RICHARD B. MELTON, d/b/a POPLAR DAWG'S EATERY 10277 COUNTY ROAD 34 DADEVILLE, AL 36853-4824,	§ §	STATE OF ALABAMA DEPARTMENT OF REVENUE ADMINISTRATIVE LAW DIVISION
Taxpayer,	§ §	DOCKET NO. S. 10-376
v.	§	
STATE OF ALABAMA DEPARTMENT OF REVENUE.	§	

FINAL ORDER

The Revenue Department assessed Richard B. Melton ("Taxpayer"), d/b/a Poplar Dawg's Eatery, for State sales tax for February 2003 through January 2009. 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 September 2, 2010. The Taxpayer and his attorney, Jim Sizemore, attended the hearing. Assistant Counsel Margaret McNeill represented the Department.

The Taxpayer has operated a restaurant near Lake Martin in Tallapoosa County, Alabama since 1996. The restaurant also sells alcoholic beverages for on-premises consumption. The issues in this case are (1) did the Department correctly estimate the Taxpayer's sales tax liability for the subject period using a purchase mark-up audit, and (2) did the Department correctly apply the 50 percent fraud penalty.

The Department audited the Taxpayer for sales tax for February 2006 through January 2009. The Department examiners requested the Taxpayer's purchase invoices, sales invoices, sales journals, cash register z-tapes, bank statements, and income tax returns for the subject period. The Taxpayer provided his bank statements, purchase invoices, and some income tax returns.

The Taxpayer failed to provide any cash register z-tapes or other sales records. He testified at the September 2 hearing that he has maintained a cash register at the business since March 2004. He explained, however, that he had routinely discarded the z-tapes and customer sales receipts during the audit period. As discussed below, the Taxpayer testified that his tax preparers computed the restaurant's monthly sales tax liability using only the restaurant's purchase invoices.

The examiners determined that the Taxpayer's purchase invoices were substantially complete. The invoices showed that the business had on average purchased $18,000 in food at wholesale in each month of the 36 month audit period. The Taxpayer had, however, only reported an average of $12,000 in retail sales on his monthly sales tax returns during the period.

The Taxpayer's 2006 and 2007 income tax returns also reported substantially more gross receipts (sales) than were reported for sales tax purposes. The 2006 and 2007 Schedule Cs reported gross sales of $301,505 and $299,586, respectively. The Taxpayer had reported and paid sales tax on gross sales of only $154,528 and $154,729 in 2006 and 2007, respectively. When asked by the examiners to explain the discrepancy between his sales as reported on his sales tax returns versus his income tax returns, the Taxpayer responded "that his income tax returns must be incorrect." (T. 44)

Because of the reported gross sales discrepancies between the Taxpayer's sales tax returns and his income tax returns, and because the Taxpayer failed to maintain any cash register z-tapes or other sales records, the examiners computed the Taxpayer's sales tax liability for the audit period using a purchase mark-up audit.

The purchase mark-up audit is a simple, oft-used Department method of determining a taxpayer's sales tax liability where 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); *Alsedeh v. State of Alabama*, S. 03-549 (Admin. Law Div. 11/3/04); *Arnold v. State of Alabama*, S. 03-1098 (Admin. Law Div. 7/27/04); *Moseley's One Stop, Inc. v. State of Alabama*, S. 03-316 (Admin. Law Div. 7/28/03); *Pelican Pub & Raw Bar, LLC v. State of Alabama*, S. 00-286 (Admin. Law Div. 12/15/00); *Joey C. Moore v. State of Alabama*, S. 99-126 (Admin. Law Div. 8/19/99); *Robert Earl Lee v. State of Alabama*, S. 98-179 (Admin. Law Div. 6/28/99).

