

FREEDOM VENTURES, INC.
d/b/a COOK'S COUNTRY STORE
1617 OZIER DRIVE
TUSCALOOSA, AL 35405-6788,

Taxpayer,

v.

STATE OF ALABAMA
DEPARTMENT OF REVENUE.

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STATE OF ALABAMA
ALABAMA TAX TRIBUNAL

DOCKET NO. S. 14-480

OPINION AND PRELIMINARY ORDER

This appeal involves a final assessment of State sales tax for January 2010 through December 2012 entered by the Revenue Department against the above Taxpayer. A hearing was conducted on July 10, 2014. The Taxpayer's owner, Ed Cook, attended the hearing. Assistant Counsel Christy Edwards represented the Department.

The Taxpayer operated a convenience store in the Taylorville community in Tuscaloosa County, Alabama during the period in issue. The Taxpayer's owner, Ed Cook, operated the business. Cook had operated a Dairy Queen for 39 years before opening the store in mid-2009.

The store had been closed for eleven months and was in a rundown condition when it was reopened by Cook. The building owners wanted the store to succeed, and consequently helped Cook repair and put new equipment in the store. They also loaned him \$19,500 to stock the store.

There were several other convenience stores and food marts in the area that competed with the Taxpayer's store. Cook testified that to bring back and establish a steady customer base, he began selling merchandize at or below cost when he reopened the business. He also gave away ice cream cones with gas purchases of over \$25, free

coffee with breakfast purchases, and free soft drink refills. Cook further testified that he did not begin raising prices until early 2012, and that while he lost money on his merchandise sales for the first two years, he could still afford to pay the store's bills, including his employees, because he cleared over \$9,900 a month on his gasoline sales, tobacco rebates, a coin-operated air pressure machine, and an ATM machine. His budget was still tight, and he could afford to pay his \$3,500 a month rent only three times during the audit period. He also only paid himself a \$9,000 annual salary.

The store also had a deli that was open for breakfast and lunch when it reopened in August 2009. The store continued serving breakfast through the audit period, but stopped serving lunch in mid-2011 because it consistently lost money. Cook testified that he lost approximately \$30,000 in food inventory by offering lunch during the audit period. And like his merchandise prices, Cook initially kept his food prices low to attract repeat customers, and did not raise his breakfast prices until the Spring of 2012.

An individual inquired with Cook in late 2012 about buying the business. During negotiations, Cook stopped restocking the store and put his fishing tackle on sale to reduce his inventory. He sold the store in February 2013. The inventory at the time was valued at \$72,254.

A Department examiner began auditing the Taxpayer for sales tax in late 2012 for September 2009 through August 2012. The audit period was subsequently changed to the period in issue, January 2010 through December 2012. The examiner requested the Taxpayer's sales tax-related records. Cook provided the store's sales summary sheets, cash purchase ledgers, and bank statements for all of the audit period, and his cash

register z-tapes for July through December 2012. He explained that his pre-July 2012 z-tapes had been destroyed by an ice machine water leak at the store in June 2012.

The examiner reviewed the store's checking account and cash purchase ledgers and determined that the store's wholesale purchases exceeded its reported retail sales for January 2010 through June 2012. She compared the available z-tapes for July through December 2012 to the sales summaries and sales tax returns for those months, and found that the returns accurately reported the store's taxable sales in those months. Using the July through December 2012 records, the examiner determined that the store's average retail mark-up for that period was 28 percent. She then projected that mark-up to the store's purchases in January 2010 through June 2012 to arrive at the store's estimated retail sales, and the additional tax due in those months. Cook appealed the resulting tax and interest due to the Administrative Law Division. Cook's appeal letter reads in part, as follows:

Your auditor used an "average" mark-up number she says she is required to use to calculate probable sales in the absence of register tapes.

My disagreement is that an "average" number cannot be applied to all businesses in all situations.

In this particular store, there are several extenuating circumstances that contribute to its sales not placing it in this "average category.

This store had been closed for 11 months when I re-opened it in August of 2009. The two years prior to its closing, the store was operated by someone who basically ran the business down to practically nothing, locked the doors and left without warning. This, in itself, gave the store a bad image in the community. This store has always been much more of a community store than a convenience store.

