ALABAMA TAX TRIBUNAL

DEVA, LLC, d/b/a ANNA'S WAY,	§	
	§	
Taxpayer,	§	DOCKET NO. S. 15-1816-JP
v.	§	
STATE OF ALABAMA DEPARTMENT OF REVENUE.	§	

OPINION AND FINAL ORDER

Deva, LLC (the "Taxpayer"), appealed to the Alabama Tax Tribunal from the entry by the Alabama Department of Revenue of two final assessments – one for state sales tax and one for the prepaid wireless service charge. The taxability of charges for prepaid wireless service was in litigation in two Alabama circuit courts, also. Thus, the Tax Tribunal held Deva's appeal in abeyance pending the outcome of those cases. Both circuit court cases ultimately were decided in favor of the taxability of the service charges, with the later case being concluded in 2018. *See Alabama Dep't of Revenue v. Downing*, 272 So.3d 184 (Ala. Civ. App. 2018). Therefore, Deva conceded that assessment, and the case proceeded on Deva's sales-tax challenge.

The sales-tax assessment covers March 2009 through December 2014 and includes tax, interest, and a fraud penalty, for a total assessment amount of $234,822.05. A hearing was conducted in January 2019, followed by the filing of briefs.

Questions Presented

In certain situations, the Revenue Department is authorized to calculate the correct amount of tax owed by a taxpayer using "the most accurate and complete information

reasonably obtainable by the department." The Revenue Department then may enter a preliminary assessment for that amount of tax, plus penalties and interest. Generally, a preliminary assessment may be entered only for the preceding three-year period. But the assessment period may be extended to six years, if the taxpayer omitted more than 25 percent from the taxable base as reported on a return. And if an underpayment is due to fraud, a penalty is added to the assessment that equals 50 percent of the tax underpayment that was fraudulent.

Here, the questions are:

1. Whether the Taxpayer proved that the Revenue Department erred in estimating the Taxpayer's taxable sales?

2. Whether the Taxpayer omitted more than 25 percent from the taxable base that it reported on its returns?

3. Whether the Revenue Department proved that the Taxpayer's underpayment of tax was fraudulent?

Law

Alabama law imposes a privilege or license tax – known as the sales tax – on those who are "engaged . . . in the business of selling at retail any tangible personal property whatsoever. . ." *See* Ala. Code § 40-23-2(1). The seller is required to add the tax to the sales price of the item and collect the tax from the purchaser, pursuant to Ala. Code § 40-23-26(a). Then, the seller generally is required to report and remit the tax monthly. Ala. Code § 40-23-7(a).

The pertinent statutes regarding the Revenue Department's audit and assessment functions read as follows:

> (1) In addition to all other recordkeeping requirements otherwise set out in this title, taxpayers shall keep and maintain an accurate and complete set of records, books, and other information sufficient to allow the department to determine the correct amount of value or correct amount of any tax, license, permit, or fee administered by the department. . .
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> (2) The department may examine and audit the records, books, or other relevant information maintained by any taxpayer or other person for the purpose of computing and determining the correct amount of value or correct amount of any tax, license, or fee administered by the department. . .

Ala. Code § 40-2A-7(a)(1) – (2).

> (b) *Procedures governing entry of preliminary and final assessments; appeals therefrom.*
>
> (1) ENTRY OF PRELIMINARY ASSESSMENT; FINAL ASSESSMENT OF UNCONTESTED TAX; EXECUTION OF PRELIMINARY AND FINAL ASSESSMENTS.
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> a. If the department determines that the amount of any tax as reported on a return is incorrect, or if no return is filed, or if the department is required to determine value, the department may calculate the correct tax or value based on the most accurate and complete information reasonably obtainable by the department. The department may thereafter enter a preliminary assessment for the correct tax or value, including any applicable penalty and interest.
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> . . .
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> (2) TIME LIMITATION FOR ENTERING PRELIMINARY ASSESSMENT. Any preliminary assessment shall be entered within three years from the due date of the return, or three years from the date the return is filed with the department, whichever is later, or if no return is required to be filed, within three years of the due date of the tax, except as follows:
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> a. A preliminary assessment may be entered at any time if no return is filed as required, or if a false or fraudulent return is filed with the intent to evade tax.
>
> b. A preliminary assessment may be entered within six years from the due date of the return or six years from the date the return is filed with the department, whichever is later, if the taxpayer omits from the taxable base an amount properly includable therein which is in excess of 25 percent of the amount of the taxable base stated in the return.

. . .

Ala. Code § 40-2A-7(b)(1) – (2).