A taxpayer's sales tax liability is computed in a purchase mark-up audit as follows: the taxpayer's total purchases are determined from the taxpayer's own purchase invoices, if complete, or otherwise from purchase information obtained from the taxpayer's vendors. Only merchandise purchased for resale is included. Cleaning and office supplies and other items consumed or used by the taxpayer and not resold are excluded. After total monthly purchases are determined, an average retail mark-up percentage is applied to determine the taxpayer's monthly retail sales. The percentage mark-up used by the Department varies by the type of business engaged in, and is taken from IRS statistical data that is included in the Department's field audit manual. Total retail sales are then multiplied by the .04 percent State sales tax rate to determine the total tax due. A credit for sales tax previously reported and paid is allowed to arrive at the additional tax due.

The examiners computed the Taxpayer's monthly purchases for the February 2006 through January 2009 audit period using the Taxpayer's own purchase invoices. They then applied the standard IRS mark-up factor of 2.7 for restaurants to arrive at the Taxpayer's

estimated monthly retail sales.[1] Total sales per the mark-up audit varied from month to month, but averaged $47,650 a month during the three year audit period. The examiners applied the .04 percent tax rate to the monthly sales amounts to determine the total tax due. They then allowed a credit for tax previously reported and paid to arrive at the additional tax due. See, Dept. Audit Report, Ex. 1 at 2 and 3.

The audit revealed that the Taxpayer had substantially underreported his taxable sales during the three year audit period. For example, the Taxpayer had on average reported and paid sales tax of $510 a month in 2008. The Department audit showed, however, that the Taxpayer's average monthly liability for the year was $1,743. There were similar underreportings in the other months of the audit period.

Because the Taxpayer had underreported his gross sales by substantially more than 50 percent during the initial three year audit period, the Department examiners investigated whether the Taxpayer had also underreported by more than 25 percent during the prior three year period. If so, the Department would be authorized to include that period in the audit pursuant to the 6 year 25 percent underreporting statute of limitations at Code of Ala. 1975, §40-2A-7(b)(2)b. That statute allows the Department to assess a 6 year period "if the taxpayer omits from the taxable base an amount properly includable therein which is in excess of 25 percent of the taxable base stated in the return."

The examiners requested the Taxpayer's records for the prior three year period.

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[1] The 2.7 factor actually results in a 1.7 times increase. For example, if the Taxpayer purchased food items at wholesale for $100, applying the 2.7 mark-up factor would result in estimated retail sales of $270. The examiners also included the Taxpayer's purchases from one vendor at cost, without mark-up, because the food items purchased from that vendor were consumed by the Taxpayer, and thus not resold. See, Dept. Audit Report, Ex. 1 at 5.

The Taxpayer failed to provide any records for that period. The examiners consequently applied the Taxpayer's average monthly retail sales ($47,650) for the original three year audit period to the months in the extended period February 2003 through January 2006. Because the taxable base (gross sales) for those prior months greatly exceeded a 25 percent omission in each month, the examiners added the February 2003 through January 2006 period to the audit.

The Department also applied the 50 percent fraud penalty. The Dept. Audit Report, Ex. 1 at 3, explains why the fraud penalty was applied.

> The taxpayer grossly underreported sales evidenced by the fact that purchases grossly exceeded reported sales. That is, reported taxable sales averaged $12,000 and taxable purchases averaged $18,000 each month during the audit period. In addition, the taxpayer failed to maintain accurate books and records used in the preparation of monthly sales tax returns evidenced by the disposal of cash register z-tapes. Therefore, a fifty percent fraud penalty was applied to the liability.

The Taxpayer does not dispute his total purchases ($635,753.47) as calculated by the Department for the initial audit period February 2006 through January 2009. He does disputed the 2.7 factor mark-up applied to the purchases because it "was based on IRS statistical data rather than any data directly related to this Taxpayer." Taxpayer's Post-Hearing Letter Brief at 2. In lieu of the Department's mark-up audit, the Taxpayer offers four alternative methods, or "test periods," from which his liability for the audit period should be computed.

The Taxpayer's first alternative method is based on a cash register z-tape (Taxpayer Ex. 5) for the period February 8 through March 31, 2010. The tape purportedly includes sales grand totals from March 4, 2004, when the Taxpayer testified that he first put the register in service, through February 8, 2010. The total sales for that period, according to

the tape, were $1,865,228.31, which reflects an average daily sales amount during the audit period of $860.74.

