

ST 14-07
Tax Type: Sales Tax
Tax Issue: Propriety of Penalty

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

THE DEPARTMENT OF	)	Docket Nos.	XXXX	
REVENUE OF THE	)	IBT No.	XXXX	
STATE OF ILLINOIS	)	NTL Nos.	XXXX,	
	)		XXXX,	XXXX,
ABC BUSINESS,	)		XXXX,	XXXX
	)	John E. White,		
Taxpayer	)	Administrative Law Judge		

RECOMMENDATION FOR DISPOSITION

Appearances: William Seitz, Fisk, Kart, Katz and Reagan, Ltd., appeared for ABC BUSINESS; Michael Coveny and Sean Cullinan, Special Assistants Attorney General, appeared for the Illinois Department of Revenue.

Synopsis:

Following an audit of its business, the Illinois Department of Revenue (Department) issued five Notices of Tax Liability (NTLs) to ABC BUSINESS (Taxpayer). The NTLs assessed tax, penalties, and interest for the months of January 2004 through June 2007. Taxpayer protested the NTLs, and requested a hearing. The parties agreed to conduct a single hearing involving this matter and another matter, involving Notices of Deficiency the Department issued to Taxpayer, to propose to assess Illinois income and replacement tax, penalties and interest against it. That related matter is the subject of a separate recommendation.

At hearing, Taxpayer challenged only the penalties assessed in the NTLs. I have reviewed the evidence, 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 operated a liquor store in Blueville that had some grocery sales. Department Ex. 2, p. 1 (copy of first page of the Department auditor's audit report).
2. Taxpayer registered as a retailer with the Department in 1985, as a C corporation, for purposes of sales and income taxes. Department Ex. 2, p. 1.
3. The Department conducted an audit of Taxpayer for the period beginning in January 2004 through June 2007. Department Ex. 2, p. 1. Carl Gronski (Gronski) conducted the audit. *Id.*, p. 6.
4. Taxpayer had one cash register in the store, and every day it was closed out. Department Ex. 2, p. 1.
5. Taxpayer did not keep, or produce for audit, cash register tapes for the days it was open and made sales at retail. Department Ex. 2, p. 1.
6. Taxpayer purchased tangible personal property (hereafter, goods) for resale on a weekly basis, and paid for its purchases either by check or with cash. Department Ex. 2, p. 1.
7. Taxpayer provided the auditor with copies of the following books and records: bank statements; accounts payable invoices; sales tax returns; and federal and state income tax returns. Department Ex. 2, p. 2.
8. Since Taxpayer did not have documentary support for the total receipts reported on its sales and use tax returns filed during the audit period, Gronski had to use an alternate method of verifying the amount of Taxpayer's sales. Department Ex. 2, p. 2.
9. The alternative method Gronski used to verify Taxpayer's sales was a mark-up analysis, which involved two steps. Department Ex. 2, p. 2. The first step was to request and obtain records from the vendors that sold goods to Taxpayer for resale for a test period, which

consisted of the months of January 2004 through June 2006, to ascertain the amount Taxpayer spent to purchase such goods. Department Ex. 2, pp. 2, 8. The second step was to apply a mark-up of Taxpayer's cost price for the goods Taxpayer purchased for resale, to estimate the amount of gross receipts Taxpayer would have realized when selling such goods, at retail. *Id.*

10. Gronski prepared schedules when performing the mark-up analysis. Department Ex. 2, pp. 8-9, 11, 14-34. Several of his schedules detail the vendors' records Gronski received after requesting them (*id.*, pp. 18-34), which Gronski then totaled for the audit period. *Id.*, pp. 8, 18.

11. During the years at issue, the monthly Illinois retailers' occupation tax (ROT) return forms that Taxpayer filed with the Department had a line on which certain retailers of alcoholic liquor were required to report the amount of all alcoholic liquor purchased and invoiced during the month for which the return pertained. *See* Department Ex. 2, pp. 14-17. On all but four of the monthly ROT returns it filed with the Department during the audit period, Taxpayer entered an amount, on the appropriate line, to report its liquor purchases. *Id.*

12. After reviewing Taxpayer's vendors' records of liquor sold to Taxpayer, Gronski scheduled the cost price of Taxpayer's purchases for resale during the following months in the audit period:

2004	2005	2006 (January through June)
564,618	671,105	335,553

Department Ex. 2, pp. 11, 18; *see also id.*, pp. 19-34.

