

ST 13-22

Tax Type: Sales Tax

Tax Issue: Audit Methodologies and/or Other Computational Issues
Books and Records Insufficient

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

THE DEPARTMENT OF REVENUE
OF THE STATE OF ILLINOIS

v.

JOHN DOE
D/B/A ABC BUSINESS,
Taxpayer

No. XXXX
Account ID XXXX
Letter ID# XXXX
XXXX
Period XXXX

Ted Sherrod
Administrative Law Judge

RECOMMENDATION FOR DISPOSITION

Appearances: Special Assistant Attorney General Michael Coveny on behalf of the Illinois Department of Revenue; Lucas Fuksa of Fuksa Khorshid, LLC on behalf of John Doe d/b/a ABC Business.

Synopsis:

This matter comes on for hearing upon a request for an initial review pursuant to 86 Ill. Admin. Code, ch. I, section 200.175 of the Department's Notices of Tax Liability number XXX and number XXX issued to the taxpayer by the Department of Revenue ("Department") on March 21, 2011 for Retailers' Occupation Tax ("ROT") and related taxes due for the period January 2004 through September 2007. The principal issue presented in this case is whether the Department correctly determined that the taxpayer should not be allowed credits offsetting unpaid Retailers' Occupation Taxes for taxes paid in error by the taxpayer to its suppliers in an amount sufficient to eliminate almost all of the taxpayer's ROT liability. A hearing in this

matter was held on April 10, 2013 during which testimony and documentary evidence was presented. The parties have also submitted post hearing briefs in lieu of closing arguments in this matter. After reviewing the evidence presented in this case, it is recommended that the Department's audit determination be modified to allow credits for taxes erroneously paid to suppliers on the amounts indicated in responses to Department requests for sales information received from the taxpayer's suppliers (EDA-20 forms) and, as so modified, be finalized.

Findings of Fact:

1. The Department's *prima facie* case against the taxpayer, including all jurisdictional elements, was established by the admission into evidence of the Department's Notices of Tax Liability for Form EDA-105-R, ROT Audit Report, showing tax due for the period January 2004 through September 2007 of \$XXXX (including interest and penalty). Department Exhibit ("Ex.") 1.¹
2. The taxpayer, a sole proprietorship and Subchapter S corporation located in Chicago, Illinois, is a tire and wheel retailer and tire installation and repair garage operator. Tr. p. 16; Department Ex. 2, 3 (Auditor's Narratives).
3. The taxpayer purchases tire brands for resale primarily from XYZ Business. Department Ex. 5, 6. It also purchases tires for resale from several other businesses. *Id.*

¹ Unless otherwise noted, findings of fact apply to the tax period in controversy.

4. From January 2004 until May 2005 the taxpayer operated as a sole proprietorship under the name John Doe d/b/a ABC Business and had as its sole proprietor John Doe. Department Ex. 2. Commencing in May, 2005, the taxpayer began operations as a subchapter S corporation under the name ABC Business Inc. Department Ex. 3. John Doe is the sole shareholder of ABC Business Inc. Tr. p. 83.
5. The taxpayer commenced operations as a sole proprietorship and, during the tax period 1/04 until 5/05 was assigned IBT number XXXX. Department Ex. 2. Upon incorporation as a subchapter S corporation in May, 2005, the taxpayer was assigned IBT number XXXX. Department Ex. 3.²
6. The taxpayer is registered to collect sales tax and filed sales tax returns (ST-1s) reporting sales taxes on all of its tire sales. Department Ex. 2, 3.
7. This case arose out of an audit conducted by Jack Stewart, a Department auditor (“Stewart” or “auditor”) who completed his audit prior to the expiration of waivers extending the statute of limitations for audit to September 2009. Department Ex. 2, 3. Stewart’s audit was conducted at the offices of QRS Business with Mary Green, the taxpayer’s accountant, acting as the taxpayer’s representative pursuant to a Power of Attorney extended to her by the taxpayer. Department Ex. 2, 3. The audit was conducted using, as the test period, the months of April 2004, March 2005, August 2005, June 2006 and November 2006. Tr. p. 40; Department Ex. 2, 3.
8. During the Department’s audit, Mary Green, the taxpayer’s accountant, provided Stewart with federal income tax returns, sales tax returns, sales invoices and purchase invoices showing the amount of some of the merchandise the taxpayer purchased. Tr. p. 17;