The Taxpayer also provided a second z-tape (Taxpayer Ex. 8) that showed that total sales from February 8, 2010 through September 1, 2010 had increased by $221,441.51. Sales for that period, per the z-tape, thus averaged $1,080.20 a day.

The Taxpayer also argues that total sales reported on his 2006 Schedule C were $301,505, or an average of $825.87 per day, and that his total sales on his 2007 Schedule C were $299,528, or an average of $820.62 per day.

The Taxpayer contends that the above alternative methods more accurately show his average daily sales than the Department's estimate of $1,565 per the audit. I disagree.

All retail businesses subject to Alabama sales tax are statutorily required to keep complete and 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 only 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 all such records must be maintained to allow the Department to verify that the correct amount of tax has been reported and paid.

The Taxpayer in this case routinely discarded his cash register tapes, and thus failed to provide the Department with any sales records for the audit period. 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).

As discussed, the Taxpayer does not dispute his monthly purchase amounts used by the examiners. He argues, however, that the 2.7 factor (1.7 mark-up) is excessive and unrelated to the Taxpayer's actual mark-up amounts.

First, the percentage mark-up used in a mark-up audit is necessarily an estimate because the method is only used if the taxpayer fails to provide sales records from which the actual sales (cost plus mark-up) can be exactly computed. The 2.7 factor mark-up applied in this case was taken from IRS statistical data showing the average mark-up for restaurants. The Taxpayer's actual mark-up may have been less, or it may have been more. But without specific records showing the Taxpayer's exact mark-up, the Department's use of the IRS average is reasonable. Having failed to keep adequate sales records, the Taxpayer cannot now argue that it is not.

The alternative methods proposed by the Taxpayer for computing his sales are also flawed.

The z-tape primarily relied on by the Taxpayer was for February 8 through March 31, 2010, which was after the audit period and the audit itself. The tape shows a cumulative sales amount of $1,865,228.31. The Taxpayer has divided that total by the number of days from March 4, 2004, when the Taxpayer claims the register was first used, to February 8,

2010, to compute a daily sales figure of $860.74. The Taxpayer then multiplies that daily total by the number of days (2,192) in the 6 year audit period to compute total sales of $1,886,742.08, versus the Department's audit total of $3,430,807.21. [2]

The above method is flawed because it makes various assumptions that are unsupported by any independent evidence. For example, there is no other evidence supporting the Taxpayer's claim that he put the register in service in March 2004. And even if the Taxpayer did begin using the register in March 2004, there are no daily tapes or other sales records showing that the Taxpayer actually recorded his sales on the register every day that he was open during the audit period. And even if he used the register daily, there is no evidence that all of his daily sales were recorded on the register. For the above reasons, the cumulative total sales amounts on the February 8 through March 31, 2010 z-tape cannot be accepted as a valid alternative method for estimating the Taxpayer's liability for the audit period.

The actual sales amounts recorded on the February 8 through March 31, 2010 z-tape also calls into question the accuracy of the tape. Total sales for the February 8

[2] The Taxpayer's computations are technically flawed because he included Sundays in the number of days the business was open. The Dept. Audit Report, Ex. 1 at 1, shows, however, that the Taxpayer's business was open for lunch from Monday through Friday and for supper on Friday and Saturday. The business was thus closed on Sunday. Consequently, Sundays should have been removed from the number of days by which the gross sales amounts were divided. That would result in a larger average daily sales amount. For example, the 2007 total sales as reported on the Taxpayer's Schedule C, when divided by 365 days, results in a daily sales figure of $820.62. When the Sundays in the year are properly removed from the calculation, the average daily sales figure increases to $956.95 ($299.528 ÷ 313 (365 less 52 Sundays)). (All of the years in issue had 52 Sundays except 2006, which had 53 because January 1, 2006 fell on a Sunday.)

through March 31 period totaled $44,804.20 per the tape. The Taxpayer's sales tax returns for February and March 2010, which included the first seven days in February that were not included on the tape, reported only $31,460 in total sales. The Taxpayer could not explain the discrepancy. (T. 51 – 54)

The Taxpayer's 2006 and 2007 Schedule Cs did report substantially more gross sales than was reported by the Taxpayer on his sales tax returns. But those sales amounts also cannot be accepted as accurate because there are no records from which gross sales as reported on his income tax returns can be verified. The credibility of the Schedule C sales amounts is further brought into question by the Taxpayer's statement to the examiners that "his income tax returns must be incorrect." (T. 44) He also told the examiners that "he was unsure of how his accountant arrived at those (Schedule C) amounts." Dept. Audit Report, Ex. 1 at 5.

