IT 18-01
Tax Type: Income Tax
Tax Issue: Unreported/underreported Income

STATE OF ILLINOIS
DEPARTMENT OF REVENUE
OFFICE OF ADMINISTRATIVE HEARINGS
CHICAGO, ILLINOIS

THE DEPARTMENT OF REVENUE OF THE STATE OF ILLINOIS	**No. XX-XX-XXX**
v.	**Letter ID XXX XXX**
	Tax Years 2010, 2011
ABC INC., Taxpayer	**Ted Sherrod Administrative Law Judge**

RECOMMENDATION FOR DISPOSITION

Appearances: Special Assistant Attorney General Rick Walton on behalf of the Illinois Department of Revenue; Adam Kandah of Akram Zanayed & Associates on behalf of ABC Inc.

Synopsis:

This matter is before this administrative tribunal as the result of a timely protest by ABC Inc. ("Taxpayer") of Notices of Deficiency the Illinois Department of Revenue ("Department") issued to it proposing to assess deficiencies for the calendar years ended 12/31/10 and 12/31/11. A hearing to consider the Taxpayer's protest was held at the Department's offices in Chicago, Illinois on August 17, 2017 and October 31, 2017. The Department's assessments arise from its determination of the amount of income the Taxpayer earned during the tax years in controversy.

During the hearing in this matter, one witness, Adel Farag, an auditor employed by the Department who conducted a sales tax audit of the Taxpayer was called by the Department and one witness, Thomas Jones, the Taxpayer's owner and store manager, was called by the Taxpayer. Both the Department and the Taxpayer introduced documentary evidence into the record during the hearing proceedings. Upon consideration of all the evidence comprising the record in this case, it is recommended that the Notices of Deficiency at issue be affirmed. In support of this recommendation, the following "Findings of Fact" and "Conclusions of Law" are made.

FINDINGS OF FACT:

1. The Department's *prima facie* case, inclusive of all jurisdictional elements, was established by the admission into evidence, under the certificate of the Director, of the Department's Notices of Deficiency for Form IL-1120-ST, Small Business Corporation Replacement Tax Return showing a liability due and owing in the amount of $4,549.93 (including penalties and interest) for the tax year ended 12/31/10 and $7,268.74 (including penalty and interest) for the tax year ended 12/31/11.[1] Department Ex. 1, 2.

2. ABC Inc. ("Taxpayer"), a subchapter S corporation incorporated in Illinois, operates a liquor and grocery store located in Sometown, Illinois. Tr. p. 66; Department Ex. 3 (Auditor Comments), 4 (Audit Narrative), 17. Most of its sales are from the sale of beer, wine, other liquors and groceries. Department Ex. 9. The Taxpayer also sells cigarettes and other tobacco products, and receives additional revenues from the sale of lottery tickets. Department Ex. 3, 4.

[1] Unless otherwise noted, findings of fact apply to the period covered by the Department's Notices of Deficiency, FYE 12/31/10 and FYE 12/31/11.

3. The Taxpayer is owned by Thomas Jones ("Jones"). Tr. p. 65; Department Ex. 3, 4. Jones has been the owner of the Taxpayer since 1995. Tr. p. 75. He also operates the business. Tr. p. 65.

4. Adel Farag ("Farag") is an auditor employed by the Department. Tr. p. 18. He has been employed by the Department for over 7 years. *Id.*

5. Commencing in October 2012, Farag performed a Retailers' Occupation Tax (sales tax) audit of the Taxpayer covering the audit period 1/10 through 3/12. Tr. pp. 19, 20; Department Ex. 3, 4, 10. In response to the Department's request to make all records of business activities available, the Taxpayer's representative Sam Smith, an Enrolled Agent employed by Smith Services of Anywhere, Illinois, provided Farag with Federal income tax returns (form 1120s) for 2010 and 2011, fixed asset and purchase invoices, sales and use tax returns, bank statements, a list of vendors and account numbers, monthly income and expense statements, and handwritten summary of sales sheets. *Id.*

6. Taxpayer tendered no cash register tapes indicating total sales. Tr. pp. 22-24; Department Ex. 4. During the hearing, Jones did not deny the Department's claim that he had not kept or maintained cash register tapes providing a daily record of the gross amount of sales as required by law (at 86 Ill. Admin. Code, ch. I, section 130.805). Tr. pp. 78, 79.

