

ST 01-3

Tax Type: Sales Tax

Issue: Unreported/Underreported Receipts (Fraud Application)

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

THE DEPARTMENT OF REVENUE)	Docket No.	99-ST-0000
OF THE STATE OF ILLINOIS)	IBT No.	0000-0000
v.)	NTL No.	00-00000000000000
ABC, INC.,)	John E. White,	
Taxpayer.)	Administrative Law Judge	

RECOMMENDATION FOR DISPOSITION

Appearances: James Stola appeared for ABC, Inc.; John Alshuler appeared for the Illinois Department of Revenue.

Synopsis:

Following audit, the Illinois Department of Revenue (“Department”) issued a Notice of Tax Liability (“NTL”) to ABC, Inc. (“ABC” or “taxpayer”) that assessed Retailers’ Occupation Tax regarding ABC’s sales during the period from January 1, 1995 through and including December 31, 1997. Taxpayer protested that NTL and asked for a hearing. In a pre-hearing order, the parties agreed that the only two issues to be resolved were whether the Department’s estimate of taxable gross receipts was proper, and whether the Department’s assessment of a fraud penalty was proper.

The hearing was held at the Department’s offices in Chicago. I have reviewed the record of that proceeding, and I am including in this recommendation findings of fact and conclusions of law. I recommend that the Director resolve the first issue in favor of the Department, and the second issue in favor of taxpayer.

Findings of Fact:

1. The Department's prima facie case, inclusive of all jurisdictional elements, was established by the admission of the Department's Correction and/or Determination of Tax Due (hereinafter "correction of returns") and the NTL, under the certificate of the Director, showing a total liability due and owing in the amount of \$92,646. Department Ex. 1.
2. Taxpayer conducts business as a tavern at Anywhere Street in Anywhere. *See* Department Ex. 1, p. 1 (top right-hand corner of correction of returns form).
3. The Department conducted an audit of taxpayer's business for the period from 1/1/95 through 12/31/97. Department Ex. 1, pp. 1-2.
4. At the time of the audit, taxpayer had no record of its daily sales, because it ordinarily disposed of its daily cash register receipts. Tr. p. 7; *see also*, People v. Cruz, 162 Ill. 2d 314, 375, 643 N.E.2d 636, 665 (1994) (attorney's statements at hearing may constitute an admission of the facts stated).
5. On the correction of taxpayer's return form, the preparer indicated that taxpayer had books and records, and that such books and records formed the basis of his computation of taxpayer's tax liability. Department Ex. 1, p. 1.
6. The corrections of returns indicated that, for each 6-month period in the audit period, taxpayer had gross receipts of either \$8,179 or \$8,180, yielding a total of \$49,077 in taxable gross receipts. Department Ex. 1, p. 1. The form also indicated that, based on those taxable gross receipts, taxpayer owed \$49,077 in tax. *Id.*

7. Both the correction of returns and the NTL included a penalty assessment for fraud, in the amount of \$24,539. Department Ex. 1.

Conclusions of Law:

The Department's correction of returns filed by the taxpayer is deemed to be prima facie correct and prima facie evidence of the correctness of the amount of tax shown to be due therein. 35 ILCS 120/4; Fillichio v. Department of Revenue, 15 Ill. 2d 327, 333, 155 N.E.2d 3, 7 (1958). The Department's prima facie case is a rebuttable presumption. Copilevitz v. Department of Revenue, 41 Ill. 2d 154, 157, 242 N.E.2d 205, 207 (1968); DuPage Liquor Store, Inc. v. McKibbin, 383 Ill. 276, 279, 48 N.E.2d 926, 927 (1943). A taxpayer cannot overcome the presumption merely by denying the accuracy of the Department's assessment. A.R. Barnes & Co. v. Department of Revenue, 173 Ill. App. 3d 826, 833, 527 N.E.2d 1048, 1053 (1st Dist. 1988). Instead, a taxpayer must present evidence that is consistent, probable and closely identified with its books and records, to show that the assessment is not correct. Fillichio v. Department of Revenue, 15 Ill. 2d at 333, 155 N.E.2d at 7; A.R. Barnes & Co., 173 Ill. App. 3d at 833-34, 527 N.E.2d at 1053.

