DAN NOLEN & SONS, INC. d/b/a BROTHER'S BAR 206 PELHAM ROAD SOUTH JACKSONVILLE, AL 36265-2542,	§	STATE OF ALABAMA ALABAMA TAX TRIBUNAL
	§	DOCKET NOS. S. 12-1427 S. 13-189
PELHAMS, INC. 116 W. LADIGA STREET JACKSONVILLE, FL 36265-6265,	§	
Taxpayers,	§	
v.	§	
STATE OF ALABAMA DEPARTMENT OF REVENUE.	§	

OPINION AND PRELIMINARY ORDER

The Revenue Department assessed Dan Nolen & Sons, Inc., d/b/a Brother's Bar ("Brother's") for State sales tax for August 2005 through January 2012, and Pelhams, Inc. ("Pelham's") for State sales tax for January 2007 through March 2012. Brother's and Pelham's (together "Taxpayers") appealed to the Revenue Department's Administrative Law Division, now the Tax Tribunal, pursuant to Code of Ala. 1975, §40-2A-7(b)(5)a.[1] A hearing was conducted on July 22, 2014. Sam McCord represented the Taxpayers. Assistant Counsel Kelley Gillikin represented the Revenue Department.

The Taxpayers operate drinking establishments located across the street from each other in downtown Jacksonville, Alabama. Brother's sold beer, soft drinks and other nonalcoholic beverages during the period in issue. It also offered live entertainment for which it charged a cover or admission fee. Pelham's sold liquor, beer, wine, and other miscellaneous items during the subject period.

[1] The Taxpayers are owned by the same individual.

In 2011, a Revenue Department examiner began auditing the Taxpayers for sales tax for the period August 2008 through July 2011. The examiner requested all of the Taxpayers' sales and purchase records, bank statements, and income tax returns. The Taxpayers provided income tax returns and bank records. They failed, however, to provide any sales receipts, cash register z-tapes, sales journals, purchase invoices, or any other records relating to their purchases or sales.

Because the Taxpayers failed to provide any sales or purchase records, the examiner computed the Taxpayers' liabilities for the subject period using a purchase mark-up audit.

The examiner first obtained purchase information from Brother's beer vendors. She compared Brother's wholesale beer purchases during the audit period and the retail sales reported by Brother's during that period. The comparison showed that Brother's wholesale purchases were greater than its reported retail sales.

To compute the gross tax due per the mark-up audit, the examiner multiplied Brother's total purchases by an IRS-provided mark-up of 2.91 percent applicable to food services and drinking places.[2] She then allowed a credit for sales tax previously reported and paid to arrive at the additional tax due for the August 2008 through July 2011 audit period.

Because Brother's had underreported its monthly sales tax by more than 25 percent during the original audit period, the examiner obtained Brother's purchase information from

[2] The examiner also reviewed Brother's 2008, 2009, and 2010 income tax returns. By comparing the gross sales and purchase amounts reported on those returns, the examiner determined that the overall mark-up for the three year period as reported on the returns was 3.01 percent, or more than the 2.91 percent IRS mark-up.

its beer vendors going back to August 2005. After applying the 2.91 percent IRS mark-up to that purchase information, the examiner determined that Brother's had underreported by more than 25 percent in every month going back to August 2005. She accordingly included those months in the audit. [3]

Brother's also failed to keep records of its door receipts during either the original or the extended audit period. The examiner asked Brother's to keep up with the number of customers that paid a cover charge during the months of November and December 2011 and January 2012. Brother's subsequently provided the examiner with individual "tick" sheets for the above months. The sheets showed that Brother's had charged an admission on 22 nights during the three month period, and that 910 individuals, or an average of 41 per night, had paid a cover charge on those 22 occasions. After reviewing Brother's webpage, the examiner also concluded that the average door charge was $3 per person, which resulted in an average of $123 per night in admissions.

The examiner also determined from Brother's webpage that Brother's sometimes had live entertainment on Wednesday, Thursday, Friday, and Saturday nights, but never on Sunday, Monday, or Tuesday. She thus assumed that Brother's had live entertainment and charged an admission fee on four nights every week, or 208 days a year. She thereafter computed Brother's admission fees in 2011 by multiplying the 208 days by the average nightly cover of $123 to arrive at a total of $25,584.

[3] If a taxpayer underreports its taxable base by more than 25 percent, the Department is authorized to assess the taxpayer for back taxes for an extended six year period. Code of Ala. 1975, §40-2A-7(b)(2)b.