7. After reviewing the records supplied by the Taxpayer in response to the Department's demand for records, and discovering that the Taxpayer had not kept a daily record of sales, Farag determined that the records provided were not adequate to verify the sales reported by the Taxpayer on its sales tax returns, and that it would be necessary for him to use an alternative method based upon the best evidence available to determine the Taxpayer's gross receipts. Tr. pp. 23-27, 29-31; Department Ex. 4.

8. Farag determined the Taxpayer's inventory purchases by mailing forms called EDA-20s requesting inventory sales information to the Taxpayer's suppliers that Farag identified from a list provided by the Taxpayer and from the Taxpayer's invoices. Tr. pp. 24-27; Department Ex. 4. Farag used this information, along with projections of purchases from vendors that did not respond to the Department's EDA-20s identified from the Taxpayer's invoices to determine what the Taxpayer's purchases were during the audit period. *Id.* Farag calculated the amount of the Taxpayer's sales by adding together the amount of total purchases reported on EDA-20s and purchases calculated from invoices as indicated above and applying a mark-up to this amount based upon average mark ups deduced from statistical averages for the Taxpayer's type of business. Tr. pp. 24-27; Department Ex. 4.

9. Farag compared his best estimate of the Taxpayer's total gross receipts to the receipts as reported on line 1 of the Taxpayer's monthly sales tax returns for the audit period. Tr. pp. 21, 22. Based upon this comparison, Farag concluded that the Taxpayer did not underreport its gross receipts (i.e. sales) on its sales tax returns filed for the audit period (January 1, 2010 through March 31, 2012). Tr. pp. 21, 22, 44, 45; Department Ex. 3, 4. Farag's findings based upon a review of available records concerning the audit period resulted in a finding of no additional sales and use tax liability due from the Taxpayer. *Id.*

10. During his sales tax audit, Farag reviewed the Taxpayer's Federal income tax returns (form 1120s) for 2010 and 2011, and determined that the Taxpayer's purchases or costs of goods sold reported on these returns greatly exceeded the purchases calculated by Farag during his sales tax audit of the Taxpayer. Tr. pp. 20, 21; Department Ex. 3, 4. As a consequence of this finding, upon concluding his sales tax audit of the Taxpayer, Farag prepared an "Audit Referral Request" referring the Taxpayer for additional auditing of the Taxpayer's Small Business Corporation Replacement Tax returns filed to report the Taxpayer's income tax liability pursuant to sections 201(a) and 502 (35 **ILCS** 5/201(a) and 35 **ILCS** 5/502) of the Illinois Income Tax Act (35 **ILCS** 5/101 *et seq.)* for the tax years ending 12/31/10 and 12/31/11 by the Department's Income Tax Division. Tr. pp. 45, 46; Department Ex. 3, 17.

11. In computing its Illinois state income tax liability for the tax years at issue, the Taxpayer included its "ordinary business income" from the Taxpayer's Schedule K reported on its 2010 and 2011 U.S. Corporation Income Tax Return for an S Corporation (IRS Form 1120S) for those years on line 1 of its Illinois IL-1120-ST return forms for those years as required by the instructions to the IL-1120-ST return forms. Department Ex. 12, 13, 15, 16.

12. The Department's income tax division conducted an audit of the Taxpayer's IL-1120-ST returns for 2010 and 2011. Department Ex. 3. During the course of this audit, the Department audited the Taxpayer's Federal income tax returns for 2010 and 2011 to determine if the Taxpayer's "ordinary business income " reported to the IRS for those years and included on line 1 of the Taxpayer's 2010 and 2011 state income tax returns as required by Illinois law was correct, and concluded that the Federal taxable income reported by the Taxpayer for those years was based upon an incorrect computation of the cost of goods sold on the Taxpayer's Federal returns. Department Ex. 3. Based upon purchases determined by Farag during his sales tax audit of the Taxpayer, the Department determined that the Taxpayer's cost of goods sold reported on its Federal return for 2010 exceeded its properly determined cost of goods sold by $XXX,XXX ($XXX,XXX reported on the Taxpayer's federal return as compared to $XXX,XXX determined by Farag) and that the Taxpayer's cost of goods sold reported on its Federal return for 2011 exceeded properly determined cost of goods sold by $XXX,XXX ($XXX,XXX reported on the Taxpayer's Federal return as compared to $XXX,XXX determined by Farag). Department Ex. 3. After re-computing the Taxpayer's Federal income tax liability using the cost of goods sold that the Department determined should have been reported, the Department's auditor found that the Taxpayer had underreported "ordinary business income" on its Federal returns and on line 1 of its state returns by $XXX,XXX ($XXX,XXX determined by the Department compared to $XX,XXX reported by the Taxpayer) for 2010 and by $XXX,XXX ($XXX,XXX determined by the Department compared to $XX,XXX reported by the Taxpayer) for 2011 on its Federal income tax returns. Department Ex. 11, 14.

