ST 10-03
Tax Type: Sales Tax
Issue: Audit Methodologies and/or Other Computational Issues

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

THE DEPARTMENT OF REVENUE OF THE STATE OF ILLINOIS v. **ABC COAL, LLC,** **Taxpayer**	**No. 00-ST-0000** **IBT# 0000-0000** **Letter ID# 000000000** **Period 12/04-12/06** **Ted Sherrod** **Administrative Law Judge**

RECOMMENDATION FOR DISPOSITION

Appearances: Special Assistant Attorney General John D. Alshuler, Esq. on behalf of the Illinois Department of Revenue; G. Michael Burke, Esq. on behalf of ABC Coal, LLC.

Synopsis:

This matter involves a protest by ABC Coal, LLC ("Taxpayer") of the Department of Revenue's Notice of Tax Liability for Form EDA 105R, Audit Report dated October 10, 2008 ("NTL") assessing tax, penalty and interest for the tax reporting periods 12/1/04 through 12/31/06. The Taxpayer does not contest the tax liability determination indicated in the NTL but objects to the amount of interest and penalty imposed on the tax determined to be due. The sole issue presented in this case is whether penalty and interest shown on the NTL was properly computed.

In lieu of a hearing, the parties have submitted a joint stipulation of facts ("Stip."), along with related exhibits. I am including in this recommendation findings of fact and conclusions of law based upon a review of the complete record and of briefs submitted by the parties in this matter.[1] I recommend that this matter be concluded in favor of the Department.

Findings of Fact:

1. On or about June 25, 2007, the Department of Revenue of the State of Illinois (the "Department") began an audit of the books and records of ABC Coal, LLC (the "Taxpayer") for the period December 1, 2004 through December 31, 2006. [Stip. ¶1].[2]

2. The Department, utilizing its best judgment and information, determined a liability for unpaid use tax in the amount of $51,392.00. Attached hereto and made a part hereof is Stipulation Exhibit Number 1 under certificate of the Director, SC-10-K Audit Correction and/or Determination of Tax Due [12/1993 to Present]. [Stip. ¶2].

3. During the course of the audit, the Department also determined that the Taxpayer was entitled to Manufacturer's Purchase Credit ("MPC") (35 **ILCS** 105/85) in the amount of $49,448.00. This was applied to the unpaid use tax determined to be due pursuant to the audit. Attached hereto and made a part hereof as Stipulation Exhibit Number 2,

[1] The Taxpayer filed a brief on November 3, 2009. The Department's reply to the Taxpayer's brief was filed on December 10, 2009. Subsequently, on December 15, 2009, the Taxpayer filed a reply to the Department's brief.

[2] Except as indicated by brackets, all Findings of Fact are *verbatim* recitations of stipulations agreed to by the parties.

under certificate of the Director, is a three page document entitled **ABC COAL, LLC., AUDITOR'S NARRATIVE.** [Stip. ¶3].

4. The Taxpayer made a payment to be applied to the audit liability in the amount of $2,535.00. This payment represented the remaining tax due after applying the MPC plus an amount of interest as applied to the liability. [Stip. ¶4].

5. As set out in the Notice of Tax Liability, under certificate of the Director, attached hereto and made a part hereof as Stipulation Exhibit Number 3, the Department calculated the late-payment penalty and interest before applying MPC to the outstanding use tax liability. [Stip. ¶5].

6. The issue to be determined is whether the Department erred in calculating interest and late-payment penalty, as applied to the unpaid use tax determined to be due pursuant to audit of the period December 1, 2004 through December 31, [2006][3], before applying the MPC as opposed to calculating interest and late-payment penalty after the MPC was applied to the use tax liability. [Stip. ¶6].

Conclusions of Law:

BACKGROUND

This case concerns the application of Manufacturer's Purchase Credit ("MPC") authorized by 35 **ILCS** 105/3-85 to offset tax liabilities incurred by the Taxpayer upon the purchase of production related tangible personal property during the period December 1, 2004 through December 31, 2006. The State of Illinois provides an exemption for the purchase of certain types of manufacturing machinery and equipment. 35 **ILCS** 120/2-

[3] See Reply Brief For Taxpayer, ABC Coal, LLC, p.2 ("[S]tipulation No.6 contains a typographical error with respect to the period of the audit[.] The statement should have read 'pursuant to the audit of the period December 1, 2004 through December 31, 2006.' ").

