MOSES ARNOLD d/b/a Arnold's One Stop General Delivery Furman, AL 36741,	§ §	STATE OF ALABAMA DEPARTMENT OF REVENUE ADMINISTRATIVE LAW DIVISION
Taxpayer,	§	DOCKET NO. S. 03-1098
v.	§ §	
STATE OF ALABAMA DEPARTMENT OF REVENUE.	§	

FINAL ORDER

The Revenue Department assessed Moses Arnold ("Taxpayer"), d/b/a Arnold's One Stop, for sales tax for April 1997 through February 2003. The Taxpayer appealed to the Administrative Law Division pursuant to Code of Ala. 1975, §40-2A-7(b)(5)a. A hearing was conducted on May 18, 2004. Collins Pettaway represented the Taxpayer. Assistant Counsel Wade Hope represented the Department.

ISSUES

This case involves two issues: (1) did the Department properly compute the Taxpayer's sales tax liability for the subject period using a purchase mark-up audit; and, (2) did the Department properly assess the Taxpayer for the 50 percent fraud penalty levied at Code of Ala. 1975, §40-2A-11(d).

FACTS

The Taxpayer has operated a gas station/convenience store in Wilcox County, Alabama for 16 years. He sells beer, soft drinks, tobacco products, and various grocery items in the store. He also prepares ready-to-eat food such as chicken, ribs, barbeque, potato salad, french fries, and various vegetables.

A Department examiner notified the Taxpayer in early 2003 that he intended to audit the Taxpayer's store for sales tax purposes. The examiner requested all of the Taxpayer's cash register tapes, purchase invoices, sales journals, bank statements, and all other records relevant to his sales tax liability.

The Taxpayer provided the examiner with his bank statements from 1997 through 2001, and also some purchase invoices for that period. He failed, however, to provide any cash register tapes or any other sales records. He explained that he did not have any sales records, and that his tax preparer used his bank statements to prepare his monthly sales tax returns.[1] He also failed to provide any records for the months after December 2001.

Because the Taxpayer failed to provide any sales records, the examiner computed the Taxpayer's liability using a purchase mark-up audit. In a purchase mark-up audit, a retailer's total purchases are determined using the retailer's purchase invoices and/or purchase information from the retailer's vendors. All exempt and nontaxable items are subtracted, and a percentage mark-up is then applied to arrive at taxable sales.

In this case, the Department examiner determined the Taxpayer's total purchases using his canceled checks and purchase invoices, and also purchase information obtained from several of the Taxpayer's larger vendors. He then compared the Taxpayer's wholesale purchases for the months for which he had records (April 1997 through December 2001) to the amounts the Taxpayer had reported on his sales tax returns in those months. As illustrated on Dept. Ex. 3, the Taxpayer's reported monthly sales were

[1] The Taxpayer maintained a cash register at his store. He testified that he maintained cash register tapes until about six months before the audit started, but that the cash register "went out" at that time, and all of his tapes have been "misplaced," and cannot be found. T. at 110.

on average less than 25 percent of his total purchases in each month.

The examiner computed the Taxpayer's gross sales for April 1997 through December 2001 by marking up the merchandise sold over-the-counter by the standard 35 percent mark-up used by the IRS for convenience stores. He marked up the prepared food items by the standard 165 percent mark-up used by the IRS for prepared food.[2]

The examiner next computed the Taxpayer's exempt food stamp and WIC (Women, Infants, Children) sales based on the Taxpayer's bank deposit records.[3] He subtracted those exempt sales to arrive at net taxable sales for April 1997 through December 2001.

As indicated, the Taxpayer failed to provide any records for January 2002 through February 2003. Consequently, the examiner estimated the Taxpayer's liability for that period by applying the average monthly liability for the period for which he did have records, i.e. April 1997 through December 2001.

