

IT 14-12

Tax Type: Income Tax

Tax Issue: Properly Determined AGI For Subchapter S Shareholders

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

**THE DEPARTMENT OF REVENUE
OF THE STATE OF ILLINOIS**

v.

**JOHN & JANE DOE,
Taxpayer**

No. XXXX
Account ID XXXX
Letter ID XXXX
XXXX
Tax Years 2008, 2009

**Ted Sherrod
Administrative Law Judge**

RECOMMENDATION FOR DISPOSITION

Appearances: Special Assistant Attorney General Ronald Forman on behalf of the Illinois Department of Revenue; Shay Allen, Law Offices of Shay Allen on behalf of John and Jane Doe.

Synopsis:

This matter is before this administrative tribunal as the result of a timely protest by JOHN AND JANE DOE (the “taxpayer”) of Notices of Deficiency the Illinois Department of Revenue (“Department”) issued to the taxpayer proposing to assess deficiencies for the calendar years ended 12/31/08 and 12/31/09. A hearing to consider the taxpayer’s protest was held at the Department’s offices in Chicago, Illinois on September 2, 2014. The Department’s assessments arise from its determination of the amount of distributive share income the taxpayer received from ABC Business Inc., a subchapter S corporation the taxpayer owned during the tax years in controversy. At the hearing the taxpayer introduced Federal amended income tax returns ABC Business Inc. filed for the tax years in controversy and Internal Revenue Service Account

Transcripts related to these amended returns, but offered no other corporate books or records related to this entity. Documentary evidence was also introduced into the record by the Department. I have reviewed the evidence the parties have submitted, and I am including in this recommendation findings of fact and conclusions of law. I recommend that the Notices of Deficiency be finalized as issued, with interest to accrue pursuant to statute.

Findings of Fact:

1. On September 4, 2012, the Department issued Notices of Deficiency for Form IL-1040, Individual Income Tax Return to JOHN AND JANE DOE (“taxpayer”), residents of Illinois, assessing tax, penalty and interest for the tax years ended 12/31/08 and 12/31/09. Department Exhibit (“Ex.”) 1.¹
2. The taxpayer was the sole shareholder of ABC Business Inc. (“ABC Business”), a subchapter S corporation domiciled in Illinois, which, during the tax years in controversy, was engaged in the operation of a gas service station and truck stop business. Tr. pp. 18, 19, 27, 46; Taxpayer Ex. 1, 2.
3. For each of the tax years in controversy, ABC Business elected to be taxed as a subchapter S corporation. Tr. pp. 5, 6, 13, 14, 19; Taxpayer’s Ex. 1, 2. Pursuant to this election, it was allowed to pass through its income and related tax liability to its shareholders rather than be taxed at the corporate level, pursuant to Internal Revenue Code sections 1361-1366 of the Internal Revenue Code. The company was also subject to the Illinois Personal Property Replacement Tax (“Replacement Tax”) and was assessed

¹ Unless otherwise noted, findings of fact apply to the tax years in controversy.

additional Replacement Tax for each of the tax years in controversy. Tr. pp. 21-23, 32-35.²

4. The Department determined the taxpayer's taxable income for the tax years at issue by including the taxpayer's distributive share of subchapter S corporation income from ABC Business in the taxpayer's adjusted gross income. Tr. pp. 5, 6, 14, 18-21, 23, 29, 30.
5. The taxpayer's distributive share of ABC Business's income was determined following the Department's sales tax (Retailers' Occupation Tax) audit of ABC Business's business activities during the tax years at issue. Tr. pp. 18-21, 23, 29, 30. At the conclusion of the Department's sales tax audit of ABC Business, the Department determined that ABC Business had not reported on its sales tax returns all of its receipts from selling gasoline and tangible personal property at retail in Illinois. *Id.* The taxpayer's distributive share of ABC Business's income for 2008 and 2009 at issue was derived from an increase in ABC Business's net income included in the taxpayer's distributive share of income from ABC Business arising from sales receipts that the Department determined ABC Business realized but failed to report during these tax years. Tr. pp. 5, 6. There is no evidence in the record that the results of the Department's sales tax audit of ABC Business were ever protested by ABC Business or revised based upon any administrative hearing or judicial determination.
6. On January 27, 2013, ABC Business filed amended returns with the Internal Revenue Service for each of the tax years in controversy. Taxpayer's Ex. 1, 2. These amended returns were accepted by the Internal Revenue Service as constituting ABC Business's