At hearing, and after the Department presented its prima facie case, taxpayer presented no evidence closely identified with its books and records — indeed, no evidence whatever — to contest the amount of tax liability. Rather, its counsel argued that the Department had not established any basis for assessing the fraud penalty against taxpayer. Tr. pp. 10-11. Thereafter, both sides rested, and commenced closing arguments. During that phase, counsel for the Department moved for the admission, under the certificate of the Director, of a report prepared by a Department employee following taxpayer's request for review of this audit by a member of the Department

audit bureau's informal conference unit. Department Ex. 2. Taxpayer objected on foundation and hearsay grounds, but not on the basis that the Department had already rested, and that the evidentiary record was, therefore, closed. *See* Tr. pp. 13-20. Over taxpayer's stated objections, the document was admitted. Tr. p. 21.

As reflected by the arguments presented at hearing, the only matter taxpayer disputes is whether it should be assessed a fraud penalty. Section 3-6 of the Uniform Penalty and Interest Act provides, in part:

Penalty for fraud.

(a) If any return or amended return is filed with intent to defraud, in addition to any penalty imposed under Section 3-3 of this Act, a penalty shall be imposed in an amount equal to 50% of any resulting deficiency.

* * * *

35 **ILCS** 735/3-6 (1994). The standard for determining whether a fraud penalty is appropriate is "... that of clear and convincing evidence." Puleo v. Department of Revenue, 117 Ill. App. 3d 260, 268, 453 N.E.2d 48, 53 (4th Dist. 1983).

The evidence the Department offered to support the fraud penalty consists of a recommendation written by a Department employee assigned to the Department's audit division's informal conference unit prior to the finalization of the audit. *See* Department Ex. 2. While that document was admitted into evidence at hearing under the certificate of the Director, there is no doubt that the document is hearsay. Specifically, it contains the out-of-court statements of a declarant (the informal conference unit conferee) which are being offered to prove the truth of the matters asserted (the statements made) within that report, chief among them the declarant's stated conclusion that the facts warrant the imposition of a fraud penalty. *Id.*, p. 3.

At hearing, counsel for the Department argued that hearsay may be admitted at an

administrative hearing where it is of the type that is normally relied upon by persons in the ordinary conduct of their business affairs. Tr. p. 20. That is a relatively good restatement of § 10-40(a) of the Illinois Administrative Procedures Act (“IAPA”). 5 **ILCS** 100/10-40(a) (“... The rules of evidence and privilege as applied in civil cases in the circuit courts of this State shall be followed. Evidence not admissible under those rules of evidence may be admitted, however, (except where precluded by statute) if it is of a type commonly relied upon by reasonably prudent men in the conduct of their affairs. ***”). Whether Department Exhibit 2 is evidence of that type, however, is a question that can ordinarily only be answered by a foundation witness. Since there was no such witness at this hearing, no foundation questions were ever asked. Thus, it must be made clear that Department Exhibit 2 was not admitted as “reliable” hearsay, pursuant to § 10-40 of the IAPA. Rather, it was admitted, pursuant to § 8 of the ROTA, because it was a “... book[], paper[], record[] or memoranda of the Department ...” that was offered under of the certificate of the Director. 35 **ILCS** 120/8. As such, the Department report was required to be admitted at hearing. *Id.* (“... Such reproduced copy shall, without further proof, be admitted into evidence before the Department or in any legal proceeding.”). What remains is an assessment of the weight to be given the exhibit. *See Jackson v. Bd. of Review of the Department of Labor*, 105 Ill. 2d 501, 509, 475 N.E.2d 879, 883-84 (1985) (fact-finder has the discretion to accord hearsay statements whatever weight they should be given).

The nature of Department Exhibit 2 mitigates against giving the statements made in that document any weight on the issue before me. First, the bottom of each page of the document contains a footer that states, “The recommendation of the Conferee becomes

final upon signature by either the Deputy Director or Program Administrator of Tax Enforcement. It authorizes and directs the Audit Bureau to conclude and finalize the audit as set forth in the approved recommendation.” Department Ex. 2, *passim*. The reproduced copy of the report that is Department Exhibit 2, however, is not signed by the Deputy Director of the Department, or by any Department Program Administrator. The document, in fact, is not even signed by the writer.

