ALABAMA TAX TRIBUNAL

OPAL MANAGEMENT, INC., D/B/A MIKE'S QUICK SERVE,	§	
Taxpayer,	§	
v.	§	DOCKET NO. S. 19-465-JP
STATE OF ALABAMA DEPARTMENT OF REVENUE.	§	

OPINION AND PRELIMINARY ORDER

Following an audit, the Alabama Department of Revenue entered a final assessment of state sales tax against Opal Management, Inc., doing business as Mike's Quick Serve (Taxpayer). The assessment also included interest and the fraud penalty, for a total of $257,497.57, and covered the periods of July 2012 through December 2017. The Taxpayer timely appealed the assessment to the Alabama Tax Tribunal, and a hearing was conducted during which both parties provided testimony and documentary evidence. Following the hearing, the case was remanded to the Revenue Department to give the parties the opportunity to resolve certain issues that were questioned during the hearing. The remand period was extended multiple times at the request of the parties. Also, the Taxpayer's attorney retired during this process and the Taxpayer retained new counsel.

Questions Presented

If a taxpayer fails to keep records by which the taxpayer's correct tax liability can be determined, the Revenue Department is authorized to calculate the correct amount of tax

owed using "the most accurate and complete information reasonably obtainable by the department." The Revenue Department then may enter a preliminary assessment for that amount of tax, plus penalties and interest. Generally, a preliminary assessment may be entered only for the preceding three-year period. But the assessment may be entered at any time if the taxpayer filed a fraudulent return with the intent to evade tax. And if an underpayment of tax is due to fraud, a penalty is added to the assessment that equals 50 percent of the underpayment that was fraudulent.

Here, the questions are:

1. Whether the Taxpayer proved that the Revenue Department erred in estimating the Taxpayer's taxable sales?

2. Whether the Revenue Department proved that the Taxpayer's underpayment of tax was fraudulent?

Law

Alabama law imposes a privilege or license tax – known as the sales tax – on those who are "engaged . . . in the business of selling at retail any tangible personal property whatsoever. . ." *See* Ala. Code § 40-23-2(1). The seller is required to add the tax to the sales price of the item and collect the tax from the purchaser, pursuant to Ala. Code § 40-23-26(a). Then, the seller generally is required to report and remit the tax monthly. Ala. Code § 40-23-7(a).

The pertinent statutes regarding the Revenue Department's audit and assessment functions read as follows:

> (1) In addition to all other recordkeeping requirements otherwise set out in this title, taxpayers shall keep and maintain an accurate and complete set of

records, books, and other information sufficient to allow the department to determine the correct amount of value or correct amount of any tax, license, permit, or fee administered by the department. . .

(2) The department may examine and audit the records, books, or other relevant information maintained by any taxpayer or other person for the purpose of computing and determining the correct amount of value or correct amount of any tax, license, or fee administered by the department. . .

Ala. Code § 40-2A-7(a)(1) – (2).

(b) *Procedures governing entry of preliminary and final assessments; appeals therefrom.*

(1) ENTRY OF PRELIMINARY ASSESSMENT; FINAL ASSESSMENT OF UNCONTESTED TAX; EXECUTION OF PRELIMINARY AND FINAL ASSESSMENTS.

a. If the department determines that the amount of any tax as reported on a return is incorrect, or if no return is filed, or if the department is required to determine value, the department may calculate the correct tax or value based on the most accurate and complete information reasonably obtainable by the department. The department may thereafter enter a preliminary assessment for the correct tax or value, including any applicable penalty and interest.

. . .

(2) TIME LIMITATION FOR ENTERING PRELIMINARY ASSESSMENT. Any preliminary assessment shall be entered within three years from the due date of the return, or three years from the date the return is filed with the department, whichever is later, or if no return is required to be filed, within three years of the due date of the tax, except as follows:

a. A preliminary assessment may be entered at any time if no return is filed as required, or if a false or fraudulent return is filed with the intent to evade tax.

b. A preliminary assessment may be entered within six years from the due date of the return or six years from the date the return is filed with the department, whichever is later, if the taxpayer omits from the taxable base an amount properly includable therein which is in excess of 25 percent of the amount of the taxable base stated in the return.

. . .

