August 16, 2006

Struggling to Estimate Sales Tax of Restaurants

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Much of the sales tax enforcement resources of the Division of Taxation is devoted to audits of restaurants and food and beverage retail establishments. The explanation generally given is that these establishments, to a greater extent than other businesses, generate much of their revenues in cash transactions that are more susceptible to slipping away from the tax authorities. Cases involving challenges to the conduct of sales tax audits of restaurants constitute a significant percentage of the published determinations of the Division of Tax Appeals.

Grave Consequences

For a restaurant under a sales tax audit, the consequences are often grave. Unlike income tax, sales tax is imposed on gross receipts and the potential liability from a sales tax audit can often exceed the restaurant's profits. Furthermore, since sales tax is a so-called "trust fund" tax, there may be personal liability on the part of owners, officers and sometimes employees for the alleged unpaid sales tax. In situations where the failure to collect and pay sales tax is clear, it is hard to generate much in the way of sympathy for the persons who failed to collect or pay over the tax due. However, due to the frequent difficulties in determining the amount of sales of restaurants, it is often the case that the tax due is not much more than a guess on the part of the Tax Division. Nevertheless, the Division of Tax Appeals generally accepts guesses in the absence of clear evidence to the contrary.

To begin, it is worthwhile to review the statutory provisions. Tax Law Section 1135(a)(1) provides that "Every 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 shall require. Such records shall include a true copy of each sales slip, invoice, receipt, statement or memorandum upon which [section 1132] requires that the tax be stated separately." Section 1135(g) requires that "such records shall be available for inspection" upon demand.[1]

Section 1138 (a)(1) authorizes the Tax Division to determine the amount of tax due on the basis of "such information as may be available." It goes on to provide that "the tax may be estimated on the basis of external indices, such as stock on hand, purchases, rental paid, . . . location, . . . number of employees or other factors."[2]

Two-Step Audit

As the structure of the statutory provisions indicates, the audit is a two-step process. First, the audit must address whether the records maintained and made available by the taxpayer comply with the requirements of section 1135(a)(1). If the records are adequate, the audit must accept them (although there may be other audit issues involving purchases, capital improvements, etc.). If the records are unavailable or inadequate, the reasonableness of external indices comes to play.

As the Tax Appeals Tribunal noted in *Sandrich, Inc*.[3]

> To determine the adequacy of a taxpayer's records, the Division must first request and thoroughly examine the taxpayer's books and records for the entire period of the proposed assessment. The purpose of the examination is to determine, through verification drawn independently from within these records 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 from which the exact amount of tax due can be determined."[4]

Relatively few cases involve disputes over the adequacy of the taxpayer's records. Two significant taxpayer victories are *Matter of King Crab Restaurant, Inc*.[5] and *Matter of Christ Cella, Inc*.[6] Both cases involved challenges to sales tax audits using a test period analysis. The taxpayers in both cases persuaded the Appellate Division to overturn the assessment on the ground that the Tax Division failed to show that the taxpayer's records were inadequate. In *Matter of King Crab*, the opinion noted that "the auditor was pre-

sented with guest checks, bank statements, a general ledger, a cash disbursements journal and purchase invoices for the entire audit period, except for the first seven months. Since petitioner did not maintain cash register tapes, these were not made available."[7] The opinion noted that the auditor testified that he "spot-checked one box of guest checks and found them to be out of chronological order."[8] The auditor concluded that the records were inadequate on the basis of his spot check and the lack of cash register tapes. The auditor further testified that because records were not available for the first seven months he "automatically assumed inadequacy of [all] records."[9] In *Matter of Christ Cella, Inc.*, the auditor went so far as to testify that "[w]e do markup tests in approximately every restaurant to determine whether the particular restaurant has the proper records or not."[10] The auditor's information sheet indicated that the records available were in good condition and that all requested records were made available.

