

ST 13-20

Tax Type: Sales Tax

Tax Issue: Unreported/Underreported Receipts (Fraud Application)

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

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

v.

**JANE DOE,
Taxpayer**

**No. XXXX
Account ID XXXX
Letter ID XXXX
XXXX
XXXX
Period XXXX**

**Ted Sherrod
Administrative Law Judge**

RECOMMENDATION FOR DISPOSITION

Appearances: Special Assistant Attorney General George Foster on behalf of the Illinois Department of Revenue; David E. Neeley, J.D., Ph.D. on behalf of Jane Doe.

Synopsis:

The Department of Revenue (“Department”) conducted an audit of Jane Doe d/b/a ABC Business covering the tax period January 1, 2007 through June 30, 2009. On August 25, 2010, the Department issued three notices of tax liability to the taxpayer assessing fraud penalties in the aggregate amount of \$XXXX. The taxpayer’s request for a late discretionary hearing was granted, and an evidentiary hearing in this matter was held on January 23, 2013. At the hearing, the taxpayer appeared and presented two witnesses. The Department introduced documents into the record under the Certificate of the Director but presented no witnesses. The taxpayer argues that the imposition of fraud penalties in this case was improper. For the reasons enumerated

below, it is recommended that this matter be resolved in favor of the taxpayer. In support of this recommendation, the following findings of fact and conclusions of law are made.

Findings of Fact:

1. Jane Doe d/b/a ABC Business (“taxpayer”) is a sole proprietorship having its sole place of business in Anywhere, Illinois, that is engaged in the business of making sales of tangible personal property, to wit: liquor and beer, at retail. Hearing transcript (“Tr.”) p. 12.¹
2. Jane Doe (“Jane Doe”), the owner and sole proprietor of ABC Business worked at the business on a day-to-day basis. Tr. p. 19.
3. Jane Doe regularly purchased the goods sold at retail. Tr. p. 17. The business’ only supplier was XYZ Business *Id.*
4. The taxpayer had no business checking account; Jane Doe collected and retained all cash receipts. Tr. pp. 22, 23.
5. Jane Doe ran a cash register total tape daily. Tr. p. 21. However, the receipts were inaccurate due to equipment malfunctions. *Id.*
6. The taxpayer did not retain anyone to perform accounting services for the business. Tr. pp. 19, 20.
7. The taxpayer filed monthly sales tax returns. Tr. p. 20. The business' sales tax returns were prepared by Jack Black, a tax preparer retained by Jane Doe. Tr. pp. 20, 21.
8. Timothy Beavers (“Beavers”), a Department of Revenue auditor, audited the taxpayer for the period beginning January 1, 2007 and ending June 30, 2009. Tr. pp. 21, 22; Department Exhibit (“Ex.”) 1, 2. During this audit, Jane Doe produced cash register

¹ Unless otherwise noted, findings of fact apply to the tax period in controversy, January 1, 2007 through June 30, 2009.

tapes. Tr. p 21. However, due to equipment malfunctions these register tapes were determined to be inaccurate and were not used by Beavers. *Id.*

9. At the conclusion the audit, the taxpayer was assessed a fraud penalty. Department Ex. 1.
10. During pre-trial proceedings, David Neely, counsel for the taxpayer requested that a subpoena be issued to XYZ Business, the taxpayer's liquor and beer supplier, for records regarding the taxpayer's purchases of liquor and beer for resale during the tax period audited by Beavers. Judicial notice is taken of a subpoena executed by Administrative Law Judge April Montgomery on November 9, 2011 which is included in the record.
11. In response to Administrative Law Judge Montgomery's subpoena, XYZ Business, tendered a schedule of the taxpayer's purchases between December 1, 2007 and December 31, 2009. Judicial notice is taken of the record of the taxpayer's purchases received by the undersigned on December 16, 2011, and said schedule of purchases is included in the record.

