STATE OF NEW YORK

STATE TAX COMMISSION

In the Matter of the Petition

of

HAWAII SEA RESTAURANT CORP.

DECISION

for Redetermination of a Deficiency or for Refund of Corporation Franchise Tax under Article 9-A of the Tax Law for the Fiscal Years Ended September 30, 1980 and September 30, 1981.:

Petitioner, Hawaii Sea Restaurant Corp., 1475 Williamsbridge Road, Bronx, New York 10461, filed a petition for a redetermination of a deficiency or for refund of corporation tax under Article 9-A of the Tax Law for the fiscal years ended September 30, 1980 and September 30, 1981 (File No. 51044).

A hearing was held before Sandra F. Heck, Hearing Officer, at the offices of the State Tax Commission, Two World Trade Center, New York, New York, on February 25, 1986 at 9:30 A.M., with all additional information to be submitted by March 21, 1986. Petitioner appeared by Robert S. Elliott, Esq. The Audit Division appeared by John P. Dugan, Esq. (Anne W. Murphy, Esq., of counsel).

ISSUES

I. Whether the Audit Division properly determined, based on a sales tax audit finding of additional taxable sales, that the proceeds from such sales represented additional taxable income to petitioner for corporate franchise tax purposes.

11. Whether the Audit Division was justified in its use of a purchase markup analysis to verify petitioner's taxable sales.

FINDINGS OF FACT

1. Petitioner, Hawaii Sea Restaurant Corp., is a Chinese restaurant in the Bronx, New York, with a restaurant, bar, and take-out service.

2. On November 7, 1983, the Audit Division issued to petitioner two notices of deficiency, asserting additional franchise tax due under Article 9-A of the Tax Law for the fiscal years ended September 30, 1980 and September 30, 1981 in the respective amounts of $3,686.40 and $4,705.10, plus interest and additions to tax as provided for in section 1085 of the Tax Law.

3. The franchise tax deficiencies under consideration in this proceeding were predicated solely on the results of a sales tax audit of petitioner's business, which audit covered the period December 1, 1978 through November 30, 1981.

4. On December 7, 1981, the Audit Division commenced a sales tax audit of petitioner's business, at which time petitioner was requested to make available all of its books and records for the audit period, December 1, 1978 through November 30, 1981. All records that were requested were made available to the auditor, including sales tax returns, federal and state income tax returns, guest checks and cash register tapes, purchase invoices, the general ledger, and cancelled checks.

5. Petitioner recorded its restaurant sales on sequentially numbered guest checks which separately stated the amount of sales tax due. The guest checks were rung up on the cash register, but, because the checks were not stored in the sequence that they were rung up, the cash register tapes could not be reconciled with the guest checks. Petitioner did not provide its customers with guest checks for bar sales, but instead recorded the bar sales on cash register tapes which did not segregate the

each transaction. The take-out sales were recorded on forms that were numbered in repeating sequences of numbers "1" through "50". The petitioner entered totals of the restaurant, bar, and take-out sales on daily sales receipt sheets. The daily sales receipt sheets were the basis on which petitioner reported and paid sales tax.

6. In order to determine whether petitioner's books and records were adequate to verify its sales tax liability, the auditor conducted an analysis of guest checks for a two day period, July 11 and 12, 1981. The totals of restaurant sales from the daily sales receipt sheets were compared to totals of restaurant sales recorded on available guests checks for the two day test period. The totals from the daily sales receipt sheets were higher than the guest check totals on both days.

7. The initial analysis of the guest checks, as described in Finding of Fact "6", revealed that petitioner did not have all of its guest checks for the two day test period. An analysis of the guest checks by number revealed that out of 236 guest checks, there were 32 checks missing (13.56%).

8. Petitioner explained that a small number of the missing checks were attributable to customers who left the restaurant without paying. The remaining missing guest checks represented credit card sales. Petitioner stored the guest checks for credit card sales, together with the credit card receipts, separately from the checks for cash sales. Petitioner claimed that the credit cards guest checks had been made available during the audit. The auditor was not available to testify at the hearing and her team leader did not know whether the auditor had examined any guest checks for credit card sales. The credit card guest checks were not available at the hearing.

9. The Audit Division, based on its finding that petitioner had missing guest checks, determined that petitioner's books and records were inadequate and, thus, the use of external indices to verify sales tax liability was justified. Accordingly, the Audit Division estimated petitioner's taxable sales and resultant sales tax liability through the use of a purchase markup analysis.

10. The Audit Division calculated the markup percentage on beer and liquor in the following manner:

a. Using the purchase prices from petitioner's purchase invoices for July, 1981, together with information supplied by petitioner regarding size, type and price of drinks, the auditor estimated the taxable sales of beer and liquor for July 1981 (beer $2,812.80, liquor $30,509.46). The total amount of purchases indicated on the invoices (beer $855.92, liquor $7,339.92) was then subtracted from the estimated taxable sales to determine gross profit (beer $1,956.88, liquor $23,169.54). By making a ratio of gross profit over purchase price, the Audit Division developed an estimated markup percentage for beer of 228.6288 percent and for liquor of 315.6647 percent.

b. The estimated markup percentages for beer and liquor were applied to total purchases of alcoholic beverages, as recorded in petitioner's general ledger for the entire audit period, to arrive at total taxable alcohol sales before adjustments ($817,952.19).[1] The total alcohol sales were reduced by the amount of purchases recorded in the general ledger for the audit period ($207,920.96) to yield gross profit ($610,031.23). By making a ratio of gross profit to purchase price, the Audit Division developed an estimated markup percentage for both beer and liquor over the entire audit period of 293.3957 percent.

c. The 293.3957 percent markup percentage was reduced to 275 percent at the request of petitioner to reflect buybacks (i.e., selling four drinks for the price of three) and variations in selling price during the audit period.

