

NOT FOR PUBLICATION WITHOUT APPROVAL OF
THE TAX COURT COMMITTEE ON OPINIONS

SAULWIL, INC.,	:	TAX COURT OF NEW JERSEY
	:	DOCKET NO. 014062-2013
Plaintiff,	:	
	:	
v.	:	
	:	
DIRECTOR, DIVISION OF TAXATION,	:	
	:	
Defendant.	:	
	:	
SAMUEL & LOUISE HAMMER,	:	DOCKET NO. 014061-2013
	:	
Plaintiffs,	:	
	:	
v.	:	
	:	
DIRECTOR, DIVISION OF TAXATION,	:	
	:	
Defendant.	:	

Approved for Publication
In the New Jersey
Tax Court Reports

Decided: January 10, 2020

Robert A. Fee for plaintiff
(Robert A. Fee, Esq., attorney).

Heather Lynn Anderson for defendant
(Gurbir S. Grewal, Attorney General of New Jersey, attorney).

SUNDAR, J.T.C.

In this matter, the court decides whether the Division of Taxation (“Taxation”), the State agency headed by defendant, the Director, Division of Taxation, correctly determined that the corporate plaintiff, Saulwil, Inc. (“Saulwil”), maintained inadequate books and records so that its reported gross receipts had to be reconstructed and increased by using an estimated markup. At issue is the audited corporate Sales and Use (“S&U”) tax for the periods October 2007 through

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September 2011. Also at issue is the New Jersey gross income tax (“TGI”) imposed upon the individual plaintiffs, Samuel and Louise Hammer (the “Hammers”) for tax years 2007-2009 resulting from the corporate audit since they, as 50% each shareholders of Saulwil, were deemed to have constructively received the gross receipts imputed to Saulwil by Taxation.¹ The amounts in dispute are as follows:

S&U tax - \$246,851, plus penalty and interest = \$330,649.

TGI - \$493,356, plus penalty and interest = \$693,631.

For the reasons explained below and based on a review of all the evidence before it, the court finds that Saulwil’s books and records were adequate. Therefore, it was unnecessary for Taxation to embark on a markup of Saulwil’s reported sales to impute additional gross receipts. Taxation’s determination to the contrary was unreasonable, consequently, its final determination assessing additional sales tax based on its markup methodology is reversed, as is its final determination imposing additional TGI on the Hammers based on their constructive receipt of income from the deemed additional corporate receipts. Nonetheless, Saulwil conceded that there are minor discrepancies in its reported gross receipts which were disclosed at trial. Therefore, Saulwil is directed to pay sales tax on these discrepancies, plus interest and penalties, which Taxation should compute. Taxation should also compute the imputed TGI to the Hammers as a result of these gross receipts discrepancies, plus interest and penalties. Further, and although the

¹ Saulwil and the Hammers together are referenced as “plaintiffs.” Since the Hammers’ TGI liability is purely a result of the corporate audit, the court will use Saulwil as the representative plaintiff throughout this opinion.

use tax was imposed based on the markup percentage determined by Taxation, Saulwil stated that it was not going to contest the same. Therefore, Saulwil should pay the use tax audited assessment. The court will issue an order and final judgment of the total due from Saulwil and the Hammers after these computations are provided.

PROCEDURAL HISTORY

The procedural history is set forth in detail in this court's prior two written letter opinions, the first dated January 26, 2017, denying Taxation's motion for summary judgment on grounds there were genuine issues of material fact, and the second dated December 13, 2017, denying Taxation's motion for involuntary dismissal of the complaints under R. 4:37-2(b) at the end of plaintiffs' case-in-chief.

Briefly, commencing December 2010, Taxation performed a cash audit of Saulwil, which operates a seafood restaurant and bar called The Crabs Claw Inn located in Lavallette, New Jersey. Taxation rejected the daily and monthly summaries of sales transactions generated by the restaurant-specific point-of-sales ("POS") software program installed in the computer terminals located in the restaurant, on grounds they were useless without cash register tapes or guest checks to verify the totals contained in the summaries; determined that the bank deposits for 2008 were significantly larger than the reported receipts on the tax year 2008 S&U and Corporation Business Tax ("CBT") returns; and deemed the reported markups (ratio of reported gross receipts to purchases or cost of goods sold) of 2.43%, 2.18%, and 2.86%, for tax years 2007-2009 as unrealistic given the successful nature of the restaurant due to its close proximity to the shore.

The auditor thereafter reconstructed Saulwil's gross receipts by computing a higher markup of 3.92% overall, using Saulwil's purchases for a two-week period in March 2011. He computed sales tax on these reconstructed gross receipts for the tax periods at issue. He also imposed use tax of \$22,777 on certain taxable expenses, the error rate (percentage of expenses deemed to have been subject to sales tax but which tax was not collected from Saulwil) being computed by the sampled expenses for tax year 2008 divided by the audited gross receipts of \$7,836,176 for the same tax year). No CBT was assessed on Saulwil; rather, TGI was assessed on the Hammers.

Pursuant to an administrative conference, Taxation reduced the overall audited markup percentage from 3.92% to 3.62% as a concession to Saulwil, which reduced the sales tax and concurrent TGI as noted above. Taxation however maintained that the audit was otherwise proper because Saulwil lacked adequate books and records, and thus, there was no need to analyze the bank deposits. Rather, per Taxation, the decision to use a markup method had to follow, and in any event, plaintiffs had no evidence to corroborate their protest.

