

ST 10-13

Tax Type: Sales Tax

**Issue: Audit Methodologies and/or Computational Issues
Reasonable Cause on Application of Penalties**

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

| | | | |
|----------------------------------|---|--------------------------|------------|
| THE DEPARTMENT OF REVENUE |) | Docket No. | 08-ST-0000 |
| OF THE STATE OF ILLINOIS |) | IBT No. | 0000-0000 |
| |) | NTL Nos. | |
| v. |) | | |
| |) | | |
| ABC GRAPHICS, INC., |) | John E. White, | |
| Taxpayer |) | Administrative Law Judge | |

RECOMMENDATION FOR DISPOSITION

Appearances: Kathleen Lach, Arnstein & Lehr, LLP, appeared for ABC Graphics, Inc.; John Alshuler, Special Assistant Attorney General, appeared for the Illinois Department of Revenue.

Synopsis:

Following audit, the Illinois Department of Revenue (Department) issued seven Notices of Tax Liability (NTLs) to ABC Graphics, Inc. (Taxpayer). Those NTLs assessed Illinois use tax regarding Taxpayer's purchases of certain tangible personal property during the period beginning July 1, 2002 through December 31, 2007. Taxpayer protested the NTLs and asked for a hearing. Pursuant to a pre-hearing order, the parties agreed that the only issue is whether the Department was correct in its assessment of tax on Taxpayer's purchases of fixed assets and consumable supplies during the audit period.

The hearing was held at the Department's offices in Chicago. Taxpayer offered documentary evidence. I have reviewed the evidence offered at hearing, and I am

including in this recommendation findings of fact and conclusions of law. I recommend that the Director finalize the NTLs as issued.

Findings of Fact:

1. Taxpayer operated a printing company and, for occupational tax purposes, was a serviceman. Department Ex. 1, p. 1 (kind of business on determination of tax due form); Taxpayer Ex. 1 (auditor's comments), p. 2; 35 ILCS 115/2 ("Serviceman" defined as "any person who is engaged in the occupation of making sales of service").
2. Taxpayer is a C corporation, with one shareholder. Taxpayer Ex. 1, p. 2.
3. The Department conducted an audit of Taxpayer's business for the period beginning July 1, 2002 through December 31, 2007. Department Ex. 1. Kathleen Moore (Moore) conducted the audit. Department Ex. 1, p. 2; Taxpayer Ex. 1, pp. 6, 14.
4. During the audit, Moore examined the following books and records that Taxpayer kept and produced for audit: federal and state income tax returns, financial statements and some bank statements. Taxpayer Ex. 1, p. 3.
5. Taxpayer also produced some sales and purchase invoices to Moore for review. Taxpayer Ex. 1, p. 3; *see also* Taxpayer Ex. 6 (copies of invoices of tangible personal property purchased by Taxpayer). The sales invoices Taxpayer produced to Moore constituted about 7% of Taxpayer's sales, and the purchase invoices it produced (Taxpayer Ex. 6) constituted about ½ of 1% of Taxpayer's total purchases. Taxpayer Ex. 1, p. 3.
6. Taxpayer did not file any monthly ST-1 (sales and use tax) returns during the audit period. Taxpayer Ex. 1, p. 3.

7. By comparing Taxpayer's cost of goods sold with its total revenues as reported on its federal returns, Moore determined that Taxpayer was a de minimus serviceman who was required to self-assess and pay Illinois use tax on the property it purchased for use, and which it thereafter transferred to others, as an incident of its sales of printing services. Taxpayer Ex. 1, p. 16; *see also* 86 Ill. Admin. Code § 140.108 ("De Minimis" Servicemen Who Incur Use Tax on Their Cost Price).
8. Following audit, Moore prepared a determination of tax due form, on which she set forth the amounts of use tax to be assessed against Taxpayer based on its purchases of fixed assets and consumable supplies. Department Ex. 1, pp. 1-2; Taxpayer Ex. 1, pp. 3-4. The Department thereafter issued seven NTLs to Taxpayer. Department Ex. 1, pp. 3-16.
9. In her audit comments, Moore wrote, in pertinent part:

USE TAX

Accounts payable invoices were paid from Anywhere, Illinois. ABC Graphics did not self assess use tax. Many corporate credit cards were used, an exact number of cards is not available, but at least ten were discovered. No credit card statements were provided, although the auditor put in a written request to John [Doe, Taxpayer's sole shareholder] for them.

