

STATE OF NEW YORK

STATE TAX COMMISSION

In the Matter of the Petition

of

MESKOURIS BROTHERS, INC.

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 November 30, 1979. :

Petitioner, Meskouris Brothers, Inc., 232 East 64th Street, New York, New York 10021, 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 November 30, 1979 (File No. 56284).

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 26, 1986 at 9:40 A.M. Petitioner appeared by Barry Leibowicz, Esq. The Audit Division appeared by John P. Dugan, Esq. (Michael B. Infantino, Esq., of counsel).

ISSUE

Whether the audit methodology employed by the Audit Division resulted in a reasonable calculation of petitioner's sales and use tax liability.

FINDINGS OF FACT

1. On July 10, 1980, as the result of a field audit, petitioner, Meskouris Brothers, Inc., executed a consent to fixing of tax not previously determined and assessed in the amount of \$57,809.63. Subsequently, on August 27, 1980, the Audit Division issued to petitioner two notices and demands for payment of sales and use taxes due. The first notice was for the period March 1, 1976

through August 31, 1979 and asserted a base tax due of \$52,279.46, together with a penalty of \$12,288.42 and interest of \$15,583.25, for a total amount due of \$80,151.13. The second notice was for the period September 1, 1979 through November 30, 1979 and asserted a base tax due of \$5,530.17, together with a penalty of \$718.92 and interest of \$455.13, for a total amount due of \$6,704.22. The amount of tax due from both assessments totals \$57,809.63. Petitioner had executed consents extending the period of limitation for assessment of sales and use taxes for the period March 1, 1976 through November 30, 1979 to September 20, 1980.

2. Petitioner paid in full the amount of tax due on the above described assessments, together with the applicable penalties and interest. Petitioner timely sought refunds in the amounts of \$15,583.25 and \$21,273.48, for a total refund sought of \$36,856.73. Said refund requests were denied by the Audit Division on July 20, 1984 resulting in the instant petitions.

3. Petitioner operates a restaurant named "The Jackson Hole," located at 232 East 64th Street, New York, New York, which is known primarily for its hamburgers. Petitioner has been in business at this location since 1972. At the time of the auditor's initial visit to the premises on April 30, 1979, the restaurant had 3 stools and approximately 12 tables for a seating capacity of 45-50 people. All sales made at petitioner's premises were subject to sales tax.

4. Upon examination of petitioner's books and records, the Audit Division determined that the books and records were inadequate to verify petitioner's taxable sales. The Audit Division based its determination on the following facts:

- a) Guest checks were not used to record every sale.
- b) Guest checks and cash register tapes were not retained for the period under audit.
- c) The receipts of the day were taken home at night by petitioner's officers and, thus, the system lacked internal controls to trace operating cash from one day to the next.
- d) Petitioner purchased most of its food and beverages with cash taken directly from the cash register during the course of a day, resulting in an underreporting of purchases.

5. Petitioner stipulated on the record that it would not raise the issue whether an indirect audit method was appropriate in this case. Petitioner limited its appeal to whether the particular indirect audit method chosen by the Audit Division (i.e., a two-day observation test) was valid.

6. The Audit Division determined that, because of the lack of internal control by the petitioner over its sales and purchases, the only indirect audit method available to it was an observation test.

7. A two-day observation test of petitioner's business operation was performed by the auditor on Tuesday, November 13, 1979 from 9:30 A.M. to 4:45 P.M., and on Friday, November 16, 1979 from approximately 9:30 A.M. to 5:00 P.M. The days were chosen to reflect variations in sales from the beginning of the week to the end of the week. The month of November was chosen because it was when the auditor and the petitioner were able to arrange a date when they were both available.