Plaintiffs filed a timely complaint in 2013. Taxation then moved for summary judgment in 2016, which this court denied in part.² At trial in 2017, after Saulwil's case-in-chief comprising of documentary evidence and testimony of the Hammers, Saulwil's general manager, Saulwil's tax return preparer, and the owner of the company that had installed the restaurant-specific POS software in Saulwil's computer system, Taxation moved to dismiss the complaints under R. 4:37-

² The court granted summary judgment on the use tax portion of Taxation's audited assessment since Saulwil's opposition in this regard was insubstantial. However, since the error rate for the use tax was based upon the tax year 2008 audited gross receipts, and the validity of the same was to be tried, the court did not determine the amount of use tax due.

2(b).³ The court denied the motion for reasons stated in its letter opinion of December 13, 2017. Trial was then continued in 2018 and 2019, wherein Taxation put forth its case with documentary evidence, and testimony of its auditor and the auditor's supervisor. Saulwil provided rebuttal testimony of its general manager and the owner of the software installer. The parties then provided written closing arguments in July and October 2019.

FACTS

As with the procedural history, relevant facts as to the audit, Saulwil's business, and evidence offered by Saulwil, are contained in the court's two prior letter opinions.⁴

Mr. Hammer is a career cook/chef specializing in seafood. The Hammers started their restaurant business several years ago on a small scale. Due to popular success, they expanded to purchase and run The Crabs Claw Inn, a free-standing building with three floors, in 1979. The restaurant prides itself on providing quality food. The first floor has a walk-in bar, lounge, dining area, kitchen and restrooms, and a porch for dining. The second floor has a small bar and a dining area. The third floor is for storage and office use. The restaurant is open all year except Christmas.

³ Prior to trial, the court permitted Saulwil to adduce testimony of the software consultant's owner over objections of Taxation but imposed a monetary sanction upon plaintiffs for violating court rules as to lack of notice of witnesses. Trial was adjourned so Taxation could depose the individual. Taxation then moved to bar trial testimony of the software consultant's owner on grounds he was not an expert and lacked personal knowledge of the functioning of POS software program installed at Saulwil's restaurant. The court denied the motion. The court also denied Saulwil's motion that due to the sheer volume of documents, it be permitted to submit summaries of the same at trial.

⁴ In its letter opinion of December 13, 2017, the court summarized the testimonial and documentary evidence provided by Saulwil, but in the limited context of the quality of evidence required for purposes of a R. 4:37-2(b) involuntary dismissal motion.

Food discounts are offered daily (half-off second entrée, early bird and lunch specials) and for special occasions (birthdays). Every day has a happy hour when drinks are sold at a discount.

The restaurant has a general manager, purchasing agent, kitchen manager, bar manager, and personnel manager. Saulwil also employs a chief cook, several line-cooks, and waitstaff (the waitstaff hires being more in the summer). Mr. Hammer, who runs the day-to-day operations, at times, cooks and prepares seafood since fish is delivered daily, and since he is experienced in all aspects of seafood (amounts to be purchased, purchase prices, amount of waste, and the like).

Food and drink are ordered by Saulwil's purchasing agent. Purchase invoices are checked, and after they are entered into the computer by the general manager, placed in files. Mr. Hammer is regularly provided a summary sheet of the purchased items, vendors, and cost. He decides when and which vendor should be paid.

Computer terminals, located in the restaurant and bar areas, are used to input all food and drink sales. The terminals use a restaurant-specific POS software program, which was "Aloha" in 2009, and then "Dinerware" beginning sometime in 2010 or 2011.⁵ QuickBooks software is used to record disbursements. QSR (Quick Service Restaurant) software, which connects to Dinerware, is used to record purchases and inventory. The POS software program was installed by a third-party entity, which also maintains the software and resolves computer issues.

⁵ The summaries provided for tax periods until 2010 differed in presentation than those for 2011. The latter had the name Dinerware Inc. at the bottom of the sheet, and an aggregate of sales broken down by revenue class (category of products sold), spillage, discounts, credit card receipts, cash receipts, tips, cash payouts, and sales tax.

The POS software program works thus: after a customer places an order, the waitstaff assigned to the table enters the order in the computer terminal. The order is then printed out in the kitchen, according to which food is prepared by the kitchen staff, and then served to the customer by the waitstaff. Waitstaff does not order any item in-person from the kitchen staff, nor is any waitstaff authorized to enter the kitchen or behind the bar. The server then prints the bill or guest check from the computer, which will include the date, server's name, table served, and the itemized order. After receipt of payment from the customer, the server enters the amount received (credit cards are swiped on the same terminal), then "closes" that table by punching another key on the terminal. Similarly, the bartender or bar manager will enter a drink order on the computer terminal, after which the drinks are prepared. There is an automated "day and night price" switch. Complimentary drinks are rung up on the terminal but are manually discounted by an entry on the terminal. Spills or tap loss are rung up as spills on the terminal, as are free drinks for the staff.

