

ST 10-18

Tax Type: Sales Tax

**Issue: Audit Methodologies and/or Other Computational Issues
Unreported/Underreported Receipts (Fraud Application)**

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

THE DEPARTMENT OF REVENUE)	Docket No.	09-ST-0000
OF THE STATE OF ILLINOIS)	Reg. No.	0000-0000
)	NTL Nos.	
v.)		
JOHN DOE d/b/a)		
ABC'S FAST FOOD,)	John E. White,	
Taxpayer.)	Administrative Law Judge	

RECOMMENDATION FOR DISPOSITION

Appearances: Steven Cloh, Ciesla & Ciesla, PC, appeared for John Doe; Shepard Smith, Special Assistant Attorney General, appeared for the Illinois Department of Revenue.

Synopsis: This matter arose after the Illinois Department of Revenue (Department) issued four Notices of Tax Liability (NTLs) to John Doe (Taxpayer or Doe), doing business as ABC'S Fast Food (ABC'S), following an audit. The NTLs assessed retailers' occupation tax (ROT), penalties, and interest, as measured by the gross receipts the Department determined Taxpayer received from selling tangible personal property at retail during the months beginning July 2005 through and including June 2008.

In a pre-hearing order, the parties identified the issues as including whether Taxpayer is liable for tax in the amount assessed, and whether the Department properly assessed a fraud penalty. I have considered the evidence adduced at hearing, and I am including in this recommendation findings of fact and conclusions of law. I recommend

that the NTLs be finalized as issued.

Findings of Fact:

1. Taxpayer operates a fast food restaurant in Illinois, as a sole proprietorship. Department Ex. 1 (copy of the Department's correction of Taxpayer's returns), p. 1 ("Kind of business" description).
2. The Department conducted an audit of Taxpayer's business for the months of July 2005 through and including June 2008. Department Ex. 1, p. 1. Salvatore Marchetti (Marchetti) conducted the audit. Department Ex. 2 (copies of audit workpapers), pp. 2-5 (copy of Marchetti's Audit Narrative); Hearing Transcript (Tr.) pp. 30-31 (Marchetti).
3. Marchetti conducted the audit at the office of Taxpayer's accountant, ACCOUNTANT (ACCOUNTANT). Department Ex. 2, pp. 3-4; Tr. p. 35 (Marchetti).
4. ACCOUNTANT prepared Doe's monthly sales and use tax returns, which were filed during the audit period. Tr. pp. 7-10 (ACCOUNTANT). He did so using monthly total figures Doe gave him. *Id.*, p. 7.
5. As part of his audit, Marchetti prepared a schedule of the information reported on the monthly returns Taxpayer filed during the audit period. Department Ex. 2, p. 18.
6. Marchetti interviewed Doe on June 5, 2008, at the beginning part of the audit. Department Ex. 2, p. 3. During that interview, Doe told Marchetti that the restaurant was doing (that is, it had gross sales of) about \$300 per day, and that the restaurant's cash register did not print out receipts. *Id.*

7. After that initial interview, Marchetti visited the restaurant ten times from June 9 through July 1, 2008. Department Ex. 2, p. 19; Tr. pp. 34-35 (Marchetti).
8. During each visit, Marchetti purchased food, ate it at the restaurant, and kept and reviewed the receipts he received after ordering food. Department Ex. 2, p. 12.
9. After reviewing the receipts he received after purchasing food at Taxpayer's restaurant, Marchetti made a schedule containing the following data and summary:

