AMERICAN LEGION POST 322 ' STATE OF ALABAMA
P.O. Box 1134 DEPARTMENT OF REVENUE
Gadsden, AL 35902, ' ADMINISTRATIVE LAW DIVISION

Taxpayer, ' DOCKET NO. S. 00-701

v. '

STATE OF ALABAMA '
DEPARTMENT OF REVENUE.

FINAL ORDER

The Revenue Department assessed State and local sales tax against American Legion Post 322 (ATaxpayer@) for February 1994 through January 2000. 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 June 25, 2001 in Birmingham, Alabama. Lavell Stacy represented the Taxpayer. Assistant Counsel Wade Hope represented the Department.

ISSUE

The issue in this case is whether the Department properly computed the Taxpayer=s sales tax liability for the subject months using an indirect purchase mark-up audit.

FACTS

The Taxpayer operates a private lounge in Gadsden, Alabama, at which it sells beer, liquor, soft drinks, and snacks to its members and their guests. The Taxpayer also occasionally charges admission to special events at its facility.

The Department audited the Taxpayer for the subject period, and requested records from which the Taxpayer=s sales tax liability could be verified. The Taxpayer provided some purchase invoices and bank records, but no cash register tapes or other sales records. The Department examiner determined that the records were insufficient, and consequently

computed the Taxpayer=s liability using a purchase mark-up audit, as follows:

The examiner reviewed the ABC Board records to determine the amount of liquor purchased by the Taxpayer in each month of the audit period. The examiner discovered that the Taxpayer=s monthly liquor purchases alone exceeded the total gross receipts reported by the Taxpayer on its monthly sales tax returns.

The examiner first reduced the Taxpayer=s total liquor purchases by 5 percent to allow for spillage. She taxed 10 percent of the drinks at cost to allow for liquor withdrawn for use by the Taxpayer. She computed the gross receipts from the rest of the liquor by first determining how many 11/2 ounce drinks could be poured from the bottles. She then multiplied the number of drinks by the price charged by the Taxpayer for each type of liquor drink. The various drink prices were provided by the Taxpayer. The examiner taxed 90 percent of the liquor at the regular sale price listed by the Taxpayer. The remaining 10 percent was taxed at a reduced happy hour price. The Taxpayer sold pint bottles by the bottle only. Consequently, the examiner taxed all pints at the listed sales price provided by the Taxpayer.

The examiner determined the Taxpayer=s beer purchases using the records of the Taxpayer=s beer vendors. She computed the Taxpayer=s total beer sales by multiplying the number of beers purchased by the Taxpayer in each month by the lowest price charged by the Taxpayer. She priced 90 percent of the beer at the lowest regular price of $2.00 per can or bottle. The remaining 10 percent was priced at the reduced happy hour price of $1.50 per can or bottle.[1]

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[1]The Taxpayer sold premium and foreign beers for much more than the minimum $2.00 price used by the examiner.

The examiner did not allow the Taxpayer a credit or allowance for theft because there were no police reports or other tangible evidence that theft had occurred. On the other hand, she did not include in the taxable measure any soft drink or snack sales, even though the Taxpayer made such sales during the audit period. The examiner also did not include in the taxable measure any gross admissions to special events held by the Taxpayer.

The examiner initially assessed the Taxpayer for only a three year period. However, because the Taxpayer=s actual liabilities exceeded 25 percent of what it had reported, she applied the special 6 year statute at Code of Ala. 1975, ' 40-2A-7(b)(2)b. February through May 1994 were initially included in the assessment, but were removed because the six year statute expired for those months before the preliminary assessment was entered. The Department also assessed the Taxpayer for the 50 percent fraud penalty levied at Code of Ala. 1975, ' 40-2A-11(d).

ANALYSIS

All taxpayers subject to sales tax are required to keep complete records from which the Department can accurately determine the taxpayer=s correct liability. Code of Ala. 1975, ' 40-2A-7(a)(1). If a taxpayer fails to keep adequate records, the Department can use the best information available to compute the taxpayer=s liability. Code of Ala. 1975, ' 40-2A-7(b)(1)a. Such liability, if reasonable under the circumstances, will be affirmed, and the taxpayer cannot complain that the liability so computed is inexact. See generally, *State of Alabama v. Red Brahma Club, Inc.*, S. 92-171 (Admin. Law Div. 4/7/95), and cases cited therein.

The Taxpayer failed to keep adequate sales records for the audit period. The Department examiner thus properly computed the Taxpayer=s liability using a purchase mark-

up audit. The purchase mark-up audit is a commonly used audit method, and reasonably estimates a taxpayer=s sales tax liability in the absence of adequate records.

