

ELBERT E. & JOANNE SCOTT 4411 Arapajo Pasadena, TX 77504,	§	STATE OF ALABAMA DEPARTMENT OF REVENUE ADMINISTRATIVE LAW DIVISION
Taxpayers,	§	DOCKET NO. INC. 01-340
v.	§	
STATE OF ALABAMA DEPARTMENT OF REVENUE.	§	

FINAL ORDER

This case involves final assessments of 1993 through 1996 income tax entered by the Department against Elbert E. and Joanne Scott (“Taxpayers”). The Taxpayers appealed to the Administrative Law Division pursuant to Code of Ala. 1975, §40-2A-7(b)(5)a. A hearing was conducted on August 23, 2001 in Mobile, Alabama. Enrolled Agent Katherine Wisocki represented the Taxpayers. Assistant Counsel Duncan Crow represented the Department.

The Taxpayers reside in Texas, but own a pawn shop in Alexander City, Alabama. The Taxpayers filed their 1993 through 1996 Alabama income tax returns in September 1997.¹ The Department audited the returns and entered the final assessments in issue. As indicated, the Taxpayers appealed to the Administrative Law Division.

On January 2, 2002 the Department’s attorney submitted a letter that aptly summarizes the Department’s audit procedure and its position in the case, as follows:

On September 9, 1997, the Petitioners filed Alabama form 40 NR returns for the years 1993 through 1996. For clarification, the Petitioners failed to file federal or Alabama returns for the years 1989, 1990, 1991, and 1992. For those years, substitutes for

¹The Taxpayers explained at the August 23 hearing that they could not file their returns until September 1997 because their long-time accountant was killed in a plane crash, and their records were tied up in the accountant’s estate and not available to the Taxpayers.

returns were filed, and final assessments resulted. The Petitioners entered into a payment agreement with the Department, and reneged on it. The Petitioners attempted to file "zero" returns with the Department and the Department refused to accept those returns.

The 1993 -- 1996 returns triggered an audit because the Petitioners stated more than once that they had no records when the department was attempting to determine their income for the 1989 -- 1992 period. The 1993 -- 1996 years were assigned to the field on September 17, 1997, for verification of the information on Schedule C of the returns. The examiner who performed the audit did not appear at the hearing because she is assigned to another field office, and the supervisor who did appear at the hearing was familiar with the challenges made to the audit by the Petitioners' representative. Mr. Griggs appeared instead of the examiner as an administrative convenience.

In May of 1998, the Petitioners requested a review by the Taxpayer Advocate of the 1989 - 1992 liabilities. Many comments by the Petitioner during the hearing only make sense in the context of the (then) ongoing discussions between the Petitioner and the Taxpayer Advocate over the outstanding liabilities for 1989 through 1992. These earlier years are not relevant to this appeal.

The examiner received the file on January 20, 1998. On October 2, 1998, the examiner requested records from the Petitioners, and the Petitioners agreed to supply her with canceled checks, bank statements, check registers, and categorized spreadsheets/work papers. The records -- which also included copies of federal returns for the years 1993 through 1996 -- were received by the examiner on October 4, 1998. These records were returned to the Petitioners on December 14, 1998.

An IFTA-1 was completed by the examiner on December 16, 1998, and an audit report was supplied the Petitioners on January 14, 1999. In addition to the amounts due, the Department added penalties for negligence (pursuant to §40-2A-11(b)). Interest was assessed pursuant to §40-1-44. In making adjustments to the Petitioners' returns, the examiner also considered 1) handwritten ledger sheets, 2) cash summary sheets; and 3) bank deposits contained in the Petitioners' bank statements.

The particular adjustments to Schedule C were made as follows: For *income* (gross receipts and other income), comparisons were made for each year between the total deposits in

the bank statements, the taxpayers' ledger sheets, and the taxpayers' cash summary sheets. The income amounts were adjusted according to these comparisons. For *returns and allowances*, the amount was determined from check listings. For *cost of goods sold*, the examiner accepted the beginning and ending inventory figures the taxpayers supplied. The amount accepted for each year for materials and supplies purchased were determined from the check listings. The Petitioners were allowed expenses supported by the check listing derived from the canceled checks provided by the Petitioners. The canceled checks were categorized and totaled. The totals were listed on the Schedule C, if deductible. Personal checks were listed and included all payments determined to be of a personal or non-deductible nature. These amounts included payments on vehicles, phones, home utilities, credit cards, personal insurance, etc. A depreciation schedule was prepared to depreciate any business capital items not allowed as expenses.