Date	Time	Mds Amt	Tax	Total	# shown on receipt	# of transactions since the last receipt	Transactions per hour
6/9/08	8:14 pm	3.95	.36	4.31	7898	NA	
6/12/08	11:53 am	4.50	.41	4.91	8759	861	13.45313
6/15/08	8:41 am	6.60	.59	7.19	9692	933	13.52174
6/18/08	11:37 am	2.45	.22	2.67	0590	898	12.64789
6/21/08	4:31 pm	5.35	.48	5.83	1701	1111	14.61842
6/23/08	3:00 pm	5.35	.48	5.83	2228	527	11.45652
6/26/09	8:51 pm	4.95	.45	5.40	3333	1105	14.16667
6/27/09	11:30 pm	1.00	.09	1.09	3727	394	14.07143
6/30/08	11:05 am	5.35	.48	5.83	4380	653	11.06780
7/1/08	3:13 pm	3.25	.33	3.58	4796	416	14.85714
TOTAL						6898	
SUMMARY							
# of hours since first receipt 21.25 days				510			
Starting # on receipt				7898			
Ending # on receipt				14,796			
Difference between starting & end				6898			
Average # of transactions							
Per hour (divide by total hours)				13.5254902			
Per day (multiply by 24)				324.6117647			
Per month (multiply by 30)				9738.352941			
Apply \$ amount to each transaction				\$5		Assumes the total for each receipts regardless of quantity	
Total receipts per day				1,623.06		(Average transaction per day x \$5)	
Times 30 days per month				48,691.76		Expected receipts for June 2008	
Reported line 1, ST-1 for June 2008				7,315.00			
Difference (underreported)				41,691.76			
Multiply by 34 months (closed for 2 months)				\$1,406,810.00			
Approximate Tax Due				\$116,158.62			
Penalty (civil fraud)				58,079.31		NOTE: When # reaches 9999 it starts	

		over at 0001
Penalty (late pay)	17,423.79	
Interest	22,070.14	
Total Liability	213,731.87	

Department Ex. 2, p. 19.

10. Marchetti prepared the schedule and summary described above because, after his interview with Doe, he had anticipated that there would be no cash register tapes, commonly called “Z tapes,” for him to review. *See* Department Ex. 2, p. 3; Tr. pp. 38-39 (Marchetti). Such Z tapes are required to be kept by a retailer, in order to document the retailer’s daily gross sales. 86 Ill. Admin. Code § 130.805(a).
11. In September 2008, ACCOUNTANT presented Marchetti with Z tapes that Taxpayer had given ACCOUNTANT regarding June 2008, the last month in the audit period. Department Ex. 2, pp. 22-33 (copies of Z tapes); Tr. pp. 6-7, 10 (ACCOUNTANT).
12. The Z tapes for June 2008 were the only Z tapes submitted for audit (Department Ex. 2, pp. 3-4), and were the first Z tapes ACCOUNTANT had ever received from Doe. Tr. pp. 7-10, 17-18 (ACCOUNTANT).
13. Marchetti made copies of the Z tapes ACCOUNTANT gave him to review, and made a schedule of the information printed on them. Department Ex. 2, pp. 21 (schedule), 22-33; Tr. pp. 12-13 (ACCOUNTANT), 32 (Marchetti).
14. Marchetti noted that the Z tapes bore sequential identifying numbers, but that none of the Z tapes printed out for consecutive days bore consecutive identifying numbers. Department Ex. 2, pp. 21-33. Based on the absence of such consecutively numbered Z tapes, Marchetti determined that other Z tapes were being run at different times of each day, and that such tapes were, thereafter, not tendered for review. Department Ex. 2, pp. 36-38 (Marchetti’s written request for authorization to assess fraud

penalty).

15. Marchetti also noticed that each Z tape began with a grand total amount, and that the beginning grand total amount printed on a Z tape produced for successive days, increased. Department Ex. 2, pp. 21-33.
16. Marchetti subtracted from the grand total printed on the Z tape for July 1, 2008, the grand total printed on the Z tape for May 31, 2008, and used that difference as Taxpayer's total gross receipts for the month of June 2008. Department Ex. 2, pp. 3-4, 21. That difference was \$71,533.71. *Id.*; Tr. pp. 12-13 (ACCOUNTANT), 36 (Marchetti).
17. Marchetti took into account the beginning grand total amount printed on the Z tapes for May 31 and July 1, 2008 because there were no tapes produced for June 1, 2, or June 30, 2008. Department Ex. 2, pp. 3-4; Tr. p. 36 (Marchetti).
18. Marchetti noted that, while the gross receipts determined based on the Z tape grand totals for June 2008 was \$71,533.71, on the Illinois sales and use tax return it filed for June 2008, Taxpayer reported gross receipts in the amount of \$6,696. Department Ex. 2, pp. 5, 21.
19. Marchetti concluded that the difference between the gross receipts he calculated from the Z tape grand totals, and the gross receipts reported on the return Taxpayer filed, for June 2008, constituted underreported receipts in the amount of \$64,837 ($71,533 - 6,696 = 64,837$), on which tax should be measured and assessed. Department Ex. 2, pp. 5, 21, 37; Tr. pp. 36-38 (Marchetti).
20. Marchetti accepted as true Taxpayer's representation that the restaurant was closed during October 2005 and June 2006, as reflected by the monthly returns that