13. The adjustments to the Taxpayer's Federal taxable income determined by the Department had the effect of increasing the Taxpayer's Illinois net income, and resulted in Illinois Income and Replacement Tax deficiencies for the tax years ended 12/31/10 and 12/31/11 which the Department assessed by issuing Notices of Deficiency for those years on June 4, 2015 in the amount of $X,XXX.XX for the tax year ended 12/31/10 and $X,XXX.XX for the tax year ended 12/31/11. Department Ex. 1, 2.

CONCLUSIONS OF LAW:

In the instant case, the Department determined that the Taxpayer, a subchapter S corporation, owes additional income tax on income it earned during the tax years ended 12/31/10 and 12/31/11. A subchapter S corporation or S corporation is a corporation that has in effect an election under section 1362 of the Internal Revenue Code ("IRC") to be taxed as a "pass through" entity passing through to its shareholders all its items of income, loss, deduction and credit, which are taken into account by its shareholders in computing their individual income tax liabilities pursuant to IRC section 1366. 35 **ILCS** 5/1501(a)(28). While Illinois recognizes a corporation's subchapter S election for state income tax purposes and taxes all individual Illinois taxpayers on their distributive shares of subchapter S corporation income (see 35 **ILCS** 5/301; 86 Ill. Admin. Code, ch. I, section 100.9750(c)), subchapter S corporations are also subject to tax at the entity level pursuant to 35 **ILCS** 5/201(c) and (d), the Illinois Replacement Income Tax. See also 35 **ILCS** 5/205(c).

Taxpayers are subject to tax on their "net income" which is their base income allocated or apportioned to Illinois less statutorily enumerated deductions. 35 **ILCS** 5/202; 86 Ill. Admin. Code, Ch. I, section 100.2050. A corporation's "base income" is its taxable income properly reportable for Federal income tax purposes for the tax year with certain modifications. 35 **ILCS** 5/203(b), 5/203(e). The Department's Form IL-1120-ST treats an S corporation's ordinary income as reported by an S corporation on its Federal form 1120S, as a proxy for Illinois base income. 2010 IL-1120-ST Instructions, p. 3

("Illinois base income means federal ordinary income modified by additions and subtractions as shown in Steps 2 through 5 of Form IL-1120-ST."). See also 86 Ill. Admin. Code, Ch. I, section 100.2405(c)(7). Just as a non-S corporation's Federal taxable income is the starting point when calculating its Illinois income tax liability, an S Corporation's ordinary income is the starting point when calculating its Illinois Replacement Tax liability. 35 **ILCS** 5/201 (c)-(d); Bodine Electric Co. v. Allphin, 81 Ill. 2d 502, 506 (1980) ("…Federal taxable income [i]s the starting point upon which State tax liability is computed.").

The instant case concerns a dispute between the parties over whether the Taxpayer's base income, i.e. its taxable income properly reportable for Federal income tax purposes was accurately reported by the Taxpayer on its 2010 and 2011 Federal income tax returns. The Department contends that it was not because the cost of inventory shown on the Taxpayer's Federal returns as the Taxpayer's "Cost of goods sold" was inaccurately high resulting in an underreporting of the Taxpayer's actual "net income" or ordinary income used to compute the Taxpayer's Illinois replacement income tax liability. Department's Post-Trial Brief ("Department's Brief") pp. 1, 2. The Taxpayer disputes the Department's claim.