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1 Because petitioner's general ledger did not separate beer and liquor purchases, the auditor first calculated the percentages of beer and liquor purchases from total alcohol purchases for the month of July 1981. The auditor also calculated, from information in petitioner's general ledger, the percentage of alcohol sold at the bar versus the percentage sold in the dining room. This second calculation was necessary because the bar sales included sales tax within the selling

11. The Audit Division applied a 76% markup percentage to food purchases listed in the general ledger for the entire audit period. This markup percentage was taken from a prior audit of the petitioner and its use in the sales tax audit herein was agreed to by petitioner.

12. The calculations and adjustments made to arrive at audited taxable sales for both food and beer and liquor sales are more specifically detailed as follows:

Alcohol Purchases - General Ledger (12/78-11/81)	$ 207,920.96	
Less: 1½% Pilferage	(3,118.81)	
Total Adjusted Alcohol Purchases	$ 204,802.15	
Total Adjusted Alcohol Purchases x 275% Markup		$ 768,008.06
Less: 2% purchases at cost for employees own use		(11,435.66)
Food Purchases - General Ledger (12/78-11/81)	$1,745,690.62	
Less: Employees' Allowance	(25,000.00)	
Less: Spoilage	(25,000.00)	
Adjusted Food Purchases	$1,695,690.62	
Less: 1½% Robberies	(25,435.36)	
Total Adjusted Food Purchases	$1,670,225.26	
Total Adjusted Food Purchases x 76% Markup		$2,939,649.26
Audited Taxable Sales		$3,696,221.66
Minus: Taxable Sales Reported Per Sales Tax Returns		(3,540,686.00)
Additional Taxable Sales		$ 155,535.66

13. The auditor calculated an error rate by dividing the additional taxable sales ($155,535.66) by taxable sales reported by petitioner on its sales tax returns ($3,540,686.00), to yield a 4.3928 percent error rate. The auditor then apportioned the additional taxable sales to the quarterly periods at issue by application of the error rate to reported taxable sales.

14. The petitioner consented to the sales tax assessment which resulted from the sales tax audit and paid the additional amount of sales tax. Petitioner was not aware at the time of the consent that the results of the sales tax audit would form the basis of corporate franchise tax deficiency

15. The franchise tax deficiencies were predicated solely on the sales tax audit. The additional taxable sales were considered to be additional gross receipts in each of the corresponding periods for corporate franchise tax.

16. The petitioner contended that the corporate franchise tax deficiencies should have been predicated upon a cash availability income tax audit performed on the managers of petitioner corporation, rather than on the sales tax audit. Petitioner claimed that the income tax audit of the managers provided a more accurate indication of the corporation's income and that, because the cash availability analysis resulted in a smaller amount of tax, it was controlling.

CONCLUSIONS OF LAW

A. That because petitioner's records were inadequate in serving as a verifiable record of taxable sales, the Audit Division was justified in estimating petitioner's sale tax liability through the application of a purchase markup analysis (see, Matter of Korba v. State Tax Commission, 84 A.D.2d 655 [1981]; Tax Law §1138[a][1].

B. That purchase markup analyses constitute an appropriate means of reconstructing a taxpayer's taxable income, and the results thereof may properly be employed as a basis to assert a deficiency for corporate franchise tax purposes (Matter of William T. Kelly, State Tax Commission, December 31, 1984; Matter of Nautilas Restaurant, Inc., State Tax Commission, November 7, 1985). But where the markup percentage was the product of negotations between the auditor and the taxpayer rather than an actual computation of the ratio of gross profits to costs, and where the taxpayer consented to the use of the negotiated figure for sales tax purposes but not for corporate franchise tax purposes, such figure alone cannot constitute a foundation for the franchise tax deficiencies asserted (Nautilus Restaurant, Inc., State Tax Commission, November 7, 1985, Golden Coach, Inc., State Tax Commission, November 7, 1985).

C. That the markup percentage for beer and liquor, although reduced through negotiations between the taxpayer and the Audit Division, was based on actual analysis of petitioner's purchases and estimated selling prices. Thus, the additional taxable sales resulting from the beer and liquor markup test may be considered additional entire net income for franchise tax purposes.

D. That the markup percentage for food was not the product of an actual markup analysis of petitioner's food purchases during the audit period, and, as such, cannot form the basis for a determination that petitioner had additional entire net income resulting from unreported taxable food sales.

E. That petitioner's argument that the Audit Division is obligated to use the results of an income tax audit performed on the managers of petitioner corporation, rather than the results of the sales tax audit, when determining a corporate franchise tax deficiency is without merit. The burden of proving that deficiency assessments were improper rests with the petitioner (Reader's Digest Ass'n., Inc. and Subsidiaries v. State Tax Commission, 103 A.D.2d 926, 478 N.Y.S.2d 168 [1984]). The fact that another method may be used to result in a different tax amount is not sufficient to show error by the Audit Division.

F. That the petition of Hawaii. Restaurant Corp. is granted to the extent indicated in Conclusion of Law "D"; the Audit Division is directed to modify the notices of deficiency issued November 7, 1983 accordingly; and, except as so granted, the petition is in all other respects denied.

DATED: Albany, New York

SEP 15 1986

STATE TAX COMMISSION

Roderick W Chu
PRESIDENT

F. D Koenig
COMMISSIONER

Maria T Jones
COMMISSIONER