After determining the Taxpayer's total taxable sales during the audit period, the examiner next allowed a credit for sales tax previously paid. That resulted in additional tax due of $52,047.16. The Department added statutory interest and a 50 percent fraud penalty to that amount. It then assessed the Taxpayer for the entire 71 months in the audit period based on the 6 year statute of limitations at Code of Ala. 1975, §40-2A-7(b)(2)b. That statute of limitations applies if a taxpayer omits more than 25 percent of the taxable

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[2] The examiner applied the larger 165 percent mark-up to only the meat prepared by the Taxpayer because he could not determine what part of the vegetables, etc. purchased by the Taxpayer had been sold over-the-counter and what had been cooked.

[3] The food stamp and WIC purchases were separately listed on the Taxpayer's bank statements during the early part of the audit period. In the latter part of the audit period, the Taxpayer accepted government issued debit cards for his food stamp and WIC sales.

base from a return.

The Taxpayer testified at the May 18 hearing that he knows nothing about taxes, and that he depended on his tax preparer to do his sales tax returns. He claimed that his tax preparer only asked him to provide his bank statements, and never asked for or instructed him to keep cash register tapes or any other sales records. That testimony is contradicted by the examiner's testimony that the tax preparer had instructed the Taxpayer to keep cash register tapes and other sales records. T. at 61.

The Taxpayer also argued that he had a large amount of bad debts that the examiner failed to consider. The Taxpayer failed, however, to provide the examiner with any records or other evidence verifying the existence or amount of any bad debts.

The Taxpayer's representative provided the Department with additional documents after the May 18 hearing. The Department reviewed the records and responded that the records did not change the audit findings. The Department's position concerning those records was explained in a memorandum from James Browder in the Department's Sales and Use Tax Division, as follows:

> The copies of items furnished will have no effect for the following reasons:
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> The attorney states Exhibit A contains outstanding bad checks. Of the 24 check copies, only 8 are payable to Arnold and none indicate whether they were offered in payment of the purchase of taxable items. Some of the checks are dated prior to the audit period, some indicate the purchase of gasoline not subject to sales tax, some are for cash, some appear to be payroll checks cashed by Arnold, and 2 are checks payable to the law firm of Chestnut, Sanders & Sanders. (I don't know what these 2 checks have to do with this audit.)
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> The attorney states Exhibit B contains account cards for credit extended that were deemed bad debts and written off as uncollectible in 2002. I cannot verify the year on these cards, and some have no month or day. Very few of these cards indicate the nature of the item purchased, and of the ones that

> do, most indicate gasoline that is not subject to sales tax.
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> The attorney states that Exhibit C contains account cards with the year noted that were also deemed uncollectible in 2002. Some cards indicate dates and some do not. Again, most of the cards that indicate the nature of the item purchased lists gasoline that is not subject to sales tax and some of the cards are duplicates.
>
> Lastly, the attorney states the income tax returns for 1997 – 2002 are enclosed. The copies of returns are of federal returns prepared on May 24, 2004, the accuracy of which are questionable. The 6 Schedule C's are incomplete in that Cost of Goods Sold lines are blank and the Bad Debts From Sales or Services lines are blank and the Gross Receipts or Sales reported barely covers the amount of the verified purchases of inventory that would be taxable when sold. These schedules also indicated Cash as their accounting method which would preclude claiming any Bad Debts unless they could prove the sale for the bad debt was included in the amount of the sales reported as their Gross Receipts or Sales on the return. I checked with the Income Tax personnel and they found no 2002 Alabama income tax return received on which any bad debts could be written off. They also found no 1998 return received.

ANALYSIS

All taxpayers subject to sales tax are required to keep complete and accurate records from which the Department can accurately determine the taxpayer's correct liability. Code of Ala. 1975, §§40-2A-7(a)(1) and 40-23-9; *State v. Mack*, 411 So.2d 799 (Ala.Civ.App. 1982). If a taxpayer fails to keep adequate records, the Department can use any reasonable method to compute the taxpayer's liability. The taxpayer cannot later complain that the liability so computed by the Department is inexact. *Jones v. C.I.R.*, 903 F.3d 1301 (10th Cir. 1990).

