ST 03-15
Tax Type: Sales Tax
Issue: Books and Records Insufficient

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

THE DEPARTMENT OF REVENUE	)	
OF THE STATE OF ILLINOIS	)	
	)	**Docket No. 02-ST-000**
v.	)	**IBT # 0000-0000**
	)	**NTL # 00-0000000000000**
ABC, INC. d/b/a	)	
XYZ FOOD & LIQUOR	)	
Taxpayer	)	

RECOMMENDATION FOR DISPOSITION

Appearances: Kent Steinkamp, Special Assistant Attorney General, for the Department of Revenue of the State of Illinois; Stephen R. Wigginton of Weilmuenster & Wigginton, P.C. for ABC, INC. d/b/a XYZ Food & Liquor.

Synopsis:

This case raises the issue of how to determine the taxpayer's liability when it loses its books and records in a fire. The Department of Revenue ("Department") conducted an audit of ABC, INC. d/b/a XYZ Food & Liquor ("taxpayer") for the months of January 1997 through December 1999. In May of 1999, a fire destroyed the taxpayer's store and its books and records that were located there. Because the auditor did not have the taxpayer's books and records, the auditor estimated the taxpayer's tax liability. At the conclusion of the audit, the Department issued a Notice of Tax Liability ("Notice") to the taxpayer for additional retailers' occupation tax ("ROT") plus penalties. The taxpayer timely protested the Notice. An evidentiary hearing was held during which the taxpayer raised the following issues: (1) whether the Department's method for preparing the corrected return meets a minimal standard of reasonableness; (2) whether the taxpayer's evidence is sufficient to overcome the Department's prima facie case; and (3) whether the penalties should be abated due to reasonable cause. After reviewing the record, it is recommended that this matter be resolved in favor of the Department.

<u>FINDINGS OF FACT</u>:

1. The taxpayer operates a grocery store known as XYZ Food & Liquor, which is located in Anywhere, Illinois. The taxpayer sells food, liquor and paper products at the store. (Tr. p. 72)

2. The Department conducted an audit of the taxpayer's business for the months of January 1997 through December 1999. (Tr. p. 10)

3. From January 1997 through May 1999, the taxpayer filed an ST-1 Sales and Use Tax Return for each month. (Taxpayer's Ex. #1, 2, 3)

4. In May of 1999, a fire destroyed the taxpayer's store and its books and records that were located there. (Tr. pp. 87-88, 95)

5. When the auditor requested the taxpayer's records in order to perform the audit, the taxpayer provided the auditor with copies of its federal income tax returns, monthly sales tax returns, and monthly financial statements that were kept by the taxpayer's accountant. (Tr. pp. 11, 79)

6. Because the taxpayer did not provide the auditor with its general ledgers, cash register tapes or other documentation supporting the amounts reported on the tax returns, the auditor estimated the taxpayer's liability. The auditor started by obtaining a list of the taxpayer's vendors. The auditor obtained the vendors from sample invoices from the year 2000 that the taxpayer provided to the auditor. (Tr. pp. 14-17)

7. The auditor contacted the vendors to obtain the amount of merchandise that the taxpayer purchased from them during the audit period. (Tr. pp. 17-20)

8. The auditor made a spread-sheet with the names of the vendors and the amounts that the taxpayer purchased from them during the audit period. For one of the vendors, XXXX Wholesale, the auditor received the actual figure for cigarette purchases for five months during 1997 and then took an average of those figures to determine the average monthly purchases for each month during the audit period. The auditor did similar calculations for another vendor, XXXX Beverage. The remaining vendors either provided a yearly total or monthly totals for each month during the audit period.[1] (Dept. Ex. #2; Tr. pp. 19-24)

9. The auditor totaled the purchases from the vendors, which equaled $712,176, and then marked up this amount by 25%. The auditor had previously used the same mark-up for audits of similar grocery stores. (Dept. Ex. #2; Tr. pp. 24-25)