Fixed Assets

Fixed Assets were examined by looking at the balance sheet and comparing the totals from year to year. There was \$32,000 in additions. No invoices were available. ... Amount due is \$2,000.

Consumable Supplies

Materials used on jobs:

As mentioned above, no payables invoices were provided to the auditor, nor was the general ledger information available. A written request for records was given to John on June 5, and an EDA 70 was mailed to him on August 15, 2008, requesting the necessary information for the audit. The only response from these requests were rough drafts of the financial statements, with writing, figures and cross

outs all over them, and ... approximately 175 pages of printout on the cash accounts representing most of the audit period. These printouts were gone over line by line by the auditor, who gathered the information on the major suppliers of ABC. Names, addresses and phone numbers were obtained by researching the internet, and EDA-20s were mailed out to 20 vendors. Seven never replied, one replied that they had lost all their records, and one replied after the calculations were done, and the EDA-123 had been sent. The other eleven suppliers responded with the requested information. As most of these suppliers were major, the eleven responses accounted for approximately 72% of all purchases during the audit period, so the auditor felt confident that the numbers she used from the circularization were good ones.

From the responses received from the suppliers, the auditor determined that approximately 85% of the purchases had not been taxed and 15% had been taxed. From the responses, the auditor found that at least two of the suppliers had sent copies of the resale certificates that John had given them. Two others said that John had given them a resale number and told them he was exempt. Another said that he sold supplies to John in 2003 which did not include tax, per John's request. But John bought from him again in 2006 and the supplier insisted on charging tax because "the number he provided could not be legitimately authorized". Three other vendors said that John tried to buy from them tax free but that they insisted on charging the sales tax, which John did pay. All the letters and backup are included in the file.

Once the percentage of what had been taxed and what had not been was determined, those percentages were applied to the total cost of goods sold for each year of the audit period. Since 2007 figures were not available, the auditor took an average of the previous three years sales and cost of goods sold, and used those averages to calculate 2007. Worksheets showing these calculations are included in the file. These amounts (85% of each year's cost of goods sold) were then entered into STT as exceptions.

AUDIT FINDINGS AND CONCLUSIONS

Tax on fixed assets amounted to \$2,000.

Use Tax on consumable supplies amounted to \$79,197.

Total Taxes due per audit is \$81,197. See Schedule 1 Summary Analysis.

Interest Due on the above is \$17,578. ***

LP penalties were applicable and amounted to \$16,239. Late filing penalties amounted to \$1,624. ***

Taxpayer Ex. 1, pp. 4-5.

10. Taxpayer paid tax to the vendors that would not sell to it without charging and collecting tax, and attempted to avoid paying tax to those vendors that would sell to it without charging and collecting tax. Taxpayer Ex. 1, pp. 3-5; Taxpayer Ex. 2-4 (copies of letters responding to Moore's requests for vendors' records regarding vendors' sales to Taxpayer); Taxpayer Ex. 6, *passim*.
11. Taxpayer provided resale certificates and/or reseller's numbers to some of its vendors, to try to purchase supplies from them without paying use tax directly to such retailers. Taxpayer Ex. 1; pp. 3-5; Taxpayer Ex. 3.

