STATE OF NEW YORK
DIVISION OF TAX APPEALS

In the Matter of the Petition	:	
of	:	
JAY'S DISTRIBUTORS, INC.	:	DETERMINATION DTA NO. 824052
for Redetermination of a Deficiency or for Refund of Cigarette Tax under Article 20 of the Tax Law for the Period March 1, 2004 through December 31, 2006.	:	

Petitioner, Jay's Distributors, Inc., filed a petition for redetermination of a deficiency or for refund of cigarette tax under Article 20 of the Tax Law for the period March 1, 2004 through December 31, 2006.

A hearing was held before Joseph W. Pinto, Jr., Administrative Law Judge, at the offices of the Division of Tax Appeals, 1384 Broadway, New York, New York, on August 15, 2012 at 10:00 A.M. All briefs were submitted by January 13, 2013, which date began the six-month period for the issuance of this determination. Petitioner appeared by Michael Buxbaum, CPA. The Division of Taxation appeared by Amanda Hiller, Esq. (Michelle M. Helm, Esq., of counsel).

ISSUES

I. Whether the Division of Taxation properly determined petitioner's tobacco products tax liability for the audit period.

II. Whether the Division of Taxation properly asserted fraud penalty based on wilful and intentional operation of multiple companies from the same location, or, in the alternative, whether petitioner was liable for penalties pursuant to Tax Law § 481.

FINDINGS OF FACT

1. Petitioner, Jay's Distributors, Inc. (Jay's), was at all times relevant herein a cigarette and tobacco wholesaler and tobacco distributor licensed in the State of New York. It operated from a warehouse located at 451-453 St. Paul's Avenue, Jersey City, New Jersey, along with two other companies, Vikisha, Inc. (Vikisha) and Jaydeen Corporation (Jaydeen). Petitioner sold cigarettes, tobacco products and accessories, food products, nonalcoholic beverages and sundries to convenience stores, delicatessens and other retail outlets primarily in the greater New York metropolitan area and Long Island. Some deliveries were made to New York customers with vans and small box trucks, and some customers picked up products at the warehouse in New Jersey.

2. During the period March 1, 2004 through December 31, 2006 (audit period), Kaushik Shah owned 100% of petitioner (70% through June 2004) and 100% of Vikisha. His spouse, Reshma Shah owned 100% of Jaydeen. Vikisha was a New Jersey wholesaler of cigarettes and cigar products that traded in New Jersey exclusively, and Jaydeen was a New Jersey corporation that was a wholesaler of soft drinks and candy in both New York and New Jersey.

3. The tobacco products tax audit of petitioner's business began in December 2006 when the matter was assigned to the auditor. A letter, dated December 20, 2006, was sent to petitioner at the Jersey City address confirming the commencement of a field audit and setting forth all documents that were expected to be produced. The letter requested New York and New Jersey tobacco tax returns; work papers, summaries, and schedules used to prepare said returns; purchase and credit invoices; manufacturer's statements for returned products; ATF approval for destruction of product; check register/cash disbursements journals and/or EFT statements; exemption certificates; and customer invoices.

4. In response to this first request for records, petitioner was able to provide some records, but it was noted that purchase invoices were missing and there were gaps in the sales invoice numbers. The auditor examined in detail the distributor of tobacco products returns (forms MT-203); tobacco tax return transcripts; monthly sales reports (printed); sales invoices; credit memoranda; purchase invoices; product listings; third-party information; and New Jersey tobacco tax return transcripts and audit findings.

5. The auditor found that the tobacco sales set forth on invoices matched the amounts on the monthly summary reports and that the totals from the monthly summary reports matched the MT-203 returns. However, the auditor was troubled by the complete commingling of inventory between Vikisha and petitioner, a fact that was conceded by petitioner. In addition, the missing purchase invoices and, to a lesser extent, the gaps in sales invoice numbers, prevented use of a detailed audit methodology, and alternative audit methods were immediately considered.

6. The common practice of petitioner and Vikisha was to purchase tobacco products from outside suppliers and store them in the warehouse at 451-453 St. Paul's Avenue in Jersey City, New Jersey. This prevented the auditor from being able to trace tobacco products from petitioner's purchases to its importation into, or its sales in, New York. Petitioner was informed that the Division of Taxation (Division) was required to perform a total accountability audit that would examine the tobacco products purchased, sales and inventories of both petitioner and Vikisha and the sales made from this inventory. Although not frequently used as an audit methodology, it had been employed by the Division in similar situations.

7. The Division made a request for computerized records but was told it could not have them. It was later established at hearing that, although petitioner maintained computerized records of sales and purchase invoices, the records were not in an auditable condition because the

records only reflected the combined totals for all the companies in the group and petitioner made the decision not to produce them to the auditor. Additionally, petitioner informed the auditor that it did not perform a physical inventory, even on an annual basis. Although this was later disputed by petitioner's president, Kaushik Shah, at hearing, inventory figures were never produced.

