MAHER M. ALSEDEH ATTALLA TOBACCO OUTLET P.O. Box 7105 Rainbow City, AL 35906-7105,	§	STATE OF ALABAMA DEPARTMENT OF REVENUE ADMINISTRATIVE LAW DIVISION
Taxpayer,	§	DOCKET NO. S. 03-549
v.	§	
STATE OF ALABAMA DEPARTMENT OF REVENUE.	§	

FINAL ORDER

The Revenue Department assessed Maher M. Alsedeh ("Taxpayer"), d/b/a Attalla Tobacco Outlet, for sales tax for October 1996 through December 2002. 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 August 12, 2004. Luther Abel 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 owned and operated three retail tobacco outlets/convenience stores during all or part of the period in question. All three stores were located in Etowah County, Alabama. The Taxpayer operated Attalla Tobacco Outlet for the entire period in issue, October 1996 through December 2002. He also operated Mike's Convenience Store from October 1996 through July 2001, and Zack's Convenience Store from October 2000

through December 2002. The Taxpayer sold tobacco products, beer, soft drinks, automotive supplies, groceries, and various miscellaneous products in all three stores.

The Department audited the Taxpayer and requested his purchase invoices, purchase journals, cash register tapes and other sales records, and his bank records for October 1999 through September 2002. The Taxpayer provided some purchase invoices relating to the Attalla Tobacco Outlet and Zack's, but none for Mike's Convenience Store. He also failed to provide any cash register tapes or other sales records for any of the stores.

The Taxpayer's records revealed that the Taxpayer's wholesale purchases for the Attalla Tobacco Outlet alone exceeded his reported retail sales from all three stores. The Department's examiners thus concluded that the Taxpayer had underreported his taxable sales during the audit period. And because the Taxpayer's wholesale purchases, without mark-up, exceeded his reported sales by over 25 percent, the examiners also expanded the audit period to 6 years, which added the period October 1996 through September 1999.[1] The months of October, November, and December 2002 were also added before the audit was completed in early 2003.

Because the Taxpayer failed to provide any sales records, the examiners computed his liability using a purchase mark-up audit. In a purchase mark-up audit, a retailer's total purchases are determined from the retailer's purchase invoices and other vendor information. All exempt and nontaxable items are deleted. A percentage mark-up is then

[1] A six year statute of limitations applies if a taxpayer omits from a taxable base in excess of 25 percent of the amount reported on the return. Code of Ala. 1975, §40-2A-7(b)(2)b.

applied to the remaining purchases to arrive at taxable sales. A credit for tax previously paid is then allowed to arrive at the net tax due.

In this case, the examiners determined the Taxpayer's wholesale purchases using his invoices and purchase information from his vendors. The examiners then determined the percentage mark-up for the various goods sold by the Taxpayer by comparing the Taxpayer's wholesale costs with the actual prices charged for the items.

Different categories of products were marked-up different percentages. For example, the examiners determined that the Taxpayer's automotive supplies were marked-up an average of 105 percent. The examiners gave the Taxpayer the benefit of the doubt and applied an across the board 50 percent mark-up to automotive supplies. The examiners also determined that the Taxpayer's average beer mark-up was 18 percent. However, they used only a 12 percent beer mark-up in the audit.

Tobacco products were a major sales item for the Taxpayer. To promote sales, various tobacco manufacturers provided the Taxpayer with sales rebates. Consequently, the Taxpayer occasionally sold some of his tobacco items at below cost. The examiners compared what the Taxpayer paid for the tobacco products with what he sold them for and determined that the Taxpayer had charged from 79 percent to 137 percent of his cost for the products. The examiners thus applied an across-the-board minus 5 percent mark-up for all tobacco products.

The examiners also allowed the Taxpayer a theft loss at the Tobacco Outlet. They did not apply a mark-up to $100 worth of products a month because the Department

estimated that the Taxpayer had withdrawn those items from inventory for personal use.[2]

As indicated, the Taxpayer only provided the examiners with partial records for October 1999 through September 2002. Consequently, the examiners determined the Taxpayer's liability for the months for which no records were provided by applying the same error rate, or percentage of underpayment, as computed for October 1999 through September 2002. They determined that the Taxpayer had underreported sales at the Attalla Tobacco Outlet by 49.7 percent; at Mike's Convenience Store by 48.5 percent; and at Zack's by 50.6 percent. They applied the lower 48.5 percent error rate to all three locations for the months for which they had no records.

After determining the Taxpayer's total taxable sales, the examiners applied the 4 percent State tax rate to arrive at total tax due. They then allowed a credit for tax previously paid, which resulted in the net tax due. They also determined that the 50 percent fraud penalty should be applied. The audit report reads in pertinent part as follows:

> It appears that the taxpayer has been deliberately misstating his taxable sales. The Attalla Tobacco Outlet had two cash registers and Zack's Place had one cash register. When examining the z-tapes and daily sheets provided, it was determined that only one z-tape per day was used to compute taxable sales reported on the sales tax return. When examining the master tapes, we found that z-tapes were run daily on all three cash registers. The misstatement of tax is confirmed not only by evidence of missing z-tapes but also by the fact that the taxpayer's monthly purchases, considering all adjustments and without applying the mark-up, exceeded the total gross receipts reported by the taxpayer on his monthly returns during the audit period. Therefore, it was determined that a civil fraud penalty should be added.

