CARTER ENTERPRISE, A PARTNERSHIP, AND ITS PARTNERS, NORRIS CARTER, RAYFUS CARTER, AND GRACE COBB RT. 1, BOX 625 NEWBERN, AL 36765	§	STATE OF ALABAMA DEPARTMENT OF REVENUE ADMINISTRATIVE LAW DIVISION
Taxpayer,	§	DOCKET NO. S. 11-965
v.	§	
STATE OF ALABAMA DEPARTMENT OF REVENUE.	§	

FINAL ORDER

The Revenue Department assessed Carter Enterprise ("Taxpayer"), a partnership, and its partners Norris Carter, Rayfus Carter, and Grace Cobb, for State sales tax for April 2008 through June 2010. 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 May 22, 2012. Norris Carter ("owner") represented the Taxpayer. Assistant Counsel Mark Griffin represented the Department.

The Taxpayer operated a night club in Perry County, Alabama during the period in issue. It sold beer and liquor, but no food, at the club. It also sometimes provided a live band or a disc jockey for musical entertainment.

The Department audited the Taxpayer for sales tax for the period in issue and requested records from which it could compute/verify the Taxpayer's liability for the period.[1] The Taxpayer's owner provided some of his cash register tapes, purchase invoices, bank statements, and the partnership's 2007, 2008, and 2009 income tax returns.

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[1] The Department audit also included some months in 2007 and the first three months in 2008. As discussed below, the examiner determined during the audit that the Taxpayer had correctly reported and paid sales tax for those periods. Those periods were thus not included in the final assessment.

The Department examiner determined that the purchase invoices were incomplete, and that the cash register receipts were incomplete/illegible. The total sales reported on the partnership's income tax returns also exceeded the sales as reported on its monthly sales tax returns.

The examiner determined that the sales reported on the Taxpayer's 2007 income tax return agreed with the sales amounts reported on the Taxpayer's sales tax returns for the period. As indicated, the examiner consequently accepted the Taxpayer's 2007 sales tax returns as correct. The 2007 income tax return also showed a 221 percent mark-up, which the examiner also accepted as reasonable and correct. The examiner subsequently applied the 221 percent mark-up to the cost of goods sold as reported on the Taxpayer's 2008 and 2009 income tax returns to determine the sales tax due in those years.

Concerning January through June 2010, the examiner used the Taxpayer's cash register tapes to compute the tax due for January through May of that year. Tapes were not available for June 2010. The examiner consequently computed the tax due for the month by using the Taxpayer's available beer and liquor purchase records and applying mark-ups of 231 percent and 166 percent, respectively.

The Taxpayer's owner testified that a band played at the club maybe five times during the audit period, and that he provided a disc jockey at the club one or two nights a month. He charged his customers $20 admission if he had a band, and $5 if he had a disc jockey. The Taxpayer failed, however, to report and pay sales tax on any of his admission proceeds.

Based on information provided by the owner, the examiner determined that the Taxpayer charged an average of $12.50 for entertainment, and that an average of 60

people paid the admission one time a month. She computed the sales tax due on the admissions using those amounts.

All retail businesses are required to keep adequate sales records from which their sales tax liability can be accurately computed. Code of Ala. 1975, §40-2A-7(a)(1); and specifically Code of Ala. 1975, §40-23-9 relating to sales tax. If a taxpayer fails to keep adequate records, the Department is authorized to compute a taxpayer's liability using the best information available. Code of Ala. 1975, §40-2A-7(b)(1)a. If the Department's computations using the best information available are reasonable, the taxpayer cannot complain that the liability so computed is inexact. *William T. Gipson v. State of Alabama*, P. 95-210 (Admin. Law Div. 01/26/96), citing *Jones v. C.I.R.*, 903 F.2d 1301 (10th Cir. 1990); *Denison v. C.I.R.*, 689 F.2d 777 (10th Cir. 1982); and *Webb v. C.I.R.*, 394 F.2d 366 (5th Cir. 1968).

In this case, the Taxpayer's cash register tapes were incomplete, illegible, and otherwise insufficient. Its purchase invoices were also incomplete because it purchased approximately half of its beer and liquor at retail, and not from wholesale vendors. The Department examiner consequently used the Taxpayer's income tax returns, and information from the Taxpayer's owner, to compute the sales tax due.

The owner did not contest how the Department computed his beer and liquor sales at the May 22 hearing. He did argue, however, that the estimated tax due on his admissions was excessive because he only charged $20 per person on five occasions during the audit period. He also thought that the examiner had assumed that he charged an admissions fee every day he was open, and taxed him accordingly.

The evidence indicates that the Taxpayer charged $5 per person more often than $20 per person for admission to an entertainment event. Consequently, the average of $12.50 used by the examiner may be too high. But the examiner only assumed one admission event per month in computing the tax due. The owner testified that he had a DJ "maybe once, twice a month," in addition to the bands. (T. 13) If it was twice a month, the examiner's admissions estimate was too low.

The Taxpayer had the burden of keeping records showing his admission charges. *Jones v. CIR*, 903 F.2d 1301 (1990). He failed to do so. The examiner's estimate of the Taxpayer's admissions is reasonable under the circumstances, and is affirmed.

