

ASHLAND ENTERPRISES, INC.  
d/b/a CC'S PACKAGE & TOBACCO  
8045 STEMLEY BRIDGE ROAD  
TALLADEGA, AL 35160-8296,

Taxpayer,

v.

STATE OF ALABAMA  
DEPARTMENT OF REVENUE.

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STATE OF ALABAMA  
DEPARTMENT OF REVENUE  
ADMINISTRATIVE LAW DIVISION

DOCKET NO. S. 12-236

### FINAL ORDER

The Revenue Department assessed Ashland Enterprises, Inc., d/b/a CC's Package & Tobacco ("Taxpayer") for State and local sales tax for June 2006 through December 2008. 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 October 11, 2012. The Taxpayer's manager, Nick Surani, represented the Taxpayer.<sup>1</sup> Assistant Counsel Margaret McNeill represented the Department.

The Taxpayer operated a grocery store in the City of Clanton, Alabama from August 2007 through September 2008; a convenience store in the City of Talladega, Alabama from June 2006 through June 2008; and a package store and tobacco outlet in rural Talladega County, Alabama from June 2008 through the end of the audit period.

The Department audited the Taxpayer for State and local sales tax for the period in issue. The Department examiner requested the Taxpayer's business records, including its cash register z-tapes, purchase invoices, bank statements, and income tax returns. The Taxpayer provided its bank statements and income tax returns. It also provided purchase invoices and z-tapes for the package and tobacco store that opened in Talladega County in

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<sup>1</sup> Surani testified at the October 11 hearing that his wife owns 100% of the corporation.

June 2008. The Taxpayer's manager explained at the October 11 hearing that he maintained the records for the other two stores at one of those stores, and that the individual that took over the store in mid-2008 threw the records away before the audit without his permission or knowledge.

Because no records were provided for the grocery and convenience stores, the examiner computed the Taxpayer's liability for the audit period using the records from the package and tobacco store. He first compared the store's monthly z-tape sales totals with the sales amounts reported for the store on the Taxpayer's monthly returns for June through December 2008. The comparison showed that the Taxpayer had not relied on the z-tapes to compute the monthly tax due because the monthly z-tape totals exceeded the reported monthly sales in all but one month (December 2008) of the seven month period.

The examiner next compared the Taxpayer's purchases at the package and tobacco store for June through December 2008 to the sales reported at the store for those months. The purchases significantly exceeded reported sales for the period. The Taxpayer's manager explained that purchases exceeded sales because he was building inventory after taking over the store in June 2008. The manager subsequently provided records showing that the store's inventory had increased by approximately \$80,000 from June through December 2008. The Department adjusted the purchases accordingly. The adjusted (reduced) purchases for the period totaled \$715,144, whereas the reported sales at the store for the period totaled only \$502,090.

Because the Taxpayer failed to provide complete or accurate records, the examiner determined that a purchase mark-up audit would most accurately reflect the Taxpayer's

correct liability for the audit period. He determined the store's purchases using the Taxpayer's purchase invoices for the period. He determined the percentage mark-ups by comparing the purchase invoices and the actual selling prices for seventy items at the store. The resulting mark-ups for the main items sold at the store, i.e., spirits, wine, beer, cigarettes, and miscellaneous items, were 37.36%, 33.20%, 31.39%, 0.51%, and 56.08%, respectively. The composite mark-up was only 12%, however, because cigarettes that had a low mark-up constituted over one-half of the total purchases for the period.

The examiner applied the percentage mark-ups to the store's wholesale purchases, which resulted in projected retail sales of \$745,307 for the period versus reported sales of \$502,090. The examiner thus determined that the Taxpayer had underreported sales at the package and tobacco store by 48.44% during the period. Because the Taxpayer had failed to provide any purchase or sales records for the grocery and convenience stores, the above underreporting factor was also applied to those stores.

The audit resulted in additional State and local tax due of \$32,366 and \$49,654, respectively, plus interest. The Department also assessed the Taxpayer for the 50% fraud penalty at Code of Ala. 1975, §40-2A-11(d) because the Taxpayer had (1) purchased inventory and paid operating expenses primarily in cash, (2) failed to maintain complete books and records, (3) failed to explain why the package and tobacco store sales had been consistently underreported, and (4) failed to adequately explain why the sales as shown on the available z-tapes consistently exceeded reported sales.

All retailers subject to Alabama sales tax are statutorily required to keep complete accurate sales, purchase, and other records from which their correct sales tax liability can

be computed. Code of Ala. 1975, §§40-2A-7(a)(1) and 40-23-9. A retailer's duty to keep sales records is straightforward and simple. The retailer must record all sales on a cash register z-tape and/or on customer invoices or receipts, which may then be compiled onto a monthly sales journal. It is commonly understood that such records must be maintained to allow the Department to verify that the correct amount of sales tax has been reported and paid.

The Taxpayer in this case failed to provide any sales or purchase records for its grocery and convenience stores, and only incomplete records for its package and tobacco store. In such cases, the Department is authorized to compute a taxpayer's correct liability using the most accurate and complete information obtainable. Code of Ala. 1975, §40-2A-7(b)(1)a. The Department can also use any reasonable method to compute the liability, and the taxpayer, having failed in the duty to keep good records, cannot later complain that the records and/or method used by the Department is improper or does not reach a correct result. *Jones v. CIR*, 903 F.3d 1301 (10th Cir. 1990); *State v. Ludlum*, 384 So.2d 1089 (Ala. Civ. App.), cert. denied, 384 So.2d 1094 (Ala. 1980) (A taxpayer must keep records showing the business transacted, and if the taxpayer fails to keep such records, the taxpayer must suffer the penalty for noncompliance). The Department examiner thus properly conducted a purchase mark-up audit to compute the Taxpayer's liability for the subject period.