5(14); 35 **ILCS** 115/2; 35 **ILCS** 110/2; 35 **ILCS** 105/3-5(18).[4] Purchasers of manufacturing machinery and equipment that qualifies for the manufacturing machinery and equipment exemption earn MPC in an amount equal to a fixed percentage of the tax which would have been incurred under the Use Tax or Service Use Tax absent this exemption. 35 **ILCS** 105/3-85. See also 86 Ill. Admin. Code, ch. I, section 130.331 ("Regulation 130.331"). This MPC may be used to pay any Use Tax or Service Use Tax liability that is incurred on the purchase of production related tangible personal property that does not qualify for the manufacturing machinery and equipment exemption at the time such property is purchased by the Taxpayer. 35 **ILCS**105/3-85.[5]

The amount of MPC that can be applied to a purchase of production related tangible personal property is limited to the State rate of tax incurred on that property (6.25%). *Id*. Accordingly, any local taxes incurred on the purchase of production related tangible personal property remain the responsibility of the purchaser.

"Production related tangible personal property" includes all tangible personal property used or consumed in a production related process by a manufacturer in a manufacturing facility in which a manufacturing process described in Section 2-45 of the Retailers' Occupation Tax Act ("ROTA") takes place, and all tangible personal property used or consumed by a manufacturer or graphic arts producer in research and development regardless of use within or without a manufacturing or graphic arts production facility. 35 **ILCS** 105/3-85. The Department's regulation for MPC provides examples of tangible personal property that will be considered production related.

[4] See also 86 Ill. Admin. Code, ch. I, section 130.330.
[5] See also 86 Ill. Admin. Code, ch. I, section 130.331(b)(1).

Regulation 130.331(b)(4). Pursuant to this regulation, such items include supplies and consumables used in a manufacturing facility, including fuels, coolants, solvents, oils, lubricants, cleaners, adhesives, hand tools, protective apparel, and fire and safety equipment used or consumed in a manufacturing facility. *Id.* Accordingly, MPC may be applied to the State tax due for the purchase of these or similar items. Regulation 130.331(b)(1).

As previously noted, the Taxpayer is contesting the computation of late payment penalty and interest due on the tax liability indicated in the NTL. The Taxpayer is not contesting the tax liability determined. However, it contends that in computing the late payment penalty and interest due on this tax liability, the Department improperly failed to apply MPC to reduce the tax due upon which the determination of penalty and interest is based. Taxpayer Brief p. 1.

The Department is required by law to charge interest and late payment penalty on any unpaid tax due and owing on the due date of the Taxpayer's return. 35 **ILCS** 735/3-3(b-20)(2); 86 Ill. Admin. Code, ch. I, section 130.905. The Department conducted an audit of the Taxpayer for the period December 1, 2004 through December 31, 2006 and issued a Notice of Tax Liability showing a tax deficiency for underreported use tax due in the amount of $51,392 and penalties and interest on this liability of $17,238. Stip. Ex.3. In arriving at this deficiency, the Department determined the interest and penalty on tax due and owing on the due date for filing returns for the audit period without taking into account MPC the Taxpayer failed to properly use at the time it purchased qualifying production related tangible personal property between December 1, 2004 through December 31, 2006. Taxpayer Brief p. 1. The Taxpayer contends that this credit should

have been retroactively applied in computing tax due on the return due dates and used to reduce the amount of tax due upon which interest and penalty was computed. Taxpayer Brief pp. 1-3.

SUMMARY OF PARTIES' POSITIONS

The Taxpayer contends that its MPC should be applied in determining the amount of its tax liability or tax ultimately owed and that penalty and interest should be computed on this ultimate tax liability. The Department's position is that the Taxpayer did not comply with the requirements prescribed in its regulations to use the MPC in computing the Taxpayer's ultimate tax liability (i.e. the amount of tax due and owing). As a result, it contends, MPC could only be used as a form of payment to pay off the ultimate tax liability the auditor arrived at after concluding the Department's audit. However, when MPC is used in this manner, the Department's directive allowing this tax relief does not allow MPC to be used to pay off any interest or penalties. For the reasons enumerated below, I agree with the Department.

ANALYSIS

Section 4 of the ROTA provides that the Department's determination of tax, penalty and interest due shown on the Department's NTL constitutes *prima facie* proof that the Taxpayer is not entitled to the relief that the Taxpayer seeks in the instant case.

35 **ILCS** 120/4.[6] This *prima facie* determination is presumed to be correct. *Id.* 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 (1943). A Taxpayer cannot overcome the statutory 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 (1st Dist. 1988). Instead, a Taxpayer has the burden to present evidence that is consistent, probable and closely identified with its books and records, to show that the Department's determination is not correct. Fillichio v. Department of Revenue, 15 Ill. 2d 327 (1958); A.R. Barnes & Co., *supra*.

