ALABAMA TAX TRIBUNAL

ALWAN, INC., D/B/A TUSCALOOSA FOOD & FASHION,	§	
	§	
Taxpayer,	§	DOCKET NO. S. 16-1315-CE
v.	§	
STATE OF ALABAMA DEPARTMENT OF REVENUE.	§	

FINAL ORDER

The Revenue Department assessed Alwan, Inc. ("Taxpayer"), doing business as Tuscaloosa Food and Fashion, for State sales tax for the periods of September 2012 through August 2015. The Taxpayer appealed to the Alabama Tax Tribunal pursuant to Code of Ala. 1975, §40-2A-7(b)(5)a. A hearing was conducted on October 16, 2017. The Taxpayer's owner, Eissa M. Al-Sanabani, attended the hearing. Assistant Attorney General Hilary Parks represented the Department.

Facts

The Taxpayer operated a convenience store within the city limits of Tuscaloosa, Alabama, during the periods at issue. The store primarily sold the following: gasoline; tobacco products; groceries, drinks and snacks; and miscellaneous non-food items, including clothing.

The Department's examiner, Monalisa Harbin, audited the store to determine compliance with State sales tax laws during the subject periods. The examiner requested the store's sales tax-related records, including the following: all books and records used to prepare sales tax returns; sales invoices and sale journals; cash register z-tapes; purchase

invoices; income tax returns; and cancelled checks and bank statements. The Taxpayer only provided some purchase invoices and gasoline sales logs. The Taxpayer did not provide the examiner with any cash register z-tapes or any records pertaining to its sales.

To report its monthly sales, the Taxpayer asserted that it totaled its monthly *purchase invoices* and deducted non-taxable food stamp sales. This calculation was phoned into the Taxpayer's accountant, Joyce Culverhouse, by an employee of the Taxpayer. This number was reported as gross sales on the Taxpayer's monthly sales tax returns.

Because the examiner was not provided complete information regarding the Taxpayer's purchases, and was provided no sales records, she estimated the Taxpayer's liability using a purchase mark-up audit. The examiner obtained the Taxpayer's purchase information for the audit period from the Taxpayer's vendors. She compared the purchases per the vendors' records with the purchase information provided by the Taxpayer and determined that the records provided by the Taxpayer were grossly incomplete. The auditor compared the Taxpayer's total purchases, calculated by invoices supplied by the Taxpayer's vendors, to the Taxpayer's reported sales and determined that the Taxpayer's purchases exceeded its reported sales for the audit period by over $340,000. Comparing the Taxpayer's actual cost of goods sold to its reported sales yielded an average markup of negative 26 percent – i.e., that the Taxpayer would be selling items at 26 percent below its cost if it was accurately reporting sales on its sales tax returns. The examiner then personally observed the selling price of the items in the store, and determined that the Taxpayer was not selling merchandise below its cost.

The examiner next applied the standard IRS mark-up of 1.41 percent to arrive at the

store's estimated retail sales. The Taxpayer's attorney objected that the mark-up was excessive. The examiner consequently agreed to recompute the mark-up by comparing the Taxpayer's wholesale cost of his merchandise with the actual prices the Taxpayer was charging its customers for the merchandise. The comparison resulted in a reduced 1.33 percent mark-up, which the examiner then applied to the Taxpayer's wholesale purchases to estimate its total retail sales for the audit period.

The Taxpayer's 2012, 2013, and 2015 income tax returns were reviewed. Reported sales on the income tax returns agreed with the reported sales per the sales tax returns. Since it was previously determined that the sales were underreported, the income tax returns could not be used to determine total sales.

Having determined that she had adequate purchase invoices from the Taxpayer's vendors, the examiner determined that the best audit method to determine taxable sales was a purchase mark-up audit. The purchase invoice cost information and the observed selling prices of the items were used to calculate a weighted average profit-over-cost mark-up for each vendor. The mark-up for each vendor was applied to the Taxpayer's purchases from that vendor during the audit period to calculate total sales.