A Schedule D was prepared to report sales of real property not previously reported. In 1993, the pawn shop was sold to a Tommy Morris for \$100,023.24. The amount was originally included in the "other income" line of Schedule C. This amount was disallowed on Schedule C and placed on the prepared Schedule D as a sale of real property. In 1994, the Petitioner sold real property to a Danny Davis; this sale had not previously been reported. In 1996, Mr. Scott sold realty to a John R. Browning for \$76,000.00. This property was purchased in 1988 from a Mr. & Mrs. Gaston for \$49,000.00. The gain of \$27,000.00 had not previously been reported. Also in 1996, a portion of the lot on which the pawn shop is situated was sold to a Mr. & Mrs. Benton. This sale had not previously been reported.

On April 30, 1999, the Department entered preliminary assessments for all four years. The Taxpayers petitioned for a review of the preliminary assessments. They did not request a conference, but submitted correspondence through their representative, Ms. Wisocki.

The Department's position has remained the same throughout the audit and appeal. That position was set out in the Hearing Officer's Preliminary Report dated February 8, 2001:

. . . The primary issues arise from the Department's examiner including items in income which the taxpayers aver should not have been included, such as accounts receivable, lay-a-way payments, and

“pulls”. (Pulls are described by Ms. Wisocki as late redemption by owners). Ms. Wisocki further states that several deductions were not allowed as show in the taxpayers’ books and records. Ms. Wisocki’s letter also includes worksheets that show a different calculation from those displayed on either the returns or the examiner’s adjustments.

* * *

The fact that the taxpayers’ returns, the examiner’s worksheets, and Ms. Wisocki’s worksheets all display a different interpretation of the books and records illustrated the limitations of the taxpayers’ records. The taxpayers clearly stated to the examiner that the summary sheets were inaccurate due to a computer problem. Therefore, it was the examiner’s duty to interpret the books and records to arrive at a reasonable determination of taxable income. (Ellipses added).

The assessments became final on April 26, 2001.

Although it took four months for the file to be transmitted to the field for audit, and it then took the examiner more than eight months to begin the audit, there was no unreasonable delay in the audit or assessment process, considering the 1993 return alone was three and one-half years late being filed. The Department used the Petitioners’ records to make adjustments to the returns, aiming for accuracy and completeness as it is required to do so. The Petitioners’ representative has not offered any more records, but only another interpretation of the records presented. As the Court knows, another interpretation is not sufficient to alter the adjustments -- only *more* records, or *better* records, would be sufficient. As usual, the Department would be pleased to review any further records the Petitioners may supply, if the records are competent and made available soon.”

The Taxpayer’s representative responded to the above letter on March 13, 2002, as follows:

Cash Expenses not recognized

The examiner accounted for only expenses paid by check. Examiner used the cash summary incorrectly and added expenses to the sales totals. We provided you with copies of these at that

hearing and copies of the examiners worksheets showing how these figures were incorrect.

Pawn shops are a cash business and customers are given cash for their merchandise. A pawn ticket is given and all items pawned are recorded by the Police department from these tickets. At this point this is a loan of money and interest is charged.

After sixty days if this merchandise is not redeemed it is pulled and is assigned and (sic) inventory number. This item is now for sale and the original loan is now a cost of goods sold item.

Mr. Scott offered the supporting documents for these and Carol Knox, the original examiner, told him it wasn't necessary as it would be too time consuming to go through them. These records are available for your examiner to use. These cash expenses are a major part of doing business and cannot be ignored. The simplicity of a pawnshop is people come to borrow cash on items and many times never return to redeem these and the amount due back is the cost of this merchandise.

Many of the disallowed items on the check registers are business expenses. An example is payment for cable in the shop. Many people pawn televisions and they need to be checked for working conditions when they come in and also if they are sold. A summary is included in our first letter.

Sale of Pawn Shop 1993

No real property was sold only merchandise and fixtures, therefore it was a sale of inventory and reported as such. All sales are reported on Schedule C and no real property was sold. Tommy Morris is a related party and sales of these items reduced the inventory.

Sale of Real Property to Danny Davis 1994

This piece of property was pawned and money loaned just as any other merchandise in inventory. The sale was reported, as any other would be. The check bounced and this could be classified as a bad debt as the man is in prison and it cannot be collected.

Taxpayers want to resolve this matter. The biggest limitation of the taxpayer's records is that the examiner did not use the cash

summary and incorrectly added expenses on those reports to sales. A simple review of paperwork provided at the hearing showing the calculations of your examiner and correct interpretations showing those cash expenses and available cash will answer the problem. You cannot add expenses back to sales, they are deducted and cash is the only way a business of this nature works.

The Department attorney responded to the Taxpayer's March 13, 2002 letter in a March 20, 2002 letter as follows:

I submit this to counter the response forwarded by the Petitioners' representative on March 13, 2002.

