

**ST 04-12**

**Tax Type: Sales Tax**

**Issue: Unreported/Underreported Receipts (Fraud Application)**

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

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

v.

**ABC CORPORATION, D/B/A  
ABC TOBACCO,**

**Taxpayer**

No. 03-ST-0000  
IBT# 0000-0000  
NTL# 00 00000000000000  
00 00000000000000

**Ted Sherrod  
Administrative Law Judge**

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**RECOMMENDATION FOR DISPOSITION**

**Appearances:** James R. Griffin of Schain, Burney, Ross & Citron, Ltd. for ABC Corporation d/b/a ABC Tobacco; Special Assistant Attorney General Shepard Smith on behalf of the Illinois Department of Revenue.

**Synopsis:**

This matter arose following the protest of Notices of Tax Liability issued by the Department of Revenue (“Department”) on May 30, 2002 and May 31, 2002 to ABC Corporation d/b/a ABC Tobacco (“taxpayer”) for the audit period January, 1998 through December, 2001. The issues presented in this case are as follows: 1) whether the taxpayer failed to report or underreported taxable receipts; 2) whether taxpayer’s taxable receipts should be reduced by sales for resale; 3) whether the taxpayer is entitled to reduce taxable receipts to reflect rebates from cigarette manufacturers known as cigarette buy-downs; and 4) whether a fraud penalty was properly applied in this case. After

reviewing the evidence adduced at hearing, it is my recommendation that the Department's Notices of Tax Liability as revised by the auditor's calculations during a re-audit subsequent to her initial audit, be finalized.

**Findings of Fact:**

1. The Department established its *prima facie* case, inclusive of all jurisdictional elements, by the admission of the Department's SC-10-K, Audit Correction and/or Determination of Tax Due and Notices of Tax Liability for the audit period January, 1998 through December, 2001. Dept. Ex. 1. <sup>1</sup>
2. Included in the assessment is a fraud penalty assessed under 35 ILCS 120/4 for the aforementioned audit period. Dept. Ex. 1.
3. ABCs Corporation d/b/a ABC Tobacco ("ABC Tobacco"), a business registered as a corporation in Illinois located in Warrenville, Illinois, is primarily engaged in the business of selling cigarettes and cigarette products. It also sells cigars and other tobacco related products, lighters, humidor cases, rolling paper, pipes, key chains, magazines and lottery tickets. Tr. pp. 9, 16, 79; Dept. Ex. 2.
4. ABC Tobacco was acquired by John Doe in 1995, and is registered with the Internal Revenue Service as a Subchapter S Corporation owned by John Doe and his wife, Jane Doe. Tr. p. 16; Dept. Ex. 2.
5. ABC Tobacco is required to file, and filed sales tax returns on a monthly basis during the audit period. Tr. p. 79; Dept. Ex. 2.
6. Commencing in November, 2000, ABC Tobacco was the subject of an audit conducted by Illinois Department of Revenue auditor Elizabeth Comiano ("auditor")

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<sup>1</sup> Unless otherwise noted, findings of fact apply to the audit period.

or “Ms. Comiano”). Ms. Comiano has conducted approximately 400 audits throughout the course of her 19 year career with the Department. Tr. pp. 78, 79.

7. Ms. Comiano commenced the audit on or about November 15, 2000. At the commencement of the audit, Ms. Comiano requested the taxpayer’s books and records, including monthly sales tax returns, purchase invoices, cancelled checks, financial statements, federal and state income tax returns, bank statements and cash register or Z tapes. Records provided by the taxpayer in response to this request were incomplete. Tr. pp. 79, 80; Dept. Ex. 2.
8. Taxpayer did not provide the auditor with cash register tapes (Z tapes). Although the taxpayer was advised that it is required to maintain Z tapes at the beginning of the audit in November 2000, it nevertheless neglected to do so. Tr. pp. 80, 81, 82, 87, 88; Dept. Ex. 2.
9. Because the invoices provided by the taxpayer were incomplete, Ms. Comiano verified taxpayer’s purchases by mailing forms called EDA-20s to the taxpayer’s suppliers. During the course of the audit, the taxpayer provided the auditor with information regarding the mark-up on all ABC Tobacco sales. The auditor used this information to determine the mark-up applicable to the audit period. Tr. pp. 84, 85, 86; Dept. Ex. 2.
10. The auditor calculated the projected sales amount by multiplying the amount of total purchases shown on invoices provided by the taxpayer and reported on EDA-20s from taxpayer’s suppliers for 1999 and 2000. The auditor then gave the taxpayer credit for the sales reported by subtracting the taxpayer’s reported sales on its monthly sales tax returns filed with the Department. The auditor arrived at an