> (d) *Underpayment due to fraud*. If any part of any underpayment of tax required to be shown on a return is due to fraud, there shall be added to the tax an amount equal to 50 percent of that portion of the underpayment which is attributable to fraud.
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> For purposes of this section, the term "fraud" shall have the same meaning as ascribed to the term under 26 U.S.C. Section 6663, as in effect from time to time.

Ala. Code § 40-2A-11(d).

Facts

Trial testimony showed that the Taxpayer filed a state sales-tax return for each and every month of the audit period. However, on audit, it was discovered that the Taxpayer kept "z-tapes," which record each transaction processed by a cash register, for only 37 months of the 70-month audit period and had no z-tapes or other records for the other 33 months. Of the 37 months with z-tapes, there were 2 months for which some daily z-tapes were missing. In short, the Taxpayer maintained a complete set of records by which its taxable sales could be determined for only 50 percent of the months under audit. (During the hearing, the parties agreed that z-tapes, which at other times were referred to as x-tapes, were the best method for determining a taxpayer's taxable sales.)

Also, the amount of taxable sales reported on each month's return for which z- tapes existed was significantly lower than the amount of taxable sales shown on the corresponding z-tapes. In fact, the Revenue Department's examiner testified that a comparison of the totals of those amounts showed an underreporting of taxable sales by approximately 62 percent. The examiner then applied that percentage to the amounts

reported on the monthly returns for which there were no z-tapes to calculate the Taxpayer's taxable sales for each of those months. Because the Taxpayer's underreporting exceeded 25 percent, the Revenue Department extended the audit period beyond the normal 3-year period. The Revenue Department also imposed the 50 percent fraud penalty.

During the hearing, the Revenue Department introduced a report of an audit that was performed on this same business of the Taxpayer for the previous periods of October 2006 through October 2008. In that report, the auditor stated that, although the Taxpayer kept a complete set of z-tapes, the Taxpayer based its taxable measure on the amount of its bank deposits. In comparing the z-tapes with the amounts reported on the corresponding returns, the auditor determined that the Taxpayer had underreported taxable sales by 49 percent. Thus, the Revenue Department added the fraud penalty to the assessment of the previous audit period.

Analysis

Estimating taxable sales

As quoted, the Taxpayer was required to maintain a complete set of records from which the correct amount of its sales-tax liability could be determined. But the Taxpayer maintained a complete set for only half of the months under audit, and the Taxpayer ignored those records in reporting taxable sales on its returns. Instead, for each month, the Taxpayer reported a taxable-sales figure that was substantially less than the correct figure recorded on the z-tapes. The Taxpayer had no explanation for its underreporting, proposing only that there could have been some errors in keying items into its cash register and stating that the Taxpayer got the monthly sales figures that it reported on its returns from its accountant.

In its brief, the Taxpayer contests the application of the 62 percent underreporting percentage to the months for which the Taxpayer had no records. (The Taxpayer does not contest the application of that percentage to the months for which it kept z-tapes.) Specifically, the Taxpayer notes that, of the 33 months with no z-tapes, 14 are estimated by the Revenue Department to have higher gross receipts than the highest monthly amount for the periods with z-tapes. The Taxpayer also notes that the average monthly gross receipts shown by z-tapes is approximately $128,000, but that the average monthly gross receipts for the periods with no z-tapes is approximately $142,000. Also, the Taxpayer argues that its annual sales pattern based on z-tape data shows that sales were less in the earlier years of the audit period and increased as time went on, unlike the pattern estimated by the Revenue Department.

In short, the Taxpayer argues that "no evidence" supports or justifies the Revenue Department's estimates for periods without z-tapes and that the Taxpayer has overcome the presumption of correctness of the final assessment, citing *84 Lumber Co., Inc. v. City of Northport*, 250 So.3d 567 (Ala. Civ. App. 2017). The Taxpayer also claims that the Revenue Department, in estimating the amount of tax due, misstated its duty as being based on the "best information available," when the correct statutory duty is to base estimates on the "most accurate and complete information reasonable obtainable." In its Reply Brief, the Taxpayer argues that, "[w]here more than one data set is available, the Department cannot simply choose the set that yields the most revenue. The legislature requires it to choose the most accurate and complete information."

The Revenue Department defends its estimation of taxable sales, and thus additional tax due, by stating that it simply determined the percentage of error that was calculable from the months with z-tapes and then applied that percentage of underreporting to the amounts reported on returns for which there were no corresponding z-tapes.