10. Once the auditor marked up the purchases, the final amount was $890,220. The auditor concluded that this was the amount of the taxpayer's total sales during the audit period that were subject to the general merchandise tax rate of 7%. (Dept. Ex. #2, Tr. pp. 25-26)

11. The auditor totaled the general merchandise sales that were reported on the taxpayer's ST-1 returns during the audit period. The total amount reported on the returns was $242,625. (Dept. Ex. #2; Tr. p. 26)

12. The auditor subtracted $242,625 from $890,220, which equals $647,595. The auditor concluded that this was the amount of general merchandise sales that the taxpayer reported under the lower food tax rate of 1.75%. (Dept. Ex. #2; Tr. p. 26)

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[1] Due to the fire, the auditor determined that the taxpayer's purchases for the months of June 1999 through December 1999 were zero. (Dept. Ex. #2)

13. The auditor took the difference between the general merchandise tax rate (7%) and the food tax rate (1.75%), which equals 5.25%, and multiplied that by $647,595. The auditor concluded that the final figure, $33,999, is the amount of additional tax owed by the taxpayer. (Dept. Ex. #2; Tr. pp. 26-27)

14. On October 5, 2001, the Department prepared a corrected return for the taxpayer that showed additional tax due of $33,999 for the period of January 1, 1997 through December 31, 1999. The corrected return included a late payment penalty and a negligence penalty. A copy of the corrected return was admitted into evidence under the certificate of the Director of the Department. (Dept. Ex. #3, p. 9)

15. The auditor imposed a negligence penalty because the amount that the auditor determined was underreported on the tax returns was more than 50% of what the taxpayer reported on the returns that were filed.[2] (Tr. pp. 31-32, 57)

CONCLUSIONS OF LAW:

The Retailers' Occupation Tax Act ("ROTA") (35 ILCS 120/1 *et seq.*) imposes a tax upon persons engaged in the business of selling at retail tangible personal property. 35 ILCS 120/2. Sections 4 and 5 of the ROTA provide that the certified copy of the corrected return issued by the Department "shall be prima facie proof of the correctness of the amount of tax due, as shown therein." 35 ILCS 105/12; 120/4; 120/5. The Department's corrected return is only prima facie proof if the Department has met a minimum standard of reasonableness in preparing the corrected return. Vitale v. Department of Revenue, 118 Ill.App.3d 210, 212 (3rd Dist. 1983). This reasonableness standard is based on the statutory requirement that the Department correct the tax return

[2] The amount of tax paid according to the returns was $33,654. (Dept. Ex. #3, p. 9, line 14). This amount plus the additional amount that the auditor determined was due ($33,999) equals $67,653. $33,999 is 50.25% of $67,653.

according to its "best judgment and information." 35 ILCS 120/4. There is no requirement that the Department substantiate the basis for its corrected return at the hearing. Masini v. Department of Revenue, 60 Ill.App.3d 11, 14 (1st Dist. 1978). When the corrected return is challenged, however, the method that was used by the Department in correcting the return must meet some minimum standard of reasonableness. Id.; Elkay Manufacturing Co. v. Sweet, 202 Ill.App.3d 466, 470 (1st Dist. 1990).

The taxpayer has called into question the method used by the Department to correct its tax return. The taxpayer asserts that the mark-up used by the Department was arbitrary and that the Department failed to consider the taxpayer's records. The taxpayer also contends that the Department's method was not minimally reasonable because the Department did not discount the estimated liability for the following factors: (1) the existing inventory at the time of the fire; (2) the purchases made with food stamps and WIC coupons; (3) theft of items from the store; and (4) spoilage of perishable goods.

The evidence in this case shows that the techniques and assumptions that the auditor used to correct the returns were minimally reasonable. The method that the auditor used is a common method that has been used by the Department in other cases (i.e., the Department has estimated gross retail sales by contacting suppliers and marking-up the purchases by an amount common in the relevant industry). See Vitale *supra* (supplies for a pizza restaurant marked-up 36%); Puleo v. Department of Revenue, 117 Ill.App.3d 260, 263-264 (4th Dist. 1983) (cost-of-sales factor of 36% applied to supplies for pizza restaurant); Fillichio v. Department of Revenue, 15 Ill.2d 327, 329 (1958) (liquor store inventory marked-up 25%).