Further, the document, while admissible pursuant to § 8 of the ROTA, is not one of the types of documents the Illinois General Assembly has deemed to be presumptively correct. *Compare* 35 **ILCS** 120/4 *with* 35 **ILCS** 120/8. Thus, there is no statutory presumption that any of the conferee’s determinations or conclusions are correct. To believe that they are, I have to place my wholehearted trust in the declarant, who was never placed under oath and who was never subjected to cross-examination.

Finally, the conferee’s report contains statements of fact that appear nowhere else in the record, and which statements are inconsistent with the face of page 1 of Department Exhibit 1, the correction of taxpayer’s returns. Specifically, Department Exhibit 1 indicates that, for the audit period, taxpayer had taxable gross receipts of \$49,077 and a tax liability, exclusive of interest or penalty, of \$49,077. Department Ex. 1, p. 1. Department Exhibit 2, however, relates that the auditor determined that taxpayer had not reported \$605,000 in sales during the audit period, and that his assessment of the civil fraud penalty was based on that determination. To accept the statements in Department Exhibit 2 as true, I would have to disregard the presumptively correct correction of taxpayer’s returns.

Now, it seems clear that whoever prepared the correction of taxpayer's returns made at least one glaring mistake on it. Specifically, the preparer simply inserted ABC's asserted tax liability on five separate lines for each 6-month period. Department Ex. 1, p. 1. Thus, on line 1 of the corrected return for the period of 1/1995 to 6/30/1995, the preparer indicated that ABC had taxable gross receipts from selling general merchandise in the amount of \$8,179, and that the tax, total tax and net tax due on those receipts (lines 6, 8, 13 & 15) also equaled \$8,179. But Illinois does not have a 100% sales tax rate; the rate is 6.5%. 35 ILCS 120/2-10. Assuming the tax figure is correct (which I will, since taxpayer did not object to the amount of tax assessed at hearing), the completed correction of returns should have reflected, on line 1, the total taxable receipts for each period that, when properly calculated, yielded the tax claimed to be due on line 15 for each period. Department Ex. 1, p. 1. Thus, the conferee's statements regarding ABC's claimed underreporting may well be correct, even though they are inconsistent with the Department's prima facie case. The fundamental problem with this record lies in trying to find some substantial *and competent* evidence to support the imposition of the penalty, to which taxpayer did object. Tr. p. 7.

In order to support any finding of fact in a contested administrative hearing, there must be substantial competent evidence of the fact set forth in the record. Rasky v. Department of Registration & Ed., 87 Ill. App. 3d 580, 587, 410 N.E.2d 69, 77 (1980); Cook Co. Federal Sav. & Loan Ass'n. v. Griffin, 73 Ill. App. 3d 210, 391 N.E.2d 473 (1979); *see also* 5 ILCS 100/10-35 (Record in contested cases). In this case, therefore, for each finding of fact set forth in this recommendation, I have cited to that part of the record where the evidence supporting the particular factual proposition might be found.

Notice, however, that there are no findings of facts which describe the conditions of taxpayer's returns as filed, or which describe the conditions of taxpayer's business that caused the Department to conclude that ABC's returns had been filed with the intent to defraud. *See* 35 ILCS 735/3-6. That is because there was no competent evidence offered to show what those facts were.

The only information offered at or about the time the Department submitted its prima facie case, and which attempts to describe why the correction of taxpayer's returns was prepared and why the NTL was issued, is found in the opening statement of the Department's counsel. Opening statements are intended to allow a party to describe what the evidence to be introduced at hearing will show. Taake v. WHGK, Inc., 228 Ill. App. 3d 692, 700, 592 N.E.2d 1159, 1165 (5th Dist. 1992). Ordinarily, what is said during the opening itself is not evidence (*id.*), unless it constitutes a clear and unequivocal statement of a fact that is inconsistent with the client's position at hearing. *See* People v. Cruz, 162 Ill. 2d 314, 375, 643 N.E.2d 636, 665 (1994) (and cases cited therein).