Conclusions of Law:

The Use Tax Act (UTA) imposes a tax “upon the privilege of using in this State tangible personal property purchased at retail from a retailer” 35 ILCS 105/3. The Illinois General Assembly incorporated into the UTA certain provisions of the complementary Retailers' Occupation Tax Act (ROTA). 35 ILCS 105/11. It incorporated the same ROTA provisions into the Service Occupation Tax Act (SOTA). 35 ILCS 130/12. Among the incorporated provisions is § 5 of the ROTA, which provides that the Department's determination of tax due constitutes prima facie proof that tax is due in the amount determined by the Department. 35 ILCS 105/12; 35 ILCS 115/12; 35 ILCS 120/5. In this case, the Department established its prima facie case when it introduced Department Exhibit 1, consisting of copies of the NTLs, as well as a copy of the auditor's determination of tax due, under the certificate of the Director. Department Ex. 1. That exhibit, without more, constitutes prima facie proof that Taxpayer owes Illinois use tax in

the amount determined by the Department. 35 ILCS 105/12; 35 ILCS 115/12; 35 ILCS 120/5.

The Department's prima facie case is a rebuttable presumption. 35 ILCS 120/7; 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 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, 527 N.E.2d 1048, 1053 (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 assessment is not correct. Fillichio v. Department of Revenue, 15 Ill. 2d 327, 333, 155 N.E.2d 3, 7 (1958); A.R. Barnes & Co., 173 Ill. App. 3d at 833-34, 527 N.E.2d at 1053.

Here, the auditor determined that Taxpayer was a de minimus serviceman, and that Taxpayer owed use tax which should be measured as a percentage of its cost price of the tangible personal property that it purchased for transfer to customers as an incident of its sales of service. Department Ex. 1; Taxpayer Ex. 1, pp. 4-5; 35 ILCS 115/3-10. Taxpayer does not challenge either of these determinations. Instead, it argues that the method by which the auditor calculated and projected her estimate of Taxpayer's use tax liability was unreasonable. Specifically, it argues that the sample size Moore used was too small, thus overstating its use tax liability. The Department responds that Moore's audit methods were reasonable, and that the estimate was required because of the absence of books and records that Taxpayer made available for review.

To support its claim, Taxpayer offered evidence consisting of Moore's workpapers, including her comments, schedules, audit history worksheets, and copies of responses she received from certain vendors. Taxpayer Exs. 1-5. It also offered copies of purchase invoices Taxpayer provided to her, and which she reviewed, showing Taxpayer's payment of tax to certain vendors for certain purchases. Taxpayer Ex. 6. After reviewing that evidence, I reject Taxpayer's argument that Moore's audit was unreasonable.

The ROTA, like the complementary SOTA and UTA, does not require the Department to substantiate the basis for the corrected return or produce the auditor who computed it in order to support its prima facie case. Fillichio, 15 Ill. 2d at 333, 155 N.E.2d at 7. Where the Department's determination of tax due is challenged, the record must only demonstrate that the Department's method of determining the amount due meets some minimum standard of reasonableness. Elkay Manufacturing Co. v. Sweet, 202 Ill. App. 3d 466, 470, 559 N.E.2d 1058, 1060 (1st Dist. 1990). The reasonableness standard is based upon § 5 of the ROTA, which requires the Department, in a case where a person has failed to file a required return, to determine the amount of tax due "according to its best judgment and information" 35 ILCS 120/5; 35 ILCS 115/12; Mel-Park Drugs, Inc. v. Department of Revenue, 218 Ill. App. 3d 203, 208, 577 N.E.2d 1278, 1281 (1st Dist. 1991); Masini v. Department of Revenue, 60 Ill. App. 3d 11, 14, 376 N.E.2d 324, 327 (1st Dist. 1978).