The Department has express authority to make, promulgate and enforce reasonable rules and regulations relating to the administration and enforcement of the ROTA and the complementary Use Tax Act. 35 **ILCS** 120/12; 35 **ILCS** 105/12. In the instant case, the Taxpayer relies upon Department regulation 700.300(g), 86 Ill. Admin. Code, ch. I, section 700.300(g), which states in pertinent part:

> For purposes of the late payment penalties, the basis of the penalty shall be the tax shown due or required to be shown on the return, whichever is applicable, reduced by any part of the tax which is paid at any time and by any credit which was properly allowable on the date the return was required to be filed.
> 86 Ill. Admin. Code, ch. I, section 700.300(g)

[6] This section of the Retailers' Occupation Tax Act is expressly incorporated by reference into the Use Tax Act by section 12 of the Use Tax Act, 35 **ILCS** 105/12.

The Taxpayer argues that regulation 700.300(g) provides for the computation of the late payment penalty imposed in the instant case by taking into account any credit that was properly allowable on the date the return was due whether or not the credit was actually taken on the return that was filed. Taxpayer Brief pp. 1-4. The record in this case indicates that the identification of purchases during the audit period to which MPC could have properly been applied to reduce the Taxpayer's liability was not made prior to the commencement of the Department's audit of the Taxpayer in June, 2007. Department's Brief p. 2. ("The Department, while reviewing the MPC taken by the Taxpayer during the Audit Period, determined that the Taxpayer had claimed some MPC in error and it was disallowed by the Auditor[.] In going through the Taxpayer's purchase(s), however, the Department was able to determine that the Taxpayer was entitled to MPC that it had not claimed."). The Taxpayer contends that MPC was properly allowable as credit in computing the amount of tax due and owing even though it was not determined until the audit of the Taxpayer had commenced in June 2007. Taxpayer Brief pp. 1-4. The issue presented in this case is whether the MPC the Taxpayer seeks to apply in computing taxes due could properly be used for this purpose.

The record shows that the Taxpayer clearly did not use MPC to pay sales tax on purchases at the time these purchases were made during 2004 through 2006. The Taxpayer did not find out that these purchases were eligible for MPC until after the audit commenced in June, 2007. The Department's regulations expressly permit a manufacturer to retroactively use MPC to pay sales tax provided this MPC has not expired and the prerequisite steps for retroactively using MPC in this manner spelled out

in the Department's regulations are completed.[7] The Department's position is that the prerequisites for retroactively using MPC to pay sales tax on prior purchases were not satisfied in this case. Therefore, the Department maintains, the Taxpayer could not use unused MPC in computing its tax liability for the tax period in controversy.

Department regulation 130.331 provides as follows:

> f) Retailers … Accepting Manufacturer's Purchase Credit
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> 1) In order to accept Manufacturer's Purchase Credit from a manufacturer …, [a retailer] must obtain a Manufacturer's Purchase Credit certificate from the manufacturer …[.] The manufacturer … may provide the certification on a form provided by the Department or on the manufacturer's … own form containing the appropriate information. The certificate must be kept in the [retailer's] books and records, but need not be submitted to the Department with the [retailer's] return.
>
> ...
>
> h) Retailers .. Accepting Manufacturer's Purchase Credit After Qualifying Purchases
>
> 1) A manufacturer … that does not provide the certification … as provided in subsection (f) of this section to a retailer … at the time of purchase of production related tangible personal property must pay the appropriate amount of Use Tax or Service Use Tax at that time to the retailer …[.] However, retailers … are not prohibited from accepting Manufacturer's Purchase Credit (MPC) certifications after qualifying sales of production related tangible personal property have taken place. Retailers … are not required to accept the certifications and are not required to refund the amount of Use Tax or Service Use Tax that was

[7] Unused MPC expires on December 31st of the second calendar year following the calendar year in which the credit arises. 35 **ILCS** 105/3-85(b); 35 **ILCS** 110/3-70(b); 86 Ill. Admin. Code, ch. I, section 130.331(b)(8). The record does not identify what portion, if any, of the Taxpayer's MPC identified on audit expired prior to the commencement of the Department's audit in June, 2007. Accordingly, it is presumed that none of the MPC applied by the auditor to reduce the Taxpayer's audit liability had expired at the time the audit of the Taxpayer was conducted.