In this case, the auditor contacted the taxpayer's suppliers to obtain the taxpayer's purchases during the audit period. The Department presented the spread-sheet that the auditor made with the names of the vendors and the amounts that the taxpayer purchased from them. (Dept. Ex. #2) For one of the vendors, XXXX Wholesale, the auditor received the actual figure for cigarette purchases for five months during 1997 and then took an average of those figures to determine the average monthly purchases for each month during the audit period.[3] The auditor did similar calculations for another vendor, XXXX Beverage. The remaining vendors either provided a yearly total or monthly totals for each month during the audit period.[4]

The taxpayer argues that the Department (1) failed to produce any of the documents or records extrapolated upon by the auditor, (2) failed to contact the vendors to further determine the accuracy of the amount of sales, and (3) failed to take into account the fact that one of the vendors had previously inaccurately invoiced the taxpayer for its purchases. None of these allegations is sufficient to invalidate the Department's prima facie case. First, the Department is not required to produce the documents that were extrapolated upon by the auditor. The Department must only present the corrected return, which is presumptively correct until the taxpayer establishes by competent evidence that it is not correct. Quincy Trading Post, Inc. v. Department of Revenue, 12 Ill.App.3d 725, 729 (4th Dist. 1973). It is not necessary for the Department to submit other documents to support its prima facie case. Id.; Mel-Park Drugs, Inc. v. Department

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[3] The taxpayer has suggested that this method is not accurate because the price of cigarettes significantly increased from 1997 to 1999, and the store therefore had fewer sales of cigarettes during that time period. (Taxpayer's brief p. 9) The taxpayer did not present evidence other than his self-serving testimony to support this contention.

[4] The taxpayer alleges that the auditor created a "hodgepodge of extrapolation methodologies" and that four other vendors provided monthly sales that could have been extrapolated like the method used for XXXXX Wholesale. (Taxpayer's brief, p. 4) Although the taxpayer states that no explanation was given for these

of Revenue, 218 Ill.App.3d 203, 207 (1st Dist. 1991). When the corrected return is challenged, in order to uphold the prima facie case it is only necessary for the evidence to show that the method used by the Department to correct the return was minimally reasonable. Masini, *supra*. The evidence in this case is sufficient to find that the Department's method was minimally reasonable without the documents extrapolated upon by the auditor. If the taxpayer wanted to see those documents, it had access to them through discovery. The taxpayer apparently made no effort to obtain them.

Next, although the taxpayer maintains that the Department failed to contact the vendors to verify the figures, according to the taxpayer's financial statements, which were presented by the taxpayer, the auditor's estimate of purchases is greatly understated. For example, the auditor determined that for 1997 the taxpayer's purchases were $231,086 (Dept. Ex. #2), but the taxpayer's financial statements show that the taxpayer's purchases for 1997 were $788,364.63. (Taxpayer Ex. #1, p. 11)[5] Finally, despite the fact that the taxpayer's president testified that one of its vendors at one point incorrectly billed the taxpayer, he also stated that the vendor corrected the error. (Tr. pp. 84-85) Because the vendor corrected the error, it is reasonable to conclude that the figures sent by that vendor to the Department are accurate.

It is important to note that once the auditor totaled the taxpayer's purchases for the years at issue, the auditor compared these figures with the sales reported on the monthly sales tax returns for the same period. By comparing the two, he found that the purchases, prior to any mark-up, were substantially greater than the actual sales shown on

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"discrepancies," I do not find any discrepancies in the auditor's method. The other four vendors provided monthly figures, so there was no need to extrapolate for missing months.

