CHELSEA A, INC. 4396 Rice Mine Road NE Tuscaloosa, AL 35406-3519,	§	STATE OF ALABAMA DEPARTMENT OF REVENUE ADMINISTRATIVE LAW DIVISION
Taxpayer,	§	DOCKET NO. S. 01-172
v.	§	
STATE OF ALABAMA DEPARTMENT OF REVENUE.	§	

FINAL ORDER

The Revenue Department assessed Chelsea A, Inc. ("Taxpayer" or "corporation") for sales tax for April 1997 through December 1999. 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 March 8, 2002 at the Department's Birmingham Taxpayer Service Center. Sam McCord and Aaron Thomas represented the Taxpayer. Assistant Counsel Mark Griffin represented the Department.

ISSUES

The issues in this case are:

(1) Did the Department correctly compute the Taxpayer's liability for the subject period using the best information available; and

(2) Did the Department correctly apply the 50 percent fraud penalty levied at Code of Ala. 1975, §40-2A-11(d)?

FACTS

The Taxpayer owned and operated two restaurants and a bar in Tuscaloosa, Alabama during the subject period. One of the restaurants, Subs N You, and the bar, Downtown Pub, were adjacent to each other in downtown Tuscaloosa. The other restaurant, Subs N More, was outside of downtown Tuscaloosa. The corporation's president, Carrie Anglin, operated the downtown

restaurant. Her sister, Amy Collins, managed the bar. An unrelated individual managed the other restaurant.

The Department audited the Taxpayer and requested records concerning the three businesses. The Taxpayer provided some purchase invoices, a handwritten sales journal for the bar and another for the two restaurants, some bank statements and checks, and copies of its 1997 and 1998 federal and Alabama income tax returns. The Taxpayer failed to provide any cash register tapes, except for one month relating to the bar and a few tapes concerning the Subs N More location. Collins told the Department examiner that she posted the bar's sales in the bar sales journal at the end of each day using the bar's cash register tapes. Anglin posted the restaurants' daily sales in the restaurant sales journal using the restaurants' tapes. The tapes from all three locations were then discarded because Collins and Anglin claim they did not know they were supposed to keep the tapes. Anglin prepared the Taxpayer's monthly sales tax returns using the sales journal.

The Department examiner investigated to determine if the records provided by the Taxpayer were complete and accurate. Purchase information obtained from the Taxpayer's food and beverage vendors revealed that the purchase invoices provided by the Taxpayer reflected only 58 percent of the Taxpayer's actual purchases in 1998, and only 56 percent in 1999. The examiner discovered that the Taxpayer had reported approximately $107,000 more in gross sales on its 1998 income tax return than it reported on its 1998 sales tax returns. The Taxpayer's representatives could not explain the discrepancy. The examiner also found that some employees and vendors had been paid

in cash, with no verifiable record of payouts. He compared the few available cash register tapes from Subs N More with the Taxpayer's restaurant sales journal, and found that the sales journal reflected only 60 percent of the amounts reported on the tapes.

The examiner concluded from the above evidence that the Taxpayer's records were insufficient to do a direct audit.[1] Consequently, he computed the Taxpayer's liability using a purchase mark-up audit. Generally, a purchase mark-up audit is conducted by taking a retailer's gross wholesale purchases, making various adjustments for spoilage, breakage, theft, etc., if applicable, and then applying a percentage mark-up to determine the estimated gross sales receipts. Tax due is then computed, and a credit is allowed for tax previously paid to arrive at the additional tax due.

In this case, the examiner separately reviewed the bar's liability using purchase information from the ABC Board and the Taxpayer's beer and wine distributors. He determined from those records that the bar's sales had been accurately reported. The examiner thus accepted the bar sales as reported, except he added pool table gross receipts beginning in June 1999 that the Taxpayer had failed to report.[2]

Concerning the food sold in the two restaurants, vendor records showed that the Taxpayer's wholesale cost of food over the audit period exceeded reported retail sales by over $100,000. The examiner thus rejected the

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[1]The examiner testified that in his 23 years as an auditor, this case presented one of the worst cases of recordkeeping he has ever encountered. As a result, it took him 260 work hours to gather information and complete the audit.