At the end of the work shift, the waitstaff hands over the total receipts to the hostess, who checks the "server report" (which contains the breakdown of food/drink orders manned by that server for a particular day and during the server's shift) to ensure that the totals match.⁶ The hostess pays the server any cash tips included in those receipts. If the tip is added on a credit card, the tip amount is paid to the server and a note to this effect is entered on the computer. The hostess places all cash and rubber-banded credit card receipts in a "bank bag" and hands it over to the bar manager, who places it in a safe along with the cash/credit card receipts from the bar (like the

⁶ The server reports were not kept as they were verified with the daily aggregates. Per the general manager, they are being retained since 2011 because of Taxation's audit.

hostess, the bar manager runs server reports, tallies, and totals all daily receipts). If any portion of the cash receipts is used to pay for purchases, a note is placed in an envelope and is recorded by the general manager in the computer as a payout. Mrs. Hammer verifies the total in the bank bags with the aggregates in the daily summaries and deposits the cash in one of the three banks wherein Saulwil has a general operating account or a payroll account. Money is transferred between these accounts for corporate purposes; however, Mr. Hammer conceded that mortgage payments deducted therefrom are for the couple's home.

Before Mrs. Hammer verifies the total receipts, the general manager tallies the daily total receipts at the end of the business day and reconciles the same with the server reports and the daily summary reports she runs. At times, she deposits the receipts in the bank. She also oversees the operations, checks mail, runs summary reports (daily, monthly, and annual), enters all purchases on the computers, and maintains the general ledger (generated by QuickBooks). She provides the summary reports (run from the POS software program) periodically to Mr. Hammer so he has an overview of the receipts. These reports are also used to compute and pay sales tax, with returns filed by her or the accountant. She did not maintain the server reports, the individual guest checks or the cash register tapes because, she stated, everything was computerized on the POS software, and maintaining them was unnecessary since (a) the daily aggregates of the receipts are contained in the summaries, and (b) she personally counts the daily receipts and tallies the total with the totals in the daily summaries that she runs.

The owner of the software installation entity testified that his company sells, installs, configures, and services the POS software for local, independently-owned restaurants, with

Saulwil being his earliest customer. The POS software is created (written and coded) exclusively by third parties. After installation, his company's staff remotely performs routine maintenance and services. His staff installed Aloha first and later upgraded and replaced it with Dinerware in Saulwil's restaurant and bar computer terminals. He stated that the POS software program was developed to eliminate theft and to ensure that every sale was accounted for. Without the computer generating a slip for the order, the ordered food will not be prepared, and this is accomplished by the software's sequel or queuing function. This latter function cannot be configured and has no user functionality, and further, it is almost impossible to manipulate the internal algorithms in the program to disrupt this queue function unless one was technologically proficient. While he or his staff could modify the POS software program to adapt to a client's needs (such as price increases), this was a different function performed by professionals prior to and during installation. He was aware of a software called "Zapper" (which apparently is used in restaurants to wipe out recorded sales), but, he declared, he has never installed this software program, and would never do so even if requested by a customer. He stated that the entries of the daily sales, if recorded, should generally always be available in the hardware, even if not separately saved or backed-up. However, he noted, such information can be wiped out if a new software is installed, there are other software upgrades or replacements, or if there were computer crashes. He stated that Dinerware was a better upgrade as it functioned in "real time." He also stated that, to his knowledge, this software did not malfunction after its installation in Saulwil's restaurant.

Saulwil's accountant testified that he prepared Saulwil's tax returns, and that there were minimal differences between the federal and state corporate returns. He stated that the

Internal Revenue Service's audit of Saulwil resulted in a \$668 federal income tax liability for the Hammers for tax year 2007, and no changes to the federal corporate income tax return for tax year 2008.

Taxation's auditor testified at length to his audit of Saulwil, which was essentially a repetition of his audit report that was in evidence. He conceded that he was wrong about deeming a \$2.09 million credit in the 2008 bank statements to be evidence of unreported cash sales, which Saulwil had continually maintained were reverse bank entries to correct erroneous debits by the bank. Regardless, he maintained, his decision to reconstruct Saulwil's receipts was proper because there were no cash register tapes showing each sale made each day, without which, he stated, there could be no audit trail. Therefore, he stated, reviewing the POS-generated daily summaries was a useless endeavor. Further, he testified, Saulwil's records were inadequate because he was not given documents he had demanded, and because the bank deposits for tax year 2008 still did not match the gross receipts reported on Saulwil's 2008 CBT returns. He detailed his markup methodology as follows: increasing the sales price of food and drinks by a certain percentage he determined was proper; computing the number of servings a particular food item produced (using the menu to compute this number) and how many drinks for sale a particular liquor item could produce (based on his experience); and then multiplying those servings by the markup percentage he had initially determined. He stated that the markup percentages from the CBT returns were unrealistically low as one could not sustain running a restaurant at those rates.

The auditor stated that cash audits involving reconstruction of sales never usually cover one tax year, but rather would typically involve at least the four tax years which are within the

statute of limitations. He also stated that sample tax periods can change during the audit process and could be whichever period Taxation decided had the most or complete documentation. Thus, here, although Saulwil's audit commenced with an agreed-to sample period of tax year 2008, he decided to use March 2011 as the sample period since there was a filed S&U return for that period, and then to use a two-week period since there were too many purchase invoices for that month, and thereafter to extrapolate his markup percentage to the sales for prior tax years 2008-2010.