² Notice of Tax Liability Letter ID number XXX issued to the taxpayer on March 21, 2011 covers the period when the taxpayer operated as a sole proprietorship. Department Ex. 1. Notice of Tax Liability number XXX issued March 21, 2011 covers the period when the taxpayer was operating as a subchapter S corporation. *Id.*

Department Ex. 2, 3. The records provided to the Department's auditor were incomplete. Tr. pp. 20, 35.³

9. After reviewing the taxpayer's records for the test months indicated above, the auditor determined that the taxpayer's records were inconsistent and unreliable. Tr. pp. 17-22, 69-71; Department Ex. 2, 3. Specifically, the auditor determined that gross sales reflected by the taxpayer's Federal income tax returns and sales invoices for these months exceeded gross sales reported on the taxpayer's sales tax returns (ST-1s) for these months. *Id.* For a portion of the test period, the auditor found that inventory purchases by the taxpayer substantially exceeded the taxpayer's sales for the same period. Tr. pp. 27, 72; Department Ex. 4.
10. Because the taxpayer did not have a complete set of records, and the invoices and other documents it provided were inaccurate and incomplete, the auditor attempted to verify the taxpayer's purchases by mailing to the taxpayer's suppliers forms called EDA-20s requesting sales information regarding sales to the taxpayer during the audit period. Tr. pp. 21-27; Department Ex. 2-4. The auditor used this information to determine the taxpayer's purchases during this period. *Id.*
11. The auditor calculated the projected sales amount by multiplying the amount of total purchases reported on the EDA-20s from the taxpayer's suppliers and applying a mark-up to this amount. *Id.* The auditor used as his mark-up the average mark-up on purchases by retail tire dealers from the Risk Management Association's Annual Statement Studies of Financial Ratio Benchmarks. *Id.*

³ The record does not indicate that the auditor was provided with any cash register tapes or with a complete inventory of the value of stock taken at least once a year, the minimum records a taxpayer is required to maintain by 86 Ill. Admin. Code, ch. I, section 130.805.

12. The auditor arrived at the amount by which the taxpayer underreported gross revenues on its returns as filed by subtracting gross receipts reported on the taxpayer's sales tax returns from total gross receipts determined by the auditor as indicated above. Department Ex. 2-4. The resulting increase in sales determined in this manner was multiplied by a tax rate of 8.75% applicable to the taxpayer's location in Chicago to determine the unreported tax due for the period under audit. *Id.*
13. The auditor determined that the taxpayer erroneously paid taxes on some of its tire purchases to its suppliers and allowed credits against the liability on unreported gross receipts it determined for these erroneous payments. Tr. pp. 27- 30, 94-99; Department Ex. 4. These credits were based upon actual invoices the auditor reviewed covering 2005 and 2006 showing such payments which were the only purchase invoices provided by the taxpayer during the audit. *Id.* An average monthly amount of sales tax paid to vendors was developed from the invoices the auditor reviewed and projected to the entire audit period. *Id.*
14. John Doe, the taxpayer's owner and sole shareholder, stated that there was no mark-up on the taxpayer's tire sales (Tr. pp. 86, 87), but introduced no books or records at hearing showing the same purchase price and sales charge for tires to substantiate this claim.
15. No Notice of Tax Liability was issued at the conclusion of the Department's audit because the taxpayer elected to have the audit liability considered by the Department's Informal Conference Board pursuant to 86 Ill. Admin. code, ch. I, section 215.115(a). Department Ex. 2, 3.⁴