When the Department introduced the Notices of Deficiency at issue in this case into evidence under the Certificate of the Director, it presented *prima facie* correct proof that the Taxpayer was liable for the tax proposed. 35 **ILCS** 5/904(a); PPG Industries, Inc. v. Department of Revenue, 328 Ill. App. 3d 16, 33, 34 (1st Dist. 2002); Balla v. Department of Revenue, 96 Ill. App. 3rd 293, 296-97 (1st Dist. 1981). The Department's *prima facie* case is a rebuttable presumption. Fillichio v. Department of Revenue, 15 Ill.

2d 327, 333 (1958). A Taxpayer cannot overcome this presumption of correctness merely by denying the accuracy of the Department's assessment. Central Furniture Mart v. Johnson, 157 Ill. App. 3d 907, 911 (1st Dist. 1987); Quincy Trading Post v. Department of Revenue, 12 Ill. App. 3d 725, 730-31 (4th Dist. 1973). Instead, a Taxpayer has the burden to present evidence that is consistent, probable and closely identified with its books and records to show that the proposed assessment is not correct. PPG Industries, *supra* at 34.

In the instant case, the Department determined the Taxpayer's net income for the tax years ended 12/31/10 and 12/31/11 based upon findings made during its Retailers' Occupation Tax ("sales tax") audit of Taxpayer that covered those years. Tr. pp. 6-8; Department Ex. 3, 4. During its sales tax audit of the Taxpayer, it did not increase the amount of Taxpayer's gross receipts above amounts reported by the Taxpayer on its sales tax returns. Tr. pp. 21, 22, 44, 45; Department Ex. 3, 4. However, during the course of its sales tax audit, the Department uncovered voluminous evidence that the Taxpayer's actual purchases of merchandise for sale or cost of goods sold during the tax years at issue were substantially less than the cost of goods sold the Taxpayer reported on its Federal returns for the tax years in controversy resulting in a substantial understatement of the Taxpayer's net income (i.e. gross receipts minus cost of goods sold) for those years. Tr. pp. 20, 21; Department Ex.3, 4. In accordance with the instructions for Form IL-1120-ST filed by the Taxpayer to report its Illinois Replacement Income Tax, the Taxpayer reported its Federal "ordinary business income" indicated on its Federal income tax returns (Form 1120S) as its income subject to Illinois Replacement Tax for the tax years in controversy. Department Ex. 11-16. Based upon findings made during its sales tax audit, the Department revised the Taxpayer's taxable income reported to Illinois to conform to the amounts of taxable income the Department found to be properly reportable based upon the Taxpayer's costs of goods sold the Department determined during its sales tax audit. ***Id***. Because the amount of the Taxpayer's cost of goods sold determined by the Department was substantially less than the cost of goods sold the Taxpayer used to determine its Federal and state taxable income, the Department recomputed the Taxpayer's net income for the tax years in controversy and determined a substantial Replacement Tax due from the Taxpayer for each of these years. Department Ex. 1, 2, 11-16.

Department's Sales Tax Audit of the Taxpayer

The Retailers' Occupation Tax Act ("ROTA"), 35 **ILCS** 120/1 *et seq.*, imposes a tax upon persons engaged in the business of selling at retail tangible personal property. 35 **ILCS** 120/3. The record in this case indicates that the Taxpayer was engaged in the retail sale of food and liquor (Tr. p. 66; Department Ex. 3, 4, 17), and therefore was subject to the ROTA. During 2012 and 2013, The Department conducted a sales tax audit of the Taxpayer for the period January 2010 through March 2012 pursuant to section 4 of the ROTA, 35 **ILCS** 120/4. Said section provides in pertinent part as follows:

> As soon as practicable after any return is filed, the Department shall examine such return and shall, if necessary, correct such return according to its best judgment and information … In the event that the return is corrected for any reason other than a mathematical error, any return so corrected by the Department shall be prima facie correct and shall be prima facie evidence of the correctness of the amount of tax due, as shown therein.

The Department's audit uncovered no additional sales tax due from the Taxpayer, essentially affirming the correctness of the Taxpayer's sales tax returns.