average error rate for 1999 and 2000 by dividing gross receipts reported on the taxpayer's sales tax returns by total gross receipts determined by the auditor as indicated above. This error rate was projected to 1998 and 2001 to arrive at taxable gross receipts for these years. Gross receipts for 1998, 1999, 2000 and 2001 determined in this manner were multiplied by a mark-up of 10%. The resulting sales determined as indicated above were multiplied by a tax rate of 6.75% to determine the amount of tax due for 1998, 1999, 2000 and 2001. Tr. pp. 85, 88, 89; Dept. Ex. 2.

- 11.** During her initial audit, Ms. Comiano determined that certain receipts taxpayer had identified on returns as deductions from its taxable gross receipts were not supported by books and records and were taxable. The auditor disallowed deductions claimed on taxpayer's returns for sales for resale and for promotional rebates from cigarette manufacturers called cigarette buy-downs. Tr. pp. 82, 90, 92.
- 12.** Taxpayer did not have in its possession resale certificates conforming to the requirements of Section 2c of the Retailers' Occupation Tax, 35 ILCS 120/2c that could be identified with transactions during the audit period. The resale certificates produced during the audit were provided without related invoices or other documents tying these resale certificates to transactions during the audit period in controversy. Tr. pp. 90, 91.
- 13.** None of the taxpayer's exhibits entered into evidence during the hearing contain certifications that the transactions claimed by the taxpayer as wholesale sales were sales for resale. Taxpayer's Ex. 1, 2, 3, 6, 15, 16.

14. Taxpayer was not registered as a cigarette distributor required to collect cigarette tax on wholesale sales of cigarettes to retailers pursuant to 35 ILCS 130/2. Tr. p. 90.
15. During the audit, Ms. Comiano disallowed deductions for rebates from cigarette manufacturers to cover discounts allowed on sales of cigarettes at the request of the manufacturers (cigarette buy-downs) because the taxpayer presented no supporting documents for these deductions. Tr. pp. 82, 91, 92.
16. Ms. Comiano did not deduct promotional payments from cigarette manufacturers based upon shelf space allotted cigarette brands by the taxpayer to promote certain cigarette manufacturers' products because these revenues were not included in taxable gross receipts during the audit. Tr. pp. 94, 95.
17. At the request of the taxpayer, the auditor conducted a reaudit of the taxpayer based upon documents given the auditor after the initial audit was completed. Upon reaudit, Ms. Comiano examined check stubs from cigarette manufacturers and, based upon this documentation, determined that the taxpayer should be allowed a deduction for cigarette buy-downs in the amount of \$13,705 for 1999 and \$8,511 for 2000. However, the auditor did not allow a deduction for checks from manufacturers determined to be reimbursements for manufacturers' coupons which are includable in taxable gross receipts pursuant to 86 Ill. Admin. Code, ch. I, sec. 130.2125. Tr. pp. 92, 93, 94.

**Conclusions of Law:**

The Department introduced its Notices of Tax Liability into evidence under the certificate of the Director. Dept. Ex. 1. This established *prima facie* proof of the correctness of the amount of tax due. 35 ILCS 120/4. The Department's *prima facie*

case is a rebuttable presumption. Copilevitz v. Department of Revenue, 41 Ill. 2d 154, 157 (1968); DuPage Liquor Store, Inc. v. McKibbin, 383 Ill. 276, 279 (1943). A taxpayer cannot overcome the presumption merely by denying the accuracy of the Department's proposed assessment. A.R. Barnes & Co. v. Department of Revenue, 173 Ill. App. 3d 826, 833 (1<sup>st</sup> Dist. 1988). Instead, a taxpayer must present evidence that is consistent, probable and identified with its books and records to show that the proposed assessment is not correct. Fillichio v. Department of Revenue, 15 Ill. 2d 327, 333 (1958); A.R. Barnes & Co., supra.

