STATE OF NEW YORK

DIVISION OF TAX APPEALS

In the Matter of the Petition	:	
of	:	
PAYNE AVENUE PIZZA & SUBS, INC.	:	DETERMINATION DTA NO. 824327
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, 2006 through February 28, 2009.	:	

Petitioner, Payne Avenue Pizza & Subs, Inc., 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, 2006 through February 28, 2009.

A hearing was held before Herbert M. Friedman, Jr., Administrative Law Judge, at the offices of the Division of Tax Appeals, 183 East Main Street, Rochester, New York, on December 18, 2012 at 9:15 A.M., with all briefs to be submitted by April 19, 2013, which date began the six-month period for the issuance of this determination. Petitioner appeared by the Law Office of Shelby Bakshi & White (Justin S. White, Esq., of counsel). The Division of Taxation appeared by Amanda Hiller, Esq. (Michael B. Infantino, Esq., of counsel).

ISSUES

I. Whether, given that the Division's use of an indirect audit method was appropriate, petitioner has shown error in the chosen audit method or result.

II. Whether petitioner has established any facts or circumstances warranting the reduction or abatement of penalties.

FINDINGS OF FACT

1. Petitioner, Payne Avenue Pizza & Subs, Inc., operated a pizza parlor in North Tonowanda, New York, during the period from March 1, 2006 through February 28, 2009. Petitioner's restaurant featured over 95% take-out service, although it did have a few tables for customers who chose to dine there. It did not, however, feature waitservice. The restaurant sold pizza, calzones, submarine sandwiches, chicken wings, pasta dishes, tacos, salads, french fries, onion rings, garlic bread, and ice cream. It also sold soft drinks but did not serve alcoholic beverages.

2. Petitioner's restaurant has been owned and operated by its principal, Paul Garofalo, throughout its entire existence of approximately 20 years.

3. An audit of petitioner's business was commenced by the Division of Taxation (Division) by letter dated February 12, 2009. At that time, petitioner was advised of the audit and directed to provide to the Division all books and records pertaining to its sales and use tax liability for the audit period, i.e., March 1, 2006 through February 28, 2009. Records requested by the Division included sales tax returns, worksheets and canceled checks, federal income tax returns, New York State corporation tax returns, a general ledger, a general journal and closing entries, sales invoices, exemption documents, fixed asset purchase and sales invoices, expense purchase invoices, merchandise purchase invoices, bank statements with canceled checks and deposit slips for all bank accounts, cash receipts journal, cash disbursement journal, depreciation schedules, guest checks and cash register tapes.

4. In response to the Division's request, petitioner provided federal income tax returns for 2006 and 2007, various bank statements, utility bills, food purchase invoices, and its check register. Guest checks or cash register tapes were not provided. The records provided were

reviewed by the Division's auditor and deemed to be inadequate in order to perform a direct audit. Petitioner does not dispute the inadequacy of the records provided.

5. As a result of the paucity of records provided, the Division performed an indirect audit to calculate the amount of taxable sales. The indirect method chosen was a markup of the cost of goods sold to determine total sales during the audit period. At the outset, the auditor requested third-party vendor verification of goods purchased by petitioner. These vendors were selected from a pool created by investigators from the Division. Based on the responses of the various third-party vendors solicited, the Division calculated petitioner's total cost of goods sold during the audit period to be $428,068.29.

6. The auditor then employed an industry index entitled Restaurant Industry Operations Report, 2006-2007 edition, to compute the gross sales of petitioner from the total cost of goods sold. The publication contains data on restaurant operations in various categories, was commonly used in the auditor's office and he was familiar with the use of the index. The index is based on financial and operating data for 2006 provided by members of the National Restaurant Association and members of various state restaurant associations. The data processing contained in the report was performed by Deloitte & Touche LLP.

7. The auditor determined petitioner's total gross sales using Exhibit D-12, entitled "Limited Service Restaurants, Statement of Income and Expenses - Ratio to Total Sales" from the aforementioned Restaurant Industry Operations Report. As noted, he determined petitioner's cost of goods sold for each of the quarters at issue by totaling the third-party vendor responses. Each quarter's total was divided by the ratio to total sales of 32.5%, the figure set forth in Exhibit

D-12 for limited service restaurants[1] in the median quartile of respondents. The Restaurant Industry Operations Report defined the median quartile as representing the middle 50% of the responses for the category item. The auditor chose the median quartile percentage because he had no sales information such as guest checks or register tapes from petitioner and, therefore, felt it would be the most reasonable quartile to use.