The supervising auditor's testimony was essentially an endorsement of the auditor's reasons for, and results of, the audit. He claimed that the daily summaries indicated results of only one terminal when in fact there were several, and that there were discrepancies between the monthly and daily summaries. Both these facts, according to him, was proof that the summaries were unreliable and that sales were under-reported. Discrepancies, he said, simply cannot occur where the business is computerized. Therefore, he asserted, without the cash register tapes from each terminal, Saulwil's books and records were properly considered to be inadequate, and even if the dollar amount of inconsistencies was insignificant, a markup should be performed. He conceded that Saulwil does not use the Zapper software to delete sales. He also conceded that the POS software is intended to minimize employee theft. Yet, he maintained, the POS is vulnerable to manipulation and easy for restaurant owners to make changes. The latter can be accomplished, he stated, by setting the computer on a demo mode, whereby sales when made can be recorded but when closed will not save any entries. This means that there will be no record of any sales made when the computer is operating on the demo mode.

FINDINGS

The issues in the case are: (a) whether Saulwil had adequate books and records; and (b) if it did not, whether Taxation's markup methodology to reconstruct Saulwil's receipts was reasonable such that the resultant sales tax assessments for each of the audited tax periods was also reasonable and not aberrant.

A vendor required to collect sales tax "shall keep records of every purchase . . . sale . . . and of all amounts paid, charged or due thereon and of the tax payable thereon" which includes "a true copy of each sales slip, invoice, receipt, statement or memorandum" for which tax must be "stated separately," and should be "available for inspection and examination at any time upon demand by" Taxation. N.J.S.A. 54:32B-16. These documents should "be preserved for a period of four years." Ibid.

Taxation's regulations are similar. See N.J.A.C. 18:24-2.3(a) (taxpayer should retain "[a] true copy of all sales slips, invoices, receipts, statements, memoranda of price, or cash register tapes, issued to any customer . . . and records of every purchase . . . for four years from the date of filing of each quarterly sales tax return"). If summary records are maintained "that show . . . total receipts and taxable receipts," a taxpayer should still "maintain individual sales slips, invoices, receipts, statements, memoranda of price, cash register tapes, or guest checks." N.J.A.C. 18:24-2.4(a). "[S]ummary sales records" have to be retained for at least "four years from the last date of the quarterly period for the filing of sales tax returns." N.J.A.C. 18:24-2.4(b). Pre-2016, a taxpayer could "dispose of individual sales slips, invoices, receipts, statements, memoranda of price, or cash register tapes, . . . after the lapse of a period not less than 90 days from the last date of the most

recent quarterly (or monthly) period for the filing of sales tax returns to which such individual sales documents pertained.” See 40 N.J.R. 177(a) (proposed April 7, 2008); 40 N.J.R. 6832(a) (adopted Oct. 27, 2008). Effective May 16, 2016, however, such records must be maintained “for a period of four years from the last date of the most recent quarterly period for the filing of sales tax returns.” N.J.A.C. 18:24-2.4(a); see 47 N.J.R. 2919(a) (proposed Dec. 7, 2015); 48 N.J.R. 824(a) (adopted April 18, 2016).

If a sales tax return “is not filed, or if a return when filed is incorrect or insufficient,” then Taxation can determine “the amount of tax due . . . from such information as may be available.” N.J.S.A. 54:32B-19. Thus, “[i]f necessary,” Taxation can “estimate[.]” sales tax by using “external indices, such as stock on hand, purchases, . . . or other factors.” Ibid. Courts have construed this statute to allow Taxation to reconstruct a taxpayer’s purchases and consequent sales if its books and records are inadequate. See Yilmaz, Inc. v. Dir., Div. of Taxation, 22 N.J. Tax 204 (Tax 2005), aff’d, 390 N.J. Super. 435 (App. Div. 2007).

Clearly, then, under the statute and precedent, Taxation can reconstruct a taxpayer’s receipts subject to tax and determine the correct tax if the taxpayer’s books and records are inadequate or there are justifiable reasons to believe that a filed tax return “is incorrect or insufficient.” Thus, Taxation’s audit determinations are not set in stone. Rather, they are presumptively correct, which means that a taxpayer can rebut the same with proof of “bona fide business records” that are qualitatively and quantitatively credible. Duncan Truck Stop, Inc. v. Dir., Div. of Taxation, 4 N.J. Tax 367, 375-76 (Tax 1982).

The term “inadequate” is not defined anywhere. Nonetheless the broad discretion allowed Taxation under N.J.S.A. 54:32B-19, and the presumptive correctness afforded its determinations, are based on the expectation that Taxation, as a governmental agency, will be reasonable in its initial determination that a taxpayer’s books and records are inadequate. See e.g. S. Burlington County NAACP v. Township of Mount Laurel, 92 N.J. 158, 305 (1983) (presumption of correctness to government decisions attaches because “those in government generally act within the powers granted to them and do so properly”); Borough of Rumson v. Peckham, 7 N.J. Tax 539, 548 (Tax 1985) (“Nonstatutory presumptions such as, *inter alia*, the presumption of correctness of a county board of taxation judgment, are based on considerations of public policy”).

Additionally, the square corners doctrine impacts Taxation’s determinations, and thus, balances with the presumption of correctness provided to those determinations. See Milligan v. Dir., Div. of Taxation, 29 N.J. Tax 381, 398-99 (Tax 2016) (“the square corners doctrine is a long-established legal principle limiting Executive Branch action which would otherwise be authorized by law”). Thus, the government cannot “conduct itself so as to achieve or preserve any kind of bargaining or litigational advantage over” a taxpayer since “[i]ts primary obligation is to comport itself with compunction and integrity”; therefore, it cannot act like “private citizens . . . in dealing with one another”). F.M.C. Stores Co. v. Borough of Morris Plains, 100 N.J. 418, 426-27 (1983).