In Illinois, retailers are required under the Retailers' Occupation Tax Act ("ROTA"), 35 ILCS 120/1 *et seq.*, to maintain adequate books and records as follows:

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 in the specific trade and other pertinent papers and documents.  
35 ILCS 120/7

Further, the Department's regulations outline what minimum records a retailer must keep under the ROTA: 1) cash register tapes and other data to keep a record of gross daily sales; 2) vendors' invoices and copies of purchase orders maintained serially; and 3) yearly inventory records. 86 Ill. Admin. Code, ch. I, sec. 130.805. If a taxpayer fails to maintain adequate records, and does not supply the Department with documentation to substantiate its gross receipts, the Department is justified in using other reasonable methods to estimate the taxpayer's revenues. Masini v. Department of Revenue, 60 Ill. App. 3d 11 (1<sup>st</sup> Dist. 1978); Mel-Park Drugs, Inc. v. Department of Revenue, 218 Ill. App. 3d 203 (1<sup>st</sup> Dist. 1991); Young v. Hulman, 39 Ill. 2d 219 (1968).

In the present case, taxpayer did not present the auditor with complete books and records since it could not produce the cash register tapes needed to document the taxpayer's daily sales. Tr. pp. 80, 82; Dept. Ex. 2. As a result, the auditor was compelled to obtain the amount of the taxpayer's purchases from its suppliers by mailing out EDA-20 forms. Tr. pp. 84, 85; Dept. Ex. 2. To arrive at a tax liability, the Department's auditor applied a mark-up to the purchases to determine the sales price of cigarettes, cigars and other tobacco related and miscellaneous items. Tr. pp. 85, 86. Taxpayer has contested various aspects of the auditor's audit methodology.

The Illinois courts have held that, to survive attack, the Department's audit methodology must only meet a minimum standard of reasonableness. Masini at 14. After the Department presented its *prima facie* case, the burden shifted to the taxpayer to present evidence sufficient to overcome the presumed correctness of the Department's determination. Fillichio at 333. Taxpayer's co-owner, John Doe attempted to meet this burden by presenting testimony that the auditor failed to take into account the low margin nature of the taxpayer's discount operation and did not use a reasonable mark-up in projecting gross receipts. Tr. pp. 26, 27, 31, 32, 33, 34, 35, 36; Taxpayer's Ex. 2. Though the taxpayer testified that the auditor's determinations were incorrect, the taxpayer did not present sufficient books and records to corroborate his allegations regarding the inaccuracy of the Department's calculations. Other than worksheets summarizing testimony, the only documentary evidence admitted into the record were: 1) an invoice from purchases made in 2000 from XXXX Company (see Taxpayer's Ex. No. 1), and 2) copies of three checks from !!!! Grocery (see Taxpayer's Ex. No. 3).

First, the taxpayer specifically disputed the 10 percent mark-up used by the auditor for sales of cigarettes and other products and offered a worksheet into evidence which used mark-up percentages ranging from 1.01 percent to 1.09 percent. Taxpayer's Ex. 2. Taxpayer, however, did not present evidence proving that this worksheet was tied to its books and records. Furthermore, at hearing, the auditor gave credible testimony that she used a 10 percent mark-up rather than the percentages shown in the taxpayer's worksheet based on information provided by the taxpayer during the audit. Even though the taxpayer disputes the auditor's claim, the taxpayer's failure to provide records to prove that the selling price used by the auditor was inherently unreasonable and should be something other than 10 percent entitles the auditor to use her judgement and rely upon the best information available. Masini, supra; Young, supra.

Case law in Illinois clearly indicates that merely denying the accuracy of the Department's assessments, offering alternative hypotheses or arguing that its audit methodology is flawed is not enough to overcome the Department's *prima facie* case. A.R. Barnes & Co., supra; Central Furniture Mart v. Johnson, 157 Ill. App. 3d 907 (1<sup>st</sup> Dist. 1987). No documentary evidence was presented by the taxpayer to prove that the auditor's determination of the amount of the mark-up was arbitrary, capricious or unreasonable. Thus, the unsubstantiated oral testimony of the taxpayer is insufficient to overcome the *prima facie* correctness of the Notices of Tax Liability.

The taxpayer also argues that the Department failed to take into account deductions from gross receipts for sales for resale and for cigarette buy-downs. Tr. pp. 10, 11. Section 7 of the ROTA, 35 **ILCS** 120/7, provides, in part:

To support deductions made on the tax return form, or authorized under this Act, on account of receipts ... from any ... kind of transaction that

is not taxable under this Act, entries in any books, records or other pertinent papers or documents of the taxpayer in relation thereto shall be in detail sufficient to show the name and address of the taxpayer's customer in each such transaction, the character of every such transaction, the date of every such transaction, the amount of receipts realized from every such transaction and such other information as may be necessary to establish the non-taxable character of such transaction under this Act. ... It shall be presumed that all sales of tangible personal property are subject to tax under this Act until the contrary is established, and the burden of proving that a transaction is not taxable hereunder shall be upon the person who would be required to remit the tax to the Department if such transaction is taxable.  
35 ILCS 120/7

