ST 18-01
Tax Type: Sales Tax
Tax Issue: Books and Records Insufficient
Statute of Limitations Application

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

THE DEPARTMENT OF REVENUE OF THE STATE OF ILLINOIS	**No. XXXX** **Account No. XXXX** **Letter ID XXXX** **XXXX**
v.	**Period XXXX**
ABC BUSINESS, Taxpayer	**Ted Sherrod Administrative Law Judge**

RECOMMENDATION FOR DISPOSITION

Appearances: Special Assistant Attorney General George Foster on behalf of the Illinois Department of Revenue; Michael Whelan, Law Office of Michael C. Whelan on behalf of ABC BUSINESS.

Synopsis:

Following an audit, the Department of Revenue ("Department") issued Notices of Tax Liability to ABC BUSINESS ("Taxpayer") that assessed Retailers' Occupation Tax regarding the Taxpayer's sales during the period 1/1/09 through 9/30/11. The Taxpayer timely protested the liabilities indicated in the Department's Notices of Tax Liability and requested a hearing. The pre-trial order the parties agreed to enumerates the issues to be decided in this case as follows: "[T]he issues include the correctness of the tax assessed

in the NTLs, whether the audit method was reasonable, and whether penalties should be abated for reasonable cause."

A hearing before Administrative Law Judge John White was held in this matter on January 26, 2015.[1] During the hearing, the Taxpayer offered the testimony of *John Doe*, the Department's auditor and *John Smith*, the Taxpayer's managing partner, and both parties submitted documentary evidence into the record. I have reviewed the evidence offered at hearing, and am including in this recommendation findings of fact and conclusions of law. I recommend that the Department's Notices of Tax Liability be cancelled.

Findings of Fact:

1. ABC BUSINESS ("Taxpayer"), a business classified as a partnership for Federal income tax purposes, was, during the tax period in controversy (1/1/09 through 9/30/11) engaged in the retail sale of soft drinks, juices, candy, food, ice, hair products, cigarettes and other tobacco products, clothing, shoes, beauty care products, medicines and other general merchandise. Department Exhibit ("Ex.") 3. The Taxpayer was open 7 days a week. Taxpayer's Ex. 4. The Taxpayer commenced business in February 1997 and closed in September 2011. Department Ex. 1 (Audit Narrative).
2. During the tax period in controversy, the Taxpayer was owned by *John Smith aka John Smith* and his wife *Jane Smith*, both of whom were partners in this

[1] The undersigned has been assigned by the chief judge of the Department's Office of Administrative Hearings to write the recommendation in this case. It is not a requirement that the Administrative Law Judge who heard and took evidence in this matter be the one to make the recommendation. American Welding Supply Co. v. Department of Revenue, 106 Ill. App. 3d 93 (5th Dist. 1982).

partnership. Tr. p. 38; Department Ex. 1 (Audit Narrative). *John Smith* was the Taxpayer's managing partner. Tr. pp. 38, 39.

3. *John Jones* of DP Accounting was the Taxpayer's accountant during the tax period in controversy. Tr. p. 49. He was responsible for all of the Taxpayer's books, records and tax returns. Department Ex. 1 (Audit Narrative).

4. During 2012 and 2013, The Department conducted an audit of the Taxpayer's business for the period January 1, 2009 through September 30, 2011. Department Ex. 1 (Audit Narrative); Taxpayer's Ex. 3. The audit was conducted using primarily the Taxpayer's records for the months of January 2011 through September 2011. Tr. pp. 12, 13, 24, 26, 27, 31, 32; Department Ex. 1 (Audit Narrative), 4. The auditor projected some of his 2011 figures over the entire tax period in controversy. *Id*.

5. During the Department's audit, *John Jones* (name misspelled in Department Exhibit 1, Audit Narrative), the Taxpayer's accountant, provided the following books and records to the Department's auditor for the period January 2011 through September 2011: 1) cash register tapes providing a daily record of gross sales; 2) a record of the amount of merchandise purchased including copies of vendors' invoices; and 3) an inventory of the value of stock on hand taken at least once each year (part of the federal partnership income tax return the auditor determined was filed; [Schedule L of the taxpayer's U.S. Return of Partnership Income]). Tr. p. 12; Department Ex. 1 (Audit Narrative).[2]

