D.W. WALTERS, INC. 1580 OAKHILL COURT AUBURN, AL 36832-6797,	§	STATE OF ALABAMA DEPARTMENT OF REVENUE ADMINISTRATIVE LAW DIVISION
Taxpayer,	§	DOCKET NO. S. 05-503
v.	§	
STATE OF ALABAMA DEPARTMENT OF REVENUE.	§	

OPINION AND PRELIMINARY ORDER

The Revenue Department assessed D.W. Walters, Inc. ("Taxpayer"), d/b/a The Goal Post, for State sales tax for July 1998 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 November 10, 2005. Will Sellers represented the Taxpayer. Assistant Counsel Margaret McNeill represented the Taxpayer.

The issues in this case are: (1) did the Department properly compute the Taxpayer's sales tax liability for the subject period using an indirect purchase mark-up audit; and, (2) did the Department correctly apply the fraud penalty.

The Taxpayer operated a retail convenience store near the Auburn University campus in Auburn, Alabama during the period in issue. The store primarily sold beer, wine, cigarettes, and miscellaneous grocery items.

The Department audited the Taxpayer for sales tax for 2000 through 2002 and requested the Taxpayer's purchase invoices, bank statements, cash register z tapes, sales journals, and other relevant records. The Taxpayer's owner provided a few purchase invoices, but no cash register tapes or other sales records. The examiner could not determine the Taxpayer's liability using those records. Consequently, he computed the Taxpayer's liability using a purchase mark-up audit.

The examiner obtained purchase information from the Taxpayer's major vendors to determine the Taxpayer's total wholesale purchases in 2000, 2001, and 2002. He then determined the Taxpayer's gross sales for those years by applying the 35 percent mark-up the Department routinely uses for convenience stores.

The gross sales as determined by the audit showed that the Taxpayer had underreported sales by more than 25 percent during the subject period. The examiner thus expanded the audit back to July 1998 pursuant to the six year statute of limitations for assessing tax at Code of Ala. 1975, §40-2A-7(b)(2)b. The examiner determined the Taxpayer's liability for the prior period based on the percentage of error found on the Taxpayer's January 2000 through December 2002 returns. The Department also assessed the Taxpayer for the 50 percent fraud penalty at Code of Ala. 1975, §40-2A-11(d).

The Taxpayer disputes the assessment on several grounds. First, it claims that three waivers of the statute of limitations executed by the Department were invalid because the waivers were in the name of the owner, Dan Walters, and not the corporation's name. Second, the Taxpayer contends that the 35 percent mark-up applied by the examiner is excessive. The Taxpayer also argues that the Department examiner made numerous mathematical and transposition mistakes in the audit. Finally, the Taxpayer asserts that the fraud penalty is not applicable.

Concerning the waivers, the Department examiner indicated on the waivers that the taxpayer was "Dan Walters," not D.W. Walters, Inc. He also put Dan Walter's social security number on the waivers, not the corporation's FEIN. The waivers were thus invalid against the corporation. See, *Fletcher Oil Company, Inc. v. State of Alabama*, Misc. 92-143 (Admin. Law Div. 9/15/92). However, the validity of the waivers is irrelevant if (1) the

Taxpayer is guilty of fraud, in which case tax can be assessed at any time, see Code of Ala. 1975, §40-2A-7(b)(2)a., or (2) the Taxpayer underpaid tax by more than 25 percent, in which case the Department can assess tax for a six year period, see §40-2A-7(b)(2)b. Whether the Taxpayer is guilty of fraud or underreported by more than 25 percent is addressed below.

The Taxpayer argues that the 35 percent mark-up applied by the examiner was excessive. Rather, it claims that its gross profit was only approximately 17.4 percent during the subject period based on a retail industry benchmark for gasoline stations and convenience stores obtained over the internet.