[2]Pool table receipts are subject to the gross receipts "sales tax" on public places of amusement levied at Code of Ala. 1975, §40-23-2(2). The examiner did not tax the pool gross receipts before June 1999 because the tables were owned by someone else, and the Taxpayer only received a commission. The examiner apparently determined that before June 1999, the owner of the tables had paid the gross receipts tax in full.

Taxpayer's food sales as reported, and

instead reconstructed the food sales using vendor purchase information. From total food purchased, the examiner first allowed for 2 percent spoilage, which he testified is average in the industry. He then subtracted the cost of the food consumed by the Taxpayer's employees, which is taxable at cost.[3]

In determining the food mark-up, the examiner obtained information from other restaurants in the area. He found that wholesale food cost usually constituted 30 to 35 percent of the retail sales price of the food. IRS information also indicated an average wholesale food cost of 30 to 35 percent. The examiner thus applied a 37 percent food cost, which equates to a 169 percent mark up.[4] After applying the mark up, the food consumed by the Taxpayer's employees was added back at cost to arrive at the taxable measure. The examiner then computed the gross tax due for the period, and allowed a credit for tax previously reported and paid. The additional tax due totaled $50,223.27. The examiner also added a 50 percent fraud penalty, but only concerning the tax underreported in the two restaurants.

Neither Anglin or Collins testified at the March 8 hearing. The Taxpayer's representative concedes that the Taxpayer failed to keep adequate records during the subject period. He argues, however, that the Taxpayer's food cost as a percentage of

[3]Tangible personal property, including food, purchased at wholesale and later withdrawn for use by the wholesale purchaser is taxable at cost pursuant to the sales tax "withdrawal" provision, Code of Ala. 1975, §40-23-1(a)(10). See generally, *State v. Morrison Cafeterias Consolidated, Inc.*, 487 So.2d 898 (Ala. 1985).

[4]The examiner used a 37 percent food cost ratio because he thought it was supportable and gave the Taxpayer a benefit because a 30 percent food cost ratio would have equated to a larger 233 percent mark-up.

sales price was much higher than the 37 percent estimated by the Department examiner. Higher food cost as a percentage of sales price would translate into a lower markup, and thus less tax due.

CPA Bill Mitchell testified for the Taxpayer. Mitchell has handled the Taxpayer's finances since October 2000. The daily receipts from all three businesses are deposited into a trust account controlled by Mitchell. Mitchell pays the Taxpayer's creditors from that account. Mitchell also maintains the Taxpayer's purchase invoices, cash register tapes, and other pertinent records.

Mitchell is familiar with how restaurants operate because he handles several other restaurants in the Tuscaloosa area. He concedes that a 30 to 35 percent food cost as a percentage of sales price is the industry standard. He claims, however, that Anglin and the other individuals that operate the two restaurants are "clueless" about how to run a business, and consequently that food cost as a percentage of retail sales price is much greater than the industry average. (T. at 60.) Mitchell claims that the Taxpayer's cost of food has averaged approximately 60 percent since he took over the Taxpayer's business in October 2000. He contends that some food cost as a percentage of sales price would have applied during the audit period, and that based on a 60 percent food cost, the additional tax due for the audit period is only $13,741.81.

ANALYSIS

Issue (1). Is the Department's audit correct?

It is common knowledge that any business making retail sales is required to keep complete, contemporaneous records showing sales and/or gross receipts subject to sales tax. Code of Ala. 1975, §§40-2A-7(a)(1) and 40-23-9. Those records should include all purchase invoices and cash register tapes or other contemporaneous records evidencing all retail sales.

If a taxpayer fails to keep adequate records, the Department is authorized to compute the taxpayer's liability using the best information available. Code of Ala. 1975, §40-2A-7(b)(1)a. An assessment based on the best available information is *prima facie* correct, and the burden is on the taxpayer to prove it is incorrect. Code of Ala. 1975, §40-2A-7(b)(5)c. Unsupported verbal assertions are not sufficient to overcome the *prima facie* correctness of a final assessment. *State v. Ludlum*, 384 So.2d 1089 (Ala.Civ.App.), *cert*. denied, 384 So.2d 1094 (Ala. 1980). If a taxpayer fails to keep records from which an exact liability can be computed, a taxpayer cannot then complain that the Department's calculations based on the best available information are inexact or excessive. *Jones v. C.I.R.*, 903 F.2d 1301 (1990); *Adamson v. Commissioner*, 745 F.2d 54 (1984).[5]