[2] The auditor's Audit Narrative states that these records were made available for the period January 2012 through September 2012. Department Ex. 1 (Audit Narrative). However, the Audit Narrative also states that the Taxpayer's business closed in September 2011. *Id*. Given the foregoing, I deduce that the

6. After reviewing the Taxpayer's books and records, the Department's auditor determined that the Taxpayer had a sufficiently complete set of books and records for the months January 2011 through September 2011 to corroborate the gross sales reported on the Taxpayer's ST-1 sales tax returns for this period. Tr. pp. 12, 24, 27, 28, 32; Department Ex. 1 (Audit Narrative). Specifically, the auditor determined that the Taxpayer's cash register receipts (z-tapes) for this period were complete. *Id.* However, the auditor further determined that the Taxpayer 's books and records were suspect because they indicated a breakdown between high and low rate sales that did not correspond to a normal breakdown between high rate and low rate sales for a store of the size of the Taxpayer's store. Tr. pp. 12, 25, 26.

7. During the evidentiary hearing in this case, the Taxpayer submitted cash register receipts (z-tapes) covering all of its days of operation during the period January 31, 2009 through November 30, 2010. Taxpayer's Ex. 4. Identical z-tapes for the period January 2011 through September 2011 were presented and reviewed by the auditor during his audit of the Taxpayer. Tr. pp. 12, 13; Department Ex. 1 (Audit Narrative). The Taxpayer's z-tapes break down sales between high rate and low rate sales and enumerate sales by either item type or category (e.g. groceries, cigarettes, soda, candy). Tr. p. 29. The Department's auditor determined that the z-tapes provided by the Taxpayer were reliable indicators of the Taxpayer's gross sales. Tr. pp. 12, 14, 24, 27, 28, 32; Department Ex. 1 (Audit Narrative).

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reference in the Audit Narrative to the period January 2012 through September 2012 was intended to be a reference to the period January 2011 through September 2011.

8. While the Taxpayer's z-tapes did not indicate non-taxable food stamp (Link Card) sales, the total food stamp (Link Card) sales shown on the Taxpayer's returns for 2009 and 2010 matched food stamp (Link Card) sales shown by the United State Department of Agriculture's records. Tr. p. 30.[3]
9. The Taxpayer made no food stamp (Link card) sales during 2011. Taxpayer's Ex. 2.
10. Because he determined that the Taxpayer's records of high rate and low rate sales were suspect, the Department's auditor used an alternative method to determine the Taxpayer's high rate and low rate sales. Tr. pp. 12, 13, 24, 25, 54; Department Ex. 1 (Audit Narrative). Specifically, the auditor ignored the breakdown between high rate and low rate sales, and the enumeration of types of items and categories shown on the z-tapes and, in lieu of the foregoing, used a breakdown of high rate and low rate sales deduced from a survey of the Taxpayer's purchases of inventory from vendors (i.e. a "circularization" of the Taxpayer's vendors) based upon the percentage of high rate and low rate purchases indicated by this circularization. *Id.* The auditor calculated the total high rate and low rate purchases indicated by the information obtained from this circularization and applied a mark up agreed to by the Taxpayer to both the high rate and low rate purchases. Tr. pp. 12, 13, 25, 58; Department Ex. 4. Based

[3] Illinois residents approved to receive food stamps under the Supplemental Nutritional Assistance Program administered by the U.S. Department of Agriculture pursuant to 7 U.S.C.A. section 2013 make food stamp purchases using an "Illinois Link Card" issued by the Illinois Department of Human Services ("DHS"). See DHS website at www.dhs.state.il.us. Sales made to customers paying with food stamps are not taxable since they are considered sales to a governmental unit exempt pursuant to 86 Ill. Admin. Code, ch. I, section 130.2080. See Illinois Department of Revenue General Information Letter No. ST 10-0021-GIL, 3/19/10. See also 86 Ill. Admin. Code, ch. I, section 150.525.

upon this computation, the auditor developed a ratio of high rate to low rate sales of 80% high rate and 20% low rate. Tr. pp. 12, 13; Department Ex. 1 (Audit Narrative). This ratio closely corresponded to the ratio to high rate to low rate sales the auditor had previously determined to be typical of a retailer the size of the Taxpayer. Tr. p. 12.