Section 7 of the ROTA provides in part as follows:

> Every person engaged in the business of selling tangible personal property at retail in this State shall keep records and books of all sales of tangible personal property, together with invoices, bills of lading, sales records, copies of bills of sale, inventories prepared as of December 31 of each year or otherwise annually as has been the custom in the specific trade and other pertinent papers and documents. … All books and records and other papers and documents which are required by this Act to be kept shall be kept in the English language and shall, at all times during business hours of the day, be subject to inspection by the Department or its duly authorized agents and employees.
> 35 **ILCS** 120/7

Pursuant to the foregoing, the ROTA prescribes specific requirements for maintaining books and records. The above indicated statutory provision has been construed to require that a taxpayer maintain cash register tapes and other data providing a daily record of its gross amount of sales. 86 Ill. Admin. Code, ch. I, section 130.805. A taxpayer's duty to keep such books and records is mandatory. Smith v. Department of Revenue, 143 Ill. App. 3d 607 (5th Dist. 1986). In the instant case, the Taxpayer's owner did not dispute the Department's claim that the Taxpayer failed to keep or maintain such information with respect to the tax period the Department audited which encompassed the calendar and tax years 2010 and 2011. Tr. pp. 78, 79.

As the Taxpayer had inadequate books and records corroborating gross receipts to tender to Farag, the Department's auditor, Farag had to use an alternative method to compute the Taxpayer's correct sales tax liability. Tr. pp. 23-27, 29-31. The Illinois courts have authorized the use of such alternative methods when a taxpayer's books and records are inadequate. Young v. Hulman, 39 Ill. 2d 219 (1968). In the absence of statutorily required records, Farag elected to use a so-called “mark-up” method (Department Ex. 3) pursuant to which he developed a mark-up percentage based upon average mark-ups for the Taxpayer’s type of business and applied this mark-up to purchases indicated by records he requested from the Taxpayer’s suppliers and projections based upon amounts shown on the Taxpayer’s invoices from its vendors. Tr. pp. 24-27; Department Ex. 3, 4.

Taxpayer’s Argument

The Taxpayer argues that the Taxpayer’s Illinois taxable income should be based upon amounts shown on the Taxpayer’s Federal income tax returns filed for 2010 and 2011, and that the amounts shown as gross receipts and expenses on the Taxpayer’s Federal returns for these years are correct. Taxpayer’s Post Trial Brief (“Taxpayer’s Brief”), p. 1. The Taxpayer attributes the discrepancy between the amount shown as its cost of goods sold on the Taxpayer’s Federal returns and the amount of its cost of goods sold determined by the Department to the Department’s failure to take into account purchases from Quality Inc. (“Quality”), a liquor retailer from whom the Taxpayer contends it made a substantial number of purchases that were not taken into account by Farag, the Department’s auditor. The Taxpayer’s purchases constituting its cost of goods sold determined by the Department during its sales tax audit of the Taxpayer were far lower than the purchases the Taxpayer reported as its “Cost of goods sold” on its Federal income tax returns and the Taxpayer disputes the lower amount of the Taxpayer’s cost of goods sold determined by the Department. *Id.*

At no point during the hearing in this case or in the Taxpayer's Brief did the Taxpayer take issue with the type of method of estimation used by the auditor, i.e., the "mark-up" method described above. Consequently, the Taxpayer has offered no evidence to show that the Department erred in any manner in determining the Taxpayer's cost of goods sold using this method. Rather, the Taxpayer contends that the Department arrived at an incorrect result because it did not use the Taxpayer's bank records in arriving at the Taxpayer's cost of goods sold. Taxpayer's Brief pp. 1, 2. The Taxpayer contends the Taxpayer's invoices and information from the Taxpayer's suppliers the Department used did not reflect all the Taxpayer's purchases because the Taxpayer made a large number of purchases from Quality that were paid for in cash and that were not documented by invoices or any other records. *Id.*[2]

The Taxpayer contends that bank records introduced during the hearing corroborate these inventory purchases from Quality by identifying payments made to this vendor that were not indicated on any invoices the Department's auditor uncovered because no invoices were provided to the Taxpayer by Quality for these purchases. *Id*. The Taxpayer asserts, without proof that sales to Quality were included in Taxpayer's sales reported on its sales tax returns filed for the tax period in controversy and that the failure to attribute any cost of goods sold to these sales distorted the Department's findings. *Id.* In effect, the Taxpayer argues that the Department failed to use the best available information when it determined the Taxpayer's cost of goods sold during its sales tax audit.