Under the circumstances, the Department's mark-up audit using the Taxpayer's own purchase invoices and applying a reasonable retail mark-up is the most accurate method by which the Taxpayer's sales for the audit period should be determined. The sales tax due per the audit 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 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.").

There is ample evidence to support the fraud penalty in this case. An obvious element of fraud is that the Taxpayer failed to provide the examiners with any cash register z-tapes or other sales records for the audit period. He testified at the September 2 hearing that he routinely discarded the tapes. But any retailer should know with certainty that such records must be maintained for audit purposes. When asked why he failed to maintain the z-tapes, the Taxpayer could give no credible answer.

The Taxpayer also told the examiners during the audit that the monthly sales totals reported on his sales tax returns were taken from his z-tapes for the month. "The taxpayer claimed to have used month end cash register z-tape reports to determine monthly sales." Dept. Audit Report, Ex. 1 at 2. He testified at the September 2 hearing, however, that his

accountants filled out his sales tax returns using his purchase invoices and other records, but not his cash register tapes. (T. 54 – 55) He could not explain how the accountants could accurately compute his monthly retail sales without any actual sales records; nor did he explain why he had not provided the z-tapes to his accountants.

ALJ: Mr. Melton, who does your sales tax returns?

TP: Messer and Associates out of West Point, Georgia.

ALJ: Same people who do your income tax?

TP: They do it all. Do everything. We ship them everything, and –

ALJ: What is everything? What do you ship them?

TP: I throw it in a box and ship it to them.

ALJ: What is it?

TP: Purchases, receipts, bills.

ALJ: Cash register tapes?

TP: No, I don't.

ALJ: Why not?

TP: It just – he does all of the purchase orders and figures it up.

ALJ: So you just send him your purchase orders and stuff you buy from your vendors?

TP: Yes, sir.

ALJ: And the accountant figures out the sales from there?

TP: Yes, sir.

ALJ: Do you have any idea how?

P: I have no idea.

T. 54 – 55.

Fraud is also evidenced by the fact that the Taxpayer substantially underreported his sales during the audit period. A retail business can stay in business over an extended period, 14 years in this case, only if the business makes a profit from its sales sufficient to pay the cost of goods sold plus all operating costs, including utilities, employee costs, etc., and a reasonable income for the owner.

In this case, the Taxpayer's purchase invoices showed that he purchased an average of $18,000 in food at wholesale in each month of the initial 36 month audit period. He only reported on average $12,000 monthly in retail sales. The Taxpayer obviously could not stay in business losing $6,000 a month in food costs alone, not considering the operating and other expenses necessarily incurred to keep the business open. The undeniable conclusion is that the Taxpayer intentionally underreported his sales tax liability during the audit period.

The above conclusion is further supported by the Taxpayer's own computations, which also show that he substantially underreported his sales during the audit period.

The Taxpayer claims that based on the cumulative totals on the February 8 through March 31, 2010 z-tape, his total sales for the audit period should be $1,886,742.08, which would have resulted in tax due of $75,469.78. It is undisputed, however, that the Taxpayer reported and paid only $38,095.09 in sales tax during the period. See, Taxpayer's Letter Brief at 3. The Taxpayer thus underreported by almost 50 percent even using his own calculations.

The final assessment, including the fraud penalty, is affirmed. Judgment is entered against the Taxpayer for $172,591.75. Additional interest is also due from the date the final

assessment was entered, March 12, 2010.

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

Entered November 4, 2010.

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BILL THOMPSON
Chief Administrative Law Judge

bt:dr
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