

**IT 14-07**

**Tax Type: Income Tax**

**Tax Issue: Unreported/Underreported Receipts (Non-Fraudulent)  
And Burden of Proof**

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

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<b>THE DEPARTMENT OF REVENUE</b>	)	Docket No.	XXXX
<b>OF THE STATE OF ILLINOIS</b>	)	Account No.	XXXX
v.	)	Tax Years	XXXX
<b>ABC BUSINESS, INC.,</b>	)	John E. White,	
Taxpayer	)	Administrative Law Judge	

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**RECOMMENDATION FOR DISPOSITION**

**Appearances:** Terrence Naughton, Naughton Law Office, appeared for ABC BUSINESS, Inc.; Ronald Forman, Special Assistant Attorney General, appeared for the Illinois Department of Revenue.

**Synopsis:**

The Illinois Department of Revenue (Department) issued two Notices of Deficiency (NODs) to ABC BUSINESS, Inc. (Taxpayer), in which it proposed to assess tax, penalties, and interest for tax years ending December 31, 2006 through December 31, 2007 (TYE 2006-2007). Taxpayer protested the NODs, and requested a hearing. Prior to and at hearing, Taxpayer conceded the liability proposed in the NOD issued for TYE 2007, and contested only the NOD issued for TYE 2006.

At hearing, Taxpayer offered the testimony of two witnesses, as well as documentary evidence. After considering the evidence, I am including in this recommendation findings of fact and conclusions of law. I recommend the Director revise the NOD to reduce the amount of tax and penalty proposed for TYE 2006, as more fully described below.

**Findings of Fact:**

1. For TYE 2006, Taxpayer filed a federal and an Illinois income tax return. Department Ex. 3 (copy of Auditor's Comments), p. 1.
2. Taxpayer filed a federal income tax for TYE 2007, but did not file an Illinois income tax return for that year. Department Ex. 1 (copy of Statement page of NOD issued for TYE 2007); Department Ex. 3, p. 1.
3. Taxpayer also filed monthly retailers' occupation tax (ROT) returns during 2006 and 2007. See Department Ex. 3, pp. 1-3.
4. The Department conducted a retailers' occupation tax (ROT) audit of Taxpayer for a period that included TYE 2006 and 2007. Department Ex. 3, p. 1.
5. As a result of the ROT audit, a referral was made to audit Taxpayer's business income tax filings. Department Ex. 3, p. 1. Terri Streeval (Streeval) conducted the income tax audit. *Id.*, p. 3.
6. Streeval's Auditors Comments provide, in part:

The referral is due to a ROT audit that resulted in underreported sales for the tax year ending 12/31/2006. The taxpayer did not file an Illinois Small Business Corporation Tax Return (IL-1120-ST) for the tax year ending 12/31/2007. The taxpayer did not file an Illinois Amended Small Business Corporation Tax Return (IL-1120-ST-X) to report the increase in income for the tax year ending 12/31/2006. The taxpayer deals in gold, silver and platinum bullion, coins and scrap jewelry. The scrap jewelry is sold to a refiner in Ohio and the bullion and coins are sold to various retailers. The taxpayer has no taxable sales and claims resale and legal tender exemption for sales tax. ...

The audit issues are as follows:

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**Verification of Underreported Receipts**

The taxpayer did not file the required corrected IL-1120-ST returns to report the underreported receipts from the ROT Field Audit. During the ROT audit, the taxpayers sales were examined using one year's sales invoices (2006) and the amount was compared to the gross receipts reported on the U.S. Income

Tax Return for an S Corporation (Form 1120S). The sales invoices exceeded the gross receipts reported on the Form 1120S. The taxpayer has no sales that are sales taxable (t/p claims resale and legal tender exemption) so the difference does not affect sales tax liability but does affect income tax liability. The Schedule 3 Sales/Receipts Reconciliation does not show the underreported amount as it does not affect sales tax, only income tax. The Form 1120S reflects the original gross sales used on Schedule 3. The Schedule of Sales Differences from the ROT audit shows the increase in income on the prepared Auditor's Report (EDA-93) for the tax year ending 12/31/2006. I included a copy of ROT Schedule 3, Schedule of Sales Differences, the U.S. 1120S return and EDA-93 in the audit work papers.

#### Verification of Ordinary Income

For the tax year ending 12/31/2006, the ordinary income (Part 1A-Line 1-Column A) on the EDA-93 is verified from IRS Record of Account. The taxpayer did not file Form 1120S or the IL-1120-ST returns for the tax year ending 12/31/2007. A copy of the Form 1120S return, never filed, is included in the audit file. The ordinary business income on the Form 1120S return is used on the prepared EDA-93. The BIT Taxpayer History Report, included in the file, was also used to verify the tax year ending 12/31/2006. No exceptions are noted.