With respect to sales for resale, the taxpayer failed to present documentation tied to any transactions during the audit period of the kind enumerated in 35 ILCS 120/7 and necessary to support this deduction. Tr. pp. 82, 90, 91. Section 2c of the ROTA, 35 ILCS 120/2c (hereinafter "section 2c of the ROTA"), enumerates the type of documentation that must be maintained to support a sale for resale exemption, as follows:

Except as provided hereinabove in this Section, a sale shall be made tax-free on the ground of being a sale for resale if the purchaser has an active registration number or resale number from the Department and furnishes that number to the seller in connection with certifying ... that all of the seller's sales are for resale, or that a particular sale is a sale for resale. ... Failure to present an active registration number or resale number and a certification to the seller that a sale is for resale creates a presumption that a sale is not for resale. This presumption may be rebutted by other evidence that all of the seller's sales are sales for resale, or that a particular sale is a sale for resale.  
35 ILCS 120/2c

When construing the requirements of section 2c of the ROTA, the Illinois Supreme Court, in Tri-America Oil Co. v. Department of Revenue, 102 Ill. 2d 234 (1984), stated:

Section 2c ... provides a method whereby a seller can avoid paying a retailers' occupation tax on sales it makes to others, sales which might otherwise be taxable as retail sales even though they may not in fact be retail sales. The presumption raised by section 4 is thus not that a given sale is a sale for retail, but is rather that tax is due in the amount indicated by the Department. The presumption is rebutted, not by

evidence that certain sales were made for resale, but either by a showing of compliance with section 2c or by a showing that section 2c does not apply.

Tri-America Oil Co. at 240

The Illinois Supreme Court's decision in Tri-America Oil clearly identifies the risk a seller takes when it makes untaxed sales without having in its possession resale certificates from purchasers covering transactions for which a resale exemption is claimed which conform to section 2c of the ROTA. In this case, while the taxpayer did present resale certificates, it presented no evidence to the auditor that these certificates were tied to transactions that took place during the audit period. Tr. pp. 90, 91. Consequently, no resale certificates showing exempt sales for resale during the audit period were produced. Moreover, no resale certificates were admitted into evidence in this case.

In lieu of resale certificates, the taxpayer has submitted worksheets identifying various sales as wholesale transactions, and checks from !!!!!'s Grocery purportedly given in payment for cigarettes purchased for resale. Taxpayer's Ex. 2, 6, 15, 16. However, the record contains no invoices to purported purchasers for resale, and no evidence that any merchandise was ever shipped to them. Accordingly, the taxpayer has failed to present documentary evidence that can be tied to the transactions reported as exempt on the taxpayer's returns. While the taxpayer also testified that sales deducted on its returns as sales for resale were wholesale sales, the Illinois Supreme Court has expressly held that oral testimony that unreported receipts were sales for resale is insufficient to carry the taxpayer's burden where the Department's regulations require documentary evidence. Copilevitz, *supra*.

In sum, no competent documentary evidence has been introduced showing taxpayer's compliance with section 2c of the ROTA or otherwise establishing the taxpayer's claim. As previously stated, the taxpayer must keep books and records documenting exemptions claimed on its returns. 35 **ILCS** 120/7. Moreover, the taxpayer has the burden of overcoming the Department's determination by providing more than its own testimony. Mel-Park Drugs, *supra*. Since the taxpayer has failed to present adequate evidence to rebut the Department's determination denying resale exemptions, the Department's refusal to allow deductions for sales for resale claimed by the taxpayer must be upheld.

With respect to the taxpayer's contention that cigarette buy-downs were improperly disallowed as deductions in determining taxable gross receipts, the auditor testified that at the time of the audit the taxpayer had no documentation to support this claim. Tr. pp. 82, 91, 92. The auditor's determination that the taxpayer failed to support the deduction of such receipts was proper at that time, based on the statutory presumption that all sales are subject to tax unless the contrary is established through the presentation of documentary evidence. 35 **ILCS** 120/7. The taxpayer, however, later obtained such documentation to support a portion of the amount excluded by the taxpayer on its returns. Tr. pp. 92, 93. As a consequence, the auditor reduced taxable receipts for 1999 by \$13,705, and reduced the taxable receipts for 2000 by \$8,511. *Id.* Since the taxpayer's error rate for the entire audit period is based on these two years, commensurate reductions to taxable receipts for 1998 and 2001 must also be made.