11. The auditor applied the aforementioned percentage to gross receipts net of non-taxable sales of newsprint (newspapers) and receipts from sales tax collected shown on the Taxpayer's sales tax returns for 2009, 2010 and 2011 to determine what gross receipts were attributable to high rate and low rate sales. Tr. pp. 17-22; Taxpayer's Ex. 2. Based upon this computation, the auditor determined that Taxpayer had underreported its high rate sales. Department Ex. 1 (Audit Narrative).

12. The auditor did not deduct all non-taxable sales from the Taxpayer's gross receipts before determining what percentage of the Taxpayer's taxable gross receipts were high rate or low rate sales. Tr. pp. 14, 15, 29. In lieu of the foregoing, the auditor deducted only taxes collected and newsprint (newspaper sales) as non-taxable before applying a ratio of high rate to low rate sales. *Id.* The auditor then applied the ratio of high rate to low rate sales determined from the results of the auditor's circularization to the remaining gross receipts. *Id.* The auditor deducted non-taxable food stamp (Link card) sales from the amount of low rate sales determined in this manner. Tr. pp. 14-20. The result of this computation was to classify the Taxpayer's entire low rate sales as non-taxable food stamp (Link card) sales for 2009 and 2010 in arriving at underreported high

rate sales used to determine the Taxpayer's tax liability for those years. *Id*.[4] The auditor's calculations resulted in treating none of the Taxpayer's low rate sales during 2009 and 2010 as sales made for cash or credit. Tr. p. 69.

13. Based upon his review of the Taxpayer's z-tapes for 2011, the auditor concluded that 26% of the Taxpayer's transactions were recorded as transactions that were not sales of tangible personal property subject to the Retailers' Occupation Tax, or "no sales." Tr. pp. 24, 26, 35. With respect to this finding, the auditor's audit notes prepared during the course of the audit include the following entry:

    > 9/6/2012 … I stopped by the location and spoke with *James Doe* of *DEF Business* number XXXX. He explained that once the lottery transaction was entered into the lottery machine, he entered a "no sale" transaction into the cash register to put the money in the register. This explains the 26% of "no sale" transactions that occurred with ABC BUSINESS.

    Taxpayer's Ex. 3

    With respect to transactions recorded as "no sales", the auditor's Audit Narrative states the following:

    > The subsequent owner was contacted and he indicated that lottery was rung up on the cash register as a "no sales." The description of entering lottery sales would be consistent with the number of "no sale" transactions (26% of transactions were rung up as "no sale") examined on the "Z" tapes in sample months.

    Department Ex. 1 (Audit Narrative).

14. The Taxpayer timely protested, and did not pay, the deficiencies indicated in the Department's Notices of Tax Liability. Department Ex. 1.

Conclusions of Law:

[4] The Taxpayer made no food stamp (Link card) sales in 2011. Taxpayer's Ex. 2.

The issue in this case is whether ABC BUSINESS ("Taxpayer") underreported taxes due from its sales of cigarettes and other high rate items by erroneously classifying sales of these high rate items as sales of low rate items. The "high rate" of tax refers to the normal state tax rate of 6.25%. See Illinois Department of Revenue Information Bulletin number FY 2010-01 dated July 1, 2009. However, not all items that are sold are taxable at the normal or high rate. *Id*. A special "low rate" of 1% is set by the language of the Retailers' Occupation Tax Act for qualifying food, drugs and medical appliances. 35 **ILCS** 105/3-10; see also 86 Ill. Admin. Code, ch. I, section 130.310, 130.311.

Section 2 of the Retailers' Occupation Tax Act, 35 **ILCS** 120/2, imposes a tax upon persons engaged in the business of selling tangible personal property at retail. In the instant case, the Department performed an audit of the Taxpayer's business and issued Notices of Tax Liability for Retailers' Occupation Tax for the period January 1, 2009 through September 30, 2011, when the Taxpayer ceased doing business. Department Ex. 1. The Taxpayer protested the taxes assessed and requested a hearing.

Pursuant to 35 **ILCS** 120/4, the correction of returns, submitted as Department Exhibit 1, is *prima facie* correct and constitutes *prima facie* evidence of the amount of tax due as shown therein. See A.R. Barnes & Co. v. Department of Revenue, 173 Ill. App. 3d 826 (1st Dist. 1988). The burden shifts to the Taxpayer to show that such a determination is incorrect once the Department establishes the *prima facie* correctness of the amount of tax due by the admission into evidence of the correction of returns. *Id*. In order to overcome the presumption of validity attached to the Department's corrected returns, a taxpayer must produce competent evidence, identified with its books and

records, showing that the Department's corrected returns are incorrect. Copilevitz v. Department of Revenue, 41 Ill. 2d 154 (1968).