The audit determinations are as follows:

#### Summary

For the tax year ending 12/31/2006, the taxpayer did not file an amended return (IL-1120-ST-X) to include the underreported receipts from the Illinois Field Audit. The EDA-122 and ICB-1 were mailed to the taxpayer. The taxpayer responded by filing the ICB-1 and ICB took jurisdiction. ICB issued an Action Decision, and there will be no changes to the final proposed adjustments. An IL-870 was mailed to the taxpayer and they did not respond.

#### Adjustment #1

For the tax year ending 12/31/2006, I prepared an Auditor's Report (EDA-93). The ordinary income of \$XXXX of which \$XXXX is Illinois base income. This established a net tax due of \$XXX. I included a copy of the EDA-93 in the audit file.

#### Section 3-3 Penalties and Section 1003 Interest

Section 3-3(b)b-20)(2) late pay penalty was calculated for \$801. In addition, Section 1003 interest will be calculated when the audit is processed. The penalty and interest should be doubled due to the recent amnesty regulations. I included a copy of the penalty calculation in the audit file.

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#### Conclusion

The case is being closed as an EL, which, after review, should be forwarded to the Audit Notice Section. The taxpayer should be billed for tax, penalty and interest due.

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Department Ex. 3, pp. 1-3.

7. Streeval's Audit Comments describe a discrepancy the ROT auditor noted between the amount of sales described in Taxpayer's invoices and the amounts reported on line 1 of its monthly retailers' occupation tax (ROT) returns for 2006. Department Ex. 3, pp. 1, 4.
8. John Doe (John Doe), Taxpayer's accountant, prepared the federal returns that Taxpayer filed during 2006 and 2007, as well as Taxpayer's Illinois returns for 2006. Tr. pp. 12-13 (testimony of John Doe).
9. Taxpayer did not issue any discovery requests to the Department during the course of this matter, and John Doe first saw Streever's Audit Comments when they were offered as an exhibit at hearing. Tr. pp. 8-11 (colloquy regarding Taxpayer's objection to the admission of Department Ex. 3).
10. Department Exhibit 3 includes a schedule of sales differences that Streevers prepared. Department Ex. 3, p. 4. Regarding TYE 2006, that schedule provides as follows:

YEAR	B&R SALES TOTAL	SALES INV	ST-1 G. RECEIPTS AFTER ADJ.	SALES INV LESS ST-1 G. RECEIPTS AFTER ADJ.	BANK DEP.	BNK DEP LESS B&R
2006	XXXX	XXXX	XXXX	XXXX	XXXX	XXXX

Department Ex. 3, p. 4.

11. The ROT audit determined that Taxpayer had no ROT liabilities due regarding the audit period, because all of its sales were exempt. Department Ex. 3, pp. 1-3. As a result, the Department did not issue any Notice(s) of Tax Liability (NTL(s)) to Taxpayer, based on a correction of the ROT returns Taxpayer filed during the periods at issue. *Id.*; *see also* 35 ILCS 120/4. Because no NTL was issued, no ROT deficiency for the applicable periods was ever finalized against Taxpayer. 35 ILCS 120/4.

12. In her Auditor's Comments, Streevers said nothing about whether Taxpayer reported, on its federal form 1120S, that it used the accrual method of accounting. Tr. pp. 1-3. Nor did she document her own, independent, determination that, when filing its federal and Illinois returns for TYE 2006, Taxpayer was required to use, or should have used, the accrual method of accounting. *Id.*; *see also* 2006 Form 1120-S for 2006, U.S. Income Tax Return for an S Corporation Schedule B, line 1 (asking the taxpayer to check one of three boxes (cash; accrual; or other) to report the method of accounting used during the year for which the return was filed) (a pdf copy of a 2006 Form 1120S is available to view at the IRS's web site, at <http://www.irs.gov/pub/irs-prior/fl120s--2006.pdf>) (last viewed on March 17, 2014).
13. During the audit, Streevers prepared a schedule of, among other things, certain amounts for which she asked Taxpayer to provide evidence to show whether it did or did not actually receive funds for what she titled, Bank charge backs. Taxpayer Ex. 2.
14. Taxpayer offered into evidence copies of ten checks drawn on the account of XYZ BUSINESS, Inc., stamped "Returned Not Paid ... Uncollected Funds." Taxpayer Ex. 1. Those checks were made payable to Taxpayer, and were dated on various dates between September and December 2006. *Id.*
15. The amounts of the checks included within Taxpayer Exhibit 1, and the dates the bank charged Taxpayer for the amounts dishonored, are included within Streeval's schedule of Bank Charge Backs. *Compare* Taxpayer Ex. 1 *with* Taxpayer Ex. 2.