Ala. Code § 40-2A-7(b)(1) – (2).

> (d) *Underpayment due to fraud.* If any part of any underpayment of tax required to be shown on a return is due to fraud, there shall be added to the tax an amount equal to 50 percent of that portion of the underpayment which is attributable to fraud.
>
> For purposes of this section, the term "fraud" shall have the same meaning as ascribed to the term under 26 U.S.C. Section 6663, as in effect from time to time.

Ala. Code § 40-2A-11(d).

Facts

The Taxpayer operated a convenience store/gas station in Montgomery, Alabama. In 2018, the Revenue Department notified the Taxpayer that it intended to audit the Taxpayer for the periods of January 2015 through December 2017. Therefore, the Revenue Department requested the Taxpayer to provide sales records, cash-register tapes, purchase invoices, bank statements, and other records for the purpose of conducting the audit.

During the audit, however, the Revenue Department discovered that the Taxpayer had not kept any "z tapes," which record every transaction processed by a cash register, for any of the months under audit. Instead, the Taxpayer's manager, Mr. Mohamed Hoque, testified that he used "z reports" or summaries from the store's cash register to write a taxable-sales amount on a worksheet each month. He apparently began with total sales for the month and then subtracted amounts for certain items such as food-stamp sales and theft and spoilage. He then provided the worksheet to the Taxpayer's accountant each month, and the accountant posted the amount from the worksheet on a sales-tax return and filed the return. (The Taxpayer also discarded the

"z reports.") The Revenue Department's auditor testified that the amounts listed on the monthly worksheets as calculated by Mr. Hoque matched the amounts reported on the Taxpayer's returns for each corresponding month.

Because the Taxpayer did not keep any z-tapes or summaries to support its reported sales amounts, the auditor determined the amount of merchandise that the Taxpayer had purchased from vendors during the audit period for resale in the Taxpayer's store. The auditor stated that he used information from only the top 8 vendors based on sales to the Taxpayer, instead of from all the Taxpayer's vendors.

After comparing the vendor information with the Taxpayer's sales-tax returns, the auditor discovered that the Taxpayer had purchased significantly more merchandise during the audit period than the Taxpayer had reported as taxable sales. Specifically, the Taxpayer purchased approximately $5.8 million in merchandise, but reported taxable sales of only $3.5 million.

Therefore, the auditor performed a purchase mark-up audit using a mark-up of 35 percent. That is, the auditor increased the Taxpayer's vendor purchases by 35 percent and used that amount, minus non-taxable sales, as the Taxpayer's taxable-sales measure for the audit period. Because the auditor believed that the Taxpayer had underreported its taxable sales by more than 25 percent, the audit period was extended from 36 months to 66 months. The Taxpayer was given credit for the sales tax that it had paid with the filing of its returns. A final assessment was entered against the Taxpayer, which included not only tax and interest, but also a fraud penalty.

Analysis

Estimating taxable sales

By law, the Taxpayer was required to maintain a complete set of records from which the correct amount of its taxable sales could be determined. Ala. Code § 40-2A-7(a)(1). But Mr. Hoque admitted that the Taxpayer did not maintain such records, choosing instead to discard its "z tapes" because "not enough space to store." Those "z tapes" would have negated the need for the Revenue Department to estimate the Taxpayer's taxable sales.

To compound the problem of not keeping adequate records, the Taxpayer reported taxable-sales amounts that were far below the Taxpayer's purchases of inventory during the audit period. In fact, in each of the 66 months under audit, the Taxpayer's inventory purchases exceeded its reported sales. Thus, for 5 ½ years, there was no month in which the Taxpayer reported selling more than it purchased from its vendors.