> properly paid by the manufacturers … in exchange for the certificates after the sales have taken place. …
>
> 2) Retailers … that choose to accept MPC certifications from manufacturers … after qualifying sales of production related tangible personal property have taken place and refund the amount of Use Tax or Service Use Tax that was properly paid by those manufacturers … must file amended returns or claims for credit or refund … [.]
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> 3) Manufacturers … who provide MPC certifications to retailers … after qualifying sales of production related tangible personal property have taken place as provided in this subsection (h) must report the use of the credit on an Annual Report of Manufacturer's Purchase Credit Used for the calendar year in which the certification was provided listing the use of the credit in the month in which the certification is provided.[8] …
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> 4) Example: A manufacturer purchased production related tangible personal property from a retailer in June 1999. The manufacturer paid use tax to the retailer at the time of purchase. In January 2001, the manufacturer asked the retailer to accept an MPC certification for the June 1999 purchase and refund the use tax (6.25 percent) paid previously by the manufacturer. The retailer chooses to accept the certification and refunds the amount of the use tax (6.25 percent) to the manufacturer. … The manufacturer must report the use of the credit in the month of January on an Annual Report of Manufacturer's Purchase Credit Used for the year 2001.

As is evident from the foregoing, in order for a manufacturer to use MPC with a retailer on a prior purchase, all of the following must occur:

1) The retailer must agree to accept the MPC and refund the sales tax previously paid by the manufacturer (if any);

[8] With respect to the deadline for filing such reports, Regulation 130.331(e)(3) provides as follows: "In order to validate credit used to satisfy the tax liability on purchases of production related tangible personal property, the manufacturer or graphic arts producer must report credit used to the Department by signing and filing an Annual Report of Manufacturer's Purchase Credit Used for each calendar year no later than the last day of the sixth month following the calendar year in which the Manufacturer's Purchase Credit was Used."

2) The manufacturer must have filed a Manufacturer's Purchaser Certificate (form ST-17, Annual Report of Manufacturer's Purchase Credit Used) for the year in which a certification to apply MPC to prior purchases is submitted to a retailer on or before June 30 of the year following the year in which a certification is submitted; and

3) The retailer must report the acceptance of MPC on a prior purchase to the Department.

The regulation makes it clear that a retailer's acceptance of MPC cannot be assumed. Specifically, regulation 130.331 states that: "Retailers and servicemen are not required to accept (MPC) and are not required to refund the amount of Use Tax or Service Use Tax that was properly paid by the manufacturers … in exchange for the MPC after the sales have taken place." See Regulation 130.331(h)(1). With respect to its retroactive use of MPC identified on audit, the Taxpayer, quoting from the Auditor's Narrative prepared by the Department's auditor, avers as follows:

> The Taxpayer was using a large amount of MPC on blasting materials used in the coal mining process. This auditor was directed by her supervisor to a private letter ruling PLR 04-0005 regarding blasting equipment. After conferring with the lead auditor, who also spoke with Mr. Rossman from Technical Support, it was agreed that due to an ICB case ruling, blasting materials were exempt from tax and the Taxpayer did not have to use their MPC for blasting materials.
>
> The Taxpayer was able to provide a listing of invoices for explosives from one vendor ... and these will also be added back to their MPC balance. It would appear that the Taxpayer will have enough MPC to pay most if not all of the tax on production related items assessed in the audit.
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> Taxpayer's Reply Brief pp. 1, 2.

Neither these averments, nor any other facts contained in the record, evidence compliance with the prerequisites for the retroactive application of MPC to pay sales tax outlined in regulation 130.331(h). To establish that it was entitled to utilize MPC identified during the audit to offset tax due on purchases of production related tangible personal property

made during the audit period, at a minimum, the Taxpayer had to show that MPC certification was accepted by the retailer from which property qualifying for MPC was purchased and that the tax paid at the time of purchase, if any, was refunded. See Regulation 130.331(h)(1), (2). The Taxpayer must also prove that it timely filed annual reports for the year or years in which MPC certification was presented to retailers in accordance with Regulation 130.331(h)(3). Ideally, it would also provide reports from retailers showing that they reported the MPC use to the Department when tax was refunded or amended their filings for the tax years in which purchases occurred to show that they were refunding tax to the Taxpayer and utilizing MPC in lieu of taxes previously reported. Since the Taxpayer has failed to show that it retroactively applied MPC in accordance with the Department's regulations, it has failed to prove that it was entitled to deduct these credits in computing its tax due for the tax period under audit.