⁴ The filing of a Request for Review with the Informal Conference Board acts as a waiver of the applicable statute of limitations that would otherwise prevent the Department from issuing a Notice of Tax Liability following the completion of an audit. In such instances, any applicable limitations period is tolled from the date the Request for Review is accepted by the Informal Conference Board up to and including 180 days following the date of the

Conclusions of Law:

This case arises from an audit assessment of the taxpayer for underreported sales taxes during the period January 2004 through December 2007. While the taxpayer does not contest the Department's determination that it failed to properly report and remit sales taxes, it contends that its entire liability is offset by credits permitted pursuant to section 105/19 of the Retailers' Occupation Tax Act ("ROTA"), 35 ILCS 105/19. Tr. pp. 5-7. Section 105/19 provides, in part, as follows:

If a retailer who has failed to pay use tax on gross receipts from retail sales is required by the Department to pay such tax, such retailer, without filing any formal claim with the Department, shall be allowed to take credit against such use tax liability to the extent, if any, to which such retailer has paid an amount equivalent to retailers' occupation tax or has paid use tax in error to his or her vendor or vendors of the same tangible personal property which such retailer bought for resale and did not first use before selling it, and no penalty or interest shall be charged to such retailer on the amount of such credit.

The above indicated portion of section 6 of the ROTA allows a taxpayer an offsetting credit for use taxes it paid to its vendor when it purchased property that it never used and later sold at retail. Cerro Wire and Cable Co. v. Department of Revenue, 111 Ill. App. 3d 882, 889 (1st Dist. 1982). In the instant case the taxpayer argues that it is entitled to this offsetting credit against any Retailers' Occupation Tax it failed to pay because it erroneously paid tax to its tire suppliers on all of its tire purchases for resale. Tr. pp. 5-7.⁵ It further argues that the tax it collected from

Informal Conference Board's decision. 86 Ill. Admin. Code, ch. I, section 215.115(f). The Department's *prima facie* case, which is deemed correct until proven otherwise by 35 ILCS 120/4, presumes that the Notices of Tax Liability at issue were issued within 180 days after the Informal Conference Board's decision, and this presumption has not been rebutted by the taxpayer. Consequently, I find that the Department's assessment at issue in this case is not barred by the Statute of Limitations on assessments prescribed by section 4 of the Retailers' Occupation Tax Act, 35 ILCS 120/4.

⁵ Subsequent to the hearing, in its post hearing brief, the taxpayer admitted that its credit for Retailers' Occupation Tax paid in error did not completely offset its unpaid Retailers' Occupation Tax liability because some of its purchases were from an out of state tire retailer that was not registered to collect tax in Illinois. Taxpayer's Brief pp.

customers but did not remit was completely offset by its credit for taxes paid in error because there was no mark-up on its sales of tires at retail. Taxpayer's Brief p. 8. The Department contends that it gave the taxpayer credit for all sales tax paid in error that the taxpayer documented during the audit. Tr. pp. 27-29, 45-50, 94-99; Department's Reply Brief ("Department's Brief") pp. 6, 7.

At the hearing, the Department introduced into evidence the Department's Notices of Tax Liability reflecting its correction of return documents. Tr. pp. 7, 8; Department Ex. 1. A corrected return prepared by the Department is deemed *prima facie* correct and the Department establishes its *prima facie* case by having the corrected return admitted into evidence. 35 ILCS 120/4; Central Furniture Mart v. Johnson, 157 Ill. App. 3d 907 (1st Dist. 1987). Therefore, when the Department introduced the Notices of Tax Liability into evidence, its *prima facie* case was established.

A taxpayer cannot overcome the Department's *prima facie* case merely by denying the accuracy of the Department's determination. Central Furniture Mart, *supra*. Simply questioning or denying the accuracy of the Department's assessment is not enough. Quincy Trading Post v. Department of Revenue, 12 Ill. App. 3d 725 (4th Dist. 1973). A taxpayer must overcome the Department's *prima facie* case by producing competent evidence identified with the taxpayer's books and records. Vitale v. Department of Revenue, 118 Ill. App. 3d 210 (3d Dist. 1983).