8. To supplement the purchase records provided by petitioner, the auditor issued "third-party" letters to multiple suppliers to verify sales made to petitioner. However, it became immediately apparent to the auditor that the level of detail necessary to track individual brands of cigars and tobacco and the myriad of product offerings for three years would be impossible, and so it was decided to use a test period. At the suggestion of petitioner's representative, Stephen J. Bercovitch, Esq., the period chosen was the entire calendar year 2005, selected to fairly reflect petitioner's tobacco activity during the audit period. The lack of clear inventory records demonstrating the flow of product through the warehouse weighed heavily in the decision to review a full year as well.[1]

9. Responses from suppliers confirmed that the purchase records received from Jay's and Vikisha were not a complete set of records, even for the year 2005. Coupled with the lack of inventory records, the Division determined that there were insufficient records to perform a detailed audit. Therefore, even though the Division decided to use a test period audit methodology and apply the results to the entire audit period, it did not seek petitioner's consent to utilize said method since it was a component part of the estimated methodology.

[1]This must be differentiated from a mere snapshot of the contents of the warehouse, which the auditor assumed was a "constant," i.e., a relatively stable value.

10. When the audit began, petitioner was represented by Stephen J. Bercovitch, Esq., and Richard Lichtig, Esq. Subsequently, petitioner retained several other legal and professional representatives.

11. Mr. Bercovitch provided separate powers of attorney from both Vikisha and Jaydeen, appointing him their representative with respect to tobacco products and sales and use tax for the period March 1, 2004 through December 31, 2006. In addition, Mr. Bercovitch provided Vikisha's available books and records. Subsequent representatives also agreed to submit powers of attorney on behalf of Vikisha and Jaydeen and understood the nature and scope of the Division's total accountability audit, including the commingled tobacco product inventories of petitioner and Vikisha.

12. The audit required four years and 566 man hours to complete due to the scope of the examination required to fully ascertain petitioner's purchases, sales and inventory. Every item needed to be broken down by product type, brand and variation for the year 2005, and the resulting data collected and entered manually into spreadsheets and computer files. This task was long and involved and the Division was hampered by petitioner's failure to make its computerized records available. The Division was aware of petitioner's computerized records because all its sales invoices were computer generated.

13. Petitioner executed numerous consents extending the period of limitations on assessment of tobacco taxes beginning in March of 2007 until September of 2009, the last of which permitted the Division to determine or assess additional tax for the entire audit period at any time on or before December 31, 2009.

14. Although the Division's review of all the tobacco products tax returns for the audit period revealed that each was filed and mathematically correct, and matched monthly summary

reports and New York sales invoices, the Division discovered a large discrepancy between product purchased by Vikisha and petitioner and their sales.

15. The third-party requests for information on sales to Vikisha, Jaydeen and petitioner garnered responses from four companies that made sales to the companies: Altadis USA Inc.; NHA, Inc.; Cheyenne International, LLC; and Swisher International, Inc. A review of the sales of these companies to petitioner was compared to the purchase information that petitioner gave to the Division and revealed that there were sales for which no purchase invoices were provided. These were designated "unaccounted for" purchases.

16. Additionally, the Division received responses from U.S. Smokeless Tobacco Brands, Inc., Corwood Sales Co., Inc., and Lane Limited that indicated that these companies made no sales to Vikisha, Jaydeen or petitioner during the audit period. There were several other unspecified vendors that did not respond to the Division's requests.

17. When the purchase records received from third parties and those provided by petitioner were compared with sales records provided by petitioner, it was determined that petitioner was making sales of products it never purchased. Since petitioner drew its product from the inventory commingled with that of Vikisha, it was concluded that Vikisha had purchased those products.

18. An example of petitioner selling product it had never purchased was discovered when the auditor looked at specific items purchased and sold during the test period. It was determined that petitioner sold various items produced by Captain Black: cans, packets and packs of little cigars, but provided no records substantiating a purchase of the goods. Lane Limited is a supplier of Captain Black products, but indicated no purchases by either Vikisha or petitioner during the audit period. Vikisha was purchasing the item elsewhere and depositing it into the commingled

inventory at the Jersey City warehouse. Petitioner then drew the product from the commingled inventory and sold it.

19. Two other examples of product sold but not purchased occurred with Winchester little cigars, a product distributed by Lane Limited, and Rooster chew and Skoal chew, products distributed by U.S. Smokeless Tobacco. In both instances, the suppliers reported no sales to either Vikisha or petitioner in 2005, yet petitioner reported sales of each of these products during 2005, underscoring the confusion raised by the commingling of inventories between Vikisha and petitioner.

20. The third-party responses also made clear that both petitioner and Vikisha were purchasing far more product than they reported selling, and since petitioner never provided inventory reports to the Division, there was no way of determining what became of the excess product purchased but not reported sold. However, since tobacco is a perishable product, its shelf life and time in inventory is limited, and it was assumed that such a product must have been sold.