In both opinions, the court ruled that test period audits were inappropriate. The court in *Matter of Christ Cella* quoted its prior opinion in *Matter of Chartair, Inc*.[11] stating that "[t]he honest and conscientious taxpayer who maintains comprehensive records as required has a right to expect that they will be used in any audit to determine his ultimate tax liability."[12] The court in *Matter of King Crab* concluded that "[t]here is no requirement that guest checks be placed in chronological order. Further, cash register tapes are not required if the information they contain can be gleaned from other sources. . . . Additionally, failure to conduct a complete audit cannot be justified simply because it would have required additional work, or because the records were too voluminous." [13]

Voiding Test Period Audits

However, more recent attempts by taxpayers to void test period audits on this basis have been unsuccessful, at least in part because the procedures for requesting and reviewing records has been tightened up in the intervening years. In *Karay Restaurant Corp.*,[14] the taxpayer claimed that since they had cash register tapes, their records were adequate and the Division could not resort to an observation test. In that case the taxpayer had not retained guest checks even after being instructed to do so during the course of prior audits. The Tax Appeals Tribunal rejected the taxpayer's claims stating that there was no way to verify the accuracy of the cash register tapes. In particular, "there is no way for the auditor or this Tribunal to know whether every transaction represented by a guest check was recorded on petitioners' cash register because petitioners conscientiously destroyed every guest check."[15]

When the Division properly demonstrates that the records of the taxpayer are insufficient or inadequate to permit an exact computation of the sales and use tax due, the Division is authorized to estimate the tax liability on the basis of external indices.[16] The methodology selected must be reasonably calculated to reflect the taxes due,[17] but exactness in the outcome of the audit method is not required.[18] While it is true that "considerable latitude is given an auditor's method of estimating sales under such circumstances as exist" in each case,[19] certain limitations have been placed on this principle. It is necessary that the record contain sufficient evidence to allow the trier of fact to determine whether the audit has a rational basis and, further, that the record contain specific information identifying the external index employed by the Division in estimating the taxpayer's liability.[20] The burden rests with the taxpayer to show by clear and convincing evidence that the methodology was unreasonable or that the amount assessed was erroneous.[21]

An examination of cases where the taxpayer has prevailed indicate that although the burden is great, in some cases the Division's methodology is sufficiently arbitrary that the courts are justified in overturning the adjustments. For example, in *Matter of Grecian Square, Inc.*,[22] the court stated that the Division's auditor increased petitioner's estimated sales figure by 200 percent on the ground that the sales were "much lower than other establishments which he had audited."[23] The court went on to note that "the record does not disclose any specific information concerning the bars which [the auditor] had audited and found to have been comparable to petitioner's."[24] The court concluded that "without some information about the size, location, number of employees and nature of the operation, this court is unable to make a determination as to the existence of a rationale basis."[25] The court therefore sent the case back to the State Tax Commission for further findings. Similarly, the auditor in *Vincent Basileo d/b/a Mimmo's Restaurant and Pizzeria*[26] computed a deficiency by comparing petitioner's restaurant sales to the average of two "substantially and materially similar" restaurants. The Tax Appeals Tribunal stated that "the record is void of any evidence that describes any aspect of these two restaurants . . . . In addition, the record does not indicate what kind of audit was performed of the other two restaurants."[27] The Tax Division argued that taxpayer secrecy rules prevented it from divulging the names of the other restaurants but the court ruled that the auditor could explain the similarities between the two restaurants and petitioner's without divulging privileged information.

Auditors frequently rely on estimates resulting from use and observation tests, where the auditors physically monitor the sales for a period of time and compare the amount of such sales with those reported for a similar period. The Tax Division is generally given a great deal of latitude in conducting these tests. For example, in *Eugene Burbacki, Officer of RIA Restaurant, Inc.*,[28] the Division was permitted to employ a use and observation test from a prior period, adjusted to reflect current menu prices, over the objection of the taxpayer's representatives who argued that intervening changes to the business obsoleted the earlier observation test. The Tax Appeals Tribunal upheld the determination of the ALJ that "while it is possible that because of these circumstances petitioners may be entitled to

some allowances, petitioners have the burden of proving not only the entitlement thereto but also the correct amount of such allowances."[29] Nevertheless, taxpayers are occasionally able to challenge some of the underlying assumptions of a use and observation test. For example, in *Commack Fish and Seafood Restaurant Corp.*,[30] a one day use and observation test in June was considered unreliable to estimate sales for earlier months on the ground that the taxpayer established that the level of prepared food sales increased as the weather improved. The ALJ thereby ordered the Tax Division to recalculate the error rate by comparing the sales during the test date (a Friday) with the average sales reported on other Fridays in June.