Taxpayer filed for those months. Department Ex. 2, pp. 5, 18; Tr. p. 37 (Marchetti).

21. For each of the remaining 34 months in the audit period, Marchetti projected that Taxpayer also had underreported receipts in the amount of \$64,837. Department Ex. 2, pp. 5, 21, 37; Tr. pp. 36-38 (Marchetti).
22. At the conclusion of the audit, Marchetti wrote a memo seeking permission to assess a fraud penalty against Taxpayer, based on the audit determinations. Department Ex. 2, pp. 36-38 (copy of December 16, 2008 memo from Marchetti); Tr. pp. 52-53 (Marchetti).
23. That request was approved, and the NTLs assessed a fraud penalty on the tax assessed. Department Ex. 1.
24. During direct examination at hearing, Doe admitted that the restaurant had monthly revenues in excess of \$20,000 during the audit period, but said that it never had revenues in excess of \$30,000 in a single month. Tr. pp. 25-26 (Doe).

Conclusions of Law:

The Department introduced a copy of the correction of Taxpayer's returns and copies of the NTLs into evidence under the certificate of the Director. Department Ex. 1. Pursuant to § 4 of the Retailers' Occupation Tax Act (ROTA), those documents constitute the Department's prima facie case in this matter. 35 ILCS 120/4, 7. 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); Mel-Park Drugs, Inc. v. Department of Revenue, 218 Ill. App. 3d 203, 217, 577 N.E.2d 1278, 1287 (1st Dist. 1991).

During closing argument, counsel for Taxpayer made two different arguments why the amount of tax assessed was not correct. First, he asserted that, while Doe was not a good record keeper, Doe testified that he never had monthly gross receipts in excess of \$27,000. Tr. pp. 43-44. Counsel argued that, based on that testimony, the amount of underreported receipts for each month in the audit period should be recalculated to be \$23,000, rather than the amount calculated by Marchetti. Tr. pp. 44-45. Counsel also argued that a restaurant with 20 seats would not be able to serve the 320 different people Marchetti originally estimated that Taxpayer served in a day, using his projections that were based on the receipts he obtained after ordering food at the restaurant. Tr. p. 44. I address each argument in turn.

Taxpayer's burden is to show, with documentary evidence closely identified with its books and records, that the Department's presumptively correct determination is wrong. Fillichio, 15 Ill. 2d at 333, 155 N.E.2d at 7; A.R. Barnes & Co., 173 Ill. App. 3d at 833-34, 527 N.E.2d at 1053. Here, however, Taxpayer offered the testimony of two witnesses, Doe and ACCOUNTANT, each of whom testified that the amount of tax assessed was not correct. As a matter of law, mere testimony is insufficient to rebut the Department's prima facie case. Fillichio, 15 Ill. 2d at 333, 155 N.E.2d at 7; Balla v. Department of Revenue, 96 Ill. App. 3d 293, 296-97, 421 N.E.2d 236, 239 (1st Dist.

1981) (uncontroverted testimony that was not corroborated with documentary evidence was insufficient to show that taxpayer was entitled to claimed exemption).