Section 7 of the ROTA requires retailers to "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.

6, 7. The taxpayer claims that the amount of such purchases was *de minimis* relative to its total purchases and produced only a modest tax liability that is considerably lower than the liability that has been assessed. *Id.*

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 (1st Dist. 1978); Mel-Park Drugs, Inc. v. Department of Revenue, 218 Ill. App. 3d 203 (1st Dist. 1991).

The record indicates that the taxpayer failed to make available for audit review the minimum books and records it was required to maintain and produce for audit. Tr. p. 17; Department Ex. 2, 3. Moreover, what records the taxpayer was able to produce were incomplete and inaccurate. Tr. pp. 17-22, 35, 69-71; Department Ex. 2, 3. When a taxpayer fails to supply the Department with adequate records to substantiate its gross receipts, the Department is justified in using an alternative method to estimate the taxpayer's gross receipts, and, in doing so, the Department is only required to meet a minimum standard of reasonableness. Mel-Park Drugs, supra.

In this case, the taxpayer presented incomplete and unreliable books and records to the Department's auditor. Since the taxpayer's books and records could not be relied upon, the auditor was compelled to obtain the amount of the taxpayer's purchases from its suppliers by mailing out EDA-20 forms. Tr. pp. 21-27; Department Ex. 2-4. To arrive at a tax liability, the Department's auditor applied a mark-up to the purchases ascertained in this manner. *Id.* The auditor compared gross receipts determined in this manner to gross receipts reported by the

taxpayer on its sales tax returns for the tax period in controversy to arrive at the taxpayer's underpayment liability. *Id.*; Department Ex. 2-4.

The Illinois appellate court has held that the estimation of tax liability using the methodology described above, in the absence of adequate books and records, meets the required minimum standard of reasonableness. *Vitale, supra*. The taxpayer has presented no reason to conclude that the holding in *Vitale* is not applicable here. Therefore, I find that the Department's audit methodology satisfied the minimum standard of reasonableness necessary to avoid overturning the Department's audit determination.

As previously noted, the gravamen of the taxpayer's claim is that it is entitled to offset, against its underreported gross receipts, taxes erroneously paid to its vendors. Tr. pp. 5-7. The taxpayer not only argues that it is entitled to this offset, but also maintains that the amount of erroneously paid taxes virtually extinguishes any liability for unreported gross receipts. *Id.* The obvious premise for this argument is that the taxpayer sold all of its tires to its customers at cost with no mark-up since if tire charges to customers reflected a mark-up above cost taxes paid based on cost would be insufficient to offset the unpaid Retailers' Occupation Tax charged to customers which would reflect the mark-up. The taxpayer maintains that its profits arose exclusively from the taxpayer's tire installation and repair services, and that it deliberately kept its tire sales prices at cost to be competitive in the market. Tr. pp. 85-87. For the reasons enumerated below, I find that the record in this case does not support this claim.

During the hearing, Stewart testified that the taxpayer's own records and admissions by the taxpayer's accountant indicated a substantial mark-up on its tire sales. Specifically, Stewart testified as follows:

Q. Now, why did you mark up the cost of the tires or other products that the Taxpayer sold to his customers?

A. Because when you take the line one gross sales divided by the cost of goods sold on the federal income tax return, or the Schedule C for the sole proprietorship, it shows a markup of 8.24 or 3.46 ... [.]

Q. And how do you know that the Taxpayer didn't markup his tires at all? ...

A. Based on the conversation with the accountant, as well as a statement that was given to me. ... The Question was placed to the accountant that if the Taxpayer is not marking up the inventory, what he is paying sales tax on. And the statement that was given to me was that in order to keep prices low for his customers, he keeps the price of the tires in his head as he quotes them to his customers, and the tax is based on the markup portion of it.

Tr. pp. 62-63.