[2] While the Taxpayer claims that purchases from Quality were not considered because such purchases from liquor retailers of liquor for resale are illegal (Taxpayer's Brief, p. 2), the record in this case contains no evidence that Farag ignored these purchases for this reason.

Department's Argument

Section 203(e)(1) of the Illinois Income Tax Act provides, in part as follows:

> [F]or purposes of this Section and Section 803(e), a taxpayer's gross income, adjusted gross income, or taxable income for the taxable year shall mean the amount of gross income, adjusted gross income or taxable income properly reportable for federal income tax purposes for the taxable year under the provisions of the … Internal Revenue Code.

The Department contends that it correctly determined the Taxpayer's "properly reportable" taxable income from information obtained during the Department's sales tax audit of the Taxpayer encompassing the tax years 2010 and 2011 at issue in this case. Department's Brief, pp. 1-3. It argues that it was required to look outside of the Taxpayer's books and records to make this determination and that it obtained additional information to determine whether the sales the Taxpayer reported were correct.

The Department, in its brief, outlines the manner in which the Department's sales tax audit was undertaken. Department's Brief, pp. 3-9, 12-14. It notes in its brief that, during its sales tax audit, the Department conducted a thorough canvass of the Taxpayer's suppliers identified by the Taxpayer to determine the Taxpayer's inventory expenses constituting its cost of goods sold. *Id.* This review, it notes, included an examination of the Taxpayer's invoices to determine the identities of all suppliers the Taxpayer made acquisitions of inventory from, and inquiries sent to these suppliers requesting the amount of their sales to the Taxpayer during the tax period in controversy. *Id.* Farag, the Department's auditor, arrived at his conclusions regarding the amount of the Taxpayer's purchases by adding up the total sales made to the Taxpayer by suppliers during the tax period and projecting additional purchases from amounts shown on the Taxpayer's purchase invoices from suppliers that did not respond to the Department's request for sales information. *Id.* The Department, in its brief, states that "[b]ased on the revised purchases figures for the sales tax audit, the (Department's) income tax auditor concluded that the Taxpayer understated its Illinois net Replacement Tax liability for the Years at Issue." Department's Brief, p. 14.

The Department contends that the Taxpayer presented no dispositive evidence challenging its determination which was deemed to be "prima facie" correct as a matter of law. Specifically, the Department argues as follows:

> The Taxpayer did not satisfy its burden of proof because it failed to adduce any credible evidence to support the substantial amounts it claimed as cost of goods sold on its US-1120s for the Years at Issue. The admission into evidence of the Department's notice of deficiency, under a certificate of the Department's Director, establishes the Department's *prima facie* case. 35 **ILCS** 5/904(a); Balla v. Dept. of Revenue, 96 Ill. App. 3d 293, 295; 421 N.E. 2d 236 (1st Dist. 1981). The taxpayer has the burden to adduce competent evidence, through its books and records, to establish that the Department's records are incorrect. Masini v. Dept. of Revenue, 96 Ill. App. 3d 1132, 421 N.E. 2d 1030 (2d Dist. 1981); Howard Worthington Inc. v. Department of Revenue, 96 Ill. App. 3d 1132, 421 N.E. 2d 1030 (2nd dist. 1981). If the taxpayer introduces credible evidence establishing the Department's notice is incorrect, the burden shifts back to the Department to prove its contentions by a preponderance of the evidence. Balla, *supra*. Testimony alone is not sufficient to overcome the Department's *prima facie* case. Central Furniture Mart v. Johnson, 157 Ill. App. 3d 907, 510 N.E. 2d 937 (1st Dist. 1987). Inasmuch as the Taxpayer in the instant matter did not adduce any credible evidence that shifted the burden of proof back to the Department, this Tribunal should uphold the [Notices of Deficiency] in this matter that are based on the purchases determined during the sales tax audit.
> Department's Brief pp. 15-16.

Essentially, the Department's argument is that since the Taxpayer failed to rebut the Department's *prima facie* case and the voluminous documentary evidence introduced by the Department to support it, the Department's assessment of additional tax liability for the tax years in controversy should be affirmed.

