law will be imposed for those months.

G. That the petition of Chateau Chemists, Inc. is granted to the extent indicated in Conclusions of Law "B", "C", "D", "E" and "F"; that the Audit Division is directed to modify the notices of determination and demands for payment of sales and use taxes due issued September 20, 1980 and February 20, 1981 accordingly; and that, except as so granted, the petition is in all other respects denied.

DATED: Albany, New York

MAY 04 1984

STATE TAX COMMISSION

Roderich O'Connell
PRESIDENT

Francis R. Koenig
COMMISSIONER

Mark J. Smith
COMMISSIONER