Here, Moore's comments and audit history worksheet provide ample evidence that Taxpayer was either unable or unwilling to provide her with the invoices — both purchase and sales invoices — that it was required to keep to document its purchases and

its daily gross receipts from selling services. 35 ILCS 105/12; 35 ILCS 115/11-12; 35 ILCS 120/7; 86 Ill. Admin. Code § 150.1301 (Users records). Since Taxpayer was a serviceman that owed tax as a percentage of its cost for the tangible personal property it transferred as an incident of its sales of service, the auditor's task required that she obtain some measure of that cost. *See* 35 ILCS 115/3-10. She could not obtain a complete set of original books and records from Taxpayer, so she requested information from Taxpayer's vendors regarding their sales of consumable supplies to Taxpayer. Taxpayer Ex. 1, pp. 3-5. This, too, was not simple, as there was no central directory of such vendors, and was achieved only by Moore's close review of the limited records that were available to her. *Id.* Using the data included on the vendors' responses, as well as the purchase invoices Taxpayer provided, Moore noted the percentage of sales by vendors to Taxpayer for which the vendors charged tax and those that did not. Taxpayer Ex. 1, pp. 3-5; Taxpayer Ex. 6. She then projected that rate to Taxpayer's total purchases. Taxpayer Ex. 1, *passim*.

When considering the reasonableness of Moore's method of determining the tax due here, moreover, it must be recalled that § 7 of the ROTA, which the legislature also incorporated into the UTA and the SOTA, presumes that all property purchased at retail is subject to tax. 35 ILCS 120/7; 35 ILCS 105/12; 35 ILCS 115/12. Those statutes place the burden of showing that a specific transaction was not subject to tax, or, as in this case, that tax was paid regarding certain transactions, on the person claiming the exemption, or claiming that tax was paid. 35 ILCS 120/7; 35 ILCS 105/12; 35 ILCS 115/12. Had she applied ROTA § 7 strictly, Moore would have been justified in assessing tax on all of Taxpayer's purchases, but for those for which it could document that it paid tax directly to the vendor. *Compare* Taxpayer Ex. 1, pp. 3-5, 16 *with* Taxpayer Exs. 2-6. Given the

dearth of documents Taxpayer produced for audit, if there were some infirmity to be associated with Moore's audit methods, it was that she was too generous to Taxpayer when projecting the assumption that Taxpayer paid tax to vendors regarding purchases where no documents could directly support such tax payments.

That said, I agree that a more complete response by all of Taxpayer's vendors, documenting all of their sales to Taxpayer, certainly would have produced a more accurate source of data from which to estimate Taxpayer's actual costs of purchasing property to transfer to others as an incident of its sales of service. But the auditor would have also been able to achieve the same result, with much less time and effort, had Taxpayer simply complied with its obligation to keep and produce for audit complete books and records. 35 ILCS 105/12; 35 ILCS 115/11-12; 35 ILCS 120/7; 86 Ill. Admin. Code § 150.1301.

Although the issue is slightly different than the one here, in Mel-Park Drugs, the court noted that, "[a]s a matter of policy, the taxpayer should not be able, in effect, to elect a less precise method of supporting its statement of gross receipts when the law clearly mandates that accurate records of actual sales receipts be kept." Mel-Park Drugs, Inc., 218 Ill. App. 3d at 217, 577 N.E.2d at 1287. The same rationale applies here. It is difficult to give any weight to Taxpayer's complaint that the Department used an unreasonable method to estimate Taxpayer's total cost of purchasing property it intended to transfer to others, when the reason why Moore had to estimate in the first place was because Taxpayer, itself, failed to keep records from which its purchases could be counted. I agree with the Department that the audit methods used by Moore were in all respects reasonable.

Although no issue related to penalties was identified in the pre-hearing order, at

hearing, Taxpayer argued that the penalties assessed should be abated for reasonable cause. The Department did not object to Taxpayer's late introduction of this new issue, other than to respond that, under the fact of this case, Taxpayer did not act reasonably. Again, I agree with the Department.