When I opened the store, the property owners were very concerned about this image. I had very little start-up money for opening the store. The property owners offered to be very lenient on the rent until the business was

well established. I opened the store with \$19,000.00 in inventory. When I sold the store in February 2013, the store had over \$70,000.00 in inventory. I spend most of the first 2½ to 3 years building inventory. At the same time, I had to get customers coming back to the store. During this time, I ran tobacco products at almost cost. I ran all soft drinks at promotional pricing, fishing tackle at 20% - 40% off, Milk products at cost, Coffee below cost, and I gave free ice cream cones with a \$25.00 gas purchases to get “pay at the pump” customers to come inside the store. I did not sell the incense, drug paraphernalia, gang shirts, hats, etc., erotic products or any of this type of merchandise commonly seen in a typical convenience store. I did not sell an alcoholic beverages, which is normally a large part of sales of this type of store.

I also operated a deli in this store. I sold breakfast and lunch. I set all my food pricing at almost cost in the deli to attract breakfast trade such as Hillcrest School students, early workers etc. who would normally be customers of Hardees Mcdonalds or the like. My breakfast business grew but our lunch suffered. I lost money on lunch business for the first year. I changed the lunch to a different style of food for the next year with the same results. Finally after 2½ years I dropped the lunch business altogether. I incurred a lot of product waste while trying to establish a lunch business. I did not raise the price of any of my breakfast foods at all until the spring of 2013 even though wholesale prices had risen during the period. During the first three years of business I survived and was able to cover expenses by keeping those expenses to a bare minimum, not taking a salary, and using rebates on food products, tobacco products and profits from fuel sales to offset expenses and from the kindness of my landlord not demanding rent during this period.

In the early part of 2012, it appeared that I had grown the inventory to a sufficient level to operate. The sales volume had reached a level that I felt comfortable raising prices on merchandise. As stock was received weekly and monthly, I gradually began increasing the mark-up on most items. I also raised prices on my breakfast items as well. Through maintaining inventory instead of growing it further, increasing mark-up on most items and controlling waste, I was fully able by mid to late 2012 to start seeing a 25% to 28% difference between purchases and sales. This difference was not possible during the first 2 ½ to 3 years of business due to the reasons I have outlined above.

This store was re-opened, rebuilt and operated as a community store with a Christian reputation, not as a typical Convenience store. Therefore, viewing this business as a typical convenience store with typical ‘sales to purchases’ “averages” is not applicable in this case.

I have NEVER failed to pay due sales taxes for my business in the 38 years I have owned retail stores. I have paid ALL the sales taxes that were actually due for this business and I do not owe any of the taxes associated with this audit.

If a retail business fails or is unable to provide the Department with complete records for an audit period, and a review of the available records shows that the retailer's wholesale purchases were more than reported sales, as in this case, the Department will assume that the retailer has underreported sales for the period. In such cases, the Department generally conducts an indirect purchase mark-up audit to estimate the retailer's sales tax liability, as the Department examiner did in this case.

A purchase mark-up audit is a simple, straightforward audit method. The retailer's wholesale purchases are determined from the retailer's purchase records, if deemed complete by the Department examiner, or from purchase information obtained from the retailer's vendors, if necessary. An average retail mark-up percentage is then applied to arrive at the retailer's estimated retail sales for the audit period. A credit for sales tax previously reported and paid is then allowed to arrive at the estimated additional tax due. The Administrative Law Division has routinely affirmed the Department's use and application of the mark-up audit method in most all cases. See generally, *GHF, Inc. v. State of Alabama*, S. 09-1221 (Admin. Law Div. 8/10/10); *Thomas v. State of Alabama*, S. 10-217 (Admin. Law Div. O.P.O. 5/18/10); *Alsedeh v. State of Alabama*, S. 03-549 (Admin. Law Div. 11/3/04).

In this case, the examiner assumed that the Taxpayer had underreported its sales from January 2010 through June 2012 because its purchases for those months were greater than its reported sales. She consequently applied the 28 percent mark-up for July

through December 2012 to the earlier audit period to estimate the additional tax due for that period.

The Taxpayer's owner, Cook, argues that the 28 percent mark-up based on his July through December 2012 sales is misleading because, as explained above, he initially sold his merchandise and food at below or at cost to build a steady customer base. Only in early 2012 did he begin raising the prices on his merchandise and breakfast items.

Cook concedes that he was unaware that his phone card sales were subject to sales tax, and that he consequently owes sales tax on his card sales of \$34,752.54. He argues, however, that the audit should otherwise be adjusted in his favor. Specifically, he initially told the examiner that there was no theft at the store that he knew of. He subsequently learned from his son, who worked at the store from when it opened until late 2011, that his son and two other employees routinely stole cartons of cigarettes and phone cards from the store from late 2009 until mid-2011.¹ The son told Cook that five or six cartons a week had been taken. Cook estimated that if the average was four cartons a week, a total of \$14,280 in cigarettes were stolen during the months that his son and the other two employees worked at the store.