Conclusions of Law:

This case arises by virtue of a request for late discretionary hearing pursuant to 86 Ill. Admin. Code, ch. I, section 200.175. This grant of late discretionary jurisdiction over this matter pertains to three notices of tax liability issued on August 25, 2010. Department Ex. 1. The notices of tax liability assessed fraud penalties determined by the Department in the course of its audit of Jane Doe d/b/a ABC Business ("taxpayer") for the period January 1, 2007 through June 30, 2009. *Id.* Consequently, the sole issue to be addressed in this case is whether the fraud penalties indicated in these notices of tax liability were properly assessed.

Unlike the proof required to establish the correctness of Department's assessment of tax and penalties other than fraud, fraud cannot be established merely through the introduction of the

Department's notices of tax liability or other documents of record into evidence. When fraud has been alleged, the burden of proof as to fraud is on the Department. Brown Specialty Co. v. Allphin, 75 Ill. App. 3d 845 (3d Dist. 1979). The Department must provide clear and convincing evidence of fraud when fraud is asserted under the Retailers' Occupation Tax Act and its complementary Use Tax Act. *Id.* Accordingly, the central question to be addressed is whether the Department has offered sufficient clear and convincing evidence that the deficiency assessed in this case was due to fraud.

During the hearing, the Department introduced the SC-10-K Audit Correction and/or Determination of Tax Due and its EDA-105-R Audit Report indicating its audit findings following its audit of ABC Business. The Department also introduced an unsigned audit narrative letter purporting to be from Timothy Beavers ("Beavers"), the auditor that conducted the audit of ABC Business, indicating the basis for his determination that the taxpayer's underpayment of liability was due to fraud. Because the burden of proof in this matter rests with the Department, none of these documents enjoy the presumption of correctness generally accorded to the Department's determinations. Brown Specialty Co., *supra*.

With respect to the fraud penalty, the only document the Department introduced that outlines any basis for the imposition of a fraud penalty is an unsigned audit narrative purportedly written by Beavers, the Department's auditor, prior to finalization of the audit of the taxpayer for the tax period in controversy. Department Ex. 1, Letter dated March 3, 2010 from Timothy Beavers to Elizabeth Comiano ("Beavers narrative"). While this document was admitted into evidence at the hearing under the certification of the Director, there is no doubt that this document is hearsay. Specifically, it contains the out of court statements of Beavers, the auditor, which are being offered to prove the truth of the matter asserted (statements made within the

report, chief among them the declarant's stated conclusion that the facts warrant the imposition of the fraud penalty).

It is well settled that hearsay may be admitted at an administrative hearing where it is of the type that is normally relied upon by persons in the ordinary conduct of their business affairs. See section 10-40(a) of the Illinois Administrative Procedures Act ("IAPA") 5 **ILCS** 100/10-40(a) ("The rules of evidence and privilege as applied in civil cases in the circuit courts of this State shall be followed[.] Evidence not admissible under those rules of evidence may be admitted, however, (except where precluded by statute) if it is of a type commonly relied upon by reasonably prudent men in the conduct of their affairs."). Whether the Department's Exhibit 1 (Beavers narrative) is evidence of this type, however, is a question that can ordinarily only be answered by a foundation witness. Since there was no such witness presented at the hearing in this case, no foundation questions were ever asked. Thus, it must be made clear that the Department's Exhibit 1 (Beavers narrative) was not admitted as "reliable" hearsay pursuant to section 10-40(a) of the IAPA. Rather, this document was admitted pursuant to section 8 of the Retailers' Occupation Tax Act because it constituted a "book[], paper[], record[] [or] memoranda of Department" offered under the certificate of the Director. 35 **ILCS** 120/8. As such, it was required to be admitted at hearing. *Id.* ("Such reproduced copy shall, without further proof, be admitted into evidence before the Department or in any legal proceeding."). What remains is an assessment of the weight to be given this exhibit. See Jackson v. Board of Review of the Department of Labor, 105 Ill. 2d 501, 509 (1985) (fact-finder has the discretion to afford hearsay statements whatever weight they should be given.). For the reasons enumerated below, I find that the Department's Exhibit 1 (Beavers narrative) is entitled to no weight on the issue before me.