² Subchapter S corporations doing business in Illinois are not subject to the regular income tax imposed by 35 ILCS 5/201(a), but are subject to the Illinois Personal Property Replacement Tax imposed by 35 ILCS 5/201(c). The Illinois Personal Property Replacement Tax due is based upon a subchapter S corporation's "net income." 35 ILCS 5/201(c).

net income for these years on Account Transcripts issued by the Internal Revenue Service. *Id.* The amounts reported on these amended returns reflected the increase in ABC Business's gross receipts determined by the Department during its sales tax audit of this company covering the tax years in controversy. Tr. pp. 38-41.

Conclusions of Law:

In the instant case, the Department issued Notices of Deficiency to JOHN AND JANE DOE (the "taxpayer"), residents of Illinois, determining that the taxpayer owes additional income tax on its distributive share of income received from ABC Business Inc. ("ABC Business"), an Illinois domiciled subchapter S corporation the taxpayer owned. Tr. pp. 5, 6, 18, 19; Department Ex. 1; Taxpayer's Ex. 1, 2. A subchapter S corporation is a corporation that has in effect an election under section 1362 of the Internal Revenue Code to be taxed as a "pass through" entity passing through to its shareholders all of its income which must be taken into account by its shareholders in computing their individual income tax liabilities, pursuant to Internal Revenue Code section 1366. 35 ILCS 5/1501(a)(28). 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. 35 ILCS 5/301; 86 Ill. Admin. Code, ch. I, section 100.9750(c). A subchapter S corporation's income flowing through to its shareholders that are Illinois residents is included in determining each shareholder's adjusted gross income which is subject to the state's income tax pursuant to 35 ILCS 5/301(a).

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 (1st Dist. 1987); Quincy Trading Post v. Department of Revenue, 12 Ill. App. 3d 725 (4th Dist. 1973). Instead, a taxpayer has the burden to present evidence that is consistent, probable and closely identified with books and records to show that the proposed assessment is not correct. PPG Industries, *supra* at 33, 34 (a taxpayer has the burden of overcoming the Department's *prima facie* case using documentary evidence, meaning books and records, and not mere testimony).

In the instant case, the Department's Notices of Deficiency issued to the taxpayer determined the amount of the increases in the taxpayer's distributive share of income from ABC Business due for the tax years ended 12/31/08 and 12/31/09 based upon its allocation of ABC Business's income to the taxpayer. Tr. pp. 5, 6, 14, 18-21, 23, 29, 30. These increases were attributable to increases in ABC Business's net income resulting from the Department's sales tax (Retailers' Occupation Tax) audit of ABC Business that covered the same years covered by the Department's Notices of Deficiency. *Id.* During its sales tax audit of ABC Business, the Department increased the amount of ABC Business's gross receipts above amounts reported by ABC Business on its sales tax returns upon finding that ABC Business had made numerous unreported sales of gasoline and other tangible personal property at retail. *Id.* Because ABC Business was a subchapter S corporation that was wholly owned by the taxpayer, the Department determined that its increases in ABC Business's gross receipts should be used in determining

ABC Business's income that flowed through to the taxpayer for purposes of determining the taxpayer's distributive share of ABC Business's income. *Id.*

During the hearing, the only witness that testified on the taxpayer's behalf was Jack Black ("Jack Black"), an accountant employed by ABC Business who worked on ABC Business's tax returns filed with the Internal Revenue Service for the tax years in controversy. Tr. p. 43.³ Jack Black testified that ABC Business included additional gross receipts determined by the Department during its sales tax audit on amended returns for 2008 and 2009 ABC Business filed with the Internal Revenue Service on January 27, 2013. Tr. pp. 38-42. However, in spite of the fact that ABC Business's Federal amended returns reporting ABC Business's gross receipts for 2008 and 2009 allegedly included the Department's increase in ABC Business's gross receipts as a result of its sales tax audit, during the hearing in this case the taxpayer argued that ABC Business's gross receipts should not have included these additional amounts. Tr. p. 15.