8. The auditor took the total of the third-party vendor purchases of $428,068.29, and divided it by the median quartile markup of 32.5% to arrive at gross sales of $1,318,450.33. After allowing for petitioner's reported gross sales of $900,202.00, its additional gross sales were calculated to be $418,248.33 for the audit period, yielding additional tax due of $33,459.87.

9. A Statement of Proposed Audit Change for Sales and Use Tax dated July 1, 2009 was issued to petitioner, which set forth additional tax due of $33,459.87 plus penalty and interest. Immediately in response, on July 30, 2009, petitioner enlisted the services of a new representative, David Gross, a sales tax consultant and certified member of the Institute of Professionals in Taxation, who informed the auditor of his disagreement with the proposed adjustment. Mr. Gross pointed out that petitioner was due a credit for tax paid on certain nontaxable paper products. Moreover, Mr. Gross informed the auditor that paper products were included in the costs of goods sold that served as a basis for the proposed adjustment. Finally, Mr. Gross disagreed with the markup used from the Restaurant Industry Operations Report.

10. Acknowledging Mr. Gross's concerns, the auditor reexamined his findings and discovered that, when creating his first proposed adjustment, he had overlooked various records of chicken wing purchases from L & N Distributors originally provided by petitioner (L & N

[1] The group "Limited Service Restaurants" includes quickservice and quick/fast casual restaurants.

Records). In fact, he also realized he had not included any chicken wing purchases whatsoever in the cost of goods purchased despite the fact that petitioner's business included that product. Although the L & N Records did not exist for every month during the audit period, the auditor determined he had adequate monthly purchase records from that company for December 2007 through November 2008. Therefore, the auditor added the previously omitted chicken wing purchases for December 2007 through November 2008 to the previously calculated third-party vendor purchases discussed in Finding of Fact 5 for the same period, applied the aforementioned 32.5% markup from the Restaurant Industry Operations Report, and reached a revised adjusted gross sales total of $661,197.24 for those 12 months. The auditor then compared petitioner's reported gross sales of $319,872.00 to the revised adjusted gross sales for that period and determined an error rate of 48.38%. Consequently, the auditor applied that error rate to petitioner's reported gross sales of $900,202.00 for the entire audit period, and calculated that petitioner had additional unreported gross sales of $960,576.94 and total adjusted gross sales of $1,860,778.94. After applying the proper tax rate, the auditor concluded that $76,846.15 in additional tax was actually due from petitioner.

11. On November 30, 2009, the Division issued a Notice of Determination to petitioner, which assessed additional sales and use tax due of $76,846.15, plus penalties and interest, for a total amount due of $131,686.96, for the period March 1, 2006 through February 28, 2009. The penalties included a statutory penalty and an omnibus penalty for omission of an amount in excess of 25% of the amount of taxes required to be shown on the return.

12. Petitioner requested a conciliation conference before the Bureau of Conciliation and Mediation Services (BCMS) in response to the statutory notice. After the conference, a conciliation order was issued on January 28, 2011 reducing the tax due to $72,083.51, and

correlatively the interest and penalties referenced in Finding of Fact 11. The adjustment was made by BCMS in order to correct, as Mr. Gross had previously pointed out, the erroneous inclusion of paper products in the cost of goods sold by petitioner and to apply a credit of $797.44 for tax incorrectly paid on pizza boxes.

13. Section D of the Restaurant Industry Operations Report discusses the profile of its contributors that were, like petitioner, limited service restaurants. Exhibit D-2 of the report addresses the average guest check of the contributors. The median quartile average check for all "food only" establishments was $6.00, while the upper quartile average check was $8.25. However, when broken down by menu theme in the same exhibit, the median quartile average check for pizza themed restaurants was $15.00, while the upper quartile average check was $21.00.

14. Petitioner did not place into evidence any guest checks or register tapes from the audit period.

15. In his examination of the audit results, Mr. Gross concluded petitioner had a smaller amount of tax due by using several alternative methods. As a foundation for his study, he attempted to determine petitioner's average guest check. In order to find that result, Mr. Gross reviewed the prices on petitioner's sample menu and a Z tape from August 19, 2009, or six months after the conclusion of the audit period. Mr. Gross concluded that petitioner's average guest check was slightly over $17.00.