21. The excess product issue was apparent to the Division when it reviewed purchase invoices provided by petitioner as well as sales records received from Klein Candy Company. Looking at purchases by item and sales by item, the Division found several instances of excess inventory for which petitioner had not accounted. In one example, Vikisha and petitioner had purchased 158 boxes of Anthony & Cleopatra cigars but only sold a total of 78 boxes, with petitioner's sales accounting for only 12 boxes. Another instance was the purchase of 2,754 boxes of various types of Phillies little cigars in 2005 and combined sales of Vikisha and petitioner of only 14 boxes.

22. In another example involving the purchase of Copenhagen chewing tobacco, Vikisha and petitioner purchased 8,886 rolls of 10 tins and claimed to have sold 4 rolls, leaving 8,882 rolls of excess inventory.[2]

The Division also found instances where there were sales of certain brands of cigars and tobacco but no record of any purchases, indicating that these may have been attributable to some suppliers that had not responded to third-party requests for information or the existence of additional suppliers that were not disclosed to the Division.

23. Another example of missing records, and further evidence that complete books and records had not been provided to the Division, was the discovery of purchase information from a company called Santa Clara, Inc. (Santa Clara), which indicated purchases in the sum of $29,839.31 on June 20 and 21, 2005, but never reflected in purchase information received from Vikisha or petitioner. Despite the fact that June was the only month of purchase records provided for Santa Clara, the Division did not assume more purchases from Santa Clara throughout the rest of 2005.

24. The Division reviewed the purchases determined from petitioner's records and third-party information, subtracted out the sales that were reported in both New Jersey and New York, and determined that the remainder was excess inventory for which petitioner was unable to account. For the test period of 2005, the Division took the excess inventory and applied an average price (determined from purchase prices of the individual items) to find the value of average unaccounted inventory.

---

[2]The Division found that two additional rolls of Couger or Red Seal Copenhagen chew were sold but not reflected on purchase records.

25. The State of New Jersey performed a tobacco products audit of petitioner in 2007 for the audit period October 2002 through September 2006. New Jersey found no additional tax due, accepting New Jersey sales as reported on its New Jersey tobacco tax returns. The Division reasoned that all product purchases that exceeded the total of New Jersey and New York reported sales was excess inventory that must have been imported or sold in New York since New Jersey had already accepted the product sales reported to it.

26. From its comparison of purchases and sales by Vikisha and petitioner by product category for the test year 2005, the Division was able to identify unaccounted for product in the sum of $893,481.37, based on actual purchase prices. This figure was divided by 12 to establish an average monthly figure, $74,456.37, and subsequently projected over the entire audit period.

Likewise, the Division totaled all unreported tobacco purchases by petitioner in 2005 from Altadis, Cheyenne International, National Honey Almond, Santa Clara, Swedish Match and Swisher, which was found to be $1,974,454.76. This sum was divided by 12 to reach the average unreported purchases per month, or $164,537.90.

The Division added the average monthly figures for unaccounted for product and unreported purchases to arrive at a total monthly wholesale price of $238,994.68,[3] to which the tax rate of 37% was applied to arrive at a monthly tax due of $88,428.03, yielding total tax due for the audit period of $3,006,553.02. The Division issued a Notice of Determination to petitioner, dated December 28, 2009, asserting additional tax due of $3,006,553.02 plus penalty and interest.

27. In its review of Vikisha's records, the Division discovered that during the audit period Vikisha made substantial sales and purchases of tobacco products to Klein Candy, a Pennsylvania

[3]The unreported tobacco purchases from the six companies were not included in the analysis of purchases and sales which yielded the unaccounted for inventory because the detail of products purchased on the invoices could not be obtained by the Division.

distributor. As an example, Vikisha reported total tobacco product sales of $821,085.94 in November 2004. Of this amount, $710,085.94, 86.51%, was sold to Klein Candy. In the same month, Klein reported sales to Vikisha of $739,889.21.

28. In 2005, the test period, Klein Candy sold Vikisha $3,836,159.89 of tobacco products and Vikisha sold $1,636,536.22 of product back to Klein. In addition, the Division noted Vikisha's sales of $2,188,929.00 of product in 2005 to One Stop Wholesale Distributors, Inc. (One Stop), a Pennsylvania distributor wholly-owned by Kaushik Shah, president and owner of petitioner. One Stop shares the same address in Wilkes-Barre, Pennsylvania, with Klein Candy.

29. Underlying invoices examined by the Division indicated that the prices charged by both distributors for the same product were identical. An example was the sale by Vikisha to Klein Candy of Dutch Master coronas on March 10, 2005 for $24.99 a box. On March 11, 2005, Klein Candy sold the same product back to Vikisha for the same price. Further, since Vikisha and petitioner commingled their inventories, the product sales and purchases between Vikisha, Klein Candy and One Stop could be ascribed to either Vikisha or petitioner.

30. Since the typical flow of tobacco products to market originates with a manufacturer selling to distributors and in turn to retailers and finally customers, intercompany transactions between distributors for identical prices was an aberration not observed by the Division prior to this particular audit.