Stewart's testimony is consistent with information indicated in Stewart's Auditor's Narrative which was admitted into the record under the Certificate of the Director. Specifically, in his Auditor's Narrative, Stewart states:

An inquiry was made to the POA as to how ST [i.e. the taxpayer] was charging and remitting the sales tax collections that he reported? I was told that ST charged and remitted sales tax on the mark-up portion of the selling price of goods since he had already paid the other tax portion due to his vendors at the time of purchase.

Taxpayer's Ex. 2

Moreover, the Department's determination that there was a mark-up on tire sales is encompassed within the presumed correctness of the Department's correction of returns reflected in the Notices of Tax Liability issued to the taxpayer. Branson v. Department of Revenue, 168 Ill. 2d 247, 257, 258 (1995). The burden shifts to the taxpayer to rebut the Department's determination through the production of documentary evidence once the Department establishes its *prima facie* case. Fillichio v. Department of Revenue, 15 Ill. 2d 327 (1958). Mere testimony is insufficient to rebut the *prima facie* correctness of the Department's findings. Mel-Park Drugs, supra. In the instant case, the only evidence that there was no mark-up on the taxpayer's tire sales is the testimony given by John Doe, the taxpayer's owner, that there was no such mark-up.

Tr. pp. 85-87.⁶ This testimony, which has not been corroborated by any documentary evidence showing that tire purchase and tire sale prices were equivalent, is insufficient to establish the taxpayer's claim that there was no mark-up on any of its tire sales.

Given evidence in the record that there was a mark-up on the taxpayer's tire sales, I find that taxes paid at cost to its tire retailers could not possibly have offset its taxes due on retail tire sales to its customers so as to eliminate all or the vast majority of the taxpayer's liability for failing to pay Retailers' Occupation Taxes due. While the taxpayer was entitled to a credit for erroneous taxes paid to its suppliers, the taxpayer has provided no basis for concluding that no tax, or only a *de minimis* amount of tax, was due from the taxpayer for this reason.

The taxpayer also contests various aspects of the auditor's audit methodology. Specifically, the taxpayer argues that the Department's auditor should have projected credits for taxes paid in error based upon the assumption that only a *de minimis* amount of purchases of tires were made without a corresponding erroneous sales tax payment. Taxpayer's Brief pp. 6-8. It contends that this audit assumption is supported by invoices and EDA-20s (i.e. responses to Department requests for sales information sent to the taxpayer's suppliers) the taxpayer produced during the hearing showing tax paid on every purchase of tires from all but one of the taxpayer's suppliers. *Id.*

During the hearing, the taxpayer presented documentary evidence, in the form of EDA-20 responses from its suppliers, indicating that the taxpayer is entitled to credit for taxes paid in error on \$92,436.09 in tire purchases from XYZ Business ("XYZ Business") in 2004, on \$XXXX in tire purchases from XYZ Business in 2005, on \$XXXX in tire purchases from XYZ

⁶ John Doe attempted to corroborate his testimony by introducing into the record an invoice he claimed showed that tires were sold at cost. Taxpayer's Ex. 8. However, the invoice only shows the sale price of the tires to the customer and does not indicate how much the taxpayer paid for them. The invoice, therefore, does not support the John Doe's testimony.

Business in 2006 and on \$XXXX in tire purchases from XYZ Business during the period January 1, 2007 through September 30, 2007. Taxpayer's Ex. 2. The EDA-20s presented also document tax payments in error to DEF Business in the amount of \$XXXX in 2004. Taxpayer's Ex. 5.