As the Court pointed out:

[S]tatutory provisions governing substantive standards and procedures for taxation, including the administrative review process, are premised on the concept that government will act scrupulously, correctly, efficiently, and honestly. It is to be assumed that the [taxing agency] will exercise its governmental

responsibilities in the field of taxation conscientiously, in good faith and without ulterior motives.

[Id. at 427].

Consequently, while this court can decide, based on evidence properly before it, whether a taxpayer has overcome the presumptive correctness of an audit determination, such evidence can also be examined to decide whether Taxation's initial conclusion as to the inadequacy of books and records was reasonable. Thus, a taxpayer can provide credible evidence (documentary and/or testimonial) to show that Taxation's reasons for performing a markup were unreasonable, and further that the consequent audited tax assessments were arbitrary and aberrant. See TAS Lakewood v. Dir., Div. of Taxation, 19 N.J. Tax 131, 139-41 (Tax 2000) (court's "review[of] the audit figures" allowed it to "conclude that the tax deficiency imposed based on the only available records, the tax returns . . . [was] reasonable and justified by law"); Yilmaz, 390 N.J. Super. at 441-42 (taxpayer can present "competent independent evidence, expert or otherwise, to challenge that presented by" Taxation to prove either an aberrant methodology or excessive assessment amount, or provide evidence through cross-examination of the auditor that Taxation's assessment is incorrect); United States v. Carson, 560 F.2d 693, 698 (5th Cir. 1977) (government reliance on simply a presumption of correctness untenable since it "would support the most arbitrary of assessments so long as the taxpayer found himself unable to prove a negative"); Walker v. Comm'r, 757 F.2d 36, 37 (3d Cir. 1985) ("In unreported income cases, the presumption of correctness imposes on the taxpayer the difficult burden of proving a negative, that he did not earn the income the government claims he earned" and while this is often "from the taxpayer's own

failure to keep business records of transactions known only to him,” yet these “record keeping failures do not justify” an unreasonable or “naked assessment”).

Whether a taxpayer’s records are “inadequate” depends on the facts and circumstances of each case. It is not necessarily the quantity of records, but also the quality. That a taxpayer does not maintain, or cannot produce, each and every record demanded by Taxation is not a conclusive indication of inadequacy in record-keeping. A taxpayer need not maintain the best or perfect records. Rather, its records should be sufficiently enough to support the veracity of its filed returns. A contrary construction would render meaningless the discretion afforded Taxation in examining books and records, and the presumptive correctness afforded its determinations.

Here, and after carefully reviewing the entire evidence provided by the parties, the court finds that Saulwil maintained adequate books and records for the audit period and during the audit. Taxation’s decision to the contrary was unreasonable, and its consequent determination to estimate a markup percentage and inflate the reported receipts was unnecessary and unsupported by N.J.S.A. 54:32B-19. The testimony provided by the Hammers and Saulwil’s general manager was entirely credible. They did not provide any cause for the court to believe that Saulwil did not maintain adequate books and records or that it made significant amounts of deliberately unreported cash sales. The general manager forthrightly conceded that there were minor discrepancies in the monthly summaries and the ledgers she maintained, however, explained that they could have occurred due to either human errors or computer glitches. These fallible errors do not provide a basis for concluding that Saulwil lacked adequate books and records justifying a markup.

That Saulwil did not retain the “cash register tapes,” an undefined phrase vis-à-vis a POS software program, does not, under the facts of this case, provide a reasonable justification for Taxation’s conclusion that Saulwil’s books and records were inadequate. Saulwil provided several pages of daily, monthly, and annual summaries. These aggregates were actual contemporaneous records for the audit period and provided a cumulative running total of all sales each day. Such records are therefore the best evidence in computing tax. They are certainly more persuasive proof than a tax based on a questionably small sampling period, here a two-week period in March 2011, and on an estimated markup that is supposed to be accepted as a credible determinative of the actual sales over a prior four-year period.

Additionally, while the daily guest checks or cash register tapes (however this latter phrase applies to a POS software program) can certainly help check the accuracy of the daily summaries, their non-retention does not automatically indicate an inadequacy of books and records mandating use of an artificial markup to reconstruct Saulwil’s sales. Pre-2016 amendment, the regulations specifically permitted a taxpayer to destroy cash register tapes and maintain summaries in their stead. See N.J.A.C. 18:24-2.3(a) (pre-2016), 40 N.J.R. 6832(a) (taxpayer can “dispose [] of individual . . . cash register tapes . . . after . . . 90 days from the last date of the most recent . . . period for the filing of sales tax returns to which such individual sales documents pertained”).⁷

⁷ The 2016 amendment replacing the 90-day retention period with four years would not apply here since the audit was done in 2011. Thus, it cannot be said that Saulwil’s decision to only maintain summaries is improper. While the 90-day regulatory limit existed for the first quarter of 2011, this sample period (as further narrowed down to two weeks in March 2011) was used only by the auditor only for markup purposes, not to initially determine the adequacy of books and records. Notably, the amended regulations continue to recognize summary sales records as acceptable

See also Charley O's, Inc. v. Dir. Div. of Taxation, 23 N.J. Tax 171, 187 (Tax 2006) (use of cash register summaries can be permissible substitutes for the daily cash register tapes). Regulations are formal guidance to taxpayers on the application of statutes, and the effectuation of statutory language and intent. As such, then, the regulations cannot be rigidly interpreted or applied especially when contrary to their plain language. Additionally, it violates the square corners principle when the regulations permit the non-retention of cash register tapes, yet Taxation posits that without these tapes, a taxpayer's books and records are inadequate.