As previously noted, the taxpayer's distributive share of ABC Business's income for each of the tax years at issue is based on the Department's sales tax audit of ABC Business during which the Department determined that ABC Business underreported gross receipts from sales of tangible personal property. During the hearing, no evidence was presented that ABC Business ever protested this determination by seeking an administrative hearing or that this determination was ever reversed by any court.

It is well settled in Illinois that a taxpayer cannot rely upon a claim that the underlying corporate liability is incorrect as a basis for rebutting a determination of individual liability that

³ While Jack Black testified that he prepared ABC Business's returns (at tr. pp. 19, 24) ABC Business's amended returns for 2008 and 2009 identify "Gene Green, E.A." rather than Jack Black as the "Paid Preparer" of these returns. Taxpayer's Ex. 1, 2. During testimony Jack Black also admitted that "Gene Green E.A." also prepared ABC Business Group's original returns for 2008 and 2009. Tr. pp. 42-44.

is based upon the finally determined underlying corporate liability. Department of Revenue v. Dombrowski, 202 Ill. App. 3d 1050 (1st Dist. 1990). Dombrowski stands for the proposition that, where the Department properly issues a final assessment to the corporation incurring the underlying corporate liability, any issues as to the correctness of that final tax deficiency can be challenged only pursuant to the Illinois Administrative Review Act (“ARA”). Dombrowski, *supra* at 1054 (“Having failed to file such an action, he has instead improperly sought judicial review of the Department’s action as part of his defense to the instant lawsuit; but because of the defendant’s failure to comply with the ARA, we are not empowered to review the merits of the Final Assessment or the Revised Final Assessment.”).

As a consequence of ABC Business’s failure to contest the Department’s audit determination of its gross receipts during the Department’s sales tax audit of ABC Business, the taxpayer is barred from contesting this audit determination. Because the Department’s determination of the amount of ABC Business’s gross receipts has become final and is legally binding, the taxpayer cannot challenge the correctness of the amount of ABC Business’s gross receipts that have been used in determining ABC Business’s net income passed through to the taxpayer for purposes of computing the taxpayer’s distributive share income.

The taxpayer also contests the correctness of the costs of goods sold that were used by the Department to determine ABC Business’s net income that passed through to the taxpayer in 2008 and 2009. Amended Federal income tax returns included in the record in this case indicate that the costs of goods sold constituted the principal expenses deducted in determining ABC Business’s taxable income for those years. Taxpayer’s Ex. 1, 2. Since the Department’s determination of such expenses is deemed to be *prima facie* correct, it was incumbent upon the taxpayer to produce documents showing the basis for ABC Business’s deductible costs of goods

sold it contends should have been used. PPG Industries, *supra* at 33, 34. However, during the hearing, the taxpayer offered no documentary evidence to show in what manner the Department erred in determining ABC Business's costs of goods sold for the tax years at issue. It must be emphasized that, in a tax case, a taxpayer's mere assertion that the Department erred in computing the taxpayer's tax liability is not sufficient to rebut the statutory presumption of correctness that attaches to the Department's audit determination. Central Furniture Mart, *supra*; Quincy Trading Post, *supra*. To rebut the Department's determination, the taxpayer must produce accounting books and records of business activities that demonstrate the amount of tax the taxpayer claims to be properly due. PPG Industries, *supra* at 35. In the instant case, the taxpayer has not satisfied its burden to rebut the Department's presumptively correct determination of the amount of ABC Business's costs of goods sold used in computing ABC Business's income and the taxpayer's distributive share of ABC Business's income by introducing documentary evidence of this nature.

The taxpayer also argues that, irrespective of the Department's determination of ABC Business's net income which passed through to the taxpayer, the Department is required to conform the amount of ABC Business's net income determined by the Department to ABC Business's costs of goods sold, other expenses and net income as reported on its Federal amended returns purportedly changing the taxpayer's income and expenses that were originally reported once these amended returns are accepted by the Internal Revenue Service. Tr. pp. 13, 14. This argument is based upon section 403(b) of the Illinois Income Tax Act, 35 **ILCS** 5/403(b) ("section 403(b)") which provides as follows:

(b) Adjustment. A final determination pursuant to the Internal Revenue Code adjusting any item or items of income, deduction or exclusion for any taxable year shall be correct for purposes of this Act to the extent such item enters into the determination of base income.