Section 7 of the Retailers' Occupation Tax Act provides as follows:

> § 7. 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 of the specific trade and other pertinent papers and documents. Every person who is engaged in the business of selling tangible personal property at retail in this State and who, in connection with such business, also engages in other activities (including, but not limited to, engaging in a service occupation) shall keep such additional records and books of all such activities as will accurately reflect the character and scope of such activities and the amount of receipts realized there from. The Department may adopt rules that establish requirements, including record forms and formats, for records required to be kept and maintained by taxpayers. For purposes of this Section, "records" means all data maintained by the taxpayer, including data on paper, microfilm, microfiche or any type of machine-sensible data compilation.
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> 35 **ILCS** 120/7; See also 86 Ill. Admin. Code, ch. I, §130.801 which incorporates into the Department's regulations the requirements enumerated in 35 **ILCS** 120/7.

The minimum books and records a taxpayer is required to maintain pursuant to section 7 of the Retailers' Occupation Tax Act are enumerated in Department regulation 130.805, 86 Ill. Admin. Code, ch. I, §130.805, which provides as follows:

> Section 130.805. What Records Constitute Minimum Requirement.
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> a) In General. A taxpayer shall maintain all records that are necessary to a determination of the correct tax liability under the Act. All required records must be made available on request by the Department. Where a taxpayer's business consists exclusively of the sale of tangible personal property at retail, the following records will be deemed by the Department to constitute a minimum for the purposes of the Act:
>
> 1) Cash register tapes and other data which will provide a daily record of the gross amount of sales.

> 2) A record of the amount of merchandise purchased. To fulfill this requirement, copies of all vendors' invoices and Taxpayers' copies of purchase orders must be retained serially and in sequence as to date.
> 3) A true and complete inventory of the value of stock on hand taken at least once a year.
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> 86 Ill. Admin. Code, ch. I, § 130.805(a)

In the instant case, the Taxpayer asserts that it maintained all books and records that it was required to maintain, and that it overcame the Department's *prima facie* case by presenting these records to the Department during the audit of the Taxpayer for the tax period in controversy. Tr. pp. 7, 8, 70, 72, 76.

The record indicates that the Taxpayer provided the Department's auditor with sales tax returns, cash register receipts, vendors' invoices and inventory records, and that the Department's auditor, in his Audit Narrative, found that the Taxpayer maintained all books and records that it was required to maintain by the Department's regulations. Compare Department Ex. 1 (Audit Narrative) and 86 Ill. Admin. Code, ch. I, section 130.805. However, the auditor testified that the records of sales he was provided during the audit were suspect because they indicated a breakdown between high rate and low rate sales that did not correspond to a normal variance between such sales for stores comparable to the Taxpayer. Tr. pp. 12, 13, 25, 26.

Having concluded that this variance justified the use of an alternative method to compute the Taxpayer's taxes due, the auditor ignored the breakdown between high rate and low rate sales shown on the Taxpayer's z-tapes and, in lieu of the foregoing, used a ratio of high rate to low rate sales deduced from a survey of the Taxpayer's purchases of inventory from vendors (i.e. "circularization" of vendors) based upon the percentage of high rate and low rate purchases indicated by this circularization. *Id.* The vendors

surveyed during this circularization were primarily determined from the Taxpayer's sales records for 2011. Department Ex. 1 (Audit Narrative) ("The taxpayer's records for the years 2009 and 2010 were not readily available, therefore most vendors were obtained from the 2011 vendors.").

The auditor calculated total high rate and low rate item purchases indicated by the information obtained from this circularization and applied a mark up to both the high rate and low rate item purchases. Tr. pp. 12, 13, 25, 58; Department Ex. 4. The mark ups used were based on mark ups previously agreed to by the Taxpayer. Tr. pp. 25, 58; Department Ex. 4.

Based upon this computation, the auditor developed a ratio of high rate to low rate sales of 80% high rate and 20% low rate. Tr. pp. 12, 13; Department Ex. 1 (Audit Narrative). This ratio closely corresponded to the ratio of high rate to low rate sales the auditor had previously determined to be typical of a retailer the size of the Taxpayer. Tr. p. 12.