31. The Division discovered several instances during the audit period where Klein Candy paid a related company, Jaydeen Corporation, for tobacco products purchased from Vikisha, even though Jaydeen was not licensed to sell tobacco products and was a New Jersey corporation that operated as a wholesaler of candy, gum, soft drinks and other non-tobacco products.

32. Although petitioner understood that its purchases, and thus its purchase records, were critical to substantiate its tobacco products returns and also central to the Division's audit methodology, it did not produce additional purchase records to challenge the Division's findings, despite claiming that such records existed.

33. By letter, dated December 6, 2007, during the audit of petitioner herein, Mr. Robert Eisman, an Associate Attorney with the Division's Office of Tax Enforcement, informed petitioner's attorney, Mr. Scott Lippert, that Jay's Distributors was being investigated for fraud and that it was in violation of the New York Tax Law for not maintaining its tobacco products in a secure and separate warehouse facility. Mr. Eisman demanded that petitioner comply with the directive of the Tax Law as soon as possible.

34. Petitioner paid an average of approximately $28,000.00 in tax per month with its tobacco tax returns during the audit period. However, the Division's audit revealed that the actual amount due was about $88,000.00 per month, indicating an underpayment of about 300%.

35. Based on the substantial underpayment of tax, petitioner's failure to produce all books and records requested, petitioner's failure to comply with the Tax Law and regulations, particularly the requirement to maintain a separate and secure warehouse for its tobacco products, petitioner's practice of importing and selling inventory from another company, billing practices that disregarded the actual vendor of its product and the unexplained circular transactions between Vikisha and Klein Candy, the Division asserted fraud penalty.

SUMMARY OF THE PARTIES' POSITIONS

36. The Division contends that petitioner's failure to provide adequate books and records upon request authorized it to estimate petitioner's taxes using a test period and records received from various external sources, and that the audit yielded a notice of determination that had a

rational basis. Since petitioner has not established by clear and convincing evidence that the audit methodology was unreasonable or that the tax determined to be due was erroneous, both the audit method and resulting notice should be sustained.

37. The Division argues that it properly asserted and established the basis for the fraud penalty given petitioner's intentional operation of multiple companies out of the same location, failure to provide adequate books and records to conduct a detailed audit, and substantial underpayment of tobacco products tax. In the alternative, the Division seeks to impose penalty pursuant to Tax Law § 481 for failure to pay the tobacco tax when due.

38. Petitioner contends that the Division's notice of determination lacked a rational basis and was arbitrary and capricious in that the audit methodology employed, the accountability audit, has no basis in case law, the regulations or audit guidelines. Petitioner believes that the focus of the audit should have been on sales in New York and that the Division's reliance on transactions between related entities and its attribution of unaccounted for inventory to petitioner was in error. Petitioner believes that since the tobacco products were not located in New York State, Tax Law § 471-b (former [1]) should be construed to prohibit the Division from utilizing an audit method that treats the inventory in the New Jersey warehouse as product that could not be accounted for and therefore assumed sold in New York.

39. Petitioner also believes that this audit methodology had never been used before, and, therefore, the resulting notice of determination was without a rational basis.

40. Petitioner argues that the auditor and his superior should be sanctioned for failing to follow audit guidelines and regulations in the audit of an out-of-state vendor. In addition, petitioner objects to the superior, Section Head Stephen Thompson, not obeying a subpoena for his appearance at the formal hearing in this matter.

41. In addition, petitioner contends that the Division did not use petitioner's detailed records in computing its assessment despite their existence at the warehouse where the audit was performed. Because of this failure to examine the books and records, petitioner urges that the notice be canceled.

42. Petitioner argues that the Division has not substantiated its assertion of fraud penalties as required by case law. Further, petitioner contends that the Division did not properly plead for an alternative penalty in lieu of the fraud penalty either in its amended answer or at hearing because the Division mistakenly asserted that the burden of proof was on petitioner, which petitioner claims is not the case.

CONCLUSIONS OF LAW

A. Tax Law § 471-b(former [1]) imposed a tobacco products tax on all tobacco products possessed in this state by any person for sale. During the audit period, the tax was calculated at the rate of 37 percent of the wholesale price of the product. The distributor is liable for payment of the tax on tobacco products which he "imports or causes to be imported into the state. . ." (Tax Law § 471-b[2]).

B. Tax Law § 470(12) defines a distributor as

> [a]ny person who imports or causes to be imported into this state any tobacco product [in excess of fifty cigars or one pound of tobacco] for sale, or who manufactures any tobacco product in this state, and any person within or without the state who is authorized by the commissioner of taxation and finance to make returns and pay the tax on tobacco products sold, shipped or delivered by him to any person in the state.

C. Tax Law § 473-a requires every distributor of tobacco products to file a return each month showing the quantity and wholesale price of all tobacco products imported or caused to be imported, and all tobacco products sold, shipped or delivered into New York State during the

prior month. If the Division determines that such return is incorrect or insufficient, it may determine the amount of tax due within three years after the return was filed (Tax Law § 478).