the returns. (Tr. p. 15) For example, the amounts shown on the ST-1 Sales and Use Tax Returns for general merchandise sold for the year 1997 total $87,425 (line 4a).[6] (Dept. Ex. #2, p. 3; Taxpayer Ex. #1) In other words, during 1997, the taxpayer claims to have sold $87,425 worth of items that were taxed at the general merchandise rate of 7%. Sales of beer and liquor are taxed at the general merchandise rate (i.e., they cannot be purchased with food stamps or WIC coupons, and they are not taxed at the lower rate of 1.75% that applies only to food, drugs, and medical appliances). During 1997, the taxpayer made the following beer and liquor purchases:

Distributing Company (beer)	$ 61,881
John Doe (beer)	28,962
XXX, Inc. (beer)	22,179
ABC Distributing, LLC (liquor)	6,239
XYZ Distributing (liquor)	25,340
XXXX Central Wholesale Co., Inc. (liquor)	19,020
Total	$163,621

The total amount purchased ($163,621) exceeds the amount of general merchandise sales reported on the returns ($87,425) by $76,196. For the year 1998, the total purchased from beer and liquor vendors ($275,273) exceeds the general merchandise sales reported on the returns ($101,775) by $173,498. For 1999, the total amount purchased ($116,722) exceeds the sales reported on the return ($53,424) by $63,298.[7] The taxpayer provided no explanation as to why the amount of beer and liquor that was purchased during the audit period, prior to any mark-up, greatly exceeds the amount of sales reported on the returns. The amount of sales on the returns would also include other general merchandise items (i.e., items that were not beer or liquor) that were not purchased with food stamps

[5] For 1998, the auditor's estimate for purchases was $338,861, yet the financial statements show $903,930.46. (Taxpayer's Ex. #2, p. 12) For 1999, the auditor's estimate was $142,229, and the financial statements show $291.983.27. (Taxpayer's Ex. #3, p. 1)

or WIC coupons. The large difference between these numbers strongly suggests inaccurate reporting by the taxpayer.

In addition, the mark-up figure that was used by the Department was reasonable. The auditor used a 25% figure, which is the same figure that he used in similar types of grocery store audits. He said that it was the average figure that is used for grocery stores in the same area. (Tr. p. 25) The taxpayer did not attempt to calculate or present additional evidence concerning its previous or current mark-up practices. A taxpayer's average mark-up can be determined by comparing its cost of goods sold with sales, and although these figures are available on the taxpayer's 1997 and 1998 federal tax returns, these amounts do not appear to be accurate. For example, on its 1998 federal tax return, the taxpayer states that its purchases were $946,624 (Taxpayer Ex. #2, p. 2, line 2), yet its financial statements show 1998 purchases as $903,930.46 (Taxpayer Ex. #2, p. 12). No explanation was given for this discrepancy.

In addition, the 1998 federal return shows both beginning and ending inventory to be exactly $65,000. (Taxpayer Ex. #2, p. 2, lines 1,7). In Fillichio, the court noted that the taxpayer reported daily receipts as exactly $400 for several months and then $700 for several months, and the court indicated that the sameness and roundness of amounts were incredible. See Fillichio at 334. Similarly, it is implausible that the beginning and ending inventory would be exactly $65,000. Furthermore, if the taxpayer's purchases are the same as the cost of goods sold, which the taxpayer indicated on its return, then the

[6] The taxpayer should have reported the amount as $87,426, which is indicated on Department's Ex. #2, because the taxpayer made a computational error on the return for February 1997.
[7] Part of the discrepancy for the year 1999 may be due to the inventory that was lost during the fire.

taxpayer marked-up its inventory by approximately 24%.[8] This figure is very close to the 25% that the Department used. When the Department's method is called into question, "the record must show only that the techniques and assumptions which the Department used met some minimum standard of reasonableness." Smith v. Department of Revenue, 143 Ill.App.3d 607, 611 (5th Dist. 1986). The auditor's assumptions concerning the mark-up figure were minimally reasonable.