Further, Taxation's insistence on retention of cash register tapes is unreasonable here because as early as February 2011 (in response to the audit questionnaire), Saulwil informed Taxation that it had, among other records, register tapes total but not "detail," and that it had computerized cash registers but did not save daily register tapes. Taxation never alerted Saulwil that this was unacceptable. Again, when Taxation decided to use 2011 as the sample period despite having agreed to use tax year 2008, it unreasonably refused to consider server reports from the post-2011 sample period (which contain details of the sales logged into a server) on grounds they are from post-audit periods. Further, there is simply no proof of a deliberate destruction of cash register tapes done to under-report sales. These facts lead the court to believe that since Taxation had already decided to perform a markup, nothing would alter this decision except production of the cash register tapes for the audited tax periods.

books and records. In any event, here, based on all the corroborative testimony, the court finds that the absence of cash register tapes alone is not a reasonable basis to deem Saulwil's books and records inadequate so as to necessitate a reconstruction of Saulwil's receipts.

In this connection, the supervising auditor's testimony that Saulwil must have under-reported its sales because one of the daily summaries showed receipts from only one terminal, was unsubstantiated, and therefore, does not prove that Saulwil had inadequate books and records. The witness had never visited the restaurant to observe the daily operations. He had never examined any daily or monthly summaries of prior tax years. His testimony was effectively rebutted by testimony of Saulwil's general manager, a long-time employee intimately familiar with its business operations, that all the workstations (terminals) must be kept open each working day and could not be shut down randomly. She also noted that revenue center is a revenue "class" denoting food, drink, etc., not a geographical term for kitchen, bar, or dining area. Her testimony was supported by the equally credible testimony of the software installer's owner that each workstation (terminal) cannot simply be turned off, and in any event, even if a summary report of all daily transactions can be run from any one terminal, all terminals consolidate the data into the main server (brain) which will thus have the same (and all) summaries.

Indeed, the most effective proof of the speculative nature of the supervisor's testimony was the auditor's testimony and report: the auditor personally viewed the restaurant and observed the operations for about two days, including food preparation, for purposes of the audit. He had reviewed the summaries provided by Saulwil. Yet his audit report did not contain a single claim or allegation that the summaries were run only from selected terminals, and therefore were unreliable. Thus, the supervising auditor's testimony that the POS-generated summaries were unreliable thereby justifying a markup exercise, is not credible, and does not support a finding that Saulwil's books and records were inadequate.

Moreover, there was simply no evidence that the POS software was altered or manipulated to delete sales. Therefore, there is no basis to dismiss the summaries as patently unreliable. There was nothing to show that Saulwil requested or independently installed Zapper or other software to delete sales records in the restaurant's computer terminals. There was no proof that the waitstaff circumvented the computer terminals (which if they had, could have been observed and reported by the auditor who personally was at the restaurant during the audit), or requested food/drink orders without entering them in the computers. Rather, the undisputed testimony was that no server was authorized to enter the kitchen or behind the bar to order food/drink. Saulwil also provided credible evidence as to the purpose and functions of the POS-generated summaries, their accuracy and contemporaneousness; and the nigh-impossible manipulability of the software codes or algorithms to alter same. Such evidence cumulatively shows that the summaries provided by Saulwil should not have been summarily rejected as unreliable for purposes of deciding whether Saulwil's books and records were adequate.

The supervising auditor's further testimony that since managers or restaurant owners can change the POS software or run them on a demo mode, the court can infer the unreliability of the summaries (sans cash register tapes or guest checks), is not credible. There was nothing to show any such manipulations were being done by the Hammers or that they had the technological savoir-faire to engage in such acts. Although the software installer's owner stated that a closed ticket (guest check) can be re-opened, he also noted that there were checks and balances in place so that this is not a daily occurrence. He also credibly testified that the demo mode is usually used prior to purchase so that a prospective restaurant understands how the software operates, but more

importantly, the entries will not print or send any order to the kitchen. Thus, the POS software program will not print a ticket to the kitchen to prepare food, nor will it print a guest check to the customer. This rebuttal, combined with his direct testimony, his thorough knowledge of computer software, and his professional experience in this business since the 1990s, provides the court with a much more reliable and persuasive proof of non-manipulation of the POS software program, as does the general manager's testimony that the demo mode is never used. If, per the supervising auditor's speculation, a POS software's queue functions can be manipulated by an owner (but not the waitstaff) by operating a cash register in a demo mode, then there is no point in demanding cash register tapes because they could also be capable of manipulation so that sales are not recorded. That something can happen is not credible proof that it happened. The supervising auditor's contention that the summaries provided by Saulwil are unreliable because the POS software has the potential for being manipulated by a manager or owner is purely speculative, and thus, is not credible evidence.

In this connection, the court finds that Saulwil's software installer's inability to retrieve details of the daily sales transactions from the computer is not fatal, nor endorses Taxation's determination that Saulwil's books and records were inadequate. The software installer's owner's testimony in this regard was entirely credible. He was thoroughly knowledgeable of, and experienced in, the POS software's functions and installation process, both generally speaking, and as installed in Saulwil's computer terminals. He credibly testified that the Dinerware program installed in 2010/2011 could have over-written the 2008-installed Aloha (or the program prior to Aloha) and render such data inaccessible. He also credibly explained the reasons why old data

cannot be retrieved due to the coding of a software or how it is written, and that front-end access would be needed to access any backups.