D. Pursuant to 20 NYCRR 89.2(b)(2), the Division

> may determine the wholesale price of any tobacco product based upon such evidence as may be presented by any person with an interest therein or such information as may be otherwise available. The [Division] may require any appointed distributor of tobacco products . . . to submit a schedule containing the description, trade/brand name and wholesale price of every tobacco product imported or caused to be imported into this State for sale, manufactured in this State or sold, shipped or delivered to any person within the State by such distributor. . . .

Under this regulation, the Division can require distributors of tobacco products to submit wholesale price information relating to the tobacco products imported or caused to be imported into the state for sale, tobacco products manufactured in this state or tobacco products sold, shipped or delivered to any person within the state. The regulation is quite broad in its reference to the information and the source of the information to be considered in establishing a wholesale price, and exhibits an intent to provide a taxpayer with the opportunity to establish the wholesale price as closely as possible to the actual manufacturer's price. Here, several factors contributed to the Division's determination that the information reported by petitioner during the audit period was not reliable, accurate or able to be substantiated.

The Division was aware that petitioner shared a warehouse in New Jersey with Vikisha, a New Jersey distributor, and petitioner made no attempt to segregate the inventories of the two companies; the commingled inventory sold by petitioner was found to be invoiced by one company and paid to another, evidencing a disregard for the independent corporate identities of the related companies; and from the beginning of the audit the Division was aware of missing purchase invoices and, to a lesser extent, gaps in sales invoice numbers, which indicated that

petitioner was not fulfilling its obligation to provide wholesale prices for all tobacco products imported or caused to be imported, and all tobacco products sold, shipped or delivered into New York State during the audit period. Therefore, from the beginning of the audit, the Division had solid grounds for doubting the adequacy of petitioner's records and accuracy of its returns filed for each month of the audit period. The return requires petitioner to accurately state the wholesale price of tobacco products subject to tax, yet given petitioner's inability to produce the records required to substantiate the tobacco products it imported into New York, the amounts entered on the returns were unacceptable and the Division was justified in seeking to determine the wholesale price of any tobacco product or products using such information as may have been otherwise available. Petitioner's arguments that it had complete and adequate records is not borne out by the record. It clearly did not produce full purchase records at any time during the audit or thereafter.

E. Reading Tax Law § 478 and 20 NYCRR 89.2(b)(2) together it is evident that the correct audit methodology is that applicable to sales and use taxes, founded upon a determination of the insufficiency of the taxpayer's record keeping that makes it virtually impossible to verify the accuracy of its monthly returns.

To that end, the Division herein followed the high standard for audits set out in ***Matter of Your Own Choice*** 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.***, ***supra***) 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).
>
> 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).

F. In this matter the Division made a proper request for books and records, in fact several. In response to the requests, petitioner failed to ever produce its complete purchase records, which were critical to determining the wholesale prices used in the preparation of its monthly tobacco products tax return. Tax Law § 470(6) provides that a manufacturer's invoice or the price at which tobacco products were purchased shall be presumed to be the wholesale price. Therefore, petitioner's failure to provide substantiating documentation of the wholesale price entitled the Division to seek the information from such information that was available. Even at hearing, although insisting that petitioner had complete records, Mr. Kaushik Shah admitted that he did not have purchase records with him and never offered to submit any.

To obtain purchase information, the Division sent requests for information to various third-party suppliers of tobacco products, only to find that petitioner and Vikisha had made significant purchases of product for which invoices were never submitted. There was at least one instance of

a supplier that was not divulged by petitioner found to be supplying product sold by petitioner. Several suppliers did not respond to the Division's requests. The conclusion to be drawn from these factors is that the purchase records discovered by the Division, in all likelihood, resulted in a conservative estimate of all the product actually obtained by, or at the disposal of, petitioner.

With this confirmation that the records presented were inadequate for a detailed audit, the Division chose an indirect audit methodology that utilized a test period, as agreed to by petitioner's representative, Mr. Stephen Bercovitch. At the representative's urging, the test period length was made one year, 2005.

A one-year test period is uncommonly long, especially when coupled with the additional complicating factors that petitioner warehoused and commingled its tobacco products with Vikisha, sometimes took delivery of product paid for by other companies and did not afford the Division the opportunity to utilize its computerized records. These factors contributed to an audit that consumed 566 hours of labor by the auditors and took four years to complete.[4] The Division examined every item purchased and sold by product type, brand and variation for the year 2005.

What became apparent after an examination of petitioner's sales and purchase records, was that petitioner had made sales of products it had never purchased. It had drawn product from the commingled inventory in the Jersey City warehouse. This was evident from petitioner's sales of Captain Black cans, packets and packs of little cigars; Winchester little cigars; and Rooster and Skoal chews. However, there were no records of purchasing the items.

In addition, petitioner and Vikisha were found to have purchased much more product than was sold. Examples given were Anthony and Cleopatra cigars; Phillies little cigars; and

---

[4]A criminal investigation (not the subject of this determination) of petitioner further added to the time necessary to complete the audit.