The taxpayer repeatedly alleges that the Department failed to use the documents provided by the taxpayer and ignored the taxpayer's records. (Taxpayer's brief pp. 5, 8, 10, 11, 12, 13). The documents that the taxpayer consistently refers to are the ST-1 forms, which are the same documents that the auditor has a duty to verify. The purpose of the auditor's work is to determine the accuracy of the returns that were filed. The sole reason for the audit is to verify the ST-1 Sales and Use Tax Returns that were filed by the taxpayer. Therefore, it makes no sense, as the taxpayer contends, that the very documents that are being audited should be the same documents that the auditor should rely upon in order to determine their accuracy.

The remaining arguments raised by the taxpayer do not support invalidating the Department's prima facie case. With respect to the existing inventory at the time of the fire, the taxpayer presented only conflicting oral testimony regarding this issue. During his direct testimony, the taxpayer's president stated that there was approximately $250,000 worth of inventory at the time of the fire. (Tr. p. 88) Under cross-examination,

[8] If the total purchases are $903,930.46 (Taxpayer Ex. #2, p. 12), and the total sales are $1,119,164 (Taxpayer Ex. #2, p. 12), then the mark up is approximately 24%. (This assumes that the purchases are roughly equivalent to cost of goods sold, as the taxpayer has indicated on its 1998 federal tax return.)

he stated that there was $150,000 worth of inventory that was lost in the fire.[9] (Tr. p. 92) Then he stated, "I had an adjuster after that fire and he added every item in the store, what kind of stuff we lost in that fire. And I have those documents in my store. If you---if you want it, I can bring it to the Court." (Tr. p. 92)

No explanation was given as to why these documents were not produced so that the amount could be deducted from the purchases to determine the tax liability. The auditor stated that if the taxpayer had provided some sort of documentation, he would probably have made an adjustment for it. (Tr. pp. 95-96) The taxpayer clearly has documents in its possession that would verify the amount of the inventory, but it did not provide them. Although the reliability of the financial statements is questionable, they do not indicate the amount of inventory and no explanation was given as to why the inventory amount could not have been obtained from the taxpayer's accountants. Without these documents, the auditor cannot take a deduction for the inventory.

The taxpayer also could have obtained verification of the amount of food stamps and WIC coupons that it redeemed during the audit period from the United States Department of Agriculture ("USDA"). The USDA administers the food stamp program (see 7 U.S.C.A. §2013) and keeps records concerning the amount of food stamps and WIC coupons that are redeemed by a retailer. The taxpayer did not present any information from the USDA that would verify the amounts redeemed during the audit period. The taxpayer repeatedly contends that the Department should have deducted the amounts that are reported on the taxpayer's sales and use tax returns from the auditor's estimated sales in order to determine the tax liability. Once again, the taxpayer is asking

[9] Both the $150,000 and $250,000 are substantially greater than the $65,000 that is shown on both the 1997 and 1998 federal tax returns as ending inventory. (Taxpayer Ex. #1, p. 2; Taxpayer Ex. #2, p. 2).

the Department to use the same documents that it is attempting to verify on order to determine the proper tax liability. In order to verify these amounts, the taxpayer could have produced documents from the USDA. Without independent substantiation of the amount of coupons that were redeemed, the deduction cannot be allowed.

With respect to the theft of items from the store, the taxpayer once again refers to an outside source that would substantiate its contention but failed to produce the evidence. The taxpayer's president provided testimony concerning incidents of theft at the store. (Tr. p. 89) Then he stated, "you can follow up with the police department. You can see a lot of reports being called and stuff like that." (Tr. p. 90) The taxpayer provided none of these reports and provided no explanation as to why they were not presented. The taxpayer also gave no indication as to how it estimated the amount of spoilage of perishable goods.

All of the taxpayer's assertions concerning inaccuracies in the Department's audit concern information that was within the taxpayer's ability to find. The taxpayer could have obtained the information to verify the deductions, but the taxpayer chose not to do so. The court in Smith v. Department of Revenue, 143 Ill.App.3d 607 (5th Dist. 1986) stated that the taxpayers' failure to produce their records permits a negative inference that if the records had been produced they would have reflected unfavorably on the taxpayers' position. Smith at 613.