It is true that there were insignificant discrepancies between the daily, monthly, and annual summaries. While these could justify imposition of tax on the actual under-reported amounts, they certainly do not support a conclusion that Saulwil's books and records were inadequate and therefore Taxation had to embark on a markup exercise creating additional taxable receipts for several tax years. This is because, first, Saulwil provided several documents other than the aggregates or summaries. Second, although the 2011 summaries produced by Dinerware were in a more sophisticated and detailed form than the ones produced by the prior software, nothing prevented Taxation from examining these summaries side-by-side to determine if they contained wide disparities. Third, Taxation's stance that if a POS software program is used there cannot be mathematical inaccuracies, or that sans 100% reconciliation it must apply a markup, is unreasonable. That Saulwil uses computerized accounting does not impose upon it a statutory or regulatory requirement that it maintain flawless record-keeping. It is difficult to agree that Taxation's markup percentages, which are pure estimates, are somehow more credible than the contemporaneous daily or monthly aggregates mechanically tallied by the POS software program.

In sum, Taxation's decision to outrightly reject the computerized summaries as useless without the cash register tapes; its conclusion that the lack of these tapes render Saulwil's books and records as per se inadequate; and its decision that a markup must be performed, are all unreasonable determinations. So is Taxation's contention that the summaries were unreliable due to the insignificant difference in amounts, and because Saulwil could have manipulated the

software. Cf. Charley O's, 23 N.J. Tax at 187 (“if summary records are available, cash register tapes are helpful, and if an auditor has reason to believe that a taxpayer’s summary records are inaccurate, and no cash register tapes are available, the use of a markup analysis is appropriate”).

Even if Taxation was deemed to be reasonable in deciding that the POS-produced summaries were unreliable, its decision to use a markup on grounds Saulwil lacked adequate books and records, is nonetheless unsupportable. Saulwil provided several contemporaneous business records as proof of adequate books and records. It produced voluminous purchase invoices for 2008, reasonably so, since Taxation agreed to use tax year 2008 as the sample period. The volume of provided invoices is evident from the several sheets of computations in the audit report. True, the audit report noted that Saulwil did not provide bank statements for 2006, 2007, and 2009; general ledger/sales journal for 2006, 2007, and 2009; and cash register receipts/guest checks for 3rd quarter 2010. This non-provision however should be balanced with what was provided during the audit: 2008 bank statements; general/sales ledger for 2008; cash disbursement journal for 2008 and first quarter 2011; purchase invoices for 2008 and for first quarter 2011; payroll records for 2008-2010; daily cash register summaries; and depreciation schedule/original asset invoices for July 2006-June 2011.⁸ Saulwil also provided several pages of credit card transactions. It even asked the auditor to personally examine the computer and the records contained therein.

⁸ The non-provision could have been a confusion as to what was really needed for audit. Taxation made varying document requests month after month in 2011 (although the audit was initiated in 2008, then commenced December 2010), some demanding cash register tapes and summaries for a specific quarter, some not (details of the requests are in the court’s prior letter opinions and the audit report admitted into evidence), and only asking for the “current” menu, not for prior tax years even when specifying that 2008 was the sample period.

In this connection, the auditor's testimony that he had to use the most current menu prices to determine the total imputed sales because Saulwil did not provide the 2008 menu is not credible - none of his document requests evidenced a demand for the 2008 menu. The auditor also contradicted himself in his testimony as to whether Saulwil produced all its purchase invoices for 2008, which casts further doubt on the reasonableness of his decision that Saulwil lacked adequate books and records. Further, Taxation accepted all the purchase invoices as credible since it did not mark those up for purposes of reconstructing Saulwil's sales. Thus, there was no evidence that purchases (food or drinks) were under-reported by Saulwil.

Additionally, Saulwil provided voluminous documents at trial to prove that it had sufficient books and records. Other than some spreadsheets summarizing the bank statements, the court finds that none of these documents were created after-the-fact and therefore they are credible, competent evidence that Saulwil had adequate books and records. It is thus difficult to see the reasonableness of Taxation's position that Saulwil's books and records were inadequate when Saulwil provided several business records.

Taxation posits that since the 2008 bank deposits did not reconcile with the gross receipts reported on Saulwil's income tax returns, it would still deem the books and records as inadequate although Saulwil had produced several documents. However, the true basis for this decision was a \$2.09 million credit in a bank account, which the auditor adamantly believed was receipts from cash sales. During trial, he conceded the legitimacy of Saulwil's contentions (made during audit and at the administrative conference) that a large portion of this amount (\$1.77 million) were reverse bank credits due to erroneous bank debits. His testimony that he would continue to

deem the books and records inadequate and perform a markup since the bank deposit totals (less the \$2.09 million credit) still did not reconcile with the gross receipts reported on the tax returns, is unpersuasive. First, the bank statements reflected several inter-bank transfers, loans, and the like, which Saulwil maintained cannot and should not be counted as unreported cash sales. There was nothing to refute this allegation.⁹ Second, the difference between the gross receipts as reported on the 2008 CBT return and the total bank deposits for this year was approximately 8%. Such a small difference does not merit imputing an additional \$9 million in gross receipts over four years, a percentage difference significantly above the approximate 8%.¹⁰ The court is unpersuaded that this less than 10% difference is a reasonable basis to launch into a markup exercise for the audited tax periods, and that the additional \$9 million assessed receipts is not aberrant.¹¹

⁹ In its letter opinion denying Taxation's motion for an involuntary dismissal, the court noted that it could not trace each bank entry as to the reversals, transfers, or the like, which were deducted from the total deposits. However, nothing was elicited from Saulwil in this respect during trial, nor adduced during Taxation's proffer of proofs. While the court can decide the validity or credibility of documents in evidence, it should not be required to act as a forensic accountant and trace the transactions in these documents.