### **Conclusions of Law:**

When the Department introduced the NODs into evidence under the certificate of the Director, it presented prima facie proof that ABC Business was liable for the tax proposed. 35 ILCS 5/904; PPG Industries, Inc. v. Department of Revenue, 328 Ill. App. 3d 16, 33, 765 N.E.2d 34, 48 (1<sup>st</sup> Dist. 2002); Balla v. Department of Revenue, 96 Ill. App. 3d 293, 296-97, 421 N.E.2d 236, 239 (1<sup>st</sup> Dist. 1981). The Department's prima facie case is a rebuttable presumption. Fillichio v. Department of Revenue, 15 Ill. 2d 327, 333, 155 N.E.2d 3, 7 (1958). A taxpayer cannot overcome the presumption merely by denying the accuracy of the Department's assessment, or merely by denying knowledge of a tax deficiency. Balla, 96 Ill. App. 3d at 296-97, 421 N.E.2d at 239. 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, Inc., 328 Ill. App. 3d at 33, 765 N.E.2d at 48 (a taxpayer has the burden of overcoming the Department's *prima facie* case using documentary evidence, meaning books and records, and not mere testimony).

The NOD issued for TYE 2006 was based on the Department's determination that the amount of Taxpayer's ordinary income, as reported on both its federal and Illinois income tax returns, should be modified — and to be more specific, increased — from the amounts reported on its returns, based on the results of an audit conducted by the Department pursuant to the Retailers' Occupation Tax Act (ROTA). Department Exs. 1, 3; *but see* 35 ILCS 5/203(h). The NOD issued for TYE 2007 was based on the best information available to the Department, after it determined that Taxpayer failed to file an Illinois income tax return for 2007. Department Exs. 1, 3. Because Taxpayer has conceded the Department's proposed assessment for TYE 2007, this

recommendation addresses only the arguments Taxpayer made regarding the NOD issued for TYE 2006.

Before identifying and addressing Taxpayer's arguments, it will help to understand the modification that forms the basis for the Department's proposed assessment of tax for 2006. Subchapter S corporations are exempt from the income tax imposed by IITA § 201(a) and (b), but are subject to the replacement tax imposed by IITA § 201(c) and (d). 35 ILCS 5/205(c). 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. 2006 IL-1120-ST Instructions, p. 4 ("Illinois base income means federal ordinary income modified by additions and subtractions as shown in Steps 2 through 5 of Form IL-1120-ST.") (a pdf copy of the Department Instructions for a 2006 form IL-1120-ST is viewable at the Department's web site, at <http://tax.illinois.gov/TaxForms/IncM2006/bus/small/IL-1120-ST-Instr.pdf>); *see also* 86 Ill. Admin. Code § 100.2405(c)(7). Just as a C 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, 410 N.E.2d 828, 830, 43 Ill. Dec. 695 (1980) ("... Federal taxable income [i]s the starting point upon which State tax liability is computed."); Department Ex. 2, pp. 2-3, 6-7 (Forms EDA-93 that Streevers prepared in this case).

Here, Streevers' Auditor's Comments contain her written confirmation that Taxpayer reported its ordinary income, on its 2006 IL-1120-ST, in the same amount as it was reported on its federal form 1120S for 2006. Department Ex. 3, pp. 1-2; *see also* 35 ILCS 5/403(a). Taxpayer's ordinary income for TYE 2006 was a negative number, -\$XXXX, meaning that it had a loss in that amount. Department Ex. 2, p. 6 (Parts 1 and IV of Form EDA-93); Department Ex. 3, pp. 1-2.

Streevers thereafter modified the amount of Taxpayer's reported loss for 2006, because an ROT auditor made a determination that Taxpayer's sales invoices reflected that Taxpayer had more gross receipts than it reported having, on ROT returns Taxpayer filed for 2006. Department Ex. 1, pp. 6-7; Department Ex. 3, pp. 1-3; *but see* 35 ILCS 5/203(h).