Stewart, during his testimony, verified the authenticity and accuracy of the EDA-20 reports the taxpayer presented into the record and implicitly admitted that they provide a reasonable basis for a credit in the amounts shown as having been taxed by the taxpayer's vendors indicated therein. Tr. pp. 50-53. However, Stewart also testified that he gave the taxpayer credit for these payments in reaching his audit determination of liability. Tr. pp. 54, 55. He testified that, although he did not use the EDA-20s included in the record, he determined the taxpayer's credit by totaling the amount of sales taxes paid on invoices from 2005 and 2006 he was presented during the audit, determined the average amount of purchases on which sales tax was paid to the taxpayer's suppliers from these invoices, and projected this average amount of purchases throughout the audit period. Tr. pp. 27-29, 94-99; Department Ex. 4. The record does not indicate the exact amount of credit given the taxpayer for each year that is fully or partly within the audit period using this methodology. However, based on the documentation presented by the taxpayer (Taxpayer's Ex. 2), to the extent Stewart's methodology failed to give the taxpayer credit for taxes paid on purchases indicated in the EDA-20s for each such year, the auditor's assessment should be adjusted to include erroneous tax payments in the amount the EDA-20s clearly indicate were made.

With respect to other invoices presented at the hearing (Taxpayer's Group Ex. 1) the taxpayer failed to show whether or not any of these invoices were used by the auditor in arriving at his audit determination and are therefore already reflected in the credit it already received.

The burden of producing such evidence rests with the taxpayer. Vitale, supra. In the absence of such proof, I find that Stewart's methodology reasonably accounted for these invoices even though they may not have all been reviewed during the audit, since Stewart projected credits to cover the entire audit period based on the sample of invoices he reviewed.

The taxpayer's claim that it is entitled to credit for sales taxes paid in error beyond the amount of credits it has been able to document (i.e. based on the assumption tax was paid in error on virtually all of the taxpayer's tire purchases) is not supported by Illinois case law. After the Department presented its *prima facie* case, the burden shifted to the taxpayer to present sufficient documentary evidence to overcome the presumed correctness of the Department's determination. Fillichio at 333. Moreover, 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. v. Department of Revenue, 173 Ill. App. 3d 826 (1st Dist. 1988); Central Furniture Mart, supra.

The burden shifts to the taxpayer to show that such a determination is incorrect once the Department establishes the *prima facie* correctness of the amount of tax through the admission into evidence of its Notices of Tax Liability. Id. In order to overcome the presumption of validity attached to the Department's determination of tax liability, the taxpayer must do more than merely deny the accuracy of the Department's findings. Id. Rather, the taxpayer must produce competent evidence, identified with its books and records showing that the Department's determinations are incorrect. Copilevitz v. Department of Revenue, 41 Ill. 2d 154 (1968).

In this case, the taxpayer has presented no dispositive documentary evidence to prove that the auditor's failure to use an audit method that assumes that tax was paid on all of the taxpayer's tire purchases was arbitrary, capricious or unreasonable. The only proof beyond that evidenced by the EDA-20s that I have determined should be reflected in a revised audit determination and invoices for which the taxpayer received credit based on the auditor's audit methodology, is the testimony given by the taxpayer's owner. Argument and testimony by the taxpayer that cannot be substantiated by competent documentary evidence closely associated with the taxpayer's books and records is insufficient to overcome the *prima facie* correctness of the Department's Notices of Tax Liability. Copelivitz, *supra*.

WHEREFORE, for the reasons stated above, it is my recommendation that the Department's Notices of Tax Liability at issue in this case be adjusted to allow credits to the extent not already allowed for taxes paid in error on tire purchases in the amount of \$XXXX in 2004, \$XXXX in 2005, \$XXXX in 2006 and \$XXXX in 2007 and, as modified, be finalized.⁷

Ted Sherrod
Administrative Law Judge

Date: October 28, 2013

⁷ The taxpayer, in its brief, also argues that the Auditor's Narrative suggests that the Notice of Tax Liability at issue for the period 1/04 through 5/05 is not based upon a correction of returns covering this tax period but rather is based upon the period 7/04 through 5/05. Taxpayer's Brief pp. 8, 9. During testimony, the auditor admitted that he did not account for the period 1/04 through 6/04 in evaluating credits due for 2004 because he thought these months were outside of the audit period. Tr. pp. 54, 99. Since I have recommended that the taxpayer be given credit for all taxes paid in error that are documented for the entire calendar year 2004, I find that any errors in the auditor's work papers noted above have been rectified.