The purchase mark-up audit used by the Department examiner in this case is an accepted method of computing a taxpayer's sales tax liability in the absence of adequate records. See generally, *Moseley's One Stop, Inc. v. State of Alabama*, S. 03-316 (Admin. Law Div. 7/28/03); *Pelican Pub & Raw Bar, LLC v. State of Alabama*, S. 00-286 (Admin.

Law Div. 12/15/00); *Joey C. Moore v. State of Alabama*, S. 99-126 (Admin. Law Div. 8/19/99); *Robert Earl Lee v. State of Alabama*, S. 98-179 (Admin. Law Div. 6/28/99); *Red Brahma Club, Inc. v. State of Alabama*, S. 92-171 (Admin. Law Div. 4/7/95); and *Wrangler Lounge v. State of Alabama*, S. 85-171 (Admin. Law Div. 7/16/86).

The Department examiner conducted a thorough, detailed audit. He computed the Taxpayer's total purchases using the Taxpayer's own records and records obtained from the Taxpayer's vendors. He excluded all exempt food stamp and WIC sales from the audit. He next correctly applied the standard IRS 165 percent mark-up for the prepared food items (meat only), and the standard IRS 35 percent mark-up to the remaining items. The Taxpayer generally objects to the audit, but has failed to provide any records or other evidence showing that the examiner's method or computations are incorrect or unreasonable. The burden was on the Taxpayer to show that the *prima facie* correct final assessment is incorrect. He has failed to do so. Consequently, the tax due as computed by the examiner is affirmed.

The Taxpayer's representative contends that the Department should have assessed the Taxpayer for only the normal three year period, and that the six year statute of limitations at §40-2A-7(b)(2)b. does not apply. I disagree.

Section 40-2A-7(b)(2)b. authorizes the Department to assess a taxpayer for six years if the taxpayer omits from a return more than 25 percent of the taxable base that should have been reported on the return. The Taxpayer in this case clearly underreported his taxable gross receipts by more than 25 percent during the audit period. As illustrated by Dept. Ex. 3, the Taxpayer reported total sales of $213,759 from April 1997 through December 2001, or an average of $3,750 a month. The Taxpayer's correct taxable sales

for the period, as computed by the Department examiner, were $1,327,279, or an average of $23,285 a month. The Taxpayer thus reported only approximately 16 percent of his taxable receipts during the period. The six year 25 percent omission statute clearly applies.

The Taxpayer's representative also argues that the fraud penalty should not have been assessed because (1) the Taxpayer is uneducated, and (2) the Taxpayer is ignorant about taxes and relied solely on his tax preparer to file his taxes.

Code of Ala. 1975, §40-2A-11(d) levies a 50 percent penalty for any underpayment due to fraud. "Fraud" is given the same meaning as ascribed in the federal fraud provision, 26 U.S.C. §6663. Consequently, federal authority and case law should be followed in determining if the fraud penalty applies. *State Dept. of Revenue v. Acker*, 636 So.2d 470 (Ala.Civ.App. 1994).[4]

The Department is required to prove fraud by clear and convincing evidence. *Bradford v. C.I.R.*, 796 F.2d 303 (1986). "The burden is upon the commissioner to prove affirmatively by clear and convincing evidence actual and intentional wrongdoing on the part of the (taxpayer) with a specific intent to evade the tax." *Lee v. U.S.*, 466 F.2d 11, 14 (1972), citing *Eagle v. Commissioner of Internal Revenue*, 242 F.2d 635, 637 (5th Cir. 1957). The existence of fraud must be determined on a case by case basis, and from a review of the entire record. *Parks v. Commissioner*, 94 T.C. 654, 660 (1990). However, because fraud is rarely admitted, "the courts must generally rely on circumstantial

[4] The federal fraud penalty cases cited herein involved income tax fraud. However, the same principles and guidelines would likewise apply to sales tax fraud.

evidence." *U.S. v. Walton*, 909 F.2d 915, 926 (6th Cir. 1990), citing *Traficant v. Commissioner*, 884 F.2d 258, 263 (6th Cir. 1989). Consequently, fraud may be established from "any conduct, the likely effect of which would be to mislead or conceal." *Walton*, 909 F.2d at 926, quoting *Spies v. United States*, 63 S.Ct. 364, 368 (1943). The failure to keep adequate records and the consistent underreporting of tax is strong evidence of fraud. *Wade v. C.I.R.*, 185 F.3d 876 (1999) ("There is no dispute (taxpayer) kept inadequate books and records, further suggesting fraud.").

