KATHY A. CARTER KATHY'S COUNTRY KITCHEN PLAZA II SHOPPING CENTER 102 ROSS CLARK CIRCLE DOTHAN, AL 36303-5831,	§ § §	STATE OF ALABAMA DEPARTMENT OF REVENUE ADMINISTRATIVE LAW DIVISION DOCKET NO. S. 04-653
Taxpayer,	§	
v.	§	
STATE OF ALABAMA DEPARTMENT OF REVENUE.	§	

OPINION AND PRELIMINARY ORDER

The Revenue Department assessed Kathy A. Carter ("Taxpayer"), d/b/a Kathy's Country Kitchen, for sales tax for June 1997 through May 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 August 25, 2005. Bill Hinesley and Paul Turner represented the Taxpayer. Assistant Counsel Margaret McNeill represented the Department.

The Taxpayer operates a buffet-style restaurant in Dothan, Alabama. The restaurant is open from 5:00 a.m. until 2:00 p.m., Monday through Friday. The restaurant moved to a new, larger location in Dothan in April 2003.

The Taxpayer's accountant, Dan McCallister, filed the Taxpayer's sales tax returns for the months in issue. McCallister testified at the August 25 hearing that the Taxpayer telephoned in the amount of her monthly sales, and that he used that information to complete her monthly sales tax returns. McCallister also used the Taxpayer's records to complete her personal income tax returns during the subject years.

The Department audited the Taxpayer for sales tax in mid-2003 for the period June 2000 through May 2003. The examiner requested all of the Taxpayer's purchase invoices, cash register tapes, and other relevant records. The Taxpayer informed the examiner that

the records had been lost or destroyed during the move to the new location in April 2003. The examiner accordingly computed the Taxpayer's liability using a purchase mark-up audit.

A retailer's liability is determined in a purchase mark-up audit by taking the retailer's wholesale purchases, deducting nontaxable items and a reasonable amount for spoilage, theft, etc., if applicable, and then applying a percentage markup to arrive at the retailer's taxable sales.

The examiner determined the Taxpayer's total purchases from records provided by her vendors. She then applied a 268 percent markup pursuant to an average markup chart compiled by the IRS. The resulting taxable sales indicated that the Taxpayer had substantially underreported her sales during the original three year audit period. The examiner consequently expanded the audit to six years, as allowed by the 25 percent omission statute of limitations at Code of Ala. 1975, §40-2A-7(b)(2)b. She also applied the 50 percent fraud penalty because the Taxpayer (1) failed to maintain records for the audit period, and (2) substantially underreported her taxable sales during the period.

The examiner concluded that the Taxpayer had substantially underreported her monthly sales based on the following facts: The Taxpayer's income tax returns, which, as indicated, the Taxpayer's accountant compiled using her records, reported her wholesale cost of goods sold to be $153,619, $157,240, $169,964, $185,385, and $205,778, for 1998 through 2002, respectively. However, she reported gross receipts for sales tax purposes of only $68,587, $73,967, $65,750, $63,601, and $68,230, respectively, in those same years. The examiner also testified that the Taxpayer paid her employees more in wages than she reported as gross sales on her sales tax returns in the subject years.

The Taxpayer does not contest her total purchases as determined by the Department. Rather, she argues that the 268 percent markup is excessive, and also that the fraud penalty is not warranted.

Issue (1). The markup percentage.

The purchase markup audit is a reasonable and oft-used method for determining a retailer's sales tax 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's attorneys do not contest the use of a markup audit, or the Taxpayer's total wholesale purchases as determined by the examiner. They argue, however, that the 268 percent standard IRS markup applied by the examiner is excessive. They assert that the IRS markup is the average for all types of restaurants, but that the Taxpayer's buffet-style business has a much lower margin because much of the food she prepares for the buffet line is not sold.

The Taxpayer's attorneys claim that a more accurate markup would be 197 percent. The Taxpayer's accountant arrived at that figure using the Taxpayer's sales records for 2004, the year after the audit period. The attorneys argue that although the 197 percent markup is based on a period after the audit period, it is reasonably accurate because the Taxpayer's business during 2004 was substantially the same as during the audit period.

The Department examiner reviewed and rejected the Taxpayer's 2004 records, and thus the proposed 197 percent markup, because she determined that the Taxpayer had also underreported her sales in that year. However, the Taxpayer's attorneys presented evidence at the August 25 hearing indicating that the Taxpayer kept her 2004 daily reports in an unorthodox manner, which resulted in the examiner including purchases from two of the Taxpayer's major vendors twice in her calculations.[1]

The Department examiner conducted a good audit based on the information available at the time. She rejected the Taxpayer's 2004 records for purposes of determining a reasonable markup because it appeared that the Taxpayer had also underreported her 2004 sales. As indicated, however, the Taxpayer's attorney presented evidence that the examiner had (understandably) misconstrued the Taxpayer's 2004 records, and that those records are accurate.

The Administrative Law Division has generally upheld the IRS percentage markups routinely used by the Department in purchase markup audits. See generally, *Seales v. State of Alabama*, S. 05-515 (Admin. Law Div. 12/16/05); *Farace v. State of Alabama*, S. 05-451 (Admin. Law Div. 8/22/05). In this case, however, there is some doubt concerning the reasonable accuracy of the 268 percent IRS markup.

First, the 268 percent markup is the average for all types of restaurants. The Taxpayer operates a buffet-style restaurant, which requires her to prepare more food than she will sell in a given day. Because some of the prepared food is not sold, it follows that her markup would be less than at a special-order restaurant.

[1] For a full explanation of the Taxpayer's position on this issue, see Taxpayer's Brief at 3, 4.

The Taxpayer also presented records from which her average markup could be determined. The records are for a period after the audit period, but the Taxpayer operated substantially the same during the subsequent period as she did during the audit period.