Each of the NTLs assessed both late filing and late payment penalties. Department Ex. 1, pp. 3-16. Together, those penalties total \$17,864. Department, Ex. 1, pp. 2-16. Section 4 of the ROTA permits the Department to assess penalties, as part of an NTL, in accordance with Illinois' Uniform Penalty and Interest Act (UPIA). 35 ILCS 120/3. Section 3-3(a-10) of the UPIA authorizes the assessment of a penalty for failure to file a tax return on or before the due date. 35 ILCS 735/3-3(a-10). Section 3-3(b) authorizes the assessment of a penalty for late payment of tax when due. 35 ILCS 735/3-3(b). Section 3-8 provides that a penalty imposed by UPIA § 3-3, *inter alia*, "shall not apply if the taxpayer shows that his failure to file a return ... at the required time was due to reasonable cause." 35 ILCS 735/3-8.

The Department has adopted a regulation regarding reasonable cause which provides that, "[t]he determination of whether a taxpayer acted with reasonable cause shall be made on a case by case basis taking into account all pertinent facts and circumstances. The most important factor to be considered in making a determination to abate a penalty will be the extent to which the taxpayer made a good faith effort to determine his proper tax liability and to file and pay his proper liability in a timely fashion." 86 Ill. Admin. Code § 700.400(b). The regulation further provides that, "[a] taxpayer will be considered to have made a good faith effort to determine and file and pay his proper tax liability if he exercised ordinary business care and prudence in doing

so. A determination of whether a taxpayer exercised ordinary business care and prudence is dependent upon the clarity of the law or its interpretation and the taxpayer's experience, knowledge, and education. ****” 86 Ill. Admin. Code § 700.400(c). The burden rests on the taxpayer to show that it acted with ordinary business care and prudence when filing its returns and paying the correct amount of tax when due. Hollinger International, Inc. v. Bower, 363 Ill. App. 3d 313, 328, 841 N.E.2d 447, 460 (1st Dist. 2005).

Here, none of the evidence showed that Taxpayer acted with ordinary business care and prudence when attempting to report and pay its regularly occurring use tax liabilities. Indeed, the evidence reflects that Taxpayer completely avoided its obligations to timely report to the Department *any* of the use tax it owed because it regularly purchased property for transfer to others as an incident of its sales of service. *See* Taxpayer Ex. 1, pp. 3-5; 35 ILCS 115/3-10. Taxpayer did not file a single monthly return, during any month in the entire audit period. Taxpayer Ex. 1, pp. 3-5. Similarly, it never paid a single dollar of use tax directly to the Department regarding those purchases for which it did not pay tax to its suppliers. *Id.*

Further, Moore determined, and the documentary evidence admitted at hearing confirms, that on separate occasions, Taxpayer notified its suppliers that it had a reseller's number and that it would re-sell the property it purchased from those suppliers. Taxpayer Ex. 1, pp. 3-5; Taxpayer Ex. 3, p. 1. The books and records Moore received from vendors included resale certificates bearing Taxpayer's name, and presumably signed by someone purporting to act on Taxpayer's behalf, which were kept by the suppliers that had received them from Taxpayer. Taxpayer Ex. 1, pp. 3-5; Taxpayer Ex.

3, p. 1. Prudent retailers and suppliers take such resale certificates from purchasers to document their good faith belief — based on the purchaser’s sworn statements — that such sales were made to exempt purchasers, or that the property purchased was for an exempt use. *E.g.*, Hess, Inc. v. Department of Revenue, 278 Ill. App. 3d 483, 663 N.E.2d 123 (5th Dist. 1996). But just because a resale certificate might be taken in good faith does not mean that it was given in good faith. That, no doubt, is why the legislature has classified the issuance of false resale certificates to others, when done knowingly, as a felony. 35 ILCS 115/15. Given the evidence (Taxpayer Ex. 1, pp. 3-5; Taxpayer Ex. 3, p. 1), Taxpayer has not borne its burden to show that the late filing and late payment penalties assessed here should be abated. Hollinger International, Inc., 363 Ill. App. 3d at 328, 841 N.E.2d at 460; 86 Ill. Admin. Code § 700.400(b).

Conclusion:

I recommend that the Director finalize the NTLs as issued, with interest to accrue pursuant to statute.

July 28, 2010
Date

John E. White, Administrative Law Judge