The Department's sales tax manager in its Auburn/Opelika District Office testified that the Department examiners in his District routinely apply a 35 percent mark-up when auditing convenience stores. The manager stated that the 35 percent mark-up was an average based on actual mark-ups compiled over time by Department examiners at various convenience stores in the area. The manager testified that in some cases the mark-up has been 45 to 50 percent.

The Administrative Law Division has decided numerous cases involving purchase mark-up audits of convenience stores or small grocery stores. In those cases, the Department generally applied mark-ups of between 24 and 35 percent based on an average mark-up chart compiled by the IRS. See, *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); *Ali v. State of Alabama*, S. 03-238 (Admin. Law Div. 8/2/05); *Arnold v. State of Alabama*, S. 03-1098 (Admin. Law Div. 7/27/04). The Administrative Law Division has routinely affirmed the mark-ups applied by the Department as reasonable.

> The IRS mark-up chart is regularly used by the Department, and provides a reasonable estimate of the average mark-up for different types of businesses. If the Taxpayer had maintained adequate records, as required by Alabama law, the Department would not have been required to estimate his percentage mark-up. And where a taxpayer fails to maintain records, as in this case, the taxpayer must not only present credible evidence showing that the Department's estimates are incorrect, he must also present evidence establishing his correct liability. *Hintz v. C.I.R.*, 712 F.2d 281 (1983); *Doyal v. C.I.R.*, 616 F.2d 1191 (1980). The Taxpayer failed to do so in this case.

Farace, *supra* at 3.

In this case, the Taxpayer offered a printout compiled by BizStats.com showing an average gross profit of 17.4 percent for gasoline stations and convenience stores. There is no evidence, however, explaining how the chart was compiled. Also, the Taxpayer primarily sold beer and wine, and did not sell gasoline. Consequently, the chart showing the average gross profit for combined gasoline station/convenience stores is not applicable.[1]

As indicated, the burden was on the Taxpayer to show not only that the 35 percent mark-up applied by the Department is incorrect, but also to present evidence showing the correct mark-up. The document obtained from BizStats.com is insufficient for that purpose. The Department arrived at the 35 percent mark-up based on prior audits in the Auburn/Opelika area. The mark-up is reasonable, and is affirmed.

[1] A business' gross profit is also different than the business' mark-up. The average gross profit on the chart offered by the Taxpayer was 17.4 percent. However, to achieve that profit, the 82.6 percent cost of goods sold must be marked up by over 21 percent. For example, if the Taxpayer had purchased a quantity of beer for $82.60 at wholesale and sold it for $100 at retail, the mark-up would have been approximately 21.1 percent.

The Taxpayer argues that all of its sales receipts were deposited into its bank account, and also that some money from nontaxable sources was also deposited. It contends that its total bank deposits during the audit period were substantially less than the gross sales amounts as computed by the Department, which, according to the Taxpayer, shows that the Department's estimated sales figures are exaggerated. However, bank deposits cannot be relied on to establish sales, and especially cash sales, because there is no way to verify that all sales receipts were deposited into the account. The Taxpayer could have used some of its cash receipts to pay employees or vendors, or for other purposes.

A purchase mark-up audit admittedly provides only an estimate of a retailer's sales. However, it is the best method of computing a retailer's liability in the absence of adequate records. The method is straightforward. A retailer's purchases are determined from vendor records. A reasonable mark-up is then applied to determine total sales. The Taxpayer's average mark-up during the audit period may have been something less than 35 percent, but it also could have been more. Under the circumstances, the Department audit was properly conducted (except for any math or transposition errors the Taxpayer may point out), and is affirmed.

The Taxpayer also claims that the Department examiner made numerous math and transposition errors in his audit. The Department agreed that if any errors were made, it would correct them and reduce the Taxpayer's liability accordingly. The Taxpayer was directed to provide the Department with a list of the examiner's mistakes after the November 10 hearing. The Administrative Law Division has not been informed that such a list has been submitted. The Taxpayer should provide a list of the audit errors to the

Administrative Law Division by April 28, 2006, with a copy to Assistant Counsel McNeill. The Department should review the list and respond by May 19, 2006.