Copenhagen chewing tobacco. This indicated that there was unaccounted for excess inventory that presumably did not remain in the warehouse due to the relatively short shelf life of tobacco products and the demand for fresh product by consumers.

G. Once the Division had procured and examined the purchase records for the myriad products purchased by petitioner and Vikisha, it sought to isolate the unaccounted for inventory available for importation by petitioner. This was accomplished by examining all purchases by all entities sharing the warehouse space for tobacco products for the year 2005 and subtracting out total sales for those entities.

Petitioner argues that the New Jersey warehouse and location of inventory prohibited the Division from using an audit methodology that essentially taxed product in New Jersey as if it were sold in New York. This argument misses the point. Petitioner could not account for the inventory at all. The Division assumed that it was imported or sold in New York. The burden of proving that the Division was in error was upon petitioner, and it has failed to carry that burden.

Total purchases for Vikisha and petitioner was determined using the purchase invoices supplied by them and adding the invoices for unreported tobacco purchases received from third parties. Total sales were taken exclusively from Vikisha's and petitioner's records. Total sales in both New York and New Jersey were subtracted from total purchases resulting in the unaccounted for product. This product was valued based on actual purchase prices and the total, $893,481.37, was divided by 12 to arrive at average unaccounted for product by month during the test year, or $74,456.37.

Unreported tobacco purchases by petitioner in 2005 from Altadis, Cheyenne International, National Honey Almond, Santa Clara, Swedish Match and Swisher was found to be $1,974,454.76. This sum was divided by 12 to reach the average unreported purchases per month,

or $164,537.90. When added to the average monthly unaccounted for product figure from Vikisha's and petitioner's records, the total monthly wholesale price was determined to be $238,994.68, and resulted in tobacco products tax due of $88,428.03 per month, and a total for the audit period of $3,006,553.02.

Petitioner objects to the audit methodology employed by the Division, contending that there is no provision for it in the case law, regulations or audit guidelines. However, the case law is clear that once the Division established that the books and records of petitioner were insufficient to perform a detailed audit, it may resort to external indices to estimate tax, as long as the estimate methodology utilized was reasonably calculated to reflect taxes due. The Division utilized petitioner's records and the invoices garnered from its suppliers. It also used petitioner's sales figures and invoices. It was forced to use the same records from its sister corporation, Vikisha, because the two companies drew from a common inventory where one company's product was not distinguishable from the other. The prices used to value product was taken from the same records.

Thus, the unaccounted for inventory was determined using petitioner's records and those of Vikisha and it was valued using their prices, notwithstanding the fact that some of the information was obtained from third-party requests that yielded more records petitioner should have produced on audit. The Division chose an audit methodology that it believed was reasonably calculated to determine petitioner's tax liability. Although petitioner's records were incomplete, the Division still managed to utilize the records available to fashion an audit methodology that was rooted in petitioner's own records and therefore reasonably calculated to reflect the tobacco product taxes due.

Where it was not provided with complete records capable of ascertaining the accuracy of their tobacco products returns, and facing the confusion created by petitioner's failure to maintain a separate and secure warehouse for its inventory, the Division faced a daunting task in trying to determine how much product was available for and imported to New York from the Jersey City warehouse. Using the approach known as a total accountability audit, the Division analyzed all products purchased and imported or sold by both companies (to the extent they could be substantiated). The difference between the two left the unaccounted for inventory, which was assumed to have been imported into New York. This conclusion is further supported by the fact that petitioner never supplied the Division with inventory figures, even informing the auditor that no inventories were performed. At hearing, Mr. Shah testified that an annual inventory was performed, but he offered no inventory values that would have supported his opposition to the audit methodology.

In fact, the auditor considered the inventory amount at any given time to be a constant, which would have had no effect on the importation totals. The auditor had been an excise tax auditor for over 20 years and completed between 75 and 100 tobacco and cigarette audits. He was often engaged in large and complex audits. His credible testimony that tobacco product was perishable, based on decades of working on tobacco and cigarette audits, meant that inventory turnover was rapid and that product spent little time in the warehouse. Therefore, unaccounted for product was assumed to have been removed for delivery or importation. Since the Division accepted the totals of product accepted as accurate by the State of New Jersey in its audit for almost the same time period, it was reasonable to conclude that the unaccounted for product was imported into New York.

Although the methodology used in this case was used infrequently, it had been employed by the Division in prior, similar audits, contrary to petitioner's conjecture and attested to by the credible testimony of the auditor. Equally without merit was petitioner's contention that the Division failed to follow the law, regulations and audit guidelines. As outlined above, it has been concluded that the Division complied with the Tax Law, regulations and case precedent. Petitioner has not indicated what guidelines were violated or detailed how it believes those guidelines were violated.