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[2] A retailer is liable for sales tax on his wholesale cost of merchandise purchased at wholesale and subsequently withdrawn for personal use. Code of Ala. 1975, §40-23-1(a)(10). The $100 worth of goods per month were thus taxed at cost, without mark-up.

The Taxpayer argues that the audit inflated his tobacco sales. Apparently, the Taxpayer claims that the Department included the manufacturer's rebates as taxable gross receipts. An August 18, 2004 letter from the Taxpayer's representative stated as follows:

> Our office offered almost $600,000.00 worth of rebates for the 3 calendar years overlapping the audit. We offered this to show the many times Mike sold products including tobacco, Pepsi, and Budweiser products below cost. The rebates while taxable as income would not be taxable for sales tax purposes.

The Taxpayer also testified that his mark-up on various items was much less than those applied by the examiners. For example, he claimed that his mark-up on beer and soft drinks was only 3 or 4 percent, not the percentage used in the audit. The Taxpayer's representative summarized as follows:

> We offered Budweiser and buffalo rock print outs into evidence, Mike testified that the profit margin on his volume products such as twelve packs of Pepsi products and cases of Budweiser had a profit margin of 3% instead of 15%-25%. While the auditor denied seeing the Budweiser print out, Mike testified that the salesman made the highlights and notations present on the form, which also indicates a 3-4% mark up. This form was offered by me to the auditors before the final assessment.

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 Department's use of a purchase mark-up audit is an accepted method of

computing a taxpayer's liability in the absence of adequate records. See generally, *Arnold v. State of Alabama*, S. 03-1098 (Admin. Law Div. 7/27/04); *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 Taxpayer claims that the Department taxed his tobacco rebates. I disagree. The examiners did not tax the rebates. Rather, recognizing that the Taxpayer sold some of his tobacco products at below cost, the examiners applied an across the board "mark-up" of minus 5 percent. That is, for every dollar of tobacco purchased at wholesale, the examiners included only ninety-five cents as taxable sales in the audit. Considering that the Taxpayer sold some of his tobacco products for a profit, the examiners' use of a minus 5 percent mark-down is reasonable. The Taxpayer also failed to present any proof showing that the estimated mark-down is incorrect.

The examiners determined the percentage mark-ups by comparing the Taxpayer's wholesale costs and his actual retail sales prices. If the examiners found that the Taxpayer had different mark-ups for similar products, they used the lower mark-up in the audit.

The Taxpayer complains generally that the mark-ups are too high. However, he failed to present any convincing evidence supporting that claim. The print-outs referred to by the Taxpayer's representative are insufficient. The Department's mark-ups are based on the Taxpayer's own prices, and are very reasonable. If the Taxpayer had kept

adequate (or any) sales records, the Department would not have been required to estimate the mark-ups. And because the Taxpayer failed in his duty to keep adequate sales records, the Department is not required to rely on the Taxpayer's unsubstantiated verbal assertions. *State v. Mack*, 411 So.2d 799 (Ala. Civ. App. 1982).

The Department also assessed the Taxpayer for the 50 percent fraud penalty. The issue of fraud was previously addressed by the Administrative Law Division in *Arnold v. State of Alabama*, S. 03-1098 (Admin. Law Div. 7/27/04).

> 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).
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> 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 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.").
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> 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. 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 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. 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).
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> 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. 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.

Arnold at 7-9.

The Taxpayer testified that he totaled his daily sales at the end of each day. He then added his daily sales for the whole month and either faxed or telephoned the monthly amount to his accountant. He testified that he then disposed of his records for the month. When asked if he knew that he was required to keep sales records, the Taxpayer responded – "No, sir. I thought after the sales when you send it to the accountant that's

what they're supposed to keep up with it, so I didn't keep up with the z-tapes and things like that." T. at 105.

The Taxpayer is an intelligent individual that has successfully operated a retail business in Alabama for at least 13 years. It is not believable that someone with the Taxpayer's intelligence and business acumen was not aware that he was required to keep cash register tapes and other sales records. He testified that he thought his accountant was supposed "to keep up with it." However, the Taxpayer only provided the accountant with a monthly sales total, but no supporting records. The accountant thus had noting to keep up with.[3]

The Taxpayer's consistent underreporting of sales on his monthly returns further supports the fraud penalty. The Taxpayer's wholesale purchases for the Tobacco Outlet alone were more than his reported sales from all three stores. The Taxpayer's failure to keep any sales records and his consistent and substantial underreporting of monthly sales supports the Department's finding of fraud.

The final assessment is affirmed. Judgment is entered against the Taxpayer for State sales tax, penalty, and interest of $498,169.86. Additional interest is also due from the date of entry of the final assessment, July 9, 2003.

This Final Order may be appealed to circuit court within 30 days pursuant to Code of

[3] The Taxpayer testified that he maintained some records, but that they were destroyed due to water damage. T. at 86, 87. He failed to explain, however, what type of records were destroyed. Presumably, they were not cash register tapes because he testified that he was not aware that he was required to keep the cash register z-tapes. In testifying about the destroyed records, the Taxpayer also repeated that "I thought the accountant has all the records, . . ." T. at 87. But as discussed, the accountant could not have had any records because the Taxpayer only provided the accountant with monthly sales totals by fax or over the phone.

Ala. 1975, §40-2A-9(g).

Entered November 3, 2004.

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BILL THOMPSON
Chief Administrative Law Judge