13. For the following periods, Taxpayer reported the following amounts its monthly ROT returns:

Return Months	Entries on Returns as Filed			
	Liquor Purchased	Total Receipts	Deductions	Taxable Receipts
1-6/2004	60,482	106,975	8,558	98,417
7-12/2004	99,008	114,542	7,820	106,722
Total 2004	159,490	221,517	16,378	205,139
1-6/2005	50,840	104,746	8,379	96,367
7-12/2005	45,250	81,076	6,615	74,461
Total 2005	96,090	185,822	14,994	170,828
1-6/2006	21,500	75,690	6,245	69,445
7/2006	4,280	15,444	1,274	14,170
8/2006	2,810	10,870	897	9,973
9/2006	4,810	11,640	960	10,680
10/2006	6,480	10,260	840	9,420
11/2006	4,920	10,990	900	10,090
12/2006	6,810	11,100	910	10,190
Total 2006	51,610	145,994	12,026	133,968

Department Ex. 2, pp. 9, 15-17.

14. Gronski compared Taxpayer's cost price of goods purchased for resale, as per his audit, with the amounts of the total liquor purchases, total receipts, and taxable receipts that Taxpayer reported on the monthly ROT returns it filed during January 2004 through June 2006.

Department Ex. 2, pp. 8-16.

15. The table below reflects the results of Gronski's comparison:

	2004	2005	2006 (January – June)
Cost Price of Purchases for Resale	564,618	671,105	335,553
Total Liquor Reported on Monthly Returns	159,490	96,090	21,500
Total Receipts Reported on Monthly Returns	221,517	185,822	75,690
Taxable Receipts Reported on Monthly Returns	205,139	170,828	69,445

Department Ex. 2, pp. 11, 14-18.

16. Gronski also noted that there was a significant difference between the cost price of goods Taxpayer purchased for resale during a given year and the amount John Doe reported as

being Taxpayer's cost of goods sold, on Schedule C of his federal individual income tax returns. Department Ex. 2, pp. 4, 36. For tax year ending 2004 (TYE 2004), John Doe reported Taxpayer's cost of goods sold as being \$38,900, and during TYE 2005, he reported it as being \$50,667. *Id.*, p. 4.

17. Gronski applied a 1.25 mark-up percentage to Taxpayer's purchases during the test period, to estimate total taxable receipts for each full year of the test period. Department Ex. 2, pp. 4, 11, 18. Gronski subtracted the amounts Taxpayer reported as taxable receipts from the marked-up purchases, and treated the difference as underreported taxable receipts. *Id.*
18. To estimate taxable receipts for months outside the test period, Gronski used the average monthly amount of taxable receipts calculated using his mark-up analysis of Taxpayer's purchases. Department Ex. 2, p. 11. From those projected taxable receipts, Gronski then subtracted the amounts Taxpayer actually reported as taxable receipts for those months, and again treated the difference as underreported taxable receipts. *Id.*, p. 4, 11.
19. Gronski began his audit of Taxpayer in January 2007. Department Ex. 2, p. 12.
20. Beginning the month after Gronski first visited Taxpayer's place of business to initiate his audit, Taxpayer's reported liquor purchases, and its taxable receipts, increased significantly, from the amounts Taxpayer had reported during prior months. Department Ex. 2, pp. 16 (schedule of 2006 returns as filed), 17 (schedule of 2007 returns as filed), 36.
21. During the 13 months from January through January 2007, Taxpayer reported liquor purchases in an average monthly amount of \$5,024. Department Ex. 2, p. 16-17 $((51,610 + 8,680)/12 \approx 5,024)$. After the audit started, it reported liquor purchases in an average monthly amount of \$17,372. *Id.*, p. 17 $((23,800 + 18,800 + 18,060 + 12,400 + 13,800)/5 \approx 17,372)$.
22. Similarly, during the 13 months from January through January 2007, Taxpayer reported total

monthly receipts in an average amount of \$12,223. Department Ex. 2, pp. 16-17. After the audit started, it began to report total monthly receipts in an average amount of \$23,704. *Id.*, p. 17.

23. During the audit period, John Doe was physically present at the store during business hours. Department Ex. 2, pp. 1, 36, 38. He paid for liquor and other goods Taxpayer purchased for resale, either by check or with cash, and made deposits of receipts into the bank. *Id.*, pp. 36, 38.