8. The observation test performed on November 13, 1979 revealed that petitioner made \$345.18 in taxable sales between the hours of 9:30 A.M. and 4:45 P.M. It was a cloudy day with drizzle. On November 16, 1979, the observation test revealed that petitioner made \$398.72 in taxable sales between the hours of 9:30 A.M. (approximately) and 5:00 P.M. It was a cool, dry day. Petitioner's

usual hours of operation are approximately 9:30 A.M. to 1:30 A.M.¹, Monday through Saturday (16 hours), and 9:30 A.M. to midnight on Sunday (14.5 hours).

9. Based on the results of the above observation test, the auditor made the following calculations:

Total sales per 2 day observation	744.00	
Total hours of observation	15.00	= \$49.60/hr.
Hours open per week	110.50	
Average Hourly Sales	x 49.60	
Total sales per week	5,480.80	
# of weeks in quarter	x 13	
Adjusted taxable sales per qtr. ended 11/30/79	71,250.00	
# of qtrs. to be applied (12/1/78-11/30/79)	x 4	
	285,000.00	
Minus Taxable Sales Reported (12/1/78-11/30/79)	-64,264.00	
	220,736.00	
Plus: Wine purchases (2,000 in 1978) after 200% markup	6,000.00	
Unreported taxable sales 12/1/78-11/30/79	226,736.00	
Unreported taxable sales 12/1/78-11/30/79	226,736.00	
Taxable sales reported 12/1/78-11/30/79	64,264.00	= 352.82%

The above calculations used only the last four quarters in the audit period (12/1/78-11/30/78) to determine the percentage of unreported to reported taxable sales. An earlier, higher assessment used the full audit period as the basis for determining a 429.87 additional taxable sales percentage. The recomputation was performed at the request of petitioner's representative, who felt it would make the assessment reflect the increase in petitioner's business and inflation. This resulted in a reduction of the tax assessed by \$12,432.80.

¹ There was some controversy on the record as to whether petitioner's business remained open until 1:00 A.M., or closed at 5:00 P.M., on the days of the observation. This controversy does not affect the results of the audit herein.

10. The 352.82 additional taxable sales percentage was applied to the taxable sales for the entire audit period (\$201,702.00) resulting in additional taxable sales of \$711,646.00 and additional tax due of \$56,931.16 for the audit period.² A penalty was added to the assessment because petitioner failed to maintain adequate records and because the audit resulted in a substantial amount of additional tax due.

11. Petitioner presented a newspaper article from the New York Daily News, dated September 23, 1979, entitled "The Urban Tourist", in which "The Jackson Hole" was listed as a good, inexpensive place to take a date after the theatre. The article said "The hamburgers are the best in town." Petitioner attributed an increase in its business to the write-up in The Daily News, but failed to produce any records to substantiate that fact. The article also indicated that "The Jackson Hole" was open in the evening past 5:00 P.M.

12. Petitioner presented a report by James W. Albrecht, Ph.D., who was qualified as an expert in the field of statistics, together with the testimony of Anthony M. Akel, Ph.D., who was similarly qualified as an expert in statistics. Dr. Akel gave his opinion that the procedure followed by the Audit Division was an attempt to develop a statistic based on sampling data. It is the opinion of both expert witnesses that the extrapolation of the results of the two-day observation test of petitioner's business over the 3½ year audit period did not produce a statistically valid result.

2 Additional tax in the amount of \$878.47 was based on a margin of error test on tax charged on guest checks on November 13 and 16, 1979, and fixed asset purchases and expense purchases on which no tax was paid. The calculations used to arrive at these additional amounts of tax were not challenged at the hearing.

13. The expert witnesses explained that in order for the audit to yield a statistically valid result, the sample must be representative and it must be large enough to allow generalization with the requisite degree of confidence.

14. Dr. Akel concluded that the sample size used by the Audit Division herein did not allow for statistically reliable or valid extrapolations because the variance and error margin were too high.

15. Dr. Albrecht's report indicated that the samples taken were not representative because the sales during the 9:00 A.M. to 5:00 P.M. period were not representative of sales from 5:00 P.M. to 1:30 A.M., the observation days were both weekdays and not representative of weekend sales and, finally, the observation of sales at the end of the audit period were not representative of the last four quarters of the audit period because it neglected the possibility of sales growth.