Despite using the phrase "best information available," the Revenue Department estimated the Taxpayer's taxable sales using the "most accurate and complete information reasonable obtainable;" *i.e.*, the Taxpayer's own z-tapes, which the Revenue Department compared to the Taxpayer's own returns to calculate an average percentage of underreporting. The Revenue Department then applied that percentage to the periods for which there were no z-tapes. The Taxpayer essentially acknowledges the validity of using its z-tape data by not disputing the Revenue Department's estimation of taxable sales for the months for which there were z-tapes.[1] For the disputed periods, it was the Taxpayer that failed to maintain z-tapes. The Taxpayer's complaint now that the Revenue Department's estimates are too high is unpersuasive, especially considering that the Taxpayer had no plausible explanation for its significant underreporting. *See State v. Ludlum*, 384 So.2d 1089, 1091 (Ala. Civ. App. 1980) (stating that, "[w]here there are no proper entries on the records . . ., the taxpayer must suffer the penalty of noncompliance and pay on the sales not so accurately recorded as exempt") (quoting *State v. T.R. Miller*

[1] The Taxpayer's reliance on *84 Lumber* is misplaced. There, the taxpayer had the records by which its liability to various local jurisdictions could be determined. Thus, the tax agencies' use of a sampling method instead of the taxpayer's totality of invoices was rejected by the appellate court. *Id.* at 574-76. Here, the Taxpayer lacked any information by which its taxable sales for the disputed months could be determined directly, thus creating the need for the Revenue Department to estimate the Taxpayer's sales.

Mill Co., 130 So.2d 185, 190 (Ala. 1961)). This is not to say that a taxpayer never can show that a tax agency's estimates are too high. Here, however, this Taxpayer has not proven that the Revenue Department erred in its estimation of the Taxpayer's taxable sales.

Extending the statute of limitations

Based on the foregoing, the Taxpayer clearly omitted more than 25 percent from its taxable base, thus allowing the Revenue Department to extend the audit period.

The fraud penalty

Ala. Code § 40-2A-11(d) levies a 50 percent penalty for any underpayment of tax due to fraud. The burden of proof in an assessment of a fraud penalty falls on the Revenue Department. Ala. Code § 40-2B-2(k)(7). 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 existence of fraud must be determined on a case-by-case basis 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). Consequently, fraud may be established from "any conduct, the likely effect of which would be to mislead or conceal." *Id.* The mere underreporting of gross receipts is itself insufficient to establish a finding of fraud, unless there is evidence of repeated understatements in successive periods when coupled with other circumstances showing an intent to conceal or misstate sales. *Barrigan v. C.I.R.*, 69

F.3d 543 (1995).

A taxpayer's failure to keep adequate books and records, a taxpayer's failure to furnish auditors with records or access to records, the consistent underreporting of tax, and implausible or inconsistent explanations regarding the underreporting are strong indicia of fraud. *See Solomon v. C.I.R.,* 732 F.2d 1459 (1984); *Wade v. C.I.R*., 185 F.3d 876 (1999). Ignorance is not a defense to fraud where the taxpayer should have reasonably known that its taxes were being grossly underreported. *Russo v. C.I.R.,* T.C. Memo 1975-268; *Temple v. C.I.R*., 67 T.C. 143 (1976).

Here, the odd – and problematic – fact for the Taxpayer is that it actually kept a complete set of records by which to determine its taxable sales for half of the audit period, yet completely disregarded those records and instead significantly underreported its sales for those months. For the other months, the Taxpayer did not maintain records, which is indicative of fraud. And, as stated, the Taxpayer had no plausible explanation for its underreporting.

These facts alone prove fraud. But here, unlike in many other fraud-penalty cases, the Revenue Department had imposed the fraud penalty on this Taxpayer for periods that ended only a few months before this audit period began. And the underreporting percentage for the current audit period is higher than the percentage for the previous periods. Thus, the Taxpayer was on direct notice that its significant underreporting could subject it to a penalty of 50 percent of the assessed tax. Yet it underreported anyway. The fraud penalty is upheld.

Conclusion

The final assessment of state sales tax is affirmed. Judgment is entered against the Taxpayer for $234,822.05, plus additional interest from the date of the assessment.

The final assessment of prepaid wireless service charge is affirmed. Judgment is entered against the Taxpayer for $3,502.80, plus additional interest from the date of the assessment.

It is so ordered.

This Opinion and Final Order may be appealed to circuit court within 30 days, pursuant to Ala. Code § 40-2B-2(m).

Entered August 27, 2020.

/s/ *Jeff Patterson*
JEFF PATTERSON
Chief Judge
Alabama Tax Tribunal

jp:dr
cc: Deva, LLC
James M. Sizemore, Jr., Esq.
Mary Martin Mitchell, Esq.