24. As a result of the audit, the Department issued five NTLs to Taxpayer. Department Ex. 1 (copies of NTLs, under the certificate of records of the Director of the Department).

25. The NTLs assessed the following amounts of tax, penalties and interest to Taxpayer, for the following periods:

NTL No.	Reporting periods	Tax	Late-payment penalty	Fraud Penalty	Interest	Total
CNXX XX21 8337 7923	1/04—11/04	42,160	8,432	21,080	9,545.31	81,217.31
CNXX XX13 17XX 2246*	12/04—3/07	135,251	27,050	67,626	18,590.34	248,715.34
CNXX X174 2312 96X4	4/07	4,109	822	2,055	196.86	7,182.86
CNXX XX93 7XX6 5927	5/07	4,109	822	2,055	176.16	7,162.16
CNXX XXX7 35X4 2561	6/07	4,109	822	2,055	159.16	7,145.16
Totals						\$ 351,422.83

Department Ex. 1, pp. 1-5 (* the NTL for the reporting period of 12/04—3/07 also assessed a late filing penalty, in the amount of \$198.00).

26. After this matter was docketed within the Department’s Office of Administrative Hearings, the parties agreed to place the matter on inactive status, pending resolution of a criminal investigation and prosecution premised on Taxpayer’s understatement of tax on the ROT returns filed during the audit period. Department Ex. 2, pp. 10 (copy of completed form EDA-4, titled, Referral to Investigations, from Gronski to Department’s Bureau of Criminal

Investigations, regarding audit of Taxpayer), 13 (page 2 of Gronski's Audit History Worksheet); *see also* Orders issued during status conferences set and held to monitor results of criminal prosecution.

27. Prior to hearing, John Doe pled guilty to the offense of Attempt, and was sentenced to a period of conditional discharge. Department Ex. 8 (copy of certified statement of conviction of John Doe for the offense of Attempt); Taxpayer Ex. 1 (copy of John Doe' Sentencing Order for 18 months of conditional discharge, and payment of restitution to the Department). The Sentence Order required John Doe to pay restitution to the Department in the amount of \$60,000. Taxpayer Ex. 1, p. 2.
28. John Doe's Sentencing Order further provided, "Defendant understands that nothing in this order prohibits the Illinois Department of Revenue from proceeding civilly to recover any additional tax, penalty or interest." Taxpayer Ex. 1, p. 2.

Conclusions of Law:

The Department introduced a copy of the NTLs it issued to Taxpayer into evidence under the certificate of the Director. Department Ex. 1. Pursuant to § 4 of the Retailers' Occupation Tax Act (ROTA), those NTLs constitutes 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). The statutory presumption extends to all elements necessary for a determination that the tax and penalties assessed are due as determined by the Department. *E.g.* Branson v. Department of Revenue, 68 Ill. 2d 247, 258, 659 N.E.2d 961, 966-67 (1995) ("nothing more [than the certified copy of the NPL] is needed to prove the Department's claim for a tax penalty against the corporate officer or employee.").

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.

Issue and Arguments

Taxpayer does not contest any amounts of tax assessed. Tr. pp. 15-16. Instead, it argues that the statutory presumption of correctness applies only to the tax proposed, and does not apply to any of the penalties proposed in the NTLs. Tr. pp. 15-16, 20.

The NTLs reflect that the Department assessed three types of penalties against Taxpayer: late filing; late payment; and fraud. Department Ex. 1, pp. 1-5. I will address the late filing and late payment penalties, and the fraud penalty, separately.

Section 4 of the ROTA provides, in pertinent part:

As soon as practicable after any return is filed, the Department shall examine such return and shall, if necessary, correct such return according to its best judgment and information. *** In the event that the return is corrected for any reason other than a mathematical error, any return so corrected by the Department shall be prima facie correct and shall be prima facie evidence of the correctness of the amount of tax due, as shown therein. ***

If the tax computed upon the basis of the gross receipts as fixed by the Department is greater than the amount of tax due under the return or returns as filed, the Department shall ... issue the taxpayer a notice of tax liability for the amount of tax claimed by the Department to be due, together with a penalty in an amount determined in accordance with Section 3-3 of the Uniform Penalty and Interest Act. ***

Proof of such notice of tax liability by the Department may be made at any hearing before the Department or the Illinois Independent Tax Tribunal or in any legal proceeding by a reproduced copy of the Department's record relating thereto in the name of the Department under the certificate of the Director of Revenue. Such reproduced copy shall without further proof, be admitted into evidence before the Department or in any legal proceeding and shall be prima facie proof of the correctness of the amount of tax due, as shown therein.