The other common method of estimating sales is to extrapolate from certain expenses of the restaurant, such as inventory or wages.[31] The Division will rely on its own statistical data as well as industry studies.[32] Taxpayers rarely are in a position to challenge these formulae but on occasion may show errors in the Division's calculations. For example, in *Ristorante Puglia, Ltd.*,[33] food and supply purchases during 1974 could not be used as a base to measure the restaurant's sales since the purchases included purchases for another restaurant.

Conclusion

Nevertheless, the authorities demonstrate the tremendous uphill battle for restaurants that do not maintain adequate records.

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1 Reg. section 533.2 elaborates on the requirements and specifically provides guidance for maintaining records on microfilm and on an "automated data processing system." For instance the regulations provide that "[a]ll records required to be kept by this Part shall be preserved for a period of three years from the due date of the return to which they relate, or the date of filing, if later. . . " Guest checks are explicitly required to be kept for a three year period, unless District Office Audit Bureau grants permission to destroy the guest checks prior to the expiration of the three-year statute of limitations.

2 Reg. section 535.2 does not elaborate on this provision.

3 *Sandrich, Inc. T/A Bruce's Yogurt*, DTA Nos. 808753 & 808748, April 15, 1993.

4 *Id.* at 8. (internal citations omitted).

5 134 A.D.2d 51(3d Dep't 1987).

6 102 A.D.2d 352 (3d Dep't 1984).

7 *Matter of King Crab Restaurant, Inc.*, 134 A.D.2d at 53.

8 *Id.*

9 *Id.*

10 *Matter of Christ Cella, Inc.*, 102 A.D.2d at 353.

11 *Matter of Chartair Inc. v. State Tax Comm'n*, 65 A.D.2d 44, 47 (3d Dep't 1978).

12 *Matter of Christ Cella, Inc.*, 102 A.D.2d at 353.

13 *Matter of King Crab Restaurant, Inc.*, 134 A.D.2d at 53. (internal citations omitted).

14 DTA Nos. 814615, 814616, 814617 & 814618, December 10, 1998.

15 *Id.* at p. 5.

16 Tax Law §1138[a][1]; *see Matter of Ristorante Puglia, Ltd. v. Chu*, 102 A.D.2d 348 (3d Dep't 1984).; *Matter of Surface Line Operators Fraternal Org. v. Tully*, 85 A.D.2d 858 (3d Dep't 1981).

17 *Matter of Ristorante Puglia, Ltd. v. Chu, supra*; *Matter of W.T. Grant Co. v. Joseph*, 2 N.Y.2d 196 (1957).

18 *Matter of Markowitz v. State Tax Comm'n.*, 54 A.D.2d 1023 (3d Dep't 1976), *aff'd* 44 N.Y.2d 684 (1978); *Matter of Lefkowitz*, DTA Nos. 801198 & 801489, May 3, 1990.

19 *Matter of Grecian Square v. State Tax Comm'n.*, 119 A.D.2d 948 (3d Dep't 1986).

20 *Matter of Grecian Square v. State Tax Comm'n., supra, Estate of Fashana d/b/a Angelo's Cornucopia*, DTA No. 805356, January 12, 1989.

21 *Matter of Meskouris Bros. v. Chu*, 139 A.D.2d 813 (3d Dep't 1988); *Matter of Surface Line Operators Fraternal Org. v. Tully*, *supra*.

22 119 A.D.2d 948 (3d Dep't 1986).

23 *Id.* at 950.

24 *Id.*

25 *Id.*

26 DTA No. 805855, May 9, 1991.

27 *Id.* at p. 4.

28 DTA Nos. 810862, 810863, & 810864, February 9, 1995.

29 *Id.* at p. 9.

[30] DTA Nos.: 806457, 806458 & 806459, February 14, 1991.

[31] *See, e.g., Matter of Carmine Restaurant, Inc.*, 99 A.D.2d 581 (3d Dep't 1984); *Estate of Alice M. Fashana, d/b/a Angelo's Cornucopia*, DTA No. 805356, January 12, 1989.

[32] For instance, National Restaurant Association's Restaurant Industry Operations Report has been relied upon by the Division on several occasions.

[33] 102 A.D.2d 348 (3d Dep't 1984).