

MOM'S KITCHEN, A PARTNERSHIP §
AND ITS PARTNERS, KAY R. CORTEZ,
MEDARDO CORTES, AND ALL §
OTHER PARTNERS

Taxpayer,

v.

STATE OF ALABAMA §
DEPARTMENT OF REVENUE. §

STATE OF ALABAMA
DEPARTMENT OF REVENUE
ADMINISTRATIVE LAW DIVISION

DOCKET NO. S. 06-471

FINAL ORDER

The Revenue Department assessed Mom's Kitchen ("Taxpayer"), a partnership, and its partners, Kay R. Cortez, Medardo Cortes, and all other partners, for State sales tax for January 2002 through December 2004. 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 17, 2006. Mike Higdon and Phillip Hornsby represented the Taxpayer. Assistant Counsel Wade Hope represented the Department.

The Taxpayer operated a restaurant in Hartford in Geneva County, Alabama during the period in issue. It also operated a restaurant in Daleville from October 2002 until April 2003. The Department audited the Taxpayer for sales tax and requested its records for the period. The Taxpayer's partners provided the examiner with monthly recaps of the business' purchases and sales, and some bank records. They failed, however, to submit any supporting records such as purchase invoices, cash register tapes, or other sales records.

A partner and the business' accountant informed the Department examiner that the business did not have any sales records. They also indicated that the business routinely paid its employees' wages and many of its vendors in cash. The examiner consequently

computed the Taxpayer's sales tax liability using an indirect purchase mark-up audit.

The examiner determined the Taxpayer's purchases from information provided by the Taxpayer's vendors. Some purchases were estimated because some vendor records were incomplete. The examiner then applied the standard IRS mark-up relative to restaurants in determining the Taxpayer's taxable sales. She then allowed a credit for tax paid on inventory purchased from a vendor and for tax previously reported and paid to the Department to arrive at the additional tax due. The 50 percent fraud penalty and interest were also added.

The Taxpayer's representatives concede that because the Taxpayer failed to maintain records during the subject period, they cannot challenge the amount of tax due as computed by the Department examiner. They contend, however, that the fraud penalty was incorrectly assessed.

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 income tax 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 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.”).

Kay Cortez testified that she and her husband had operated a restaurant in Florida before moving to Alabama. She explained that they failed to maintain sales and other records at the restaurant because they were “not paying attention.” (T. 72) She stated that her husband is Spanish and was not familiar with the importance of keeping records. Finally, she claimed that her purchases as determined by the examiner were inflated because she regularly purchased food from vendors for a friend that operated a nearby restaurant. Unfortunately, no admissible evidence was submitted supporting that claim.

The Taxpayer’s partners told the Department examiner during the audit that their restaurant was their only source of income. To determine if the partners had correctly reported their sales, the examiner compared the partners’ annual expenditures to the sales amounts reported in the year. The expenditures included the verified amounts paid to vendors, amounts estimated by the partners as having been paid in cash for wages,

building rent, mortgage payments, etc., and various other expenditures that were either documented or estimated by the partners.

The partners later told the examiner that they had received \$2,000 a month during the subject years from an estate in Mexico, and also a \$15,000 loan from a relative in 2003.

The examiner deducted or reduced the partners' expenditures by the above amounts (\$24,000, \$39,000, and \$24,000 in 2003, 2003, and 2004, respectively), even though the partners failed to prove that they had actually received the money.

The above computations showed that the partners spent \$230,203 in 2002, \$250,032 in 2003, and \$284,555 in 2004. They reported sales receipts of \$192,281, \$174,185, and \$187,240, respectively, in those years. The difference in the amounts spent and the sales reported, i.e., the unexplained income, totaled \$37,922 in 2002, \$75,847 in 2003, and \$97,415 in 2004.

Kay Cortez testified openly at the October 17 hearing. But based on the cumulative circumstantial evidence in this case, I must conclude that the fraud penalty was correctly applied. The partnership failed to keep any sales or purchase records, which, as indicated, is evidence of fraud. Ms. Cortez's excuse that she and her husband failed to keep records because they were not paying attention is insufficient. Mr. Cortez may have been unaware of the importance of keeping records, but Ms. Cortez is an intelligent person that had previously been required to pay sales tax and keep records at her restaurant in Florida. The partnership's failure to keep records thus supports a fraud finding.

The partners also received substantial amounts of unexplained income in the subject years. They admittedly paid their vendors, employees, and others in cash. The examiner

accepted the partners' estimates concerning their cash payments when she compared the partners' expenditures with their reported sales. However, they could have made additional expenditures that the examiner failed to consider in her comparison. She also allowed the partners credit for \$87,000 they claim to have received from relatives in the subject years, even though no proof was submitted supporting the claim. But even if the examiner's comparison is deemed to be complete and accurate, it still shows that the partners had substantial unexplained and unreported income in the subject years. That income can only be attributed to intentionally unreported sales.

The final assessment, including the fraud penalty, is affirmed. Judgment is entered against the Taxpayer for \$27,368.28. Additional interest is also due from the date the final assessment was entered, October 14, 2005.

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

Entered April 13, 2007.

BILL THOMPSON
Chief Administrative Law Judge

bt:dr

cc: J. Wade Hope, Esq.
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