35 ILCS 120/4.

Illinois courts have long treated the issuance of penalties like those described in UPIA § 3-3 to be a ministerial act, based simply on a mathematical percentage of the amount of tax the Department determined to be due. Diogenes v. Department of Finance, 377 Ill. 15, 22, 35 N.E.2d 342, 346 (1941) (“The taxpayer's return, as amended by the Department to include the ‘A’ penalty, was prima facie correct, and the duty rested upon the plaintiff to establish that his tax return had been filed on time and that the penalty was, in consequence, improperly exacted.”);

Department of Finance v. Gandolfi, 375 Ill. 237, 240, 30 N.E.2d 737, 739 (1940) (“Our decision in Department of Finance v. Cohen, supra, that the power to review and revise tax returns under the Retailers' Occupation Tax Act is ministerial, and not judicial, as requiring merely a calculation or computation from data upon which all minds must ordinarily reach the same result, applies with equal force to the assessment of penalties under sections 4 and 5.”).

Further, § 3-8 of the UPIA provides:

Sec. 3-8. No penalties if reasonable cause exists. The penalties imposed under the provisions of Sections 3-3, 3-4, 3-5, and 3-7.5 of this Act shall not apply if the taxpayer shows that his failure to file a return or pay tax at the required time was due to reasonable cause. Reasonable cause shall be determined in each situation in accordance with the rules and regulations promulgated by the Department. A taxpayer may protest the imposition of a penalty under Section 3-3, 3-4, 3-5, or 3-7.5 on the basis of reasonable cause without protesting the underlying tax liability.

35 ILCS 735/3-8. The Illinois General Assembly’s placement of the burden on the taxpayer to show that one of the penalties listed in UPIA § 3-8 should *not* apply makes clear that such penalties were intended to be assessed automatically, upon the Department’s presumptively correct determination that a return was not timely filed, or that the correct amount of tax was not paid when due. *Id.*; 35 ILCS 735/3-3; Diogenes, 377 Ill. at 22, 35 N.E.2d at 346.

On this point, the court in Hollinger International, Inc. v. Bower, 363 Ill. App. 3d 313, 841 N.E.2d 447 (1st Dist. 2005), wrote:

... an agency’s determination as to whether reasonable cause existed in justifying the abatement of a tax penalty will be reversed only if the agency’s decision was against the manifest weight of the evidence and only if the opposite conclusion was clearly evident. *PPG Industries, Inc. v. Department of Revenue*, 328 Ill.App.3d 16, 21, 262 Ill.Dec. 208, 765 N.E.2d 34 (2002). The existence of reasonable cause justifying abatement of a tax penalty is a factual determination that is to be decided only on a case-by-case basis. *PPG Industries, Inc.*, 328 Ill.App.3d at 21, 262 Ill.Dec. 208, 765 N.E.2d 34. The taxpayer has the burden of proving by competent evidence that the proposed assessment is not correct. *Fillichio v. Department of Revenue*, 15 Ill.2d 327, 333, 155 N.E.2d 3 (1958).

Hollinger International, Inc., 363 Ill. App. 3d at 315-16, 841 N.E.2d at 450.

Based on the plain language of § 4 of the ROTA, § 3-3 of the UPIA, and consistent Illinois court decisions on the subject, I reject Taxpayer's argument that the statutory presumption of correctness does not attach to the Department's assessment of the late filing and late payment penalties. The Department's determination that penalties were due is presumed correct, and Taxpayer bears the burden to show that the UPIA § 3-3 penalties — or some amount of them — were not due. 35 ILCS 735/3-8; Hollinger International, Inc., 363 Ill. App. 3d at 315-16, 841 N.E.2d at 450. Taxpayer offered no evidence that the penalties assessed are in any way improper. Nor has it ever argued that it acted reasonably, or with good faith, when it failed timely to report and to pay the tax determined — and conceded — to be due. I recommend that the late filing and late payment penalties be finalized as issued.

