PELICAN PUB & RAW BAR, LLC P.O. Box 1058 Dauphin Island, AL 36528-1058,	'	STATE OF ALABAMA DEPARTMENT OF REVENUE ADMINISTRATIVE LAW DIVISION
Taxpayer,	'	DOCKET NO. S. 00-286
v.	'	
STATE OF ALABAMA DEPARTMENT OF REVENUE.	'	

OPINION AND PRELIMINARY ORDER

The Revenue Department assessed State and City of Dauphin Island sales tax against Pelican Pub & Raw Bar, LLC for April 1996 through March 1998. David and Vickie Connolly (AConnollys@) appealed to the Administrative Law Division pursuant to Code of Ala. 1975, '40-2A-7(b)(5)a. A hearing was conducted on October 16, 2000 in Mobile, Alabama. The Connollys attended the hearing. Assistant Counsel Duncan Crow represented the Department.

ISSUE

The Connollys were two of the four original members of the Pelican Pub & Raw Bar, LLC when it incorporated in early 1996. The other two members were Frank Chliszczyk (AChliszczyk@) and his wife. The LLC operated a bar, the Pelican Pub, on Dauphin Island, Alabama during the period in issue. The Department conducted a sales tax purchase mark-up audit of the bar. The issue in this case is whether the audit was properly conducted and reasonably establishes the bar=s sales tax liability for the subject period.

FACTS

The LLC opened the Pelican Pub on Dauphin Island in April 1996. Chliszczyk managed the bar from when it opened until mid-1997. Vickie Connolly also worked at the

bar beginning in June 1996. The bar failed to file State or Dauphin Island sales tax returns from April through September 1996 because no one was aware sales taxes were owed. The LLC paid the back taxes in October 1996, and since that time has timely filed returns and paid the tax due as reported.

The Connollys and Chliszczyk developed an ongoing disagreement, and Chliszczyk left the business in August 1997. The Connollys started managing the bar at that time, and eventually bought out the Chliszczyks= interest in the LLC in February 1999. Chliszczyk testified at the October 16 hearing that while he managed the bar, he and Vickie Connolly regularly received money from the bar Aunder the table.@ He testified that cash register z-tapes were regularly removed and never turned over to the bar=s tax preparer, and that the cash reflected on those z-tapes, which he estimated to be $1,500 to $2,000 per month, was removed from the register and never reported. Vickie Connolly denies that she ever received a salary from the bar.

Chliszczyk contacted the Department in February 1998 concerning alleged improprieties at the bar. In May 1998, the Department started a sales tax audit of the bar for the period in issue. The Connollys provided the Department examiner with the bar=s records, including all z-tapes in their possession. The examiner also obtained some z-tapes from Chliszczyk. The examiner reviewed the z-tapes and determined that a substantial number were missing. Vickie Connolly explained that some of the missing z-tapes had been used for practice on the register, and then discarded. Because the bar=s sales records were incomplete, the examiner conducted a purchase mark-up audit.

The examiner divided the bar's sales into three categories - liquor, beer, and wine. The examiner computed the liquor sales by first determining how many 1 1/4 ounce drinks could be poured from the various size liquor bottles used at the bar. If a bottle contained a number of drinks plus a fraction, the examiner rounded down to the next whole number to allow for spillage and waste. For example, a liter bottle contains 27.05 drinks. The examiner rounded down to 27. He then multiplied the drinks per bottle by an average drink price of $2.75 to arrive at gross receipts derived from each bottle. The bar had advertised drinks from $2.75 to $4.00, depending on the type of drink. The examiner used the lower $2.75 figure to take into account drinks sold at reduced happy hour prices. The examiner multiplied the gross receipts per bottle by the number of bottles purchased by the bar in each month to arrive at total monthly liquor sales.

The examiner computed the bar's monthly beer sales by multiplying the number of beers purchased by the bar in each month by $1.50. The bar generally charged $1.75 for can and keg beer, and from $2.25 to $3.00 for imported bottle beer. The examiner used the lower $1.50 figure to allow for reduced price happy hour sales.

The bar's wine sales were computed in the same manner as its liquor and beer sales. The bar's monthly wholesale wine purchases were multiplied by $2.75 per glass to arrive at total monthly wine sales. The advertised price for wine was $3.00 per glass. The examiner used the lower $2.75 figure to take into account reduced price happy hour sales.