### **Issues and Arguments**

Taxpayer asserts two reasons why the Department's modification for 2006 was incorrect in this case. Both arguments focus on the amount by which the Department modified (that is, the amount by which it increased) the amount of Taxpayer's reported ordinary income, which, again, was actually a loss. Department Ex. 2, p. 6. Both arguments reflect Taxpayer's general disagreement with the auditor's determination that it actually received all of the amounts either Streevers, or the ROT auditor, determined that Taxpayer realized in 2006, as shown on Taxpayer's sales invoices dated 2006. Department Ex. 3, pp. 1-4. I address each argument in turn.

In essence, Taxpayer's first argument is that the Department treated Taxpayer's sales invoices as though it were using the accrual method of accounting, whereas Taxpayer's accountant testified that it used the cash method of accounting. Department Ex. 3, *passim*; *see also Aetna Screw Products Co. v. Borg*, 116 Ill. App. 3d 206, 207, 451 N.E.2d 1260, 1262 (1<sup>st</sup> Dist. 1983) (describing the accrual and cash methods of accounting, respectively, as follows: "the accrual method of accounting, record[s] income and expenses at the time the right to or liability for payment accrued regardless of when the money actually was received or paid. ... [whereas] the cash basis of accounting, record[s] income and expenses at the time money actually was received or disbursed.").

Taxpayer's first argument is supported solely by the testimony of its accountant. Tr. pp. 14-15 (John Doe). However, and as already noted, a taxpayer cannot rebut the presumption of correctness that attaches to the Department's prima facie case merely by offering testimony that the Department's determinations were not correct. PPG Industries, Inc., 328 Ill. App. 3d at 33, 765 N.E.2d at 48; Balla, 96 Ill. App. 3d at 296-97, 421 N.E.2d at 239. Taxpayer did not corroborate John Doe's testimony that Taxpayer used the cash method of accounting during 2006. Like the individual taxpayer in Balla, John Doe's testimony could have been corroborated simply by offering accurate copies of Taxpayer's filed federal and Illinois tax returns for 2006 — assuming, of course, that Taxpayer, in fact, checked the appropriate boxes to report that it used the cash method of accounting during that year. *See Balla*, 96 Ill. App. 3d at 296-97, 421 N.E.2d at 239 (“At the Department hearing, the hearing officer requested her to produce a copy of her 1975 federal tax return and the federal audit report. The hearing officer considered these documents to be very important in establishing the petitioner's claim ....”).

On this point, IITA § 403 requires taxpayers to report items of income, deduction and exclusion on its Illinois income tax return “in the same manner and amounts as reflected in [its] federal income tax return for the same taxable year.” 35 ILCS 5/403(a). The record reflects that Streevers confirmed that Taxpayer reported its ordinary income, on its Illinois return, in the same *amount* as it did on its federal return. Department Ex. 3, pp. 1-2; *see also* 35 ILCS 5/203(b), (g), (h). But her audit comments say nothing about whether, on its Illinois and federal returns, Taxpayer reported that it used the cash method when accounting for such ordinary income. Department Ex. 3, pp. 1-2. Had Taxpayer offered documentary evidence to show that it used the cash method of accounting for income tax reporting in TYE 2006, and evidence to show that the Department's income tax audit treated the amounts shown due on all of Taxpayer's 2006 sales

invoices as having been received in 2006, such evidence would have called into question the reasonableness of the audit. Answer Iowa, Inc. v. Department of Revenue, 161 Ill. App. 3d 247, 514 N.E.2d 488 (4<sup>th</sup> Dist. 1987). Since the plain text of § 403 requires taxpayers to use the same method of accounting for items of income, etc. for both federal and state income tax reporting purposes, it would generally not be reasonable for an auditor, when ostensibly “correcting” Taxpayer’s return, to ignore the method it actually used. *See* 35 ILCS 5/403(a).

Alternatively, Taxpayer could have used one or more of the tools available to it through the discovery process to investigate and/or confirm whether the NOD was premised on the Department’s determination that Taxpayer used the accrual method of accounting when reporting the income shown due on its sales invoices. *See* 86 Ill. Admin. Code § 200.125. But the record suggests that Taxpayer did not request any discovery in this case. Tr. pp. 8-11 (colloquy regarding offer of Department Ex. 3). In sum, since the record includes no documentary evidence to corroborate John Doe’s testimony that the Department’s modification of ordinary income was erroneous because Taxpayer used cash accounting, Taxpayer has not rebutted the Department’s prima facie case. PPG Industries, Inc., 328 Ill. App. 3d at 33, 765 N.E.2d at 48; Balla, 96 Ill. App. 3d at 296-97, 421 N.E.2d at 239.