The Taxpayer's CPA is a competent individual that sincerely believes that the food mark-up applied by the Department examiner is excessive. However, his conclusions are based on his dealings with the Taxpayer beginning almost a year after the end of the audit period. Consequently, he can only speculate as to how the Taxpayer might have operated during the audit period. Also, his calculations rely solely on the daily sales information given to him by the Taxpayer. Restaurants and bars are cash intensive businesses, and that information may or may not have been accurate and complete.

The CPA may be correct that the Taxpayer's food cost was more than the 37 percent estimated by the Department examiner. But however sincere, his

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[5]The cited cases involved federal income tax. However, the same principle applies for Alabama tax purposes. See generally, *Watkins v. State of Alabama*, S. 97-111 (Admin. Law Div. 1/9/98); *Red Brahma Club, Inc. v. State of Alabama*, S. 92-171 (Admin. Law Div. 4/7/96); *Gibson v. State of Alabama*, P. 95-210 (Admin. Law Div. 1/26/96).

speculations on the issue are insufficient grounds to reject the *prima facie* correct and reasonable audit conducted by the Department examiner.

In *Ludlum, supra*, the taxpayer was a nurseryman that sold nursery products at retail and also performed certain nontaxable services. The Department taxed the taxpayer on his entire gross receipts because he failed to keep adequate records separating the taxable sales and the nontaxable services. The taxpayer appealed to circuit court.

The taxpayer's accountant testified in circuit court that he used the taxpayer's available deposit slips and invoices from the audit period to categorize receipts as either taxable or nontaxable. He also used a subsequent "test period" during which the taxpayer kept adequate records to determine that 80 percent of the taxpayer's receipts were from nontaxable services. The circuit judge held that the taxpayer's records were adequate, and that the accountant's calculations based on those records were correct.

In a split decision, the Court of Civil Appeals affirmed the circuit court. In doing so, the Court reiterated that the Department is not required to rely on the verbal assertions of a taxpayer, citing *State v. T.R. Miller Mill Co.*, 130 So.2d 185, 190 (1961). It noted, however, that the circuit judge found as a matter of fact that the taxpayer's records were sufficient. Viewing the circuit judge's conclusions with the usual presumption of correctness applicable in ore tenus hearings, the Court refused to reverse the circuit judge's findings.

Although I rarely disagree with the well-reasoned opinions of Judges Holmes and Bradley, I agree with Judge Wright's dissenting opinion in *Ludlum*.

> It is undisputed that the taxpayer kept no records during the assessment years of gross sales, gross receipts or gross receipts of sales from which the amount of tax could be determined. It is admitted that the prima facie correct assessment is disputed not from any valid and definitive record to the contrary, but upon formulas and calculations made from verbal assertions, unitemized

> and unidentified bank deposits, other material not kept as records but assembled after the assessment, and percentages fabricated from so-called test from periods subsequent to the years in question.
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> I do not believe the cases cited as authority by the majority support the decision in this case. Each of them explicitly holds that it is the statutory duty of the taxpayer to keep and preserve sufficient records of gross sales and receipts of his business from which the tax may be determined. In each of the cases it is stated that there were records of invoices (*State v. Mims*) or of sales (*State v. Levey*) in existence at the time of the audit, though unartfully kept, sufficient to make a determination of the tax. There is no case which holds that the assessment may be overcome by subsequent fabrication and calculations from test periods, formulas, verbal assertions or mere assumptions as is found in this case. To overturn the assessment in this case is to ignore the statute requiring the keeping of records and establishing the prima facie correctness of the assessment.

Ludlum, 384 So.2d at 1094.

As indicated, the majority in *Ludlum* affirmed the circuit judge based on the presumption of correctness of his finding of fact that the taxpayer's records were adequate. There is no such presumption in this case. Rather, it is undisputed that the Taxpayer's records were not adequate, and the applicable presumption is that the Department's assessment is *prima facie* correct. Code of Ala. 1975, §40-2A-7(b)(5)c. ("On appeal to the circuit court or the Administrative Law Division, the final assessment shall be *prima facie* correct, and the burden of proof shall be on the taxpayer to prove the assessment is incorrect.") The tax due as computed by the Department examiner is affirmed.