The Connollys provided the examiner with an ending inventory figure. The examiner marked up the inventory to what it would have sold for, and allowed a credit for that amount in the last month of the audit.

The examiner did not back out the combined 8 percent State, Mobile County, and Dauphin Island sales tax from total gross receipts because he did not observe a sign at the bar indicating that sales tax was included in the price.

The examiner provided the Connollys with a copy of the audit in July 1998. On several occasions over the next few months, the Connollys provided additional information and pointed out various mistakes in the audit to the examiner. Each time, the examiner took the additional information into account, corrected the math and other mistakes, and revised the audit accordingly. The examiner subsequently forwarded the audit, as adjusted, to the Sales Tax Division in Montgomery for review. The Department reviewed the audit and entered preliminary assessments against the LLC on April 23, 1999.

The Connollys petitioned for a review from the preliminary assessments on May 11, 1999. A Department hearing officer scheduled a conference for June 22, 1999. However, the Connollys telephoned the hearing officer on June 21 and requested that the audit be returned to Mobile for further adjustments. The hearing officer canceled the conference, and returned the audit to the examiner on June 25.

The examiner further corrected and adjusted the audit based on additional information provided by the Connollys. The examiner submitted his readjusted audit to the hearing officer in Montgomery in early September 1999. The Connollys complained to the hearing officer on several occasions over the following months that the audit still contained numerous mistakes. The hearing officer thoroughly reviewed the factual and legal aspects of the audit. He eventually affirmed the audit, and entered final assessments on April 14, 2000. Corrected final assessments were entered on May 24, 2000. The Connollys appealed.

The Connollys object to the audit for the following reasons:

(1) The Connollys contend that the examiner should have backed out the 8 percent sales tax from gross receipts. As indicated, the examiner refused to back out the tax because he did not observe a sign at the bar stating that sales tax was included in the price. The Connollys testified, however, that they did have a sign at the bar stating that 8 percent tax was included. Such a sign was submitted into evidence at the October 16 hearing.

(2) The Connollys object that the examiner did not give them a reasonable spillage allowance. The Department argues that spillage was considered when the examiner rounded the number of drinks in a bottle down to the next whole number.

(3) The Connollys argue that by treating a sale as having occurred in the month a product was purchased, and by allowing credit for ending inventory only at the end of the audit period, they are being charged excessive penalty and interest. For example, assume the bar purchased six bottles of Old Forester in December 1996, the Department marked up and assessed the six bottles as if they had been sold in that month. Interest began accruing at that time. If the bar sold only three of the bottles, the Department allowed a credit for the three unsold bottles still in inventory at the end of the audit period. The Connollys thus argue that the Department incorrectly charged penalty and interest on the three unsold bottles from December 1996 until March 1998.

(4) The Connollys complain generally that they were unfairly selected for audit, and that the audit was improperly done and took too long to complete.

ANALYSIS

If a taxpayer fails to keep adequate records, the Department is authorized to use the best information available to reasonably compute the taxpayer=s liability. Code of Ala. 1975, '40-2A-7(b)(1)a. Because the LLC failed to maintain adequate sales records, the examiner properly computed the bar=s sales tax liability using a purchase mark-up audit.[1]

Issue (1) Should the 8 percent sales tax be backed out of gross receipts?

Sales tax can be backed out of a lump-sum sales price, but only if the amount of tax included is specified on a sales receipt, or on a sign at the taxpayer=s facility. See, Dept. Reg. 810-6-2-.86.

The examiner correctly refused to back out the 8 percent tax because he did not observe a sign at the bar showing that tax was included in the price. The Connollys testified, however, that they had several signs at the bar. They offered one into evidence

[1]The Connollys and their CPA agree that use of the purchase mark-up audit was proper. See, November 1, 2000 letter from Lovina Koch CPA, at 2, and November 1, 2000 letter from David Connolly, at 12. For other Administrative Law Division cases in which the purchase mark-up audit method was affirmed, see, *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); *Wrangler Lounge v. State of Alabama*. S. 85-171 (Admin. Law Div. 7/16/86).

at the October 16 hearing. Based on that evidence, the Department is directed to back out the 8 percent tax from gross receipts.