Fraud was in issue in *State of Alabama v. New Joy Young Restaurant, Inc.*, S. 91-246 (Admin. Law Div. 7/8/92). The Administrative Law Division affirmed the fraud penalty in that case because the taxpayer failed to keep sales records and consistently underreported sales to the Department.[5] The Administrative Law Division rejected the taxpayer's claim of ignorance concerning business matters, citing *Korecky v. CIR*, 781 F.2d 1566 (1986).

> In defense of the accusation of fraud, Korecky contends that he was inexperienced in financial matters and that he relied on the expertise of his bookkeeper. . . . However, he did have the practical experience gained from operating his own business for over a decade. As such, he cannot be excused from keeping accurate records of sales receipts, which is a rather straightforward bookkeeping task. See, *Webb v. Commissioner*, 394 F.2d 366, 379-80 . . . .

Korecky, 781 F.2d at 1569.

The Taxpayer in this case is not sophisticated and has little formal education, but as indicated above, anyone that has owned and successfully operated a gas

[5] *New Joy Young* was reversed on other grounds by the Court of Civil Appeals, 667 So.2d 1391 (Ala. 1995). However, the Administrative Law Division's finding of fraud was not reversed.

station/convenience store for 16 years has practical experience and is not ignorant. The Taxpayer or anyone that is capable of managing a retail business certainly knows or should reasonably know that they must maintain adequate sales records by which their sales tax liability can be accurately computed. The Taxpayer failed to do so in this case, and instead provided his tax preparer with only his purchase invoices. Any reasonable person, and certainly a successful businessman, should know that monthly sales cannot be accurately computed from such raw purchase data.[6] The U.S. Tax Court has also consistently rejected ignorance as a defense to fraud where the taxpayer should have reasonably known that his 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 evidence is sufficient to establish that the Taxpayer willfully filed fraudulent sales tax returns during the subject months with the intent to evade tax.[7] He knew how much money he was taking in at his business, and he certainly knew that he was reporting much less on his monthly sales tax returns. The Taxpayer's claim of ignorance is unconvincing.

The above finding is also confirmed by one small but revealing fact. As shown on Dept. Ex. 3, the Taxpayer reported average monthly sales of $2,000 - $3,000 from 1997 through 2000. His reported sales increased in 2001 and 2002 to an average of

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[6] There is no evidence explaining how the preparer used the purchase information to compute the Taxpayer's monthly sales, and certainly there is nothing to explain how she prepared the Taxpayer's returns for those months, January 2002 through February 2003, that he did not even maintain purchase invoices.

[7] In addition to the applicability of the 6 year 25 percent omission statute of limitations discussed above, Code of Ala. 1975, §40-2A-7(b)(2)a. also allows the Department to assess tax at any time in the case of fraud.

approximately $5,000 - $8,000. However, in January and February 2003, after the Department examiner had notified the Taxpayer that it was going to audit him for sales tax, the Taxpayer's reported sales jumped to $13,000 and $17,000, respectively. The large increase in reported sales strongly suggests that the Taxpayer knew he was underreporting sales tax, and that he tried to make amends after learning that he was to be audited.

The final assessment is affirmed. Judgment is entered against the Taxpayer for State sales tax, penalty, and interest of $91,116.54. Additional interest is also due from the date of entry of the final assessment, November 4, 2003.

This Final Order may be appealed to circuit court within 30 days pursuant to Code of Ala. 1975, §40-2A-9(g).

Entered July 27, 2004.

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BILL THOMPSON
Chief Administrative Law Judge