Analysis

As is evident from the foregoing, the *gravamen* of the Taxpayer's argument is its claim that the Department did not consider bank records showing purchases from Quality, a liquor retailer, in arriving at the Taxpayer's cost of goods sold used in determining the Taxpayer's sales for sales tax purposes during 2010 and 2011. Taxpayer avers that, as a result, significant amounts of the Taxpayer's purchases were erroneously omitted in computing the Taxpayer's cost of goods sold rendering the Department's findings erroneous. As noted, this determination of the Taxpayer's cost of goods sold was used by the Department's income tax auditor in determining that the Taxpayer had erroneously reported its cost of goods sold for income tax purposes resulting in the income tax assessments at issue in this matter. While the Taxpayer further contends that sales of inventory purchased from Quality were included in sales the Taxpayer reported on its sales tax returns (Taxpayer's Brief, p. 3), and thus necessitated the inclusion of the cost of goods sold attributed to such sales in the Taxpayer's cost of goods sold, the record in this case contains no documentary evidence to substantiate these claims.

The bank records the Taxpayer claims the Department did not consider were introduced into the record during the hearing as Taxpayer's Exhibit 1. This exhibit includes 16 checks written to Quality, drawn on the Taxpayer's bank account during the months of August through November 2011. ***Id***. The Taxpayer claims that sales identified by these checks and other sales made to the Taxpayer by Quality were not considered by the Department in reaching its determination of the Taxpayer's purchases constituting the Taxpayer's cost of goods sold for 2010 and 2011. Taxpayer's Brief pp. 2, 3. Notably, these checks only cover the period August 2011 through November 2011 which is only 17% of the tax years at issue in this case.

The Taxpayer's claim that these bank records were not considered by Farag in arriving at the Taxpayer's cost of goods sold does not comport with the testimony given during the hearing in this case. During the hearing, Thomas Jones, the Taxpayer's owner, testified that the bank statements noted above were given to Farag, the Department's auditor (Tr. p. 81), and Farag testified that these bank statements were reviewed in arriving at the Department's determination of the Taxpayer's cost of goods sold. Tr. pp. 54, 55, 61.

While the record in this case indicates that the Taxpayer's checks and other bank records were given little if any weight in arriving at the Department's determination of the Taxpayer's cost of goods sold (Department Ex. 4), where the Department's audit methodology is challenged, the record need not show that it was better than an alternative audit methodology it might have used. Mel-Park Drugs v. Department of Revenue, 218 Ill. App. 3d 203 (1st Dist. 1991). The Department's audit will be dispositive if its audit has met a minimum standard of reasonableness. Elkay Manufacturing Co. v. Sweet, 202 Ill. App. 3d 466, 470 (1st Dist. 1990); PPG Industries, *supra* at 33 ("Under Illinois law, the formula employed must not be arbitrary or unreasonable."). The reasonableness standard is based upon section 4 of the Retailers' Occupation Tax Act, which requires the Department to correct returns according to its best judgment and information. Mel-Park Drugs, *supra* at 218; Masini v. Department of Revenue, 60 Ill. App. 3d 11, 14 (1st Dist.

1978). As previously noted, in the instant case the Taxpayer's bank records were incomplete, covering only a small portion of the tax years in controversy. Moreover, these records could not be tied to any of the Taxpayer's invoices for inventory purchases. The fact that these bank records were incomplete and ambiguous lends credence to the conclusion the Department's auditor Farag reached that they were not the best evidence of the Taxpayer's cost of goods sold resulting in them being given no weight in arriving at his determination. Given the foregoing, it clearly was not unreasonable for Farag to conclude that he could not accord great significance to these records in arriving at the Taxpayer's cost of goods sold. For this reason, I find that his decision not to rely upon these records did not cause his audit results to be arbitrary, capricious or unreasonable, or cause the Department's audit to fall below the minimum standard of reasonableness required under the case law noted above.

Moreover, the Taxpayer's argument that the Department's auditors should have given additional weight to the Taxpayer's purchases from Quality even though there were no invoices from this company in the Taxpayer's books and records, and should have relied more heavily on the Taxpayer's bank records showing transactions with Quality is insufficient to rebut the Department's *prima facie* case. Case law in Illinois clearly indicates that merely denying the accuracy of the Department's assessments, offering alternative hypotheses that cannot be corroborated by legally mandated books and records or arguing that its audit methodology is flawed is not enough to overcome the Department's *prima facie* case. A.R. Barnes & Co. v. Department of Revenue, 173 Ill. App. 3d 826 (1st Dist. 1988); Central Furniture Mart, *supra*; Mel-Park Drugs, *supra;* Goldfarb v. Department of Revenue, 411 Ill. 573 (1952).

