ALABAMA TAX TRIBUNAL

AJ'S DISCOUNT STORE, LLC,	§	
	§	
Taxpayer,	§	DOCKET NO. S. 19-951-LP
v.	§	
STATE OF ALABAMA DEPARTMENT OF REVENUE.	§	

OPINION AND PRELIMINARY ORDER

This appeal involves a final assessment of State sales tax for November 1, 2015, through October 31, 2018. A hearing was conducted on December 17, 2019. The Taxpayer's owner, Arif Jiwa, and his attorney, Blake Madison, attended the hearing. Assistant Counsel Hilary Parks and examiner Christina Odom represented the Alabama Department of Revenue.

AJ's Discount Store is a convenience store selling the normal variety of items. Per the Wholesale Retail Accountability Act (hereinafter "WRAP"), certain vendors selling to convenience stores submit records of their sales to the Revenue Department. Records received from the WRAP program indicated that AJ's Discount Store was underreporting its sales. As a result, the Revenue Department audited the Taxpayer for compliance with the sales tax laws of the State of Alabama for periods 11/01/2015-10/31/2015.

Upon audit, the Taxpayer provided some records, including z-tapes, but upon review, the records were determined to be inaccurate as they could not be reconciled. Additionally, they included an extreme number of canceled transactions that were not in the normal course of business for a convenience store. Thus, a purchase markup audit was conducted using the standard Internal Revenue Service ("IRS") markup of 35%, and using impartial and independent vendor records. It

was determined that the Taxpayer was underreporting by over half a million dollars, representing approximately 50 percent of its sales. Consequently, a fraud penalty was applied.

The Taxpayer argues that credit should be given for inventory, that the markup is too high, that theft and spoilage should have been considered, and the fraud penalty should be voided.

The Taxpayer did provide z-tapes to the auditor and argues that they are accurate. However, the auditor was unable to reconcile those z-tapes with the other evidence, including the purchase invoices from the vendors, which revealed that the Taxpayer's purchases far exceeded reported sales. At the hearing, Mr. Jiwa explained that he often purchases products, such as wine, in bulk, and that items are often shoplifted due to the store's location in an impoverished area. However, the auditor accounted for the excess inventory, and theft is calculated into the IRS standard. While the Taxpayer may have experienced greater theft than the average, and the owner did testify to this fact, it did not produce the records necessary to account for the loss.

The Taxpayer also argues that the 35 percent mark-up is higher than its actual mark-up. The Taxpayer contends that it sells mostly alcohol and tobacco products, which have a mark-up of under 15 percent. Additionally, the Taxpayer points out that the auditor recognized the low mark-up percentage of many of the Taxpayer's products. However, she also found that other goods, such as snacks, soft drinks, and various grocery items, were marked up much higher, some nearing 100 percent. As the Revenue Department points out, the IRS mark-up is an average.

The Revenue 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 Revenue 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 Revenue 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 underreporting 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 Taxpayer provided credible testimony as to much of the underreporting. While the Taxpayer owner could not supply documentation necessary to overcome the presumption of correctness of the final assessment of tax, his testimony did provide plausible explanations for the numerous cancellations, theft, and increase in reported sales following the audit.

The Taxpayer owner testified as to the extreme number of cancellations recorded on the z-tapes. For part of the audit period, the cash register was not working properly, causing many transactions to be canceled. Furthermore, throughout the audit period, customers would frequently present more items for purchase than they could afford. The cash register does not have a function

which would allow the clerk to remove one item from the total. Instead, the entire order required canceling, and a new transaction would be entered. Sometimes, Mr. Jiwa testified, a customer's order would be canceled multiple times until an affordable total was reached. The Revenue Department states that the Taxpayer's argument here is incongruous with its position that the vast majority of sales were of alcohol and tobacco products because the Taxpayer stated that children were often requiring canceled transactions. However, the Taxpayer did not limit the customers' requiring canceled transactions to children. In fact, the Taxpayer owner testified that the reason he permitted the customers to present for purchase more items than they may be able to afford was that the customers would start a fight with the owner and kick over stands holding goods for sale and throw things at him. He stated that the store is located in a dangerous area, and he provided evidence that the store has been the victim of armed robberies. He was told by law enforcement not to pursue a robbery case as it could further endanger him. For the same reasons he did not confront shoplifters. As for the increase in sales reported following the audit, Mr. Jiwa testified that his sales increased at that time due to the closing of the store across the street. Thus, fraud has not been proven, and the fraud penalty should be reduced to a negligence penalty.

The Revenue Department is directed to adjust the Taxpayer's liability by deleting the fraud penalty and assessing the negligence penalty. It should notify the Tax Tribunal no later than **October 16, 2020**, of the adjusted amount 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 Ala. Code § 40-2B-2(m).

Entered September 25, 2020.

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

lhp:dr
cc: Blake A. Madison, Esq
Hilary Y. Parks, Esq.