Since petitioner was not able to document the product it purchased, and in some cases failed to reveal distributors it purchased from, it could not establish that its tobacco products tax returns were accurate and it assumed the burden of proving that the Division's audit methodology and assessment was in error. Petitioner bears the burden of proving with clear and convincing evidence that the assessment is erroneous (***Matter of Scarpulla v. State Tax Commn.***) and the audit method was unreasonable (***Matter of Surface Line Operators Fraternal Org. v. Tully***). It is determined that its has not carried the heavy burden placed upon it herein. (Tax Law § 471-b[former1]) and 20 NYCRR 3000.15[d][5].)

H. In ***Matter of Cinelli*** (Tax Appeals Tribunal, September 14, 1989), the Tribunal provided the following guidance in determining whether a taxpayer may be subject to a civil fraud penalty:

> The burden of showing fraud under § 1145(a)(2) has consistently been interpreted to reside with the Division (***Matter of Ilter Sener d/b/a Jimmy's Gas Station***, Tax Appeals Tribunal, May 5, 1988; ***Matter of Nicholas Kucherov d/b/a Nick's Marine***, State Tax Commn., April 15, 1987, ***affd Kucherov v. Chu*** [147 AD2d 877, 538 NYS2d 339]). The standard of proof necessary to support a finding of fraud requires "clear, definite and unmistakable 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 Ilter Sener***, ***supra***, citing, ***Matter of Walter and Gertrude Shutt***, State Tax Commn., July 13, 1982).

> For a taxpayer to be subject to a civil fraud penalty, willful intent is a critical element; the individual or the corporation, acting through its officers, must have acted deliberately, knowingly, and with the specific intent to violate the Tax Law (***Matter of Cousins Service Station, Inc.***, Tax Appeals Tribunal, August 11, 1988). Fraud need not be established by direct evidence, but can be shown by surveying the taxpayer's entire course of business and drawing reasonable inferences therefrom (***see***, ***Korecky v. Commr.***, 781 F2d 1566 [11th Cir 1986]; ***Briggs v. Commr.***, 440 F2d 5 [6th Cir 1962]).

In ***Matter of Waples*** (Tax Appeals Tribunal, January 11, 1990), the Tribunal summarized some of the relevant considerations as follows:

> Because the sales tax penalty provisions are modeled after Federal penalty provisions, Federal statutes and case law are properly used for guidance in ascertaining whether the requisite intent for fraud has been established (***Matter of Uncle Jim's Donut and Dairy Store, Inc.***, Tax Appeals Tribunal, October 5, 1989; ***Matter of Ilter Sener***, ***supra***). Factors found to be significant include consistent and substantial understatement of tax, the amount of the deficiency itself, a pattern of repeated deficiencies, the taxpayer's entire course of conduct and the taxpayer's failure to maintain bank accounts or adequate records (***see***, ***Merritt v. Commr.***, 301 F2d 484; ***Bradbury v. Commr.***, T.C. Memo 1971-63; ***Webb v. Commr***., 394 F2d 366; ***see also***, ***Matter of AAA Sign Co.***, Tax Appeals Tribunal, June 22, 1989). Because direct proof of the taxpayer's intent is rarely available, fraud may be proved by circumstantial evidence, including the taxpayer's entire course of conduct (***Intersimone v. Commr.***, T.C. Memo 1987-290; ***Stone v. Commr.***, 56 T.C. 213, 223-224; ***Korecky v. Commr.***, 781 F2d 1566). Fraud may not be presumed or imputed, but rather must be established by affirmative evidence (***Intersimone v. Commr.***, ***supra***). Hence, a finding of fraud should not be sustained where the attendant circumstances create at most only a suspicion of fraud (***Goldberg v. Commr.***, 239 F2d 316). The issue of whether fraud with the intent to evade payment of tax has been established presents a question of fact to be determined upon consideration of the entire record (***Jordan v. Commr.***, T.C. Memo 1986-389; ***see***, ***Matter of AAA Sign Co.***, ***supra***).

I. For the following reasons, it is hereby determined that the fraud penalty was properly imposed by the Division:

a. Petitioner's knowing and intentional commingling of it inventory with another company, in violation of Tax Law § 480(1)(d). That section specifically requires every applicant seeking to be a wholesale dealer of cigarettes and tobacco products to file proof that it maintains

a secure separate warehousing facility for conducting its wholesale business. This factor alone, conceded by petitioner, prohibited the Division from tracing any import or sale transaction represented by the values entered on its tobacco tax returns for the entire audit period back to the purchase of a product. As the facts reveal, some products may have been purchased by Vikisha and some had no traceable origin at all. Petitioner was reporting the importation of phantom product that had no known origin and for which it could not verify a wholesale price. The conclusion to be drawn from this is that it was intentionally reporting wholesale prices on its tobacco products returns that it could not substantiate due to its grossly negligent warehouse operations.

b. Contributing to the confusion surrounding its inventory were the circular transactions between Vikisha (which, because of the commingled inventory shared an identity with petitioner) and Klein Candy and One Stop. There, intercompany transactions between distributors for identical products with identical prices on successive days was an aberration not observed by the Division prior to this particular audit. They were transactions with no apparent legitimate business purpose that were contrary to the typical flow of tobacco products to market, i.e., from manufacturers to distributors, and then to retailers and consumers.

c. Petitioner's failure to maintain complete books and records, most notably purchase records, was evidence of fraud (***Matter of Lefkowitz***, Tax Appeals Tribunal, May 3, 1990). The missing purchase invoices were confirmed by the responses of third-party suppliers that provided invoices and records of sales to petitioner for which petitioner submitted no records.