35 ILCS 5/403(b)

The record indicates that the Internal Revenue Service accepted ABC Business's amended returns for 2008 and 2009 as correct for Federal income tax purposes. Taxpayer's Ex. 1, 2. The taxpayer argues that, as a consequence, the Internal Revenue Service changed ABC Business's income and expenses for the tax years at issue from amounts originally reported to those shown on ABC Business's amended Federal income tax returns and that these Internal Revenue Service "adjustments" must be deemed correct for Illinois state tax purposes pursuant to section 403(b).

With respect to the amounts included in ABC Business's costs of goods sold, since the Department's determination of such amounts used in computing ABC Business's net income that passed through to the taxpayer, is deemed to be *prima facie* correct, it was incumbent upon the taxpayer to produce documents showing the basis for the deductible costs of goods sold expenses it contends should have been used and why the Department's determination is incorrect. PPG Industries, supra.

The taxpayer purports to meet this burden by showing that ABC Business's costs of goods sold reported for 2008 and 2009 were changed by the Internal Revenue Service, and that these changes constituted "adjustments" to ABC Business's expenses as required by section 403(b) in order for such amounts to be conclusively deemed correct for state tax purposes. As proof of these changes or "adjustments", the taxpayer submitted into the record copies of the amended returns ABC Business filed showing a "cost of goods sold" amount for 2008 and 2009, the tax years at issue. Taxpayer's Ex. 1, 2. It also introduced copies of Internal Revenue Service Account Transcripts indicating that the amounts of net income shown on these amended returns were accepted by the Internal Revenue Service. *Id.* However, the taxpayer presented no

evidence of the amounts of ABC Business's costs of goods sold shown on ABC Business's original returns for 2008 and 2009. Accordingly, the only evidence that the amounts of its costs of goods sold shown on ABC Business's original returns differed from the costs of goods sold shown on ABC Business's amended returns is the taxpayer's testimony that the amounts shown as cost of goods sold on these returns differed.

Moreover, the testimony the taxpayer's witness, Jack Black, gave regarding the purported changes to ABC Business's costs of goods sold reported on its amended returns from its original returns is suspect. During the hearing, Jack Black, the taxpayer's only witness, admitted that he did not personally prepare ABC Business's original returns and was not certain what costs of goods sold were reported on them. Tr. pp. 39, 40, 42-44. Since there is no documentary evidence that the costs of goods sold shown on ABC Business's amended returns constituted changes or "adjustments" to its originally reported costs of goods sold, and the testimony concerning whether or not the costs of goods sold reported on ABC Business's amended returns differed from the amounts reported on its original returns is suspect, the record contains no conclusive evidence of any kind that the amended returns accepted by the Internal Revenue Service were based on changes to ABC Business's costs of goods sold.

Again it must be emphasized that, in a tax case, a taxpayer's mere assertion that Department erred in computing the taxpayer's tax liability is not sufficient to rebut the statutory presumption of correctness that attaches to the Department's *prima facie* correct audit determination. Central Furniture Mart, *supra*; Quincy Trading Post, *supra*. To rebut the Department's determination, the taxpayer must produce accounting books and records of business activities that demonstrate the amount of tax the taxpayer claims to be properly due. PPG Industries, *supra* at 35. In the instant case, the taxpayer has not produced sufficient

documentary evidence to establish that the Internal Revenue Service changed ABC Business's costs of goods sold by changing these amounts from the amounts reported on ABC Business's original returns to the amounts reported on the amended returns ABC Business filed with the Internal Revenue Service. To prove that the costs of goods sold were changed, the taxpayer needed to submit copies of ABC Business's original returns for 2008 and 2009 showing costs of goods sold that differed from the amounts on ABC Business's amended returns. Consequently, the taxpayer has failed to establish sufficient documentary evidence to support the application of section 403(b) to the facts presented in the instant case.

During the hearing, the Department disagreed with the taxpayer regarding whether the Internal Revenue Service's acceptance of ABC Business's amended returns constitutes "adjustments" by the Internal Revenue Service that must be accepted as correct by the state pursuant to section 403(b). I have not addressed this issue because, even if the taxpayer is correct in its contention that the Internal Revenue Service's acceptance of ABC Business's amended returns constituted Internal Revenue Service "adjustments" to ABC Business's expenses pursuant to section 403(b), the taxpayer has presented insufficient evidence to apply section 403(b), as so construed, based upon the evidence presented in this 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: November 5, 2014