¹⁰ The total 2008 bank deposits (after deducting collected sales tax) was about \$6.99 million. If the reverse bank credits are removed, the deposits total to around \$5.22 million. This is about \$390,000 more than the gross receipts of about \$4.83 million reported on the 2008 CBT return, thus, about an 8% difference. The difference between the receipts reported on the S&U returns for tax year 2008 (\$4.75 million) and the \$5.22 million total bank deposits is \$410,000, thus still less than 10%. This is without considering the reversed checks, inter-bank transfers and line-of-credit advances, all shown on the bank statements and totaling approximately \$1.77 million for tax year 2008.

¹¹ The total audited sales tax for the four years divided by 7% sales tax rate shows about \$9 million of gross receipts. There was nothing to show that imputing \$9 million of additional receipts was reasonable such as with evidence of unaccounted cash deposits by the Hammers in their individual bank accounts, their lavish lifestyle, their ownership of expensive assets, or their large donations/gifts.

In sum, based on a thorough review of the evidence properly before it, the court finds that Saulwil had adequate books and records during the time of the audit, and that Taxation's determination to the contrary was unreasonable and incorrect. This is not a case where there was a total lack of records or the available records were so scant or so incredible that Taxation was justified in recomputing tax. See e.g. TAS Lakewood, 19 N.J. Tax at 139 (taxpayer had no records to corroborate the sales reported on the corporate income tax returns); Alpha I, Inc. v. Dir., Div. of Taxation, 19 N.J. Tax 53 (Tax 2000) (where a taxpayer destroys records prematurely, it places itself in jeopardy for additional tax). Cf. Yilamz, 390 N.J. Super. at 438 (agreeing that a markup methodology could be used since the taxpayer "did not retain cash register receipts, did not use guest checks and did not maintain summary records of sales"). Consequently, Taxation's decision to perform the estimated markup and to impute significantly additional gross receipts (thus income) to Saulwil, is unreasonable and unsupportable. Therefore, the court does not need to examine the reasonableness of the markup methodology used by Taxation (although it has some reservations in this regard such as: (1) the extremely small sample period in 2011 to perform the markup and extrapolate those results to tax periods 2008-2011 even when Saulwil provided voluminous purchase invoices for tax year 2008, the agreed-to sample year; (2) the decision to extrapolate the estimated markup for all tax periods simply because of the policy that an audit will typically will apply the markup for all tax years within the statute of limitations; (3) the estimate markup percentages were based simply on the auditor's "experience" with nothing to show that the applied percentages were the norm in the food and drink industry; and (4) the auditor's lay

opinion that Saulwil's reported markup percentages reflected on its tax returns were unrealistically low, justifying a markup for all tax years).

CONCLUSION

For all of the above reasons, Taxation's additional sales tax assessment, which was based on an incorrect determination that Saulwil's books and records were inadequate must be reversed. Therefore, the assessment of TGI liabilities on the Hammers based on the imputed income they "constructively" received as shareholders of Saulwil, is also reversed.

Saulwil provided summary sheets with supporting contemporaneous records: (1) comparing receipts reported on the CBT returns versus S&U returns for tax years 2008-2010; (2) total "net" bank deposits (deposits less reversed bank errors; reversed checks and credits; transfers; Line-of-Credit advances) for 2008-2010; and (3) General Ledger Comparison to receipts reported on the CBT and S&U returns for 2007-2010. Saulwil admits that these documents show some discrepancies as to the receipts reported on its corporate tax returns.¹² Therefore, it must pay sales tax on the discrepancies. Additionally, during trial, Saulwil agreed that it will not contest the use tax assessment; therefore, this should also be paid.

¹² For tax years 2008 and 2009, the CBT returns showed gross receipts of \$70,367 and \$10,037 more than the gross receipts reported on the S&U returns (the general ledger totals are similar to the CBT returns except they show \$2 more, and for the period January 1, 2007 to December 31, 2007 show \$5,780 more than reported on the S&U returns). However, for tax year 2010, the S&U returns reported \$16,359 more receipts than on the CBT return. For tax year 2010, the total "net" bank deposits were higher than the receipts reported on the S&U returns (\$4,864,332.76 versus \$4,782,030). However, for tax years 2008 and 2009, the net deposits were lower than the reported sales receipts.

Saulwil must provide documentation to Taxation showing the total sales tax due on the discrepancies for the audit periods at issue, on or before February 28, 2020. Interest and penalty will thereafter be calculated by Taxation on this amount. Taxation should also (after Saulwil's submission) calculate the TGI liability of the Hammers for the imputed income arising from the above referenced discrepancies for the tax periods in Taxation's final determination, plus interest and penalties. After these computations are made, the same should be provided to the court on or before March 20, 2020. The court will then enter an order as to the sales tax (plus interest and penalty) owed by Saulwil, and TGI (plus interest and penalty) owed by the Hammers.