

STATE OF ALABAMA
DEPARTMENT OF REVENUE,

STATE OF ALABAMA
DEPARTMENT OF REVENUE
ADMINISTRATIVE LAW DIVISION

v.

DOCKET NO. S. 84-110
INC. 84-

111
ESCAMBIA GLASS COMPANY, INC.

Taxpayer.

FINAL ORDER

This matter involves two contested preliminary assessments concerning State and City of Atmore sales tax entered by the Revenue Department against Escambia Glass Company, Inc. (Taxpayer).

The assessments were entered on November 1, 1983. On February 16, 1984, the Taxpayer, through counsel, requested a formal administrative hearing with this office. After proper notice to the Taxpayer by certified mail, a hearing was held on June 6, 1984.

At the hearing the Taxpayer was represented by attorney Charles R. Godwin. The Revenue Department was represented by assistant counsel Mark Griffin. Based on the testimony and exhibits introduced at the hearing, and in consideration of the briefs filed by the parties subsequent to the hearing, the following findings and conclusion are hereby made and entered.

FINDINGS OF FACTS

The Taxpayer is in the business of selling and installing glass and other items involving glass, such as door closer, sunscreens, garage doors, windshields, etc.

The Revenue Department audited the Taxpayer for the period July 1, 1980 through June 30, 1983 and based thereon entered the

assessments in issue. In determining the Taxpayer's liability, the Department used an indirect audit method involving a markup percentage. Use of the indirect method was necessary in that the Taxpayer admitted that it had not kept complete and accurate records of its sales during the period in question. That fact was supported by the testimony of the Taxpayer's accountant at the hearing.

Briefly stated, the indirect audit was performed as follows:

The amount of total purchases, including all items purchased by the Taxpayer for resale or other use, was determined from the Taxpayer's records. From that figure, purchase discounts were subtracted, incoming freight was added, beginning inventory was added, less ending inventory and materials withdrawn for use. In consideration of material lost due to breakage and waste, a 10% allowance was originally provided, but was changed to 15%. After the above adjustments, the adjusted purchases figure was multiplied by a markup percentage. How the markup percentage was computed is discussed below. After application of the markup percentage, the materials withdrawn for use were added back and nontaxable sales and bad debts were subtracted. The resulting figure was the taxable measure to which the applicable tax rates were applied. In addition, a fraud penalty was added because the Taxpayer admitted that it had not properly recorded and reported all sales as required by law.

The markup percentage used in the audit was determined entirely from the Taxpayer's records. First, the Department examiner randomly selected twenty of the Taxpayer's sales invoices, involving twenty-five separate items sold by the Taxpayer. The group of twenty-five items included at least one of all, or nearly all, of the different items sold by the Taxpayer. From the invoices, the sales price of each item was determined. The cost of each item was then provided by the Taxpayer. In providing the cost of each item, the Taxpayer included only the cost of the primary item involved in the sale. The cost of various miscellaneous items, such as glue, sealant and other items used to construct and/or install the item, was not included. The gross profit was then computed by subtracting the cost of the item from its sales price. Using gross profit as the numerator and the cost of the item as the denominator, the markup percentage was determined to be approximately 103%.

Concerning the breakage allowance, the 15% allowed by the Department was, of necessity, arbitrarily determined. Understandably, the Taxpayer kept no records concerning what part of its total purchases were broken, discarded or otherwise not sold. However, at the hearing, Mr. Adiel Adams, the owner, testified that after the issue came to his attention, he began observing the amount of breakage and waste and estimated it to be anywhere from 20% to 40%.

In conjunction with the sales tax audit, the Department also conducted a corporate income tax audit on Escambia Glass Company, Inc. and a personal income tax audit on Mr. and Mrs. Adiel Adams, the owners of Escambia Glass Company, Inc. However, no corporate income tax preliminary assessment has been entered to date, and the personal income tax assessment entered against Mr. and Mrs. Adams has been settled by the parties. Consequently, only the two sales tax preliminary assessments are in issue.

CONCLUSIONS OF LAW

Because the Taxpayer admittedly failed to keep accurate and complete records of its entire sales during the assessment period, the Department acted properly in conducting an indirect method audit to determine the Taxpayer's liability. The Taxpayer doesn't object to the fact that the Department performed an indirect audit, but does take issue with certain specifics as to the manner in which it was performed.

First, the Taxpayer argues that the markup percentage was improperly determined. The contention is that the sample group of 25 sales used by the Department was too small to be accurately representative of the Taxpayer's total sales during the assessment period. In addition, the Taxpayer argues that while the total purchases figure used in the audit include all purchases, the cost figure for the 25 items used in the markup formula included only the cost of the primary material involved in the sale. For

example, if the sample invoice item was a windshield, only the cost of the glass was provided by the Taxpayer and not the cost of the miscellaneous materials such as glue, sealant, etc. that were used in assembling or installing the windshield. The Taxpayer argues that by including the miscellaneous items in the purchase figure, and not including their cost in the denominator of the markup formula, the total sales figures was improperly inflated.