The Taxpayer had no plausible explanation for its underreporting. During the hearing, Mr. Hoque testified that, after the audit, he estimated the Taxpayer's mark-up to be about 12 percent. But he provided no records to support his claim, and his attempted explanation was simply incoherent. When asked by the Taxpayer's attorney how he determined a 12 percent mark-up, Mr. Hoque stated:

> From the state audit what I found, I purchased 2.9 million dollars. I'm just going with what the State found. Obviously some of this number significantly wrong, but I added those numbers. If you added 2.9 million and $700,000 on Sam's Club, but if you go invoice only see the number. But if you go to invoice, you will see it's 8-to 900 cartons of cigarettes I purchase total, that's -- I used to sell. And

> what tobacco companies provide me 80 cents a pack, which is $8 average I used to get rebate per carton. They used to provide me 80 cents. And I used to sell below the cost. If my cost was $60 a carton, I used to $50 a car -- well, minus $8, 62, so it's sometimes $61. You know, let's say -- you know, I used to lose 10 cents, because surrounding area, which is Dollar General, Circle K, Shell, just to match their price some two, three penny difference from them. So if you combine, those come out to be 3.6 million dollar, and if you do 8 percent markup on that, that match to what the State giving me credit for, $253,000 buy-down, which is -- match the State number. So that's really I make from the tobacco. That's combined purchase close to 3.6 million dollars. Also beer mark --markup no more than 15 percent. Sometimes below. Why? Because Dollar General sell --they -- they -- around every other month, let's say, 8.99 for 12 pack, but your cost is $9.50 and they're selling below the cost. I'm not sure how they allowed to do that. And that kills my business. Sometimes I have to match with them, so that means I'm losing 50 cents just to get the customer in. So with saying that, so my markup average 14 percent and that alone almost 2 million dollar purchase. That give me 5.6 million dollar purchase total beer and cigarettes, the whole store. And if you average what about Blue Bell Ice Cream and all the other stuff, that come out to be 12 percent.

Therefore, the Taxpayer did not prove that the Revenue Department erred in its estimation of the Taxpayer's taxable sales. *See State v. Ludlum*, 384 So.2d 1089, 1091 (Ala. Civ. App. 1980) (stating that, "[w]here there are no proper entries on the records . . ., the taxpayer must suffer the penalty of noncompliance and pay on the sales not so accurately recorded as exempt") (quoting *State v. T.R. Miller Mill Co.*, 130 So.2d 185, 190 (Ala. 1961)). In its post-hearing brief, the Taxpayer attached a third-party affidavit and an affidavit from Mr. Hoque in an attempt to show that the Taxpayer's wholesale purchases were lower than the amounts determined by the Revenue Department. The Revenue Department countered with its own affidavit from the same third-party "to set the record straight." These post-hearing submissions have not been relied on by the Tax Tribunal in deciding this appeal. Instead, the decision is based on the evidence that

was presented to the Tax Tribunal during the hearing.

The fraud penalty

Ala. Code § 40-2A-11(d) levies a 50-percent 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).

Here, the Taxpayer admittedly kept no records of actual sales amounts. Also, the Taxpayer's taxable sales, as reported on its sales-tax returns, were significantly less than the amounts purchased at wholesale from its vendors. And this underreporting was continuous and prolonged – for 66 months. Finally, the Taxpayer had no plausible explanation for the foregoing. Therefore, the Revenue Department proved fraud with the intent to evade tax in the Taxpayer's sales-tax reporting.

This finding of fraud eliminates the need to discuss the extension of the audit period beyond 3 years pursuant to the 25-percent underreporting rule in Ala. Code § 40-2A-7(b)(2)b. There, subsection (b)(2)a provides that "[a] preliminary assessment may be entered at any time if ... a false or fraudulent return is filed with the intent to evade tax."

Conclusion

The final assessment is affirmed in all respects, except as to one item. The Revenue Department informed the Tax Tribunal after the hearing that the tax portion of the final assessment is due to be reduced by $196 due to the incorrect reversal of an adjustment that was made after the issuance of the Revenue Department's hearing officer's report. That reduction also will affect the interest and penalty portions of the assessment.

Therefore, the Revenue Department is directed to recalculate the final assessment based on the $196 reduction in tax and then inform the Tax Tribunal of the recalculated amount due, with interest calculated to the entry date of the final

assessment which was **April 3, 2019**. A Final Order then will be entered based on this opinion.

The Revenue Department's recalculation is due to the Tax Tribunal no later than **September 3, 2021**.

It is so ordered.

Entered August 18, 2021.

/s/ *Jeff Patterson*
JEFF PATTERSON
Chief Judge
Alabama Tax Tribunal

cc: Dwight Pridgen, Esq.
David E. Avery, III, Esq.