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. §6653. Consequently, federal authority should be followed in determining if the fraud

penalty applies. *State Dept. of Revenue v. Acker*, 636 So.2d 470 (Ala.Civ.App. 1994).

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). However, 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 applied the fraud penalty in this case because the Taxpayer (1) paid vendors and employees in cash, with no record of the amounts paid out, (2) failed to maintain complete bank records, and bank deposits in some months greatly exceeded reported sales, (3) failed to maintain complete purchase records and implausibly destroyed cash register tapes, (4) reported gross sales on its 1998 income tax return that exceeded sales reported for sales

tax purposes during the year by over $100,000, and (5) consistently underreported sales on its monthly sales tax returns.

Fraud was in issue in *State of Alabama v. New Joy Young Restaurant*, Inc. S. 91-246 (Admin. Law Div. 7/8/92), which also involved a restaurant. The Administrative Law Division affirmed the fraud penalty in that case because of the taxpayer failed to keep sales records and consistently underreported sales to the Department.[6] The Administrative Law Division rejected the taxpayer's claim of ignorance concerning business matters, citing *Korecky v. CIR*, 781 F.2d 1566 (1986).

> In defense of the accusation of fraud, Korecky contends that he was inexperienced in financial matters and that he relied on the expertise of his bookkeeper. . . . However, he did have the practical experience gained from operating his own business for over a decade. As such, he cannot be excused from keeping accurate records of sales receipts, which is a rather straightforward bookkeeping task. See, Webb v. Commissioner, 394 F.2d 366, 379-80 . . . .

Korecky, 781 F.2d at 1569.

On the other hand, the Administrative Law Division rejected the Department's application of the fraud penalty in *American Legion Post 322 v. State of Alabama*, S. 00-701 (Admin. Law Div. 7/20/01). In that case, as in this case, the Department was required to compute the taxpayer's liability using a purchase mark-up audit because the taxpayer failed to keep adequate records. ("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." *American Legion*, S. 00-701 at 4.) The Department also added a fraud penalty.

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[6] *New Joy Young* was reversed on other grounds by the Court of Civil Appeals, 667 So.2d 1391 (Ala. 1995). However, the Administrative Law Division's finding of fraud was not reversed.

The current officers of the American Legion testified at the hearing before the Administrative Law Division that the prior officers in control during the audit period allowed a great deal of pilferage and theft, which largely explained the discrepancy in tax due per the purchase mark-up audit. The tax due as computed by the Department audit was affirmed, but the fraud penalty was removed based on that credible and believable testimony.

In this case, the facts strongly suggest that the Taxpayer intentionally underreported sales tax. The need to keep complete records for tax purposes is common knowledge. Consequently, the fact that the Taxpayer failed to maintain its purchase invoices, and practically no cash register tapes, is strong evidence of fraud. Additionally, the wholesale cost of the food purchased by the Taxpayer during the audit period, before mark-up, exceeded reported food sales by over $100,000. The Taxpayer's representatives also could not explain why gross sales reported on the corporation's 1998 income tax return exceeded sales reported on its sales tax returns in that year by over $100,000. Even if a 60 percent food cost is applied, as argued by the Taxpayer, the Taxpayer still admittedly underreported tax by $13,741.81, or an average of $416 per month, during the 33 month audit period. That equates to unreported sales of $10,400 per month. Such a consistent and substantial underreporting of taxable sales cannot plausibly be explained away as due to ignorance or sloppy business habits.

Anglin and/or Collins could have testified under penalty of perjury at the March 8 hearing and attempted to explain their failure to keep good records and the discrepancies discussed above. Perhaps their testimony would have been adequate to offset the strong circumstantial evidence of fraud. See, *American Legion, supra*. They failed to do so. The fraud penalty is affirmed.

The final assessment is affirmed. Judgment is entered against the Taxpayer for tax, penalty, and interest of $82,142.27. Additional interest is also due from the date of entry of the final assessment, January 9, 2001.

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

Entered May 29, 2002.

BILL THOMPSON
Chief Administrative Law Judge

bt:dr
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