While in the store observing the selling price of items in the store, the examiner also observed an inventory of clothing. However, the Taxpayer did not supply the examiner with purchase information regarding clothing. During the audit, a representative explained that the clothing was included in the inventory purchased when the Taxpayer purchased the store. The representative further explained that, on average, the store sold two t-shirts a day at a selling price of $7.50 each. Using the pricing and sales information provided by the Taxpayer, the examiner estimated the monthly clothing sales to be $60. These sales

were included in the calculation of gross sales.

The purchase mark-up audit resulted in an overall profit-over-cost mark-up for items sold in the store to be 17 percent. Because the Taxpayer failed to provide any documentation regarding non-taxable food stamp sales, no deductions were allowed. The audit revealed that the Taxpayer's sales were over $670,000 underreported. Because the Taxpayer's wholesale purchases during the audit period substantially and consistently exceeded its reported retail sales, the examiner also applied the 50 percent fraud penalty levied at Code of Ala. 1975, §40-2A-11(d).

The Taxpayer also underreported its prepaid wireless retail transactions, resulting in additional Prepaid Wireless 911 Charges due. Using the electronic prepaid sales device used by the Taxpayer, the examiner determined the Taxpayer's total sales of prepaid wireless. Credit was given for 911 Charges previously remitted by the Taxpayer.

The Taxpayer was billed for the additional tax due, interest and a fraud penalty. Billing progressed to entry of final assessment on October 24, 2016 in the amount of $33,466.64, consisting of tax due in the amount of $21,258.04, interest of $1,579.55, and fraud penalty of $10,629.05.

The Taxpayer timely appealed. In its Notice of Appeal, the Taxpayer's representative asserted that the Taxpayer was not liable for the fraud penalty because it did not knowingly or intentionally underreport its sales during the period. The Taxpayer indicated that the tax portion of the assessment was not disputed.

The Department timely filed its Answer, asserting that the Taxpayer failed to maintain records and that it substantially and consistently underreported sales without single explanation. This conduct, it argues, is strong evidence of fraud. For this and other

reasons set forth below, I agree.

Analysis

The Department is authorized to compute a taxpayer's correct liability using the most accurate and complete information obtainable. Code of Ala. 1975, §40-2A-7(b)(1)a. The Department can also use any reasonable method to compute the liability, and the taxpayer, having failed in the duty to keep good records, cannot later complain that the records and/or method used by the Department is improper or does not reach a correct result. *Jones v. CIR*, 903 F.3d 1301 (10th Cir. 1990); *State v. Ludlum*, 384 So.2d 1089 (Ala. Civ. App.), cert. denied, 384 So.2d 1094 (Ala. 1980) (holding that a taxpayer must keep records showing the business transacted, and if the taxpayer fails to keep such records, the taxpayer must suffer the penalty for noncompliance.).

The purchase mark-up audit is a simple, oft-used Department method of determining a taxpayer's sales tax liability when the taxpayer fails to keep accurate sales 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). Because the Taxpayer in this case failed to maintain adequate records from which its sales could be accurately computed or verified, the Department examiner correctly conducted a purchase mark-up audit to reasonably compute the Taxpayer's liability for the audit period. The tax due, as computed by the audit, is by its nature an estimate. However, out of necessity, the examiner was required to estimate the Taxpayer's liability because the Taxpayer failed to maintain adequate records.

As discussed, the Department assessed the Taxpayer for the fraud penalty because it failed to maintain records, and because its wholesale purchases substantially and consistently exceeded its reported retail sales. Code of Ala. 1975, §40-2A-11(d) levies a 50 percent fraud penalty for any underpayment of tax due to fraud. For purposes of the penalty, "fraud" is given the same meaning as ascribed in the federal fraud provision, 26 U.S.C. §6663. Consequently, federal authority should be followed in determining if the fraud penalty applies. *Best v. State, Dept. of Revenue*, 423 So.2d 859 (Ala. Civ. App. 1982).