As discussed, the cost of the ice cream that was given away was \$5,746.32. The examiner allowed the Taxpayer a \$25,000 adjustment for an increase in inventory based on the \$25,000 ending inventory amount reported on the Taxpayer's 2009 income tax return and Cook's estimate that his ending inventory value was \$50,000. Cook sold the

¹ The son confessed to Cook after completing a drug and alcohol rehab treatment in late 2012. He did not tell his father about the theft beforehand because the other two employees knew that the son was also stealing from the business, and the son did not want them to tell his father.

business in early 2013, and his inventory at the time of sale was \$72,254.² Given that the store's beginning inventory in August 2009 was \$19,500, the inventory adjustment thus should have been \$52,254, not \$25,000.

The Department examiner that audited the Taxpayer is a veteran examiner that has successfully testified in numerous cases before the Administrative Law Division. She also conducted a technically correct purchase mark-up audit that resulted in the final assessment in issue. But extenuating facts and circumstances indicate that the audit results do not accurately reflect the Taxpayer's true liability for the audit period.

Cook maintained accurate and complete records during the audit period. As discussed, the examiner reviewed the available July through December 2012 z-tapes and sales summaries and determined that Cook had correctly and fully reported the store's sales for those months. The examiner also accepted as correct and used Cook's check registers and cash purchase ledgers to determine the store's wholesale purchases during the entire audit period, which further confirms the accuracy of Cook's records. The fact that all of the Taxpayer's available records for the audit period were complete and accurate strongly suggests that the store's returns for those months were also correct.

The primary dispute Cook has with the audit is the 28 percent mark-up applied to the entire audit period. Absent extenuating circumstances, it is proper that the average percentage mark-up computed for a period for which adequate records were provided

² As discussed, Cook stopped purchasing replacement inventory in late 2012 in anticipation of selling the business, which suggests that the inventory value was higher than \$72,000 on December 31, 2012.

should be projected over the audit period for which records were not available. This case is an exception, however, because it does involve extenuating circumstances.

As discussed, the 28 percent mark-up is based on the average for the last six months of the audit period, July through December 2012. Cook presented evidence, however, that the store's average mark-up for July and August of 2012 was 9.5 percent and 14.8 percent, respectively. According to Cook, those percentages were higher than the prior audit months because he began raising his prices in the Spring of 2012. He also argues that his mark-up was increased to the 28 percent average for July through December 2012 only because in late 2012 he stopped purchasing merchandise for the store in anticipation of selling the business. The fact that he stopped purchasing merchandise in the last months of 2012 would result in a non-representative increase in the mark-up percentage of the goods sold in those months.

Finally, as a general rule, actual records and other documentary evidence must govern and control over the oral assertions of a taxpayer. See generally, *State v. Ludlum*, 384 So.2d 1089 (Ala. Civ. App.), cert. denied, 384 So.2d 1094 (Ala. 1980). But the above general rule does not require that a taxpayer's testimony must be disregarded in all cases. I viewed Cook's testimony at the July 10 hearing, and have since studied the transcript of and exhibits present at the hearing. Based on his demeanor and the specificity and openness of his testimony, and his supporting exhibits, I can only conclude that he was a credible, believable witness. Simply stated, his story holds water.

The Department should recompute the sales tax due by removing from the taxable measure \$14,280, \$5,746, \$30,000, and \$27,254, which represents the cost of the stolen cigarettes, the loss on the free ice cream, the loss on the lunch deli, and the increased

ending inventory amount, respectively. It should then apply a 12.1 percent mark-up, or the average mark-up for July and August 2012. It should notify the Tribunal of the adjusted amount due. An appropriate Final Order will then be entered.

I emphasize that this case is an exception to the general rule. In most all prior purchase mark-up audit cases, the retailer failed to keep proper purchase and sales records for some or all of the audit period. In this case, there is evidence that Cook maintained complete and accurate records for the entire audit period. Unfortunately, through no fault of Cook's, the store's pre-July 2012 z-tapes were accidentally destroyed by a water leak in June 2012. And while an average mark-up percentage based on either the average IRS mark-up guidelines or the use of the taxpayer's records for a part of the audit period, as in this case, is generally affirmed, Cook adequately explained and presented evidence showing that the 28 percent mark-up was too high.

This Opinion and Preliminary Order is not an appealable Order. The Final Order, when entered, may be appealed to circuit court within 30 days pursuant to Code of Ala. 1975, §40-2A-9(g).

Entered October 17, 2014.

BILL THOMPSON
Chief Tax Tribunal Judge

bt:dr

cc: Margaret Johnson McNeill, Esq.
Ed Cook