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 income tax 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).

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.").

The evidence in this case establishes that the Taxpayer substantially underreported its taxable sales during the audit period. The Taxpayer purchased on average $97,427 worth of alcohol and merchandise at wholesale during each month of the December 2000 through December 2002 audit period. See, Schedules B and C of Dept. Ex. 1. Even if a 17.4 percent mark-up is applied, as claimed by the Taxpayer, the Taxpayer's retail sales would have averaged approximately $115,000 per month. However, the Taxpayer's monthly sales as reported averaged only approximately $55,600 per month during the period. See, billing sheet in Dept. Ex. 1 (4 percent tax paid x 25 equals gross receipts). Obviously, the Taxpayer could not have stayed in business if his wholesale purchases had exceeded his retail sales by an average of more than $41,000 in each month of the audit period.

The Taxpayer produced some cash register tapes at the November 10 hearing, although it conceded that it did not have complete tapes for any of the months in issue. The May 2002 tapes totaled $94,120. However, the Taxpayer reported and paid only $2,844 in sales tax in May 2002, which reflects sales of $71,100. Likewise, the Taxpayer's partial tapes for October 2002 showed sales of $115,238. But the Taxpayer reported and paid $3,010 in sales tax in the month, which reflects sales of only $75,250. Consequently, even the Taxpayer's own partial records show that it substantially underreported tax during the audit period.

The Taxpayer's owner attempted to explain why not all of the sales had been reported by claiming that he relied on college students he hired to total his cash register tapes for him. He testified that he just reported and paid tax on the amounts that were given to him by the students. See, R. 95 – 100. However, in response to a question

concerning how he did his taxes during the audit period, the owner responded – "Well, I added up my cash register tapes." R. 95. He then went on to explain that he usually relied on his student employees to add his cash register tapes.

It is unbelievable that the owner of a retail business that sold beer and wine on a college campus would, without question, rely on college students to correctly add up his daily sales amounts. I can also think of no plausible reason why college students given that responsibility would, without the knowledge and consent of the owner, consistently and substantially underreport the business' sales in each month. The owner certainly knew or had an approximate idea how much beer, wine, and groceries he purchased each month, and certainly he knew how much money he took in during a month. With that knowledge, he would certainly realize that the sales amounts he was reporting to the Department were substantially less than his average monthly purchases. Under the circumstances, I must conclude that the Taxpayer's owner knew that his business was substantially underreporting sales tax during the period. The above is reinforced by the fact that the Taxpayer failed to initially provide all of his records to the Department examiner. The examiner stated in his closing remarks in the audit report, Dept. Ex. 1, that the Taxpayer "has been uncooperative by not providing the information requested to complete this audit."

A similar situation was involved in *Carter v. State of Alabama*, S. 04-653 (Admin. Law Div. O.P.O. 2/8/06). The taxpayer in *Carter* claimed that her records had been lost. The evidence also established that the taxpayer had substantially underreported her monthly sales. The Administrative Law Division affirmed the 50 percent fraud penalty, as follows:

> 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.
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> 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.

Carter at 7.

Because the finding of fraud is affirmed, it is irrelevant that the waivers executed by the Department are invalid. If a taxpayer is guilty of fraud, the Department may assess tax at any time. Section 40-2A-7(b)(2).

As discussed, the Taxpayer claims that the examiner made substantial errors in his audit. If that is correct, and the Taxpayer's monthly purchases and tax paid per the audit are found to be substantially incorrect, the above finding of fraud may be reconsidered. The Taxpayer should submit its list of the alleged audit errors to the Administrative Law Division by April 28, 2006, with a copy to Assistant Counsel McNeill. An appropriate Order will be issued after the Department responds.

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 March 17, 2006.

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BILL THOMPSON
Chief Administrative Law Judge