The auditor applied the aforementioned percentage to gross receipts after deducting non-taxable sales of newsprint (newspapers) and receipts from sales tax collected to determine what portion of the Taxpayer's gross receipts were attributable to high rate and low rate sales. Tr. pp. 17-21; Taxpayer's Ex. 2. Based upon this computation, the auditor determined that the Taxpayer had underreported its high rate sales. *Id.*

In arriving at the liability shown on the Notices of Tax Liability, the auditor primarily relied upon the Taxpayer's z-tapes for 2011 and its Retailers' Occupation Tax

returns for 2009, 2010 and 2011. Tr. pp. 12-14, 24, 26, 27; Taxpayer's Ex. 2. He did not ask for or review the Taxpayer's z-tapes for 2009 and 2010. Tr. pp. 26, 27, 31, 32.

During the hearing in this case the Taxpayer's daily z-tapes, sequentially numbered in relation to each other, were provided to this tribunal for 2009 and 2010. Taxpayer's Ex. 4. Moreover, the record indicates that the Department's auditor was provided with the Taxpayer's z-tapes for 2011 during his audit of the Taxpayer. Department Ex. 1 (Audit Narrative).

The Taxpayer's z-tapes break down sales between high rate and low rate sales and enumerate sales either by type of item or category of items sold each day. Taxpayer's Ex. 4. The Department's auditor determined that the Taxpayer's z tapes were an accurate and reliable indication of the Taxpayer's gross sales. Tr. p. 12, 14, 24, 27, 28, 32; Department Ex. 1 (Audit Narrative). The auditor further testified that the designation of sales as high rate or low rate on the z-tapes was a function of the cash register itself, and that the z-tapes contained no evidence of being annotated or corrected after sales were rung up. Tr. pp. 29, 30. The record contains no evidence that the Taxpayer's cash registers were not working properly or that any of the Taxpayer's employees were negligent or incompetent in performing the task of ringing up the Taxpayer's sales.

As previously noted, Department regulation 130.805(a)(1), in enumerating what records constitute the minimum records required to be maintained by a taxpayer, states as follows:

> a) In general. A taxpayer shall maintain all records that are necessary to a determination of the correct tax liability under the Act. … Where a taxpayer's business consists exclusively of the sale of tangible personal property at retail, the following records will be

> deemed by the Department to constitute a minimum for the purposes of the Act:
> (1) Cash register tapes and other data which will provide a daily record of the gross amount of sales.

Based upon the auditor's determination that the Taxpayer's z-tapes were an accurate and reliable indicator of the Taxpayer's gross sales, and the absence of any evidence that these z-tapes were altered, modified or incorrectly produced, I find that the z-tapes constituted records satisfying the this minimum standard for records to be maintained by a retailer pursuant to 86 Illinois Admin. Code, ch. I, section 130.805(a)(1). Because, through the maintenance of these z-tapes, the Taxpayer met the Department's legal requirements prescribed by Regulation 805(a)(1), I find these z-tapes to be sufficient documentary evidence demanded by the courts to sustain the Taxpayer's claim that's it accurately reported its taxes due. Copilevitz, *supra*; Fillichio v. Department of Revenue, 15 Ill. 2d 327, 333 (1959) ("The taxpayer, thus, has the burden of proving by competent evidence that the proposed assessment is not correct, and when such evidence is not so inconsistent or improbable in itself as to be unworthy of belief, the burden then shifts to the Department which is required to prove its case by competent evidence."). Given that the auditor found that the Taxpayer's z-tapes were a complete and accurate record of the Taxpayer's sales, and the record contains no evidence suggesting that the manner in which these z-tapes were produced was deficient, I do not find them inconsistent with the Taxpayer's claim that its records are accurate or render this claim so improbable in itself as to be unworthy of belief. In sum, the z-tapes the Taxpayer has presented are sufficient documentary evidence to corroborate the Taxpayer's claim that its returns for the tax period in controversy were correct and to rebut the Department's finding to the contrary.