In addition, petitioner's record keeping was grossly negligent. It refused to produce electronic records to the Division on audit, a factor that would have shortened the audit considerably, because the records of petitioner, Vikisha and Jaydeen could not be segregated.

As noted in the Findings of Fact, the companies did not respect each other's separate corporate identities, paying for one another's product, receiving product invoiced to another company and importing product without regard for its origin or ownership.

These factors justified the audit methodology chosen by the Division, which has been determined to be reasonable and reasonably calculated to determine the tax due.

d. This record establishes that petitioner willfully, knowingly and intentionally underreported and underpaid the tobacco product taxes due and owing for the entire audit period. Petitioner's course of conduct was knowing and intentional. It was aware that it was commingling its inventory; it was aware that it was deliberately receiving and importing the product of another company; it was aware that the returns were being filed without regard for the actual wholesale prices for each item; and it knew that it could not trace the importation of any specific product back to its specific invoice.

It is of no moment that petitioner's accountant was aware of this scheme and failed to correct it. In fact, petitioner's accountant even testified that he told petitioner not to produce its electronic records to the Division on audit because they were so confused with the other related corporate entities. He admitted that products invoiced to one company could be delivered to another and products delivered to one company could be paid for by another, thus making a mockery of the requirement to maintain adequate records of wholesale prices.

Petitioner correctly argues that substantial underreporting is not enough to establish fraud. However, where, as here, it continues throughout the audit period, it constitutes strong evidence of fraud (***see Merritt v. Commissioner***; ***see also Matter of 1126 Genesee St.***; ***Matter of Cousins Serv. Sta.*** [where consistent and substantial understatement of tax was found to be a significant factor in finding fraud]).

Based on the foregoing, it is concluded that the evidence, considered as a whole, supports the imposition of the fraud penalty by the Division.

J. Petitioner argues that the Division did not properly plead for an alternative penalty, provided for in Tax Law § 481(a)(i)(A), in lieu of the fraud penalty either in its amended answer or at hearing based on its belief that the Division mistakenly asserted that the burden of proof was on petitioner. Petitioner believes that the burden rests with the Division based on ***Matter of Ilter Sener*** (Tax Appeals Tribunal, May 5, 1988).

The Tax Law does not have a separate provision for the burden of proof in tobacco products tax administrative proceedings. However, the regulations provide that the burden of proof is upon the petitioner except as otherwise provided by law. (20 NYCRR 3000.15[d][5].) In addition, the State Administrative Procedure Act (SAPA) provides that the burden of proof shall be on the party who initiated the proceeding (petitioner). (SAPA § 306[1].) In ***Matter of Sholly*** (Tax Appeals Tribunal, January 11, 1990), the Tribunal stated in pertinent part:

> While we have recognized that where fundamental considerations of fairness and due process are implicated it is appropriate to shift the burden of proof to the Division [***see, Matter of Ilter Sener***, Tax Appeals Tribunal, May 5, 1988 (placing the burden of proof on the Division where the late-payment penalty is asserted for the first time by the Division in its answer as an alternative to the fraud penalty)], we perceive no such concerns present here. Petitioner has not asserted any violation of the principles of fairness or due process and we fail to discern any such violations of sufficient magnitude to warrant shifting the burden to the Division in this matter.

Petitioner herein suffered no violation of its due process rights and was accorded the fundamental considerations of fairness. Prior to hearing each side was aware of the legal theories of its adversary, and the administrative law judge, through prehearing conferences with the parties, was able to discern that neither party would be surprised by additional theories at hearing or be unable to freely offer evidence, either in support of its own position or as a defense to its

adversary's position. The proper remedy for surprise or inability to respond in a meaningful manner is not a shifting of the burden of proof, as petitioner urges, but being afforded the additional time necessary to make that response. Since petitioner has never asserted a violation of its due process rights or the principles of fairness, and the administrative law judge observed none, it is determined that none occurred.

K. Petitioner's allegation that the Division failed to heed a subpoena issued to the section head assigned to this audit, Mr. Stephen Thompson, is totally unsubstantiated. The subpoena is not in evidence and the circumstances of its service were undisclosed. If, as alleged, it was issued by an attorney retained by petitioner shortly before hearing, any enforcement action would necessarily be in a court of competent jurisdiction, not the Division of Tax Appeals.

L. The petition of Jay's Distributors, Inc. is denied, and the Notice of Determination, dated December 28, 2009, is sustained.

DATED: Albany, New York
July 3, 2013

/s/ Joseph W. Pinto, Jr.
ADMINISTRATIVE LAW JUDGE