By comparing Brother's total 2011 beer sales per the audit with its 2011 door receipts as computed above, the examiner determined that 41 percent of Brother's total receipts in 2011 were from door receipts, with 59 percent from beer sales. She then used the 59/41 percent ratio to compute the door receipts over the entire extended audit period. For example, the examiner determined per the audit that Brother's had total beer sales of $74,234.96 from August through December 2005. That amount constituted 59 percent of $125,821.97, so the 41 percent in cover charges totaled $51,587.01 (total combined receipts of $125,821.97 less beer sales of $74,234.96 equals cover charges of $51,587.01), or over $10,300 per month in 2005. See Dept. Ex. J. She did similar projections over the remaining periods in the audit to determine Brother's total admission fees.

The examiner also computed Pelham's liability using a purchase mark-up audit. She obtained Pelham's purchase information from the ABC Board, Pelham's beer and wine vendors, and various other businesses that had sold items to Pelham's during the August 2008 through July 2011 audit period. She applied the 2.91 percent mark-up to determine Pelham's gross sales for the period. She then allowed a credit for the tax previously reported and paid to arrive at the additional tax due.

As with Brother's, the examiner also obtained purchase records from Pelham's vendors for the period January 2007 through July 2008. Applying the 2.91 percent mark-up to those purchase amounts, the examiner determined that Pelham's had underreported

by more than 25 percent in every month except January, July, and May 2007. With the exception of those three months, Pelham's audit was extended back to January 2007.[4]

The examiner also added to the audit the months during which the audit was being conducted. As indicated, the Brother's audit and assessment goes through January 2012, and the Pelham's audit and assessment goes through March 2012.

The Department entered preliminary assessments against Brother's and Pelham's on August 3, 2012 and October 29, 2012, respectively. It entered the final assessments in issue on November 9, 2012 and January 3, 2013, respectively.

In hundreds of prior cases, the Department's Administrative Law Division, now the Tax Tribunal, affirmed the Department's use of a purchase mark-up sales tax audit in cases where the taxpayer failed to provide the Department with adequate records. 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). As stated by the Department in its post-hearing brief, at 6:

> The Taxpayer was unable to provide any records regarding its beer purchases and sales for the audit period. Because the Taxpayer was unable to provide such records, the Department had to determine the Taxpayer's sales tax obligation for the audit period by other means. As this Court has held,
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> > [a]ll taxpayers are burdened with the affirmative duty of maintaining adequate records from which their correct tax liability can be accurately computed and/or confirmed by the Department. Code of Ala. 1975, §40-2A-7(a)(1). If a taxpayer

[4] The Pelham's final assessment includes January 2007, even though the examiner did not include that month in the audit. Because the Pelham's audit and assessment only goes back to January 2007, it is assumed that Pelham's did not open for business until January 2007.

> fails to provide the Department with adequate records, for whatever reason, the Department is authorized to "calculate the correct tax . . . based on the most accurate and complete information reasonably obtainable." Code of Ala. 1975, §40-2A-7(b)(1)a.
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> *Rocking Chair Truckstop, Inc. v. State of Alabama Dep't of Revenue*, S. 10-176 (Admin. Law Div. July 13, 2012). "A purchase mark-up audit is a simple, oft-used Department method of determining a taxpayer's sales tax liability where the Taxpayer fails to keep accurate sales records." *Id.* "The IRS average mark-up information is included in the Department's audit manual, and has been routinely used by the Department for years, if not decades." *Quick N Ez, Inc. v. State of Alabama Dep't of Revenue*, S. 10-245 (Admin. Law Div. August 23, 2011). Although the IRS mark-up percentages are estimates, the "are the best information available in lieu of a taxpayer's actual records." *Id.*

The Taxpayers concede that they failed to provide the Department with any z-tapes or other sales records. The Department examiner was thus justified in conducting a purchase mark-up audit. The Taxpayers do not object to the audit method used by the examiner. They argue, however, that the audit was not properly applied under the circumstances.

The Taxpayers specifically contend that the 2.91 percent mark-up is excessive. They argue that the IRS mark-up applies to sole proprietorships where the owner is present and can prevent theft and spoilage, whereas Brother's and Pelham's had an absentee owner. They assert that because both bars employed college kids, there was excessive amounts of spillage, waste, and pilferage far beyond what occurs in a normal drinking establishment. They also argue that because Pelham's free poured its liquor drinks, most drinks contained more than the usual amount of liquor, thereby reducing Pelham's profit, i.e., mark-up.