Cash Expenses

The examiner accounted for bona fide expenses properly evidenced by the taxpayers' books and records. If the taxpayers have pawn tickets to present as evidence, the Department will consider such, as long as the Department is satisfied that all receipts are reported.

Pawn shops are indeed a cash business. But operating out of the hip pocket does not excuse a taxpayer from the requirement to keep and maintain adequate records for the Department to use. The taxpayers have failed miserably in keeping records. The department used the best information reasonably obtainable to make its determination. The Code and the case law both hold that a presumption of correctness appends to that determination, and the taxpayers have failed to produce evidence clearly establishing that the determination is wrong.

Once an item is held up for sale, it is an inventory item, not a part of the cost of goods sold. The inventory item must be carried at the amount paid (pawn value) and then only removed from inventory when sold. This, too, must be supported by adequate records.

I am not aware of any evidence that Examiner Knox refused records of the taxpayer; I also question the availability of such records. At least one Department employee is available for testimony or by affidavit that the taxpayer husband stated to her that his records were destroyed (not rendered temporarily unavailable) in a plane crash which killed his then-accountant. If there has been a prior misrepresentation of fact, the Department will pursue the issue of the taxpayer's credibility.

If cash was taken from the cash register to pay expenses and was not accounted for as income by the cash register or other means, then the cash expenses must be added to the income in order to account for all of the cash receipts. Whether deductible or not, the subtraction of cash from the till of the cash register reduces the amount of cash counted at the end of the day. Allowing expenses to be deducted from this shortened count of cash not only artificially deflates the income reported by the taxpayer, but also serves to inflate the amount of expenses.

1993 Sale of Pawn Shop

There is simply no proof of the taxpayers' allegations made regarding this item.

1994 Sale of Real Property to Danny Davis

The Department asserts this sale was never reported. Because it was not reported, it cannot be deductible.

The cash summary touted by the taxpayers is not indicative of income. It is unreliable, and cannot be accurately tied in with the other paperwork submitted by the taxpayer. This is the reason the examiner used such a large body of evidence to reconstruct income. This is also the reason the picture painted by the examiner (despite her auditing prowess) is a little difficult to understand at first. It mangles logic to argue that expenses excluded from the cash count may then be later deducted for tax purposes.

The assessments entered are the most accurate and comprehensive representation of the evidence in this case. Please enter a final order reflecting this.

In essence, this is a records case. Of the hundreds of individual income tax audit cases I have decided over the years, this is one of the hardest to decide. The Department examiner followed normal audit procedures in conducting a detailed audit using the Taxpayers' records. Her audit report is several hundred pages long, and includes thousands of entries.

The Taxpayers' counter that a pawn shop is a cash intensive business, and that the examiner failed to give them proper credit for cash payouts. They

also claim that various business expenses were improperly classified as personal, and that various real estate transactions were mischaracterized by the examiner, as indicated above.

I have reviewed all of the evidence and have read and reread the 87-page transcript of the August 23 hearing. I agree with the Taxpayers that the nature of the pawn business is cash intensive. However, the examiner computed the Taxpayers' liabilities for the subject years using the best information available. Code of Ala. 1975, §40-2A-7(b)(1)a. The Taxpayers' liabilities, as established by the examiner's audit, are probably overstated. But the burden was on the Taxpayers to prove that the final assessments are incorrect. They concede that their records for the subject years were incomplete. Without sufficient records verifying or establishing the Taxpayers' correct liability, the *prima facie* correct final assessments based on the audit report must be affirmed.

The final assessments also include substantial penalties. As stated above, the Taxpayers were unable to timely file returns for the subject years because their records were being held by a court in Louisiana pending the settlement of their accountant's estate. Under the circumstances, the penalties are waived for reasonable cause. Code of Ala. 1975, §40-2A-11(h).

The final assessments, less the penalties, are affirmed. Judgment is entered against the Taxpayers for 1993 tax and interest of \$25,978.80; 1994 tax and interest of \$13,532.51; 1995 tax and interest of \$9,738.52; and 1996 tax and interest of \$16,465.59.

This Final Order may be appealed to circuit court within 30 days pursuant to Code of Ala. 1975, §40-2A-9(g). In lieu of appealing to circuit court, the Taxpayers may apply for a rehearing within 15 days of this Order. The case will

then be submitted to the Department's Taxpayer Advocate for review and response.

Entered May 6, 2002.

BILL THOMPSON
Chief Administrative Law Judge

bt:dr

cc: Duncan R. Crow, Esq.
B. Katherine Wisocki, EA
Kim Herman