The Department also assessed the Taxpayer for the 50 percent fraud penalty levied at Code of Ala. 1975, §40-2A-11(d). The applicability of the fraud penalty was discussed in *Melton v. State of Alabama*, Docket S. 10-376 (Admin. Law Div. 11/4/2010), as follows:

> 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).
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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).
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> 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.").
> *Melton* at 9 – 10.

Department Reg. 810-14-1-.32 also explains when the fraud penalty should apply:

> (2) The term "fraud" shall include instances where there is intentional wrongdoing, usually involving an element of deception. Where direct evidence of fraud is not available, fraud may be determined from the circumstances surrounding the taxpayer's acts or omissions. The burden of proof on the issue of fraud shall be upon the Department. To establish fraud, the Department must clearly and convincingly prove that a tax deficiency is due to fraud with a deliberate intent to evade taxes. Negligence, even if it is gross, does not necessarily establish fraud.

The Department assessed the Taxpayer for the fraud penalty primarily because (1) it failed to keep adequate records; (2) it underreported its sales; (3) it "purchased a large amount of inventory from outside sources to conceal its purchase activity" (Department audit report, Ex. 1 at 4); and (4) it did not report its admission charges.

The owner testified that he maintained daily cash register tapes that he used to compute his sales. Unfortunately, the Department could not use the tapes because "they were not zeroed out each day and amounts were carried over from one day to the next making it impossible to determine sales; a large majority of the tapes were faded and not legible." (T. 21). The above shows that the Taxpayer did maintain cash register tapes, but that they could not be used because there were errors in operating the register, i.e., not zeroing out the daily totals, and the tapes were not properly stored to prevent fading.

Concerning the Taxpayer's purchase of beer and liquor at retail "from outside sources," i.e., Wal-Mart, Sam's Club, etc., the owner explained that he operated on a small budget and was unable to buy a sufficient supply of beer when his wholesale vendor came

by once a week. Consequently, if he ran out during the weekend, he would buy more at a retail outlet.

> ALJ Thompson: Well, tell me about where you buy your liquor and beer.
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> Mr. Carter: Well, when I – when I initially opened, the people that I – that I talked with and bought it, you know, they said that I could buy my beer.
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> And by being a small, day-to-day operation, I – I didn't have – I had background. I got ripped off by my contractor, and I lost a lot of money. So I – I didn't have enough to – to buy a large inventory – to keep a large inventory.
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> And, basically, that sales was closed on the weekend to a small place like me that operate on a day-to-day basis. And I bought my beer – I bought some beer from Sam's, I bought some from Wal-Mart, I bought some from other places.
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> ALJ Thompson: Did you buy some from other distributors?
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> Mr. Carter: Yeah, that's who I bought it from. You know, I would buy like only – they would come through on a Thursday; I would buy – I would buy what I thought I would need for the – the weekend. And then, when I didn't have enough, I would buy from the other places.

(T. 15 – 17).

The evidence shows that the Taxpayer purchased additional beer from various retail outlets due to need, and not in an attempt to conceal some of his purchases, as claimed by the Department. The Taxpayer's owner was also unaware that his admissions charges were subject to sales tax.

The owner is an unsophisticated taxpayer that for tax purposes was negligent in running his business. As indicated above, "[n]egligence, even if it is gross, does not necessarily establish fraud." Reg. 810-14-1-.32(2).

Fraud also usually involves an attempt by the taxpayer to hide or cover-up the fraudulent activity. The Taxpayer's owner in this case may have underreported his sales on

his sales tax returns, but he made no overt attempt to hide that fact. The fact that the partnership's income tax returns reported more sales than it reported for sales tax purposes was a red flag to the examiner showing that the partnership had not correctly reported its sales tax during the audit period. But anyone attempting to evade tax would not knowingly report different sales amounts on their sales tax and income tax returns. Likewise, a person attempting to evade or fraudulently underreport the tax due on admissions would not fail to report and pay any tax on their admission charges. Rather, they would underreport the amounts received and then either not keep records showing the actual admissions receipts, or keep false or partial records verifying the amounts reported.

While the Taxpayer's owner was grossly negligent for tax purposes in operating his business during the audit period, I do not believe under the circumstances that he intentionally and knowingly attempted to evade his sales tax liability during the period. Consequently, the 10 percent failure to pay penalty at Code of Ala. 1975, §40-2A-11(b)(2), and the 5 percent negligence penalty at Code of Ala. 1975, §40-2A-11(c) should apply in lieu of the 50 percent fraud penalty.[2]

The tax due as assessed, plus the above penalties and applicable interest, is affirmed. Judgment is entered against the Taxpayer for $6,907.16. Additional interest is also due from the date the final assessment was entered, November 8, 2011.

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

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[2] The Taxpayer's owner is on notice that he must maintain complete and legible cash register tapes, complete purchase invoices, and other records from which the Department can compute and verify his correct sales tax liability. The fraud penalty may apply in the future if he fails to do so.

Entered June 25, 2012.

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BILL THOMPSON
Chief Administrative Law Judge

bt:dr
cc: Mark Griffin, Esq.
Norris Carter
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