16. Armed with this information, Mr. Gross estimated petitioner's sales using two methods. First, he applied his calculation of petitioner's average guest check to the performance measurement of "average check" from Exhibit D-2 of Section D of the Restaurant Industry Operations Report. He noted that for all limited service restaurants serving food only, the upper

quartile of respondents had a guest check of $8.25, well below his $17.00 computation for petitioner. Thereafter, Mr. Gross, like the auditor, used Exhibit D-12, but applied the upper quartile ratio of 35.4%, rather than the median quartile ratio of 32.5%, to determine petitioner's gross sales based on cost of goods sold. Using this deviation, Mr. Gross concluded petitioner's tax due for the audit period to be $35,645.45. Unlike the auditor, though, Mr. Gross did not calculate and apply an error rate between reported and determined total gross sales.

17. However, Mr. Gross also recognized that when examining average guest check by menu theme in Exhibit D-2, the upper quartile of respondents with a pizza theme had an average guest check of $21.00, while the median quartile's average check was $15.00. Therefore, despite his use of the upper quartile in his methodology discussed in Finding of Fact 16, Mr. Gross concluded that petitioner's average guest check was in the median quartile for pizza theme restaurants.

18. Consequently, Mr. Gross alternatively applied petitioner's average guest check to Exhibit D-18, a chart that determined total sales from cost of goods sold based on a menu theme. There was no menu themed chart for pizza in Exhibit D-18, though, so Mr. Gross chose the menu theme "American (varied)." The ratio of expenses to total sales on this chart was 36.5% for American establishments in the median quartile. Using this method, Mr. Gross concluded that petitioner's tax due for the audit period was $32,591.22.

19. As a result of his study, Mr. Gross opined as a witness at hearing that the auditor's overall conclusions were incorrect.

SUMMARY OF THE PARTIES' POSITIONS

20. Petitioner argues that the auditor made several errors that caused him to reach an erroneous conclusion. First, petitioner maintains that the auditor used the incorrect quartile when

determining its ratio of cost of goods sold to gross sales. Additionally, petitioner states that the purchase information gathered from third-party vendors was consistently rounded up. Finally, it argues that the auditor "double dipped" by using both a markup and an error rate method.

21. The Division asserts that petitioner failed to prove by clear and convincing evidence that the estimation of the sales tax due by means of its test analysis was reasonable. The Division also argues that petitioner has not demonstrated reasonable cause justifying the abatement of the assessed penalties.

CONCLUSIONS OF LAW

A. Tax Law § 1135(a)(1) provides that:

> [e]very person required to collect tax shall keep records of every sale . . . and of all amounts paid, charged or due thereon and of the tax payable thereon, in such form as the commissioner of taxation and finance may by regulation require. Such records shall include a true copy of each sales slip, invoice, receipt, statement or memorandum upon which subdivision (a) of section eleven hundred thirty-two requires that the tax be stated separately.

The sales records required to be maintained include, among other things, sales slips, invoices, receipts, statements or other memoranda of sale, guest checks, cash register tapes and any other original sales documents (20 NYCRR 533.2[b][1]).

B. Tax Law § 1138(a)(1) provides, in relevant part, that if a sales tax return was not filed, "or if a return when filed is incorrect or insufficient, the amount of tax due shall be determined [by the Division of Taxation] from such information as may be available. If necessary, the tax may be estimated on the basis of external indices . . . ." When acting pursuant to section 1138(a)(1), the Division is required to select a method reasonably calculated to reflect the tax due. The burden then rests upon the taxpayer to demonstrate that the method of audit or the

amount of the assessment was erroneous (***see Matter of Your Own Choice, Inc.***, Tax Appeals Tribunal, February 20, 2003).

C. The standard for reviewing a sales tax audit where external indices were employed was set forth in ***Matter of Your Own Choice, Inc.***, as follows:

> To determine the adequacy of a taxpayer's records, the Division must first request (***Matter of Christ Cella, Inc. v. State Tax Commn.***, 102 AD2d 352, 477 NYS2d 858) and thoroughly examine (***Matter of King Crab Rest. v. Chu***, 134 AD2d 51, 522 NYS2d 978) the taxpayer's books and records for the entire period of the proposed assessment (***Matter of Adamides v. Chu***, 134 AD2d 776, 521 NYS2d 826, ***lv denied*** 71 NY2d 806, 530 NYS2d 109). The purpose of the examination is to determine, through verification drawn independently from within these records (***Matter of Giordano v. State Tax Commn.***, 145 AD2d 726, 535 NYS2d 255; ***Matter of Urban Liqs. v. State Tax Commn.***, 90 AD2d 576, 456 NYS2d 138; ***Matter of Meyer v. State Tax Commn.***, 61 AD2d 223, 402 NYS2d 74, ***lv denied*** 44 NY2d 645, 406 NYS2d 1025; ***see also, Matter of Hennekens v. State Tax Commn.***, 114 AD2d 599, 494 NYS2d 208), that they are, in fact, so insufficient that it is "virtually impossible [for the Division of Taxation] to verify taxable sales receipts and conduct a complete audit" (***Matter of Chartair, Inc. v. State Tax Commn.***, 65 AD2d 44, 411 NYS2d 41, 43; ***Matter of Christ Cella, Inc. v. State Tax Commn., supra***), "from which the exact amount of tax due can be determined" (***Matter of Mohawk Airlines v. Tully***, 75 AD2d 249, 429 NYS2d 759, 760).
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> Where the Division follows this procedure, thereby demonstrating that the records are incomplete or inaccurate, the Division may resort to external indices to estimate tax (***Matter of Urban Liqs. v. State Tax Commn., supra***). The estimate methodology utilized must be reasonably calculated to reflect taxes due (***Matter of W. T. Grant Co. v. Joseph***, 2 NY2d 196, 159 NYS2d 150, ***cert denied*** 355 US 869, 2 L Ed 2d 75), but exactness in the outcome of the audit method is not required (***Matter of Markowitz v. State Tax Commn.***, 54 AD2d 1023, 388 NYS2d 176, ***affd*** 44 NY2d 684, 405 NYS2d 454; ***Matter of Cinelli***, Tax Appeals Tribunal, September 14, 1989). The taxpayer bears the burden of proving with clear and convincing evidence that the assessment is erroneous (***Matter of Scarpulla v. State Tax Commn.***, 120 AD2d 842, 502 NYS2d 113) or that the audit methodology is unreasonable (***Matter of Surface Line Operators Fraternal Org. v. Tully***, 85 AD2d 858, 446 NYS2d 451; ***Matter of Cousins Serv. Station***, Tax Appeals Tribunal, August 11, 1988). In addition, "[c]onsiderable latitude is given an auditor's method of estimating sales under such circumstances as exist in [each] case" (***Matter of Grecian Sq. v. New York State Tax Commn.***, 119 AD2d 948, 501 NYS2d 219, 221).

D. In the present matter, it is undisputed that, based on the lack of records provided by petitioner, the Division properly resorted to external indices to estimate the tax due. The Division accomplished its indirect audit by using petitioner's purchase figures obtained from third-party vendors and petitioner itself, and performing a markup based on the cost of goods sold index from the 2006-2007 Restaurant Industry Operations Report. Use of this report has been upheld by the Tax Appeals Tribunal as a valid tool in the conduct of an indirect audit methodology (***see e.g. Matter of 33 Virginia Place, Inc.***, Tax Appeals Tribunal, December 23, 2009; ***Matter of Bitable on Broadway***, Tax Appeals Tribunal, January 23, 1992).

E. As noted above, petitioner has the burden of proof to show, by clear and convincing evidence, that the result of the audit was unreasonably inaccurate or that the amount of tax assessed was erroneous (***see Matter of Your Own Choice, Inc.***). Petitioner failed to meet this burden as it offered insufficient evidence to refute the audit results. First, petitioner argues that the Division incorrectly estimated the average guest check and, thus, used the wrong quartile in its estimate. Had the Division accurately done so, petitioner posits, the markup of costs of goods sold would have come from the upper, rather than the median quartile on Exhibit D-12, thereby reducing the markup percentage in the measurement used by the auditor. However, the only evidence in the record of petitioner's average guest check was a copy of a sample menu, Mr. Garofalo's recollection, and a Z tape from after the audit period. This scant evidence does not clearly and convincingly demonstrate either a reliable average check price for the audit period or that the Division used the wrong quartile (***see Matter of Crescent Beach, Inc.***, Tax Appeals Tribunal, September 22, 2011).