Additionally, Taxpayer's arguments regarding Marchetti's estimate of the number of customers served, or orders taken, at the restaurant during any given day during June 2008 did not form the basis of the tax actually assessed. *Compare* Department Ex. 2, p. 19 *with id.*, p. 21 *and* Department Ex. 1. Marchetti prepared the correction of returns on his estimate of underreported receipts calculated from entries on the Z tapes for June 2008, not from his original estimate. Department Ex. 1; Department Ex. 2, p. 21. But even if Marchetti's original estimate of the amount of Taxpayer's monthly underreported receipts did form the basis for the correction of returns and the NTL's, Taxpayer could not rebut it simply by offering testimony that it was incorrect. Fillichio, 15 Ill. 2d at 333, 155 N.E.2d at 7; Balla, 96 Ill. App. 3d 296-97, 421 N.E.2d at 239. Both Marchetti's original and final estimates, moreover, were premised on his review of Taxpayer's own books and records, which were made during the audit period. Department Ex. 2, pp. 3-5, 19, 21-33. In contrast, no such books and records, from the audit period, corroborate either ACCOUNTANT's or Doe's estimates of Taxpayer's gross receipts during that period.

The next issue is the propriety of the fraud penalty assessed against Taxpayer. Department Ex. 1. Section 3-6 of the Uniform Penalty and Interest Act (UPIA) provides, in part:

Penalty for fraud.

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

* * * *

35 ILCS 735/3-6.

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, 453 N.E.2d 48, 53 (4th Dist. 1983). Clear and convincing evidence of an intent to defraud can be circumstantial in nature. *E.g.*, Vitale v. Department of Revenue, 118 Ill. App. 3d 210, 213, 454 N.E.2d 799, 802 (3d Dist. 1983). Most frequently, the circumstances evincing an intent to defraud are revealed by an examination of the extent to which a taxpayer underreported the true amount of its gross receipts, and an examination of whether the failure to properly report was intentional or otherwise. *See id.*

Taxpayer made no argument on this issue at hearing. *See* Tr. pp. 43-45. Department counsel, on the other hand, argued that the books and records reviewed by Marchetti clearly revealed fraud. Tr. pp. 42-43. I agree that the evidence supports a determination that Doe filed returns during the audit period with an intent to defraud, and the best evidence of that intent is found in his own sworn testimony.

At hearing, Doe admitted that, during the audit period, the restaurant regularly had monthly revenues that were in excess of \$20,000. Tr. pp. 25-26 (Doe). During that same period, Taxpayer's filed returns reported that its average monthly gross receipts were less than \$4,500. Department Ex. 2, p. 18. Again, in this case, ABC'S, the restaurant, is a sole-proprietorship owned and operated by Doe. Department Ex. 2, p. 2.

In Puleo, the appellate court reviewed the Department's administrative hearing determination that a fraud penalty was properly assessed. Puleo, 117 Ill. App. 3d at 263-64, 268, 453 N.E.2d at 50-51, 53. In that case, a retailer admitted to two Department agents that he had filed returns for the business merely by estimating the amount of the

business' monthly gross receipts, and that he had no documentation to show what those actual monthly receipts were. *Id.*, at 263-64, 453 N.E.2d at 50-51. The agents testified at hearing regarding those out-of-court statements by the taxpayer, which formed part of the bases for upholding the fraud penalty assessment. Here, there is no middleman; Doe made his admissions at hearing, under oath. Tr. pp. 25-26 (Doe). When the individual owner of a business acknowledges, under oath, that his business had actual monthly receipts in excess of \$20,000, during periods where he reported that the business' monthly receipts were less than one quarter that amount, an intent to defraud is established. Puleo, 117 Ill. App. 3d at 263-64, 268, 453 N.E.2d at 50-51, 53.

As a final note, I acknowledge that Taxpayer's admission was not that his underreporting of gross receipts reached the level estimated by Marchetti's audit. But he certainly admitted that he filed returns that grossly underreported what the business' actual receipts were. Tr. pp. 25-26 (Doe). Under the plain terms of UPIA, where "any return or amended return is filed with intent to defraud, in addition to any penalty imposed under Section 3-3 of this Act, a penalty shall be imposed in an amount equal to 50% of any resulting deficiency." 35 ILCS 735/3-6(a). While Taxpayer clearly disputes the amount of the deficiency resulting from this audit, the evidence fully supports the conclusion that a fraud penalty was properly assessed here.

Conclusion:

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

November 4, 2010
Date

John E. White, Administrative Law Judge