Taxpayer next argues that the Department’s modification of Taxpayer’s ordinary income was erroneous for a different reason. Taxpayer claims that it did not actually receive some of the invoiced payments tendered to Taxpayer during 2006, because one of the customers named on such sales invoices issued checks to Taxpayer that were dishonored when Taxpayer’s bank presented them for payment. Taxpayer Ex. 1, pp. 1-10 (copies of dishonored checks); Tr. pp. 23-26 (John Doe). Unlike Taxpayer’s first argument, however, on this issue, Taxpayer offered copies of checks that were identified on a schedule prepared by Streevers, and which schedule

was given to John Doe during the audit. Taxpayer Exs. 1-2. The copies of the dishonored checks were not available to Taxpayer during the audit (*see* Taxpayer Ex. 2 (copy of Streevers' schedule dated November 8, 2012)), but it was able to obtain them from its bank prior to hearing. Taxpayer Ex. 1, p. 11 (copy of email to John Doe, dated February 28, 2013, referring to copies of dishonored checks attached to the email); Tr. pp. 32-34 (John Doe). The checks were drawn by one of Taxpayer's customers, made payable to Taxpayer, dated during the later months of 2006, and each of the ten checks bear a stamp showing that it was "Returned Not Paid ... Uncollected Funds[.]" Taxpayer Ex. 1, pp. 1-10; Tr. pp. 23-26 (John Doe). The dishonored checks totaled \$121,072.97. Taxpayer Ex. 1.

Taxpayer, in sum, offered documentary evidence, as well as credible testimony closely identified with its books and records, to show that it did not receive all of the amounts the Department determined should be added to Taxpayer's reported ordinary income/loss for 2006. Taxpayer Ex. 1-2; Tr. pp. 23-26 (John Doe). Once a taxpayer rebuts one of the Department's determinations, the burden shifts to the Department to prove its case by a preponderance of the competent evidence. Miller v. Department of Revenue, 408 Ill 574, 581-82, 97 N.E.2d 788, 792 (1951). Here, the Department offered no such evidence. Therefore, the documentary evidence supports a reduction in the amount by which the Department increased Taxpayer's reported ordinary loss. Taxpayer Exs. 1-2.

The Department modified Taxpayer's ordinary and base income by adding \$XXXX to the amount of Taxpayer's reported ordinary loss of -\$XXXX, for a corrected amount of \$XXXX. Department Ex. 2, p. 6 (Parts 1 and IV of Form EDA-93). But since Taxpayer has offered documentary evidence to show that it did not receive \$XXXX of the \$XXXX in additional income the Department determined Taxpayer received, the corrected amount of Taxpayer's base

income for 2006 should be reduced by \$XXXX. This means that the corrected amount of Taxpayer's base income should be reduced to \$XXXX. *Id.*; Taxpayer Ex. 1, pp. 1-10 (XXXX – XXXX = XXXX). The correct amount of replacement tax on that amount is \$XXX. 35 ILCS 5/201(c); Department Ex. 2, p. 6 ( $235,026 * .015 = 3,525.39$ ).

As a final note, when preparing the Pre-Hearing Order, the parties did not identify any challenge to the penalty proposed in the NOD issued for TYE 2006. Issues not raised are waived. So, Taxpayer makes no claim that the penalty proposed for TYE 2006 should be abated because it exercised ordinary business care and prudence when attempting to report and pay the correct amount of tax due. Notwithstanding that waiver, the basis for measuring a late payment penalty is the amount of tax shown due (or required to be shown due) on a return, reduced by any tax paid on time, and by any credit which was properly allowable on the date the return was required to be filed. 35 ILCS 735/3-3(c).

Here, the Department proposed to assess a penalty under the authority of UPIA § 3-3(b-20)(2), in the amount of \$XXXX, which is 40% of the proposed \$XXX replacement tax deficiency. Department Ex. 1, p. 3; 35 ILCS 735/3-3(b-20)(2), (j). Because the evidence supports a reduction in the amount of tax proposed due, from \$XXX to \$XXX, the late-payment penalty must also be revised, to conform to the pertinent paragraphs of UPIA § 3-3. 35 ILCS 735/3-3(b-20)(2), (c), (j). The late penalty due should be reduced from \$XXXX to \$XXX. 35 ILCS 735/3-3(b-20)(2), (c), (j) ( $XXX * 0.40 = 1,410$ ).

**Conclusion:**

I respectfully recommend that the Director finalize the NOD issued for TYE 2007 as issued, pursuant to statute. I recommend that the Director revise the NOD issued for TYE 2006 to reduce the tax and penalty proposed, as described above, and that it then be finalized as so

revised, pursuant to statute.

April 21, 2014

John E. White  
Administrative Law Judge