Moreover, Mr. Gross's conflicting testimony at hearing on this point actually supports the Division's use of the median quartile. Initially, Mr. Gross opined that based on the menu, Z tape

and Mr. Garofalo's memory, the average guest check during the period at issue was approximately $17.00 and that the Division should have used the upper quartile measurement on Exhibit D-12 when determining total sales from cost of goods sold. However, he later pointed to Exhibit D-2 from the Restaurant Industry Report, which lists the average check price for all restaurants that participated in the survey, stated his preference for use of a menu themed index, noted that petitioner's average check was closest to the median quartile for menu theme restaurants featuring "pizza," and used that quartile. This confusing testimony hardly convincingly demonstrates that the Division's results were erroneous. Thus, as petitioner failed to carry its burden, it is concluded that the audit results were reasonable (***see Matter of La Naj Home Furnishings, Inc.***, Tax Appeals Tribunal, January 31, 2013).

F. Petitioner's argument that the Division improperly inflated the purchase information gathered from third-party vendors is similarly rejected. The record is devoid of reliable evidence that contradicts the Division's calculation of petitioner's cost of goods sold.

G. Petitioner also finds fault with the Division's use of both a markup and error rate in its calculations. Indeed, petitioner goes so far as to state that the Division "double dipped" in an attempt to find the highest estimate of gross sales. This position is completely unsupported by the record. In reaching its conclusions, the Division simply totaled petitioner's purchase costs from the most complete period for which such records were possessed (November 2007 through December 2008), calculated total sales for that period using the Restaurant Industry Operations Report markup, determined an error rate with petitioner's reported sales, and extrapolated that rate over the entire audit period. At the hearing, the auditor repeatedly provided the rationale for choosing to apply this method. Meanwhile, petitioner has offered no evidence to refute this method or highlight the error of its results. It is well settled that exactness in the outcome of the

audit method is not required when it is the taxpayer's failure to maintain proper records that prevents it (***Matter of Markowitz v. State Tax Commn.***, 54 AD2d 1023 [3d Dept1976], ***affd*** 44 NY2d 684 [1978]).

H. Petitioner alternatively offered its own analyses of cost markups using different measurements from the 2006-2007 Restaurant Industry Report. In each, petitioner unsurprisingly came up with a lower tax due. Petitioner, however, cannot invalidate the Division's audit simply by offering its own "estimate" of tax liability as a substitute for the Division's (***see Matter of 33 Virginia Place***; ***Matter of Albanese Ready Mix***, Tax Appeals Tribunal, June 15, 1989; ***Matter of Sol Wahba, Inc. v. New York State Tax Commn.***, 127 AD2d 943 [1987]). Moreover, petitioner's analyses lacked guest checks, register tapes, or other source records as support, thereby suffering from the same problem that gave rise to the indirect audit.

I. In sum, petitioner's challenge must fail because it provided no source documentation, either upon audit or at hearing, that would establish the actual amount of its sales. Absent any records, petitioner's arguments do not provide any grounds for changing the Division's audit results. Hence, petitioner failed to carry its burden of showing the audit to be unreasonably inaccurate or clearly erroneous (***see Matter of Bejing China Buffet, Inc.***, Tax Appeals Tribunal, February 23, 2012).

J. Tax Law § 1145(a)(1)(i) imposes a penalty upon persons who fail to timely file a return or timely pay the tax imposed by Articles 28 and 29 of the Tax Law. The penalty and additional interest may be waived if "such failure or delay was due to reasonable cause and not due to willful neglect" (Tax Law § 1145[a][1][iii]). The taxpayer bears the burden of establishing that the actions were based upon reasonable cause and not willful neglect (***see Matter of Philip Morris***, Tax Appeals Tribunal, April 29, 1993; ***Matter of MCI***

Telecommunications Corp., Tax Appeals Tribunal, January 16, 1992, ***confirmed*** 193 AD2d 978, 598 NYS2d 360 [1993]).

Petitioner has offered no evidence upon which a finding of reasonable cause could be made. As the Division points out, it did not produce the source records that it was required by law to maintain. Moreover, petitioner has failed to prove that the Division's assessment of omnibus penalty pursuant to Tax Law § 1145(a)(1)(vi) for omission of an amount in excess of 25% of the amount of taxes required to be shown on its tax return was improper. Accordingly, penalties assessed herein are sustained.

K. The petition of Payne Avenue Pizza & Subs, Inc. is denied and the Notice of Determination dated November 30, 2009, as modified by the conciliation order of January 28, 2011, is sustained.

DATED: Albany, New York
October 3, 2013

/s/ Herbert M. Friedman, Jr.
ADMINISTRATIVE LAW JUDGE