In this case, a comparison of the auditor's estimated purchases and the purchases on the taxpayer's financial statements indicates that the auditor substantially underestimated the amount of purchases. Also, a comparison of the auditor's estimated purchases with the sales reported on the sales tax returns indicates that the taxpayer substantially understated its sales. The taxpayer reported questionable amounts of inventory and purchases on its 1998 federal tax return, provided conflicting testimony regarding the inventory, and did not present an insurance document or information from its accountant to substantiate the amount of the inventory. The taxpayer did not provide information from the USDA to verify the deductions that it took on its returns for purchases made with food stamps and WIC coupons. This raises a concern as to whether the information that the taxpayer could have produced would have reflected unfavorably on the taxpayer.

Without producing any documentary evidence to support its contentions, it cannot be found that the taxpayer has overcome the Department's prima facie case. "A taxpayer does not overcome the Department's prima facie case merely by denying the Department's case or by suggesting hypothetical weaknesses. He must establish by documentary evidence that the hypothetical weaknesses are relevant to his business." Vitale at 213. Losing its books and records in a fire does not completely absolve the taxpayer of all responsibility for substantiating its receipts and deductions on its tax returns. In this case, the taxpayer made no effort whatsoever to support its claims. The record, which includes the taxpayer's own conflicting documentation, is simply devoid of evidence supporting the taxpayer's contentions.

The taxpayer's oral testimony without sufficient corroborative evidence will not rebut a prima facie case. A.R. Barnes & Co. v. Department of Revenue, 173 Ill.App.3d 826, 835 (1^{st} Dist. 1988). The ROTA puts the burden on the taxpayer to come forward with any evidence that it has to prove that the assessment is inaccurate. In view of the fact that the taxpayer did not produce any credible proof to support its self-serving testimony in order to overcome the proposed assessment, the tax as finally assessed must be upheld.

Finally, the taxpayer has requested that the penalties be abated due to reasonable cause. The Department imposed the negligence and late-payment penalties pursuant to sections 3-3 and 3-5 of the Uniform Penalty and Interest Act (UPIA) (35 ILCS 735/3-1 *et seq*.). Section 3-8 of the UPIA provides a basis for the abatement of these penalties and states in part as follows:

> "The penalties imposed under the provisions of Sections 3-3, 3-4, and 3-5 of this Act shall not apply if the taxpayer shows that his failure to file a return or pay tax at the required time was due to reasonable cause. Reasonable cause shall be determined in each situation in accordance with the rules and regulations promulgated by the Department." (35 ILCS 735/3-8)

The auditor imposed the negligence penalty because the amount of the assessment was more than 50% of the amount that should have been reported. The assessment was actually 50.25% of the amount that should have been reported. The taxpayer asserts that this penalty would be appropriate only if every number on the Department's worksheet concerning the vendors is correct. The taxpayer believes that the numbers are not accurate and that the auditor may have made a mathematical mistake. The taxpayer also states that the auditor admitted that if the sales would have been discounted for items purchased with food stamps or WIC coupons, then the assessment would have been below the 50% threshold and the penalty would not have been imposed. The taxpayer therefore argues that the negligence penalty is entirely without merit.

The record does not support the taxpayer's contention that the auditor over-estimated the liability. Although the taxpayer lost its books and records in a fire, the taxpayer presented its financial statements that were kept by its accountant. According to the financial statements, the taxpayer's 1997 purchases were $788,364.63. The auditor estimated the 1997 purchases to be $231,086. The auditor made similar under-estimates for the 1998 and 1999 purchases. The difference between these numbers is substantial.

Thus, the documents submitted by the taxpayer support a finding that the Department's assessment is significantly smaller than it should be. The taxpayer did not attempt to explain these differences. Because the evidence presented by the taxpayer supports a finding that the auditor significantly under-estimated the assessment, it cannot be found that the taxpayer established reasonable cause to abate the penalties.

Recommendation:

For the foregoing reasons, it is recommended that the assessment and the penalties be upheld.

Linda Olivero
Administrative Law Judge

Enter: September 29, 2003