The Taxpayer objects generally to the Department audit. The Taxpayer=s current officers concede that during the audit period, the individuals that operated the lounge were guilty of gross mismanagement, and allowed a great deal of inventory theft. They argue that proper controls and security measures are now in effect, and that the Taxpayer should not be burdened with a large tax debt due to the wrongdoings and mismanagement of the prior operators.

The two current officers that testified at the June 25 hearing appear to be honest, sincere individuals. Unfortunately for the Taxpayer, the fact that it is currently being properly managed and is correctly reporting and paying all tax due cannot relieve the Taxpayer of its past liabilities.

The Department also audited the Taxpayer in 1988. The Taxpayer failed to provide any records to the Department at that time. The Department examiner that conducted the audit in issue also audited the Taxpayer in 1988. She instructed the Taxpayer after the first audit to keep adequate records and inventory controls in the future.

The examiner periodically reviewed the Taxpayer=s monthly returns after the first audit to insure that the Taxpayer was properly paying its taxes. She testified that the Taxpayer=s average liability in the late 1980s and early 1990s was $500 to $700 a month, which she considered appropriate. However, the reported amounts dropped to $200 or $300 per month in 1993. They remained low until the Taxpayer received the examiner=s audit notice letter in 1999, at which time the reported amounts increased to $600 or $700 a month. The above indicates that the Taxpayer consistently underreported its taxable gross receipts during the audit period. That is confirmed by the fact that the Taxpayer=s monthly liquor purchases, without mark-up and without considering the Taxpayer=s beer, snack, and soft drink sales, exceeded the total gross receipts reported by the Taxpayer on its monthly returns during the audit period.

The Taxpayer=s tax preparer also knew that the Taxpayer was underreporting its sale tax during the audit period. He prepared the Taxpayer=s returns based on sales figures provided by the Taxpayer=s management. He warned the individuals that operated the lounge during the audit period that the figures being reported were too low. (T. at 13.) Those individuals continued, however, to give the tax preparer the same low sales figures to report to the Department.

The Taxpayer=s only technical objections to the audit are (1) more than 10 percent of inventory was withdrawn for use by the Taxpayer, and thus should have been taxed at cost, (2) the happy hour percentage is too low, (3) the assessment should have been for three years, not six years, and (4) the fraud penalty is not appropriate.

Concerning contentions (1) and (2), the Department examiner was required to estimate the amount of inventory withdrawn for use by the Taxpayer, and also the percentage of happy hour sales, because the Taxpayer failed to provide adequate records. The examiner performed an excellent audit, and the amounts she estimated for inventory withdrawn for use and happy hour sales are reasonable. As indicated, having failed to keep adequate records, the Taxpayer cannot now complain that the examiner=s reasonable estimates are incorrect.

Code of Ala. 1975, '40-2A-7(b)(2)b. allows the Department to assess a taxpayer for six years if the taxpayer omits 25 percent of the amount that should have been reported on a return. The Department audit clearly established that the Taxpayer underreported by more than 25 percent during the months in issue. The Department thus properly assessed the Taxpayer for the six year period.

Code of Ala. 1975, '40-2A-11(d) levies a 50 percent penalty for any underpayment due to fraud. For purposes of the penalty, Afraud@ 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.

The Department is required to prove fraud by clear and convincing evidence. *Bradford v. C.I.R.*, 796 F.2d 303 (1986). AThe 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 failed to maintain adequate records or properly report and pay its sales taxes during the audit period. Those factors are evidence of fraud. It appears, however, that a large part of the underpayment resulted from inventory theft at the lounge. The Taxpayer=s current officers testified that the individuals that operated the lounge during the audit period allowed a great deal of pilferage and theft. The Department was not required to rely on those verbal assertions in computing the Taxpayer=s liability. *State v. Mack*, 411 So.2d 799 (Ala.Civ.App. 1982); *State v. Ludlum*, 384 So.2d 1089 (Ala.Civ.App.), cert. denied 384 So.2d 1094 (Ala. 1980). The testimony was believable, however, and can be considered in determining if the fraud penalty applies. Viewing the circumstances as a whole, the fraud penalty is deleted from the assessments. The five percent negligence penalty levied at Code of Ala. 1975, ' 40-2A-11(c) is instead applied.

The current and future operators of the Taxpayer=s lounge are put on notice that complete and accurate records of purchases, sales, and other gross receipts must be maintained. The Department should closely monitor the Taxpayer=s sales tax returns, and if the Taxpayer fails to properly pay its taxes, it should be dealt with to the fullest extent of the law.

The final assessments, as adjusted, are affirmed. Judgment is entered against the Taxpayer for State sales tax of $56,945.68, and combined local tax of $14,236.47. Additional interest is also due from the date of entry of the final assessments, October 12, 2000.

This Final Order may be appealed to circuit court within 30 days pursuant to Code of Ala. 1975, ' 40-2A-9(g).

Entered July 20, 2001.