ALABAMA TAX TRIBUNAL

KWIK MART, LLC,	§	
Taxpayer,	§	DOCKET NO. S. 18-694-LP
v.	§	
STATE OF ALABAMA DEPARTMENT OF REVENUE.	§	

FINAL ORDER

This appeal involves a final assessment of State sales tax for August 2014 through July 2017. The Taxpayer's representative contacted the Tax Tribunal on November 28, 2018, and requested that the case be set for hearing. A hearing was conducted on February 12, 2019. The Taxpayer's representative failed to attend the hearing. Assistant Counsel Sarah Bell represented the Revenue Department. Department examiner Terri Barnes-Smith also attended the hearing.

The Taxpayer operated a convenience store within the city limits of Selma, Alabama, during the period at issue. The store primarily sold the following: tobacco products, groceries, drinks and snacks, and other typical items sold by similar stores.

The Department's examiner, Terri Barnes-Smith, 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 provided some vendor invoices and federal and state income tax returns. The Taxpayer did not provide the examiner with any cash register z-tapes because it claims it threw them away after giving the information to its bookkeeper.

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 49.68%.

The examiner next applied the standard IRS mark-up of 1.35 percent to arrive at the store's estimated retail sales. The Taxpayer's representative objected in his notice of appeal that the mark-up was excessive and that the fraud penalty should be reduced to the negligence penalty.

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.

The audit revealed that the Taxpayer's sales were over 49.68% 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 Ala. Code § 40-2A-11(d).

The Taxpayer was billed for the additional tax due, interest and a fraud penalty. Billing progressed to entry of final assessment on June 19, 2018, in the amount of $76,811.48, consisting of tax due in the amount of $48,374.83, interest of $4,249.14, and fraud penalty of $24,187.51.

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 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.

The Department is authorized to compute a taxpayer's correct liability using the most accurate and complete information obtainable. Ala. Code § 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. Ala. Code § 40-2A-11(d) levies a 50 percent fraud penalty for any underpayment of tax due to fraud. The burden of proof in an assessment of a fraud penalty falls on the Department. Ala. Code § 40-2B-2(k)(7). 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).

The Department's Administrative Law Division, now the Tax Tribunal, has affirmed the fraud penalty numerous times in similar cases, see *GHF, supra*, and *Alsedeh, supra*. The fact that the Taxpayer's retail sales were nearly 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 Department thus met its burden to prove fraud. As indicated, the Taxpayer failed to attend the February 12, 2019, hearing and has otherwise failed to prove that the remaining aspects of the prima facie correct final assessment is incorrect.

The final assessment is affirmed. Judgment is entered against the Taxpayer for tax, interest, and the fraud penalty in the amount of $76,811.48. Additional interest is also due from the date the final assessment was entered, June 19, 2018.

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

Entered March 18, 2019.

/s/ Leslie H. Pitman
LESLIE H. PITMAN
Associate Tax Tribunal Judge

lhp:dr
cc: Brad Shriver, Esq.
David M. Folmar, Esq.