The Department also assessed a fraud penalty to Taxpayer. Department Ex. 1. Section 3-6 of the UPIA provides, in pertinent part, “[i]f 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 a taxpayer's intent to defraud can be circumstantial in nature. Vitale v. Department of Revenue, 118 Ill. App. 3d 210, 213, 454 N.E.2d 799, 802 (3d Dist. 1983). Probative evidence that a return was filed with an intent to defraud is evidence that tends to make it more likely than not that a filed return contained representations that were false, and that such representations were made with knowledge that they were false. Camco, Inc. v. Lowery, 362 Ill. App. 3d 421, 839 N.E.2d 655, 665 (1st Dist. 2005) (“Evidence is probative when to the normal

mind it tends to prove or disprove a matter at issue.”); 37 Am. Jur. 2d Fraud and Deceit § 488 (“Evidence that a representation was made with knowledge of its falsity is regarded as proof of an intent to deceive.”); *see also* Puleo, 117 Ill. App. 3d at 268, 453 N.E.2d at 53 (“the record is uncontradicted that the plaintiff admitted to the fraud agents that he had not filed correct returns ...”).

Here, the Department auditor determined that Taxpayer “grossly underreport[ed]” its monthly taxable receipts over the course of the 42-month audit period. Department Ex. 2, p. 10. That determination was based, in large part, on Gronski’s extensive and documented investigation of the amounts Taxpayer spent to purchase liquor for resale, and his comparison of such amounts with the amounts Taxpayer entered on the monthly ROT returns it filed during the audit period. *Id.*, pp. 1-11, 14-34.

On each of the monthly returns Taxpayer filed during the audit period, Taxpayer made a representation of the amount of its liquor purchases during the month, as well as representations of the total and taxable gross receipts it realized from selling goods at retail. Department Ex. 2, pp. 11, 14-18. During 2004, Taxpayer purchased over \$564,000 worth of goods for resale (Department Ex. 2, pp. 11, 18), and the greatest majority of those purchases were from liquor distributors. *Id.*, pp. 11, 18-34. But on the monthly returns Taxpayer filed for 2004, Taxpayer reported that it had liquor purchases of less than \$160,000. Department Ex. 2, pp. 11, 14. During 2005, Taxpayer purchased over \$671,000 worth of goods for resale, but reported less than \$97,000 in liquor purchases. *Id.*, pp. 11, 15. Finally, during the first six months of 2006, Taxpayer purchased over \$335,000 worth of goods for resale, while reporting liquor purchases of less than \$22,000. *Id.*, pp. 11, 16.

Further, during his audit, Gronski observed and reported that John Doe was personally engaged in the actual day-to-day operations of running the liquor store. Department Ex. 2, pp. 1, 36, 38. He took delivery of the goods the store purchased for resale, and he paid the persons who either delivered such goods or sold them to the store. *Id.* During the audit period, Taxpayer reported liquor purchases that were, respectively, 28% (159,490/564,000 \approx 0.282783), 14% (96,090/671,000 \approx 0.143204), and 6% (21,500/335,000 \approx 0.064179) of its actual cost for such goods. Department Ex. 2, pp. 14-18. Finally, John Doe voluntarily pled guilty to the offense of attempt, which is a specific attempt crime (People v. Gilman, 113 Ill. App. 3d 73, 76, 446 N.E.2d 595, 597 (4th Dist. 1983)), and agreed to pay restitution to the Department. Taxpayer Ex. 1.

In sum, the evidence shows that Taxpayer's filed returns contained false representations of the amounts of its liquor purchases, taxable receipts, and tax due. Department Ex. 2, pp. 11, 14-18). The record also contains circumstantial evidence that John Doe knew that Taxpayer's ROT returns contained false representations. *Id.*, pp. 36, 38; Taxpayer Ex. 1; *see also* Puleo, 117 Ill. App. 3d 260, 453 N.E.2d at 53. This evidence includes: John Doe' direct and personal involvement in buying and paying for the goods Taxpayer purchased for resale; the significant increase in the amounts of purchases and receipts Taxpayer began to report, immediately after the Department began its audit; and John Doe' admission of guilt to a specific attempt crime related to the Department's investigation of Taxpayer, and his payment of restitution to the Department. The evidence clearly and convincingly shows that Taxpayer filed returns during the audit period with an intent to defraud. 35 ILCS 735/3-6; Vitale, 118 Ill. App. 3d at 213, 454 N.E.2d at 802. Therefore, I recommend that the fraud penalty be finalized as issued.

Conclusion:

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

February 25, 2014

John E. White
Administrative Law Judge