In sum, the record clearly shows that the Taxpayer failed to prove that it met the regulatory requirements for using unused MPC to pay sales tax due on purchases made during the audit period. The only way in which MPC can be used to reduce the Taxpayer's ultimate tax liability found to be due is to apply MPC to pay sales tax due on such purchases. The Taxpayer failed to properly do this. Consequently, the Department's refusal to modify the Taxpayer's ultimate tax liability based on the Taxpayer's use of MPC to pay sales tax during the audit period was proper. The Taxpayer's ultimate tax liability was properly determined without taking into account the Taxpayer's unused MPC as payment of sales tax due during the audit period, and penalty and interest was based on this ultimate tax liability. As a result, the Department correctly refused to reduce penalty and interest based on an ultimate tax liability determined by using unused

MPC to pay sales tax in the manner requested by the Taxpayer. Accordingly, the Department's denial of the relief sought by the Taxpayer in this case was proper.

PROPRIETY OF USING MPC TO PAY OFF ULTIMATE TAX LIABILITY DETERMINED ON AUDIT RATHER THAN AS CREDIT AGAINST SALES TAX DUE ON PRIOR PURCHASES

Because of the complexity of receiving credit for sales tax paid against prior purchases using MPC pursuant to the Department's regulations, the Department allows tax relief to Taxpayers that could have used MPC to pay sales tax due on prior purchases but failed to properly do so. However, this tax relief is not in the form of a credit against taxes due on purchases that would affect the Taxpayer's ultimate tax liability or the amount of tax, penalty and interest determined to be due. Accordingly, this tax relief is not the same as the tax relief provided when MPC is correctly used. Rather, this tax relief is available only after the amount of tax, penalty and interest due have been finally determined by the auditor. Once the auditor makes a final determination, the auditor can accept unused MPC as a form of payment of the final liability the auditor has determined. The record indicates that this is clearly what the Department did in this case. See Auditor's Narrative ("It would appear that the Taxpayer will have enough MPC to pay most if not all of the taxes on production related items assessed in the audit."). The use of MPC in this manner is permitted by Illinois Department of Revenue Information Bulletin No. FY 95-3 (9/1/94) which provides as follows:

> **HOW MAY I USE THIS CREDIT?**
>
> -- You may apply this credit toward only your Illinois sales tax obligations when you purchase qualifying production related tangible personal property. ...
>
> -- In general, you may not use this credit to offset other liabilities; however, you may be allowed to use it to satisfy tax liabilities revealed in an audit that are related to your use of Manufacturing Machinery and Equipment Exemption or the Manufacturer's Purchase Credit. <u>You may not use this credit to offset any penalty or interest liabilities.</u> (emphasis added)

As is evident from the foregoing, the Department permits the use of unused MPC that cannot be used to pay sales tax to "satisfy" (i.e. pay off) certain liabilities once they have been determined to be due and owing on audit. However, when this tax relief is allowed, the Department's directive <u>expressly prohibits</u> the use of any portion of unused MPC applied in this manner to pay off interest or penalty determined as part of the Taxpayer's ultimate tax liability. Accordingly, the Department properly denied the Taxpayer's request to apply MPC to reduce the auditor's determination of interest and penalty when MPC was used to pay off the Taxpayer's ultimate liability in accordance with Department Information Bulletin No. FY 95-3.

<u>SUMMARY</u>

In sum, the Taxpayer has failed to rebut the Department's *prima facie* case establishing that interest and penalties were properly applied to the amount of use tax determined to be due on audit without reducing the Taxpayer's ultimate tax liability by applying unused MPC as payment of sales tax due on purchases made during the audit period. Specifically, the Taxpayer failed to show that it met regulatory requirements for retroactively applying MPC to pay sales tax due on purchases made during the audit

period so as to reduce its ultimate tax liability determined for the period 2004 through 2006. Finally, the auditor properly allowed the Taxpayer to pay off the ultimate tax liability determined on audit using MPC pursuant to the Department directive permitting such tax relief. However, the directive permitting the auditor to do this expressly prohibits the use of unused MPC to reduce interest and penalties determined on audit to be due. Therefore, for the reasons enumerated above, the Department's refusal to reduce penalties and interest related to the Taxpayer's 2004-2006 liability determined on audit was proper.

WHEREFORE, for the reasons stated above, it is my recommendation that the Department's NTL determination for the tax period at issue, including the determination of interest and penalties contained therein, be upheld.

Ted Sherrod
Administrative Law Judge

Date: February 4, 2010