I appreciate the testimony offered by the Taxpayers in support of the above claims. And I suspect that some of the claims are at least partially valid. But the Department is not and should not be required to accept what I suspect or what a taxpayer verbally asserts in lieu of good records and hard numbers. "The State is not required to rely on verbal assertions of the taxpayer in determining the correctness of the tax return, but records should be available disclosing the business transacted." *State v. Ludlum*, 384 So.2d 1089 (Ala. Civ. App. 1980), quoting from *State v. T.R. Miller*, 130 So.2d 189, 190 (Ala. 1961).

The Taxpayers chose to operate as they did using college students as managers and employees. The Taxpayers were, however, still ultimately responsible for and had the duty to provide and maintain complete and adequate records reflecting their sales. They failed to do so. As the Alabama Supreme Court has stated, "[w]here there are no proper entries on the records. . ., the taxpayer must suffer the penalty of non-compliance. . . ." *State v. T.R. Miller Mill Co.*, 130 So.2d at 190. Consequently, the sales tax due on the Taxpayer's retail sales, as computed by the examiner, must be affirmed, except concerning the sales tax assessed against Brother's for the months before July 2006, which the Department concedes are out-of-statute.

Concerning the cover charges, the examiner used the information provided by Brother's for November and December 2011 and January 2012 to determine that Brother's had charged admission fees on 22 nights during the three month period, and that a total of 910 individuals had paid the cover. As discussed, the average of 41 paying customers per

night using an average $3 per person cover equates to $123 in admissions per night. The above computations are based on information provided by Brother's, and are reasonable.[5]

The examiner then, however, determined that Brother's charged an admission on every Wednesday, Thursday, Friday, and Saturday of every week based on Brother's webpage, which showed that at one time or another, Brother's had scheduled live entertainment on a Wednesday, or a Thursday, or a Friday, or a Saturday night. Consequently, instead of finding that Brother's charged admission of 88 occasions annually (22 times in the 3 months of November and December 2011 and January 2012 x 4), the examiner concluded that Brother's had charged admissions on 208 nights annually (4 days a week x 52).

The examiner computed the annual admissions for the base year 2011 by multiplying the 208 nights by the average nightly admissions of $123 to arrive at a total of $25,584. She then determined that 59 percent of Brother's 2011 gross receipts constituted beer sales with the remaining 41 percent being admission fees. She then projected or applied those percentages to the retail beer sales as computed per her audit over the remaining periods in the audit to determine the admissions in those periods.

I appreciate the examiner's admitted creativity in computing Brother's admission fees, but while she otherwise performed a thorough, technically correct audit, I disagree with how she computed the admission fees.

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[5] In her audit report, Dept. Ex. A, at p. 2, the examiner stated – "The months of November, December, and January appear to adequately represent the average amount of business for Brother's Bar. These months are not the lowest or highest sales producing months."

To begin, the fact that Brother's at some point in time had live entertainment on a given night, Wednesday, for example, does not prove that it had live entertainment and charged an admission on every Wednesday night during the extended audit period. There is also otherwise no evidence proving or even suggesting that Brother's was open and charged admission on Wednesday through Saturday 52 weeks of the year. Without such evidence, the assumption that Brother's was open four nights every week, or 208 nights a year, must be rejected.[6]

The only evidence concerning the admission fees are the sheets provided by Brother's for November and December 2011 and January 2012. As discussed, the examiner indicated that those months "adequately represent the average amount of business for Brother's Bar." Those sheets show that Brother's had live entertainment 22 times in a three month period, with an average take of $123 per night. That is the best, and only, evidence available concerning the admission fees. The Department should accordingly use that information to recompute the admission fees for the Brother's audit period and the sales tax due thereon.

The Department also assessed a negligence and a late payment penalty against both Brother's and Pelham's. The negligence penalties must be affirmed because both Taxpayers were clearly negligent in maintaining records and properly reporting the tax due. Under the circumstances, the late payment penalties are waived for cause.

[6] Brother's also presented believable testimony that it was open and had live entertainment less than 100 nights in a given year. But while that evidence can be considered, the finding that the 208 days per year figure should be rejected is based on the fact that there is no evidence supporting that amount.

The Department is directed to recompute the amounts due as indicated above. A Final Order will then be entered for the adjusted amounts due.

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, §40-2B-2(m).

Entered September 8, 2015.

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BILL THOMPSON
Chief Tax Tribunal Judge

bt:dr
cc: Kelley A. Gillikin, Esq.
Samuel R. McCord, Esq.