In *State v. Ludlum*, 384 So.2d 1089 (Ala. Civ. App. 1980), the taxpayer failed to maintain records during the audit period from which his exempt sales could be determined. The taxpayer's accountant used the taxpayer's records for a test period after the audit period to determine the percentage of exempt sales during the audit period. The Court of Civil Appeals accepted the circuit judge's finding that the accountant's computations were sufficient. "Using a 'test period' in which adequate records were kept, the taxpayer's accountant was able to determine (the amount of the taxpayer's exempt services). Although the time frame for this test period did not coincide with the years covered by the assessments, there was testimony that the taxpayer's business was substantially the same in both instances." *Ludlum*, 384 So.2d at 1092.

In *State of Alabama v. Marvin Durbin*, S. 92-339 (Admin. Law Div. 9/28/93), I opined that I disagreed with the majority in *Ludlum*, and that Judge Wright's dissent was the better reasoned view. *Durbin* at 4. I nonetheless ruled in *Durbin* that under the particular circumstances of that case, the taxpayer's records were sufficient to determine his taxable versus exempt sales.

If a retailer fails to keep records identifying exempt sales or transactions, the retailer is generally liable for tax on all sales which cannot be established as exempt. *Ludlum* is an exception. In this case, the issue is not whether the Taxpayer's sales can be estimated in lieu of records. The Department agrees that they should be. Rather, the issue is how should the Taxpayer's sales be best estimated. Under the circumstances, the 197 percent

markup established by the Taxpayer's 2004 records is reasonable, and should be applied as the best estimate of the Taxpayer's markup during the audit period.

Issue (2). The fraud penalty.

Code of Ala. 1975, 40-2A-11(d) levies a 50 percent penalty for any underpayment due to fraud. 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 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). The mere underreporting of tax is by itself insufficient to establish fraud, unless coupled with other circumstances showing a clear intent to evade tax. *Barragan v. C.I.R.*, 69 F.3d 543 (9th Cir. 1995).

The Taxpayer's attorneys argue that the Department has not established that the Taxpayer intentionally underreported her sales tax with the intent to evade. They claim that the Taxpayer is uneducated and unsophisticated in business matters, and that "[e]ven if the Court determines that the Taxpayer's lack of education and unorthodox business operation was negligent, the negligent keeping of business records, even to the point of making the

ascertainment of tax liability almost impossible, does not, by itself, equate fraud." Taxpayer's Brief at 8.

The Department examiner cited the Taxpayer's failure to maintain records as evidence of fraud. The Taxpayer's attorneys counter that the Taxpayer could not provide the records because they were lost when she moved in April 2003.

It is possible, of course, that the Taxpayer either failed to maintain adequate records or intentionally destroyed the records after she was notified of the Department's audit. There is evidence that the Taxpayer did keep some records because her CPA testified that he used the Taxpayer's records to complete her income tax returns. Giving the Taxpayer the benefit of the doubt that her records were inadvertently lost, and there is no evidence to the contrary, her failure to provide records does not, by itself, show a willful intent to evade tax.

The examiner next cited the fact that the Taxpayer had substantially underreported her sales tax during the audit period. The Taxpayer's attorneys argue that the "substantial understatement of income is insufficient by itself to support findings of fraud." Taxpayer's Brief at 6. However, substantial underreporting is strong circumstantial evidence of fraud, which is the type of evidence courts must generally rely on to detect fraud. See, *U.S. v. Walton*, 909 F.2d 915 (6th Cir. 1990); *Seales v. State of Alabama*, *infra* at 4. Under the circumstances, the Taxpayer's consistent and substantial underreporting of her taxable sales, coupled with her lack of records, is sufficient to constitute fraud.

The Taxpayer telephoned her accountant and told him the amount of her monthly sales. The accountant duly reported those amounts on the Taxpayer's monthly returns. The total sales as reported were clearly understated because the sales were substantially

less than the Taxpayer's cost of goods sold as reported on her income tax returns. If a 197 percent markup is applied to the wholesale cost of goods sold, which the Taxpayer claims is reasonable, then her reported sales during the audit period were less than 25 percent of her actual sales. For example, the Taxpayer's cost of goods sold in 2002 per her income tax return was approximately $206,000. That amount multiplied by 197 percent would result in total sales of approximately $406,000. The Taxpayer reported total sales of only $68,230 on her 2002 sales tax returns. The underreporting of sales in the other years in issue was equally egregious. That consistent and substantial underreporting of tax can only be attributed to an intentional intent to evade tax.

The Taxpayer's failure to correctly report her sales also cannot be attributed to the fact that she is uneducated and supposedly unsophisticated in business matters. Ringing up sales at a restaurant and then totaling and reporting the sales each month is not a difficult task. If the Taxpayer is smart enough to successfully operate a restaurant, she certainly can accurately record and report her sales.

The finding that the Taxpayer intentionally underreported her monthly sales is further supported by the fact that she paid her employees more each month than she reported in monthly sales. The Taxpayer could not have stayed in business if she paid her employees more than she took in in revenue. In addition to her employee expenses, the Taxpayer also had to have gross sales sufficient to buy the food she sold, pay the utilities and other expenses necessarily incurred in operating the restaurant, and then have enough profit left over to pay her personal expenses. The only explanation is that the Taxpayer grossly underreported her sales with the intent to evade.

The Department is directed to recompute the Taxpayer's liability by applying a 197 percent markup. The 50 percent fraud penalty should then be added to the tax due. Applicable interest should also be added. An appropriate Final Order will be entered after the Department notifies the Administrative Law Division 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 Code of Ala. 1975, §40-2A-9(g).

Entered February 8, 2006.

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BILL THOMPSON
Chief Administrative Law Judge

bt:dr
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