The existence of fraud must be determined on a case-by-case basis from a review of the entire record. *Parks v. Commissioner*, 94 T.C. 654, 660 (1990). Because fraud is rarely admitted, "the courts must generally rely on circumstantial evidence." *U.S. v. Walton*, 909 F.2d 915, 926 (6th Cir. 1990). Consequently, fraud may be established from "any conduct, the likely effect of which would be to mislead or conceal." *Id.* The mere under reporting of gross receipts is itself insufficient to establish a finding of fraud, unless there is evidence of repeated understatements in successive periods when coupled with other circumstances showing an intent to conceal or misstate sales. *Barrigan v. C.I.R.*, 69 F.3d 543 (1995).

A taxpayer's failure to keep adequate books and records, a taxpayer's failure to furnish auditors with records or access to records, the consistent underreporting of tax, and implausible or inconsistent explanations regarding the underreporting are strong indicia of fraud. *See Solomon v. C.I.R.,* 732 F.2d 1459 (1984); *Wade v. C.I.R.*, 185 F.3d 876 (1999). Ignorance is not a defense to fraud where the taxpayer should have reasonably known that

its taxes were being grossly underreported. *Russo v. C.I.R.,* T.C. Memo 1975-268; *Temple v. C.I.R.*, 67 T.C. 143 (1976).

Fraud can be established by cumulative, circumstantial evidence. The Department has shown by irrefutable evidence that the Taxpayer regularly purchased significantly more inventory than was reported to the State as sales proceeds. Mr. Al-Sanabani, the owner, testified openly at the October 16 hearing. He could not explain how the Taxpayer's returns were consistently, grossly understated. He testified that he understood that the Taxpayer was mistakenly reporting purchases rather than sales on its sales tax returns. However, the evidence presented shows that the Taxpayer's actual purchases were $340,000 over what was reported. Even the Taxpayer's own computations support a finding that the Taxpayer's intentionally underreported sales.

Any retailer should know with certainty that sales records must be maintained for audit purposes. When asked why the Taxpayer failed to maintain z-tapes or sales journals, Mr. Al-Sanabani could give no credible answer. In addition, he could not explain how the accountant could accurately compute monthly retail sales without any actual sales records, nor could he explain how his staff could do so. Further, Mr. Al-Sanabani could not testify as to how sales tax was collected on the Taxpayer's retail sales. Rather than researching the possible causes and offering testimony as to why the Taxpayer's sales were consistently and significantly underreported, a fact with which he agrees, Mr. Al-Sanabani merely pled that he was completely ignorant regarding his store's sales and his staff's reporting of those sales to the State.

The Department's Administrative Law Division, now the Tax Tribunal, has affirmed the fraud penalty numerous times in similar cases, see *Zienni v. State of Alabama*, Misc. 13-294 (Admin. Law Div. 2/7/2014); *Carter Enterprises v. State of Alabama*, S. 11-965 (Admin. Law Div. 6/25/2012); *Melton v. State of Alabama*, S. 05-281 (Admin. Law Div. 4/26/2005). The fact that the Taxpayer's retail sales were more than 50 percent underreported, that the underreporting was consistent throughout the audit period, and that the Taxpayer refused to offer a single, plausible explanation for such significant and consistent underreporting supports a finding that the Department correctly applied the fraud penalty in this case.

The final assessment is affirmed. Judgment is entered against the Taxpayer for tax, penalty, and interest in the amount of $33,466.64. Additional interest is also due from the date the final assessment was entered, October 24, 2016.

This Final Order may be appealed to circuit court within 30 days pursuant to Code of Ala. 1975, §40-2B-1(m).

Entered May 15, 2018.

/s/ *C. O. Edwards*
CHRISTY O. EDWARDS
Associate Tax Tribunal Judge

cc: Hilary Y. Parks, Esq.
Elissa M. Al-Sanabani