The Department's opening statement in this case included a virtual narrative of facts describing the conduct of the audit. Specifically, part of the opening statement was:

[The] Department's auditor was therefore forced to use his best judgment and information in calculating gross sales. The auditor examined the Taxpayer's sales tax returns as filed, its federal and corporate income tax returns, purchase invoices, and vendor circularizations.

Based on this information, the auditor projected sales of beer, wine and liquor. The auditor determined the difference between the reported sales and expected sales was too extreme to be in error because the reported sales did not even cover purchases made during the period.

The auditor prepared an amended return which the Taxpayers — which the Taxpayer refused to sign, and an assessment was subsequently issued which the Taxpayer timely protested. This proceeding then has been convened

for the purpose of hearing that protest. That concludes our opening statement.

Tr. p. 6. During its case in chief and during rebuttal, however, no competent evidence was offered to provide any support at all for the key facts described by Department counsel.

During his opening statement, counsel for taxpayer admitted that, at the time of the audit, taxpayer had no record of its daily sales, because it ordinarily disposed of its daily cash register receipts. *See* Tr. p. 7; *see also*, People v. Cruz, 162 Ill. 2d 314, 375, 643 N.E.2d 636, 665 (1994). In the event of an audit, a retailer's failure to maintain a record of its daily receipts may well result in its inability to support any deductions claimed on the retailer's returns. *See* Mel-Park Drugs, Inc. v. Department of Revenue, 218 Ill. App. 3d 203, 219-20, 577 N.E.2d 1278, 1288-89 (1st Dist. 1991); 86 Ill. Admin. Code §§ 130.801(b), 130.805(a), 130.810(a)-(b). But failing to keep minimum books and records does not, standing alone, constitute clear and convincing evidence that the retailer filed false returns. Vitale v. Department of Revenue, 118 Ill. App. 3d 210, 213, 454 N.E.2d 799, 802 (3d Dist. 1983) (citing, in addition to taxpayer's failure to keep records, competent evidence to show that taxpayer had been underreporting taxable gross receipts at a rate that could not have been unintentional); Puleo, 117 Ill. App. 3d at 268, 453 N.E.2d at 53 (citing, in addition to taxpayer's failure to keep records, taxpayer's admission that he had been filing incorrect returns).

Circumstantial evidence is enough to support the imposition of a fraud penalty. Vitale, 118 Ill. App. 3d at 213, 454 N.E.2d at 802. But there was no competent circumstantial evidence introduced at this hearing. Department Exhibit 2 is not written by the auditor, the individual who had first-hand, personal knowledge of the condition,

and the actual review, of taxpayer's books and records. Additionally, the auditor-prepared schedules that are ordinarily completed at or about the time of the auditor's review of a taxpayer's books and records are not part of that exhibit, and are not part of this record. Those documents would have at least constituted the contemporaneously recorded recollection of the person who actually reviewed ABC's books and records, and may well have factually supported the determinations he made after completing his review.

Without those competent Department documents in the record, however, the only evidence describing what the factual bases were for the auditor's determinations is the unsigned, conclusion-filled report of a Department employee who did not personally conduct the audit, and who was never made available for cross-examination at hearing. I respectfully submit that rank hearsay included in a document that is not accorded presumptive correctness by statute, and which is not supported by any other competent evidence of an intent to defraud, cannot substitute for the substantial, clear and convincing evidence which is required to be included in the administrative record. Vitale, 118 Ill. App. 3d at 213, 454 N.E.2d at 803; Rasky, 87 Ill. App. 3d at 587, 410 N.E.2d at 77; 5 ILCS 100/10-50. Because there is no competent evidence in the record showing that ABC filed its returns with the intent to defraud, I recommend that the fraud penalty not be imposed.

Conclusion:

I recommend that the Director revise NTL number 00-000000000000 to eliminate the fraud penalty, and that the revised NTL then be finalized, with interest to accrue pursuant to statute.

1/5/01
Date

Administrative Law Judge