Issue (2) Should the Pelican Pub be allowed a larger spillage allowance?

The Connollys contend that rounding down the number of drinks in a bottle to the next whole number does not allow enough for spillage and breakage that normally occurs in a bar. For example, the number of 1 1/4 ounce drinks in a liter bottle, a common size used at the bar, is 27.05. Rounding down that number to 27 only allows for waste of less than .10 of an ounce per bottle.

I agree with the Connollys on this point. Under the circumstances, a 5 percent spillage allowance, or less than one drink per liter bottle, is reasonable.

Issue (3) Should the ending inventory be prorated as a credit over the entire audit period?

The Department audit shows that the bar=s monthly beer, liquor, and wine purchases averaged approximately $16,600. The bar=s ending inventory was $39,757. However, that ending inventory figure constituted the marked-up sales price for which the inventory would have sold, not the wholesale cost of the inventory. The year ending inventory amounts provided by the Connollys for 1997 and 1998 were $3,936 and $5,434, respectively, or less than the bar=s average monthly purchases. That indicates that most of the inventory was sold within a month of when it was purchased. It is reasonable to assume, without evidence to the contrary, that the Connollys, who are intelligent individuals, would have purchased only that amount of beer, wine, and liquor that they reasonably expected to sell in the near future. The bar may have held some products for

several months, especially unusual liquor brands, but there is no evidence to that effect. Although not exact, the first in/first out method used by the Department to account for ending inventory was reasonable under the circumstances, and is accepted.

Issue (4) Was the audit reasonable and fairly conducted?

The Connollys complain that they were unfairly selected for audit by the Department. Chliszczyk contacted the Department in February 1998 concerning improprieties at the bar. Chliszczyk and the Connollys were in an ongoing business dispute at that time. The Department claims that its audit was routine, but even if the Department audited the bar based on Chliszczyk=s lead, it did not act improperly or unfairly in doing so.

It is common and reasonable for the Department to rely on what it considers reliable third party leads in determining which taxpayers to audit. Chliszczyk had first hand knowledge of how the bar operated because he was a member of the LLC and managed the bar for over a year and a half. It would have been reasonable for the Department to audit the bar based on Chliszczyk=s allegations that the business was not properly paying its sales tax. The Department would have been remiss in its duty if it had ignored such information. The reasonableness of the audit is confirmed by the fact that the Connollys concede that at least $6,200 in additional tax is owed for the audit period. See, November 1, 2000 letter from David Connolly, at 16.

The Connollys also complain that the audit took too long and that the examiner made too many mistakes. The examiner finished the initial audit and presented it to the Connollys in mid-Summer 1998, a reasonable time under the circumstances. Over the

next twenty months, the Connollys on numerous occasions presented additional information and pointed out mathematical and other mistakes in the audit. It is unfortunate that the audit included mathematical, transposition, and other errors, but each time the examiner revised the audit in due course. In total, the audit was revised nine or ten times. If the bar had kept adequate sales records, an extended indirect purchase mark-up audit would not have been necessary. The Connollys blame Chliszczyk for the bar=s missing records, but they went into business with him and allowed him to manage the bar. They must accept the consequences of their decision.

On the other hand, a two year audit process is unusual, even if the delay was in part caused by the Connollys providing additional information piecemeal during the audit. The Sales Tax Division=s lone hearing officer, through no fault of his own, was also unable to promptly review the audit due to his heavy caseload and very limited personnel.

The Department=s Taxpayer Advocate is authorized to abate interest that accrues due to undue delay by the Department. Code of Ala. 1975, '40-2A-4(b)(1)c. A copy of this Opinion and Preliminary Order will be forwarded to the Taxpayer Advocate, who will investigate and notify the Administrative Law Division if a portion of the interest should be abated.[2] The Administrative Law Division will then enter an Order directing the Sales Tax Division how to recompute the final assessments in issue. A Final Order will then be entered for the adjusted amounts due.

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[2]The Department assessed the LLC for only the five percent negligence penalty levied at Code of Ala. 1975, '40-2A-11(c) based on its failure to keep adequate records. That five percent penalty would have been the same dollar amount regardless of how long the audit took.

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 Code of Ala. 1975, '40-2A-9(g).

Entered December 15, 2000.