16. The Audit Division's position with respect to the argument that the audit results were not statistically valid was that the audit method was not designed as a statistical sample, but rather was an effort, in the absence of books and records, to project the amount of taxable sales based on information collected about the actual operation of petitioner's business. The use of statistical sampling by the Audit Division is limited to those cases where there are complete source documents.

17. Petitioner claimed that the audit method failed to reflect seasonal variations in its business. Petitioner also claimed that the results were inflated because the hours of observation were petitioner's busiest hours and because the dates at the end of the audit period reflected a substantial increase in petitioner's business. Petitioner presented no documentary evidence

to support its claim and presented no alternative method to verify its sales tax liability.

18. Petitioner presented evidence that an audit, covering the same time period herein, of the corporation for franchise tax purposes and of the officers for personal income tax (cash availability) resulted in no additional assessments.

CONCLUSIONS OF LAW

A. That section 1135 of the Tax Law requires every person required to collect sales tax to keep records of every sale for audit purposes. Where the taxpayer fails to keep such records, or where the records are insufficient to verify that sales tax was properly collected, the tax commission may estimate the amount of tax due based on external indices (Tax Law §1138[a]).

B. That it is the duty of the tax commission, when estimating tax liability using external indices, to select a method of audit reasonably calculated to reflect the sales and use taxes due. The burden then rests upon the taxpayer to demonstrate that the method of audit or the amount of tax assessed was erroneous (Surface Line Operators Fraternal Organization, Inc. v. Tully, 85 A.D.2d 858 [1982]).

C. That there is no requirement under the Tax Law, the regulations promulgated thereto, or in the case law of New York State that the audit method yield a statistically valid result. In fact, New York courts have recognized that where petitioner's recordkeeping is faulty, exactness is not required in the determination of tax liability (Meyer v. State Tax Comm., 61 A.D.2d 223 [1978]; Korba v. State Tax Comm., 84 A.D.2d 655 [1981]; Day Surgicals, Inc. v. State Tax Comm., 97 A.D.2d 865 [1983]). The fact that a larger number of hours of observation would result in a more accurate result does not render the audit procedure invalid.

D. That petitioner's books and records were not only insufficient to allow a detailed examination to verify sales tax liability, but they were so inadequate as to virtually preclude any method of estimating sales tax liability other than an observation test. The requirement that the tax commission choose an audit method reasonably calculated to reflect tax due must be considered in view of the information made available to it to estimate tax liability. Where, as in the instant case, petitioner was unable to substantiate any of its reported taxable sales, the tax commission has upheld the use of observation tests (see, Hugo German d/b/a German Coffee Shop, State Tax Commission, January 18, 1985; 265 City Island Sea Food Market, Inc., State Tax Commission, May 6, 1983).


E. That petitioner has failed to present any alternative method to verify its tax liability and has failed to present evidence sufficient to modify the amount of tax assessed. Accordingly, the burden of proving that the method of audit or the amount of tax assessed was erroneous has not been met by the petitioner.

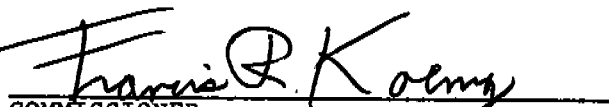
F. That the petition of Meskouris Brothers, Inc. is denied and the denial of refund issued July 20, 1984 is sustained.

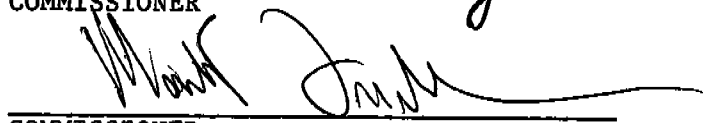
DATED: Albany, New York

STATE TAX COMMISSION

SEP 15 1986


PRESIDENT


COMMISSIONER


COMMISSIONER