The purchase mark-up audit is a simple, oft-used Department method of determining a taxpayer's sales tax liability when the taxpayer fails to keep accurate sales records. See generally, *GHF, Inc. v. State of Alabama*, S. 09-1221 (Admin. Law Div.

8/10/10); *Thomas v. State of Alabama*, S. 10-217 (Admin. Law Div. O.P.O. 5/18/10); *Alsede h v. State of Alabama*, S. 03-549 (Admin. Law Div. 11/3/04).

The Department examiner correctly conducted the purchase mark-up audit in this case. He determined the Taxpayer's purchases using the Taxpayer's purchase invoices at the package and tobacco store. And instead of using a standard IRS mark-up estimate, which is common, the examiner conducted a detailed study to determine how much the Taxpayer marked-up the various items sold in the store, which resulted in a relatively low 12 percent composite mark-up.

As discussed, the Taxpayer's manager contends that he did not have records for the grocery and convenience stores because he kept the records at one of those stores, and the person that took over the store in mid-2008 threw them away. The Taxpayer owns the building where the records were stored, and according to the manager, the person that took over the store in June 2008 discarded the records because they were damaged when the water heater at the store burst.

The manager also argued that he received substantial rebates on cigarettes and other tobacco products from his tobacco suppliers, and consequently sold the cigarettes and the other tobacco products for below cost. He also contended that on several occasions he borrowed money that totaled almost \$40,000 from various friends/vendors because he needed help financing the package and tobacco store after it opened in June 2008. He claimed that he borrowed the money when the vendors called on the business, and that he always repaid the money within a couple of weeks. He (or an employee) would ring up the loans on the store's cash register, but would subtract the loan amounts from the

z-tapes when he reported the store's sales on the monthly returns. The manager explained that because the loans on the z-tapes were not reported on the sales tax returns, the register z-tape totals sometimes exceeded his reported sales.<sup>2</sup>

To begin, the examiner did not use or consider the tobacco rebates in conducting the audit. Rather, he computed the tobacco mark-up based on what the Taxpayer paid for the products and what he sold them for to the customers. Consequently, the fact that the Taxpayer received tobacco rebates is irrelevant. It is also irrelevant that the loans were improperly recorded on the z-tapes because the z-tapes also were not used to conduct the audit. As discussed, the examiner otherwise properly conducted the audit. The tax due as computed by the audit is reasonable, and is affirmed.

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

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<sup>2</sup> The Department examiner testified that he was not told about the loans from the four vendors during the audit. He also explained that the z-tapes provided by the manager were the daily total tapes, and thus did not show the individual transactions. He thus could not verify the loans by viewing the tapes.

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 Department assessed the fraud penalty in this case because the Taxpayer dealt primarily in cash, failed to keep complete records for all three stores, had underreported sales per the purchase mark-up audit, and failed to explain to the examiner during the audit why the store’s sales as shown on the z-tapes exceeded reported sales.

A retailer may deal primarily in cash for various reasons, but doing so raises valid suspicions that the retailer is not accurately recording purchases, sales, and other transactions. A retailer’s failure to keep complete and accurate records is also a badge of fraud. The Taxpayer’s manager testified, however, that the records for the grocery and convenience stores were kept in one of those stores, and were thrown away by the person that took over the store from the Taxpayer. The manager explained that the person that

discarded the records told him that he did so because they were water damaged when the water heater at the location burst. Unfortunately, the person that allegedly discarded the records did not testify at the October 11 hearing, nor is there evidence that the water heater at the location was replaced or repaired.

The fact that the tobacco store's z-tape totals consistently exceeded reported sales on its face indicates an intentional underreporting. The manager testified at the October 11 hearing, however, that he had entered approximately \$40,000 in third party loans as sales on the z-tapes, and that he subtracted the loans before recording the store's sales on the Taxpayer's monthly returns. That explanation would at least partially explain the discrepancy in the z-tapes and the reported sales. But again, the individuals that allegedly loaned the manager the money did not testify at the October 11 hearing concerning the loans, and there is no other evidence, i.e., z-tapes showing daily transactions, etc., supporting the manager's testimony concerning the loans.

The factor that best supports the Department's case is that the Taxpayer's retail sales per the audit totaled \$745,307, but the Taxpayer only reported sales of \$502,090 for the period. As indicated, the purchase mark-up audit was properly conducted and is reasonable. Consequently, the fact that the reported sales were consistently and substantially lower than the estimated sales per the audit strongly suggests that there was an intentional underreporting of sales.

This is a close case, but given the fact that the Taxpayer consistently underreported its monthly sales, and that its wholesale purchases, without mark-up, substantially and



consistently exceeded its reported sales, along with the other badges of fraud discussed above, I must find that the Department correctly applied the fraud penalty in this case.

The final assessment is affirmed. Judgment is entered against the Taxpayer for State and local sales tax, fraud penalty, and interest for \$50,913.03 and \$82,022.24, respectively. Additional interest is also due from the date the final assessments were entered, January 17, 2012.

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

Entered January 16, 2013.

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BILL THOMPSON  
Chief Administrative Law Judge

bt:dr

cc: Margaret Johnson McNeill, Esq.  
Nick Surani  
Joe Walls  
Mike Emfinger