Other objections that the Taxpayer raises concerning the audit are that the breakage allowance of 15% is too low, that some sales included as taxable should have been exempt in that they occurred in Florida, and that the fraud penalty is unjustified and should be abated.

The first question is whether the average profit margin of 103% on the group of 25 items randomly selected by the Department is an adequate and accurate representation of the Taxpayer's profit margin on its total sales during the audit period.

The Department examiner that performed the audit testified that in selecting the sample group he attempted to get a cross section of all items sold by the Taxpayer. In response, the Taxpayer argues that a group of 25 items out of a class of over 6,000 sales could not possibly be fairly representative. However, the issue is not necessarily whether the sample group contained a proportionately accurate sampling of the various items sold by the Taxpayer, but rather whether the profit margin determined from the

sample group was an accurate estimate of the Taxpayer's overall profit margin. Except for one item that was not included in the sample group, door glass for automobiles, there is no evidence to show that the profit margin on the sample group was larger than the average profit margin on all of the Taxpayer's sales. In other words, there is no substantial evidence to show that any of the individual items included in the random sample of 25 had a larger than average profit margin. Thus, there is no evidence to show that the average sample profit margin of 103% is larger than the overall margin on all of the Taxpayer's sales.

The Taxpayer argues that the larger the sample size, the greater the probability that the result will be more accurate. While that reasoning is mathematically sound, it does not establish that a smaller sample group will necessarily result in an inaccurate estimate. Further, the Taxpayer also contends that the larger the sample size, the smaller the gross profit margin will be. That assumption is unfounded. The profit margin could either rise or fall with an increase in group size. It is just as logical to say that the margin on the 25 items selected by the Department is lower than the true average margin than it is to contend that it is higher. In either case, in selecting the sample group the Department examiner succeeded in getting a varied sampling of the Taxpayer's sales. There being no substantial evidence to show that the profit margin obtained from the sample group is larger than the

average profit margin on all sales made by the Taxpayer, the profit margin derived by the Department examiner should be accepted.

The second argument raised by the Taxpayer is that because the cost figure (the denominator) used in the markup formula did not include the cost of the miscellaneous items such as glue, sealant, etc., those items should not have been included in the total purchases figure to which, with some adjustments, the markup percentage was applied. The Taxpayer argues that to exclude the cost of those items from the markup formula and to include them in total purchases results in an inflated total sales figure.

A review of the facts shows that the beginning total purchases figure used in the audit included all items purchased by the Taxpayer, including those miscellaneous items used by the Taxpayer in making and installing its products. The evidence also establishes that the cost figures provided by the Taxpayer concerning the sample items in the markup formula included only the cost of the primary material, and not the cost of the miscellaneous items. Both parties agree that because the cost of the various miscellaneous items was not included in the markup formula, those items should not be included in total purchases. Accordingly, the total purchases should be adjusted so as to exclude those miscellaneous items the cost of which was not included in the cost figure (the denominator) used in the markup formula.

There is no question that the Taxpayer should get some amount

as a credit for breakage and waste of materials. The Taxpayer was not required to, nor did it, keep any records concerning the amount of breakage and waste of materials during the audit period. Accordingly, any allowance must be arbitrarily estimated. The Department originally estimated a 10% breakage allowance, but after negotiation the amount was raised to 15%. Mr. Adiel Adams testified that after becoming aware of the issue, he began estimating the amount of breakage and determined that a minimum of 20% of all materials were rendered useless through breakage and waste. Considering the nature of the Taxpayer's business and the materials involved, a 20% breakage figure does not seem unreasonable. Accordingly, upon recomputation of the audit, the Taxpayer should be given a 20% breakage allowance.

The Taxpayer also claims that some of the sales during the period in issue should not have been included in the audit because they were made in Florida. However, there was no evidence submitted at the hearing from which this office can determine that any of the sales were tax exempt out-of-state sales. Consequently, no exemption for out-of-state sales can be given.

The final issue raised by the Taxpayer concerns the fraud penalty of 25% included in the assessment. Code of Ala. 1975, '40-23-16 provides in part as follows:

If the Department be of the opinion that there was a willful or fraudulent intent by the Taxpayer to evade the

tax due, it may assess a penalty of 25% of the tax; provided, that upon appeal such action shall be reviewable.

The Taxpayer argues that the penalty should not be added in light of the fact that the Taxpayer fully cooperated with the auditing examiner. However, the Taxpayer admits that a number of unreported sales were made for which no records were kept. Further, the testimony of the Taxpayer's accountant indicates that for two of the three years in issue, over \$16,000.00 in sales went unreported. That figure represents only unreported sales for which an invoice or work order existed and does not take into consideration the possibility of cash sales. Based on the admitted underreporting of sales, the Department acted reasonably in applying the 25% fraud penalty.

In consideration of the above findings and conclusions, it is hereby ordered that the Revenue Department, with the cooperation of the Taxpayer, recompute the audit as directed herein and thereafter submit the revised audit and proposed liability to this office for review. An order will then be issued requiring the Department to enter a final assessment in accordance therewith.

Done this the 4th day of September, 1984.

ILL THOMPSON

Chief Administrative Law Judge

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