The premise of the Taxpayer's argument is that the bank records the Taxpayer introduced identify a supplier, Quality that the Department's auditor should not have omitted from his compilation of the Taxpayer's purchases. This premise is undermined by the fact that there is no documentation that in any way ties the checks written to Quality by the Taxpayer to purchases of inventory at issue in this case. The credibility of the Taxpayer's claim that these checks were for the purchase of inventory sold during the period at issue in this case is further compromised by the fact that such purchases if intended as purchases for resale by the Taxpayer, would have been illegal under the provisions of the Illinois Liquor Control Act (at 235 **ILCS** 5/5-1(d)) because Quality, by the Taxpayer's own admission, was a liquor retailer and purchases of liquor for retail sale from other retailers is expressly prohibited. See also Liquor Control Commission Regulation 11 Ill. Admin. Code 100.250.

Moreover, the aggregate amount of purchases from Quality evidenced by these checks during the period August through November 2011 is $43,000. Taxpayer's Ex. 1. Even if it is assumed that the aggregate amount of these checks reflects payments for inventory purchased from Quality for sale, the amounts they indicate fall far short of approximating the huge difference between the cost of goods sold the Department determined for 2011 ($265,977) and the much higher cost of goods sold the Taxpayer reported on its Federal returns for 2011 ($595,831). Hence, the discrepancy between the amount determined by the Department and the amount the Taxpayer reported on its Federal return for 2011 clearly cannot be explained solely by the auditor's purported omission of purchases from Quality. Furthermore, the record contains no checks or other documentary evidence of transactions between the Taxpayer and Quality during 2010.

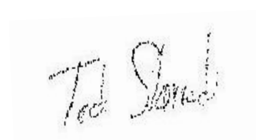
For the reasons noted above, I find the evidence adduced by the Taxpayer of purported purchases from Quality insufficient to disprove the correctness of the amounts determined by the Department or to rebut the Department's *prima facie* correct determination reflected in its Notices of Deficiency issued in this case.

The only other evidence of the volume of the additional transactions reconciling the cost of goods sold the Taxpayer reported on its Federal returns and the Taxpayer's much lower cost of goods sold determined by the Department during its sales tax audit are testimonial assertions on behalf of the Taxpayer during the hearing. Tr. pp. 75-80. Oral testimony without corroborating books and records is clearly insufficient to overcome the Department's *prima facie* case. Mel-Park Drugs, *supra* at 217 ("To overcome the Department's *prima facie* case, the Taxpayer must present more than its testimony denying the accuracy of the assessments, but must present sufficient documentary support for its assertions."). The Illinois Courts have made it clear that a Taxpayer cannot overcome the Department's *prima facie* case merely by denying the accuracy of the Department's determination. Masini, *supra*; Central Furniture Mart, *supra*. A Taxpayer can overcome the Department's *prima facie* case only by producing competent evidence identified with the Taxpayer's books and records. Vitale v. Department of Revenue, 118 Ill. App. 3d 210, 213 (3d Dist. 1983).

In lieu of documentary evidence of additional transactions sufficient to explain the discrepancy between "Cost of goods sold" the Taxpayer reported on its Federal returns and the cost of goods sold the Department determined during its sales tax audit, the Taxpayer has attempted to rebut the Department's *prima facie* case through testimony designed to provide a plausible explanation for the higher cost of goods sold reflected on the Taxpayer's Federal returns. The Taxpayer's unsubstantiated testimony based on the Taxpayer's guesses and circumstantial evidence is simply not sufficient to meet the Taxpayer's burden in this case. Given the insufficient proof of additional inventory purchases from Quality that are not documented in the Taxpayer's sales records, I must conclude that the Taxpayer's testimony regarding additional inventory purchases is insufficient to rebut the Department's *prima facie* case.

Conclusion:

It is recommended that the Director finalize the Notices of Deficiency at issue, with interest to accrue pursuant to statute.



Ted Sherrod
Administrative Law Judge

Date: March 21, 2018