The auditor also found that a portion of promotional rebates constituted non-deductible coupon rebates properly includable in taxable receipts pursuant to 86 Ill.

Admin. Code, ch. I, sec. 130.2125.<sup>2</sup> Tr. p. 94. She also disallowed any deductions for “rack rentals” (i.e. receipts for allocating additional shelf space to certain cigarette brands) since these revenues were never included in gross receipts. Tr. p. 95. The taxpayer has submitted no additional documentation to rebut these findings or to support the deduction of any amounts not allowed by the auditor as cigarette buy-downs. Accordingly, I find that the auditor correctly disallowed a portion of the amounts the taxpayer deducted from taxable receipts as cigarette buy-downs.

The taxpayer also objects to the imposition of a fraud penalty pursuant to 35 ILCS 120/4 and 35 ILCS 735/3-6 in this case. The standard for determining whether a fraud penalty is appropriate is clear and convincing evidence. Puleo v. Department of Revenue, 117 Ill. App. 3d 260, 268 (4<sup>th</sup> Dist. 1983). Moreover, where civil fraud is alleged, the Department must show intent. Vitale v. Department of Revenue, 118 Ill. App. 3d 210, 213 (3rd Dist. 1983). Clear and convincing evidence of an intent to defraud can be circumstantial in nature. Vitale, supra.

While the Department contends that the taxpayer admitted its mark-up on sales was 10%, the taxpayer’s position is that it did not give this information to the Department. Moreover, it argues, even if the Department’s contention was true, the taxpayer’s alleged cooperation with the Department’s auditor in this manner is inconsistent with a deliberate attempt to deceive or mislead her. Tr. p.114. The taxpayer also maintains that there is no evidence it deliberately failed to maintain adequate books

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<sup>2</sup> 86 Ill. Admin. Code, ch. I, sec. 130.2125 provides, in pertinent part, as follows: “(I)f a retailer allows a purchaser a discount from the selling price on the basis of a discount coupon for which the retailer will receive full or partial reimbursement (from a manufacturer, distributor or other source), the retailer incurs Retailers’ Occupation Tax liability on the receipts received from the purchaser and the amount of any coupon reimbursement.”

and records necessary to support deductions reported on its sales tax returns or fabricated its claim that it engaged in resale transactions and received cigarette buy-downs. Tr. pp. 11, 115, 116, 117, 118.

Under Illinois case law, it is not necessary to find overt conduct of this kind showing a deliberate attempt to deceive or mislead the auditor to support an inference of fraudulent intent. Admissions that such actions were taken, which would be tantamount to a confession of one's true mental state, are rare. Accordingly, the courts have found the requisite intent from circumstantial evidence of declarations, acts or conduct from which it may fairly be inferred that the accused acted intentionally. Puleo, *supra*; People v. L&M Liquors, Inc., 37 Ill. App. 3d 117, 122 (1<sup>st</sup> Dist. 1976) (“Of course ... [intent] ... may be shown by circumstantial evidence”).

In Vitale, *supra*, the court found the necessary intent from a number of facts having nothing to do with any overt conduct by the taxpayer during the audit. Evidence found sufficient to support a finding of fraud in that case included the court's finding that taxpayer's purchases significantly exceeded sales, and that the taxpayer failed to maintain business records. Vitale at 213. In Puleo, *supra*, the court, as in Vitale, found circumstantial evidence sufficient to support imposition of a fraud penalty where the taxpayer's purchases exceeded sales during the tax periods in controversy and its books and records were inadequate.

In this case, there are a number of factors that support a finding of fraudulent intent. Specifically, ABC Tobacco's purchases determined on audit exceeded reported sales by \$299,612 for 1999, and by \$239,287 for 2000. Dept. Ex. 2. Moreover, not only did the taxpayer fail to maintain required books and records, but the failure to

maintain mandatory documents prevailed throughout the 48 month audit period. Indeed, the taxpayer refused to maintain required books and records even after being instructed to do so by the auditor more than a year before the audit period concluded. Tr. pp. 80, 81, 82, 87, 88; Department Ex. 2. These factors constitute the type of clear and convincing evidence of intent to commit fraud recognized by Illinois case law. Therefore, the Department's assessment of fraud penalties must be sustained.

**WHEREFORE**, for the reasons stated above, it is my recommendation that Notice of Tax Liability number 00 0000000000000 and Notice of Tax Liability number 00 00000000000000, as revised by process of re-audit, be finalized.

Ted Sherrod  
Administrative Law Judge

Date: March 19, 2004