The auditor also claims that he was required to estimate the Taxpayer's liability because he had difficulty determining why items were classified as high rate or low rate sales on the Taxpayer's z-tapes. Tr. pp. 24-26. However, it is unclear from the record whether the auditor attempted to get any clarification of why items were so classified from the Taxpayer's accountant. Tr. p. 31. In the absence of any clear evidence that the auditor sought such guidance before deeming the Taxpayer's z-tapes unsuitable to determine whether the Taxpayer underreported the amount of taxes due, I do not find this explanation a sufficient justification for ignoring the Taxpayer's z-tapes.

The auditor also seeks to justify the use of an alternative method to determine the Taxpayer's high rate and low rate sales rather than using the Taxpayer's books and records for this purpose on the grounds that the Taxpayer reported 26% of its sales as transactions not constituting sales of tangible personal property taxable under the Retailers' Occupation Tax Act, or "no sales" but, during the audit, gave no explanation of its reason for doing so. Tr. pp. 24, 26, 35. Specifically, the auditor testified as follows:

> Q. And then also you noted an unusual amount of no sales that were rung up?
> A. Yes. 26 percent of the transactions.
> Q. Was. The Taxpayer able to provide a …
> A. When I asked him he didn't know. In *Mr. Jones*' office I asked what no sales were, and he didn't have a response for me at that time.
> Q. Okay. So the Taxpayer had no explanation of why there were so many no sales rung up, is that correct?
> A. That's correct.
> Q. And again, the percentage was 26 percent?
> A. Correct.
> Tr. p. 26.

This testimony indicating that the auditor had no explanation for the 26 percent of the Taxpayer's sales rung up as "no sale" and did not know what transactions these ring

ups reflected is contradicted by evidence contained in the record that the auditor was advised that these "no sale" transactions were attributable to the Taxpayer's lottery ticket sales. Specifically, the auditor, in his notes constituting a daily record of what transpired during the audit (tr. p. 33), recorded the following entry.

> 9/6/2012 … I stopped by the location and spoke with *James Doe* of *DEF Business* number XXXX. He explained that once the lottery transaction was entered into the lottery machine, he entered a "no sale" transaction into the cash register to put the money in the register. This explains the 26% of "no sale" transactions that occurred with ABC BUSINESS.
>
> Taxpayer's Ex. 3.

Moreover, in his Audit Narrative (Department Exhibit 1), the auditor states the following:

> The subsequent owner was contacted and he indicated that lottery was rung up on the cash register as a "no sales." The description of entering lottery sales would be consistent with the number of "no sale" transactions (26% of transactions were rung up as "no sale") examined on the "Z" tapes in sample months.

As is evident from the foregoing, the record indicates that the auditor concluded during the audit that he had received a satisfactory explanation of the items shown as "no sales" on the Taxpayer's z-tapes. Given the auditor's finding that he was satisfied with the explanation for the items reported as "no-sale" transactions, I do not find the auditor's testimony to the contrary a sufficient basis for ignoring the Taxpayer's books and records and using an alternative methodology.

The Department is required to meet a minimum standard of reasonableness when correcting the Taxpayer's returns. Fillichio, *supra*. In defense of his audit findings, the auditor gave extensive testimony indicating why his estimate of the Taxpayer's tax liability was reasonable. However, the threshold issue before such testimony can be

given any probative weight is whether the auditor was legally justified in estimating the Taxpayer's liability and ignoring the Taxpayer's books and records.

The Illinois courts have plainly stated that, once a retailer complies with its statutory obligation to support its reported gross receipts with adequate books and records, and provides these records to the Department, the Department is not at liberty to ignore them. Goldfarb v. Department of Revenue, 411 Ill. 573 (1952); Miller v. Department of Revenue, 408 Ill. 574 (1951). Notably, the facts upon which the court based its holding in Goldfarb are substantially similar to the facts presented here. In Golfarb, the Court summarized the facts at issue in that case as follows:

> The taxpayer [after a request by the Department auditors] thereupon turned over all his records to them, consisting of his cash receipts and sales books, bank deposit books, disbursement records, retailer occupation tax returns, accounts receivable ledger, cancelled checks, bank statements, income tax returns, purchase invoices, and general ledger. According to the testimony of the auditors, they ignored the taxpayer's records except his purchases and the inventories as shown on his income tax reports and proceeded to make their audit from these latter records alone and the oral statements made to them by the taxpayer.
> Goldfarb, *supra* at 575-76.