Where civil fraud under section 4 of the Retailers' Occupation Tax Act (35 ILCS 120/4) is alleged, the Department must show intent. Intent for this purpose can be shown by circumstantial evidence. Vitale v. Department of Revenue, 118 Ill. App. 3d 210, 218 (3d Dist. 1983). In the Vitale case, the court found the necessary intent from a number of facts, including the following: the taxpayer had understated his gross receipts by as much as 200%; in one year the taxpayer's purchases exceeded his sales by 46%; finally, the taxpayer failed to maintain business records. Vitale, *supra* at 213.

Beavers in his narrative letter indicating his rationale for imposing a fraud penalty, indicates that it is based upon his determination that the taxpayer underreported gross receipts by 84% during the audit period in controversy. Neither the responses to the Department's circularization of the taxpayer's purported vendors, nor the auditor's schedules regarding his review of the books and records that are ordinarily completed at or about the time of the completion of the audit are part of the Department's Exhibit 1; none of these documents are part of the record. These documents would have at least constituted a contemporaneously recorded recollection of Beavers' review of the taxpayer's books and records and might have factually supported the determinations the auditor made after completing his review. Without the foregoing, the only evidence providing a factual basis for the auditor's determination that fraud is appropriate in this matter is hearsay consisting of the unsigned, conclusion filled report of the auditor who was never made available for cross examination at hearing.

The record in this case also includes a schedule of purchases made by the taxpayer from XYZ Business during all but the first 11 months of the tax period in controversy. This schedule is significant because the record contains credible, unrebuted testimony that XYZ Business was the taxpayer's sole supplier of liquor and beer. Tr. p. 17. This schedule shows purchases that are

substantially lower than those indicated in the auditor's narrative. Specifically, the auditor states that his findings are based on undisclosed records showing purchases made by the taxpayer of \$98,859.80 in 2007. Annualizing this amount produces purchases for the month of December of \$8,238.32. However, the record of purchases for the month of December provided by XYZ Business shows purchases of only \$4,754.63, almost half the amount the auditor avers to be the correct amount of purchases for that month. For 2008, the auditor's narrative states that the taxpayer made purchases of \$57,606.86. However the schedule from XYZ Business shows purchases of only \$40,473.15. The auditor's narrative indicates that the taxpayer's purchases for the first six months of 2009 were \$32,073.24. However the schedule from XYZ Business show purchases of only of \$24,218.64. The unexplained discrepancies between the amounts averred to by the auditor and the amounts shown in the record that was subpoenaed from the taxpayer's supplier undermine the credibility of the hearsay assertions contained in the auditor's narrative. Given testimony and records from XYZ Business which conflict with the auditor's unsubstantiated assertions, I accord no weight to the hearsay statements contained in Department's Exhibit 1.

Because the burden of proof is on the Department in this case, I find that the SC-10-K Audit Correction and/or Determination of Tax Due and the EDA-105-R do not enjoy the presumption of correctness normally accorded such evidence. Brown Specialty Co., *supra*. Moreover, even if the information contained in these documents were accepted as true and correct, they only state the taxpayer's tax liability. They do not indicate how this liability was arrived at. Consequently, they contain insufficient information from which to infer intent based upon circumstantial evidence pursuant to the Vitale case, noted above.

The Department's entire case rests upon the assertions contained in Beavers narrative letter. I respectfully submit that rank hearsay included in an unsigned document that is not accorded presumptive correctness by statute and which is not supported by proven evidence of an intent to defraud cannot substitute for the substantial, clear and convincing evidence which is required to be included in the administrative record in order to affirm a determination of fraud. Vitale, *supra* at 213. Because there is no such evidence in the record showing that the taxpayer filed returns with an intent to defraud, the fraud penalty cannot be imposed in the instant case.

WHEREFORE, for the reasons stated above, it is my recommendation that the Department's notices of tax liability at issue in this case be cancelled.

Ted Sherrod
Administrative Law Judge

Date: July 16, 2013