The evidence regarding books and records produced for the auditor in the instant case, as indicated in Department Exhibit 1 (Audit Narrative) contains the essential records presented in Goldfarb (i.e. cash register receipts, retailer occupation tax returns, income tax returns and purchase invoices) where the court found the availability of such books and records sufficient to bar the use of an alternative method to determine the taxpayer's tax liabilities and required, instead, that the taxpayer's books and records be used to make this determination. Goldfarb, *supra*.

Because the Taxpayer maintained enough books and records to comply with the Department's regulations, and the record in this case contains no evidence that they were not competent and reliable, I find that the auditor was not justified in ignoring and going outside of these records to estimate the Taxpayer's liability. Goldfarb, *supra*. Accordingly, I find that the Taxpayer has presented competent and credible documentary evidence that its sales tax returns for the tax period in controversy were accurate and correct and has therefore rebutted the Department's *prima facie* case to the contrary.

The burden shifts to the Department to prove its case by a preponderance of the evidence when a taxpayer rebuts the Department's *prima facie* case. Goldfarb, *supra*; Miller, *supra*; Novicki v. Department of Finance, 373 Ill. 342 (1940). In rebuttal, the Department has provided evidence that, in lieu of using the Taxpayer's books and records, it estimated the Taxpayer's liability based upon a survey or "circularization" of the Taxpayer's vendors and, based on this circularization, determined a discrepancy between sales reported as low rate sales and high rate sales on the Taxpayer's z-tapes and the findings indicated by the Department's circularization. Tr. pp. 12-14; Department Ex. 1 (Audit Narrative). For the reasons previously noted, I find that the Department was not legally justified in ignoring the Taxpayer's books and records and estimating the Taxpayer's tax liability. Goldfarb, *supra* Miller, *supra*. For this reason, I find that the Department's estimate of the Taxpayer's tax liability is not entitled to any probative weight in determining whether the Taxpayer underreported its gross receipts. *Id*. Moreover, even if this evidence were entitled to consideration, for the reasons enumerated below, I find that it would be insufficient to rebut the Taxpayer's documentary evidence.

The record indicates that the Department estimated that only 20% of the Taxpayer's sales during the period in controversy were low rate sales. Tr. pp. 12-14; Department Ex. 1 (Audit Narrative). It further determined that the Taxpayer's non-taxable food stamp (Link card) sales for 2009 and 2010 actually exceeded the Department's estimate of the Taxpayer's low rate sales in those years and offset all of the Taxpayer's low rate sales against food stamp (Link card) sales. Tr. pp. 14-20; Taxpayer's Ex. 2. In effect, the Department estimated that all of the Taxpayer's low rate sales were food stamp or Link card sales thus eliminating all sales taxable as low rate sales during these two years. *Id.*

The Department's audit methodology effectively presumed that all of the Taxpayer's low rate sales during 2009 and 2010 were non-taxable food stamp or Link card sales. Tr. pp. 66-69. Consequently, food stamp (Link card) sales were removed from taxable sales by reducing to zero the number of taxable low rate sales made by the Taxpayer during 2009 and 2010 thus skewing the ratio between taxable high rate sales and taxable low rate sales in favor of taxable high rate sales for the tax period in controversy. Tr. pp. 14-20, 66-69. In essence, the auditor presumed that the Taxpayer made no low rate sales for cash or credit in 2009 or 2010. Tr. p. 69.

The Taxpayer's returns for 2009 and 2010 reported both low rate and high rate sales based upon z-tapes showing the sale of both high rate and low rate items shown on the Taxpayer's z-tapes for those years. Department Ex. 1 (Audit Narrative); Taxpayer's Ex. 2, 4. The Department never asked for, or reviewed any of the Taxpayer's z-tapes for these years. Tr. pp. 26, 27, 31, 32. In lieu of evidence based upon a review of the Taxpayer's books and records, the Department produced evidence that is based only upon

its estimates and presumptions. I find the Department's undocumented presumption that all of the Taxpayer's sales of low rate items during 2009 and 2010 were non-taxable food stamp (Link card) sales insufficient evidence to rebut the documentary evidence of actual taxable low rate sales provided by the Taxpayer's 2009 and 2010 z-tapes. Department Ex. 1 (Audit Narrative); Taxpayer's Ex. 2, 4.

My evaluation of the Department's evidence in this matter is informed by testimony that the auditor had a preconceived notion of what ratio between high rate sales and low rate sales the z-tapes would show and reacted with a decision to ignore them when the information revealed by the z-tapes did not correspond to his preconceptions. Tr. pp. 12, 24. Given the foregoing, it is not inconceivable that his perceptions of what the circularization evidence showed was clouded by his pre audit conclusions of what the audit results would be.

Where a taxpayer presents evidence sufficient to rebut the Department's *prima facie* case, the correctness of the Department's determination cannot be established merely through the introduction of the Department's notices of tax liability or other documents of record into evidence. Rather, when the Department's *prima facie* case has been rebutted, the burden of proof is on the Department. Novicki, *supra*. The Department must provide competent evidence sufficient to rebut a taxpayer's claims. *Id*. In the instant case, I find that the Department has not offered evidence sufficient to meet its burden of showing that the Taxpayer's documentary evidence is incorrect.

Moreover, even if the Department had met its burden necessary to rebut the Taxpayer's documentary evidence, a portion of the audit assessment determination giving rise to the Notices of Tax Liability at issue was clearly barred by the statute of

limitations. Specifically, section 120/4 of the Retailers' Occupation Tax Act provides as follows:

> Except in the case of a fraudulent return, or in the case of an amended return … no notice of tax liability shall be issued on and after each January 1 and July 1 covering gross receipts received during any month or period of time more than 3 years prior to such January 1 and July 1, respectively. If, before the expiration of the time prescribed in this Section for the issuance of a notice of tax liability, both the Department and the taxpayer have consented in writing to its issuance after such time, such notice may be issued at any time prior to the expiration of the period agreed upon.
>
> 35 **ILCS** 120/4

Pursuant to the foregoing, notices of tax liability issued on or after January 1 of any given year may not cover gross receipts or other amounts received during any month or other period of time more than three years before January 1. *Id.* Notices issued on or after July 1 of any given year may not cover gross receipts or any other amounts received during any period of time more than three years before that July 1. *Id.*

In the instant case, the Department's assessment of the Taxpayer for any months during 2009 was barred absent the issuance of a Notice of Tax Liability by the Department no later than December 31, 2012 by the provisions of section 120/4 noted above. The Department's Notices of Tax Liability covering 1/09 through 12/09 are dated January 17, 2013 which is after the expiration of the statute of limitations for assessments pertaining to 2009 prescribed by section 120/4. Department Ex. 1. While the records indicate that the Taxpayer signed a waiver waiving the statute of limitations bar as authorized pursuant to section 120/4, this waiver expired on December 31, 2012. Taxpayer's Ex. 5. Consequently, the Department's waiver did not extend the period for assessment to the months January 2009 through December 2009 to January 17, 2013, the

date on which the Notices of Tax Liability at issue in this case covering 2009 were issued.

The Department contends that the timeliness of the statute of limitations is not before this tribunal because this issue was not agreed to as a contested matter to be adjudicated in the instant case. Tr. pp. 70, 78. In support of this contention, the Department cites the pre-trial order entered in this case.

A perusal of the pre-trial order entered in this case indicates that this conclusion is without merit. Specifically, the pre-trial order states as follows:

> The parties advise that the issues include the correctness of the tax assessed in the NTLs, whether the audit method was reasonable, and whether penalties should be abated for reasonable cause.

The very broad enumeration of the issues to be decided in this matter, including the specific enumeration as an issue whether the tax was correctly assessed, is clearly sufficient to allow a determination that the Notices of Tax Liability for the period January 2009 through December 2009 did not properly assess liability because the Notices of Tax Liability covering this period were not timely issued.

CONCLUSION

In sum, I find that the Taxpayer's documentary evidence presented in this case is sufficient to rebut the presumption of correctness accorded the Department's assessment, and that the evidence presented by the Department to rebut the Taxpayer's documentary evidence is insufficient to overcome the Taxpayer's proof that its sales tax returns were correct. I further find that a portion of the assessment covering the period 1/1/09 through 12/31/09, at issue is barred by the statute of limitations on assessments prescribed by section 120/4 of the Retailers' Occupation Tax Act, 35 **ILCS** 120/4.

WHEREFORE, for the reasons stated above, it is my recommendation that the Department's Notices of Tax Liability at issue in this case be cancelled.

Ted Sherrod
Administrative Law Judge

Date: June 2, 2016