ST 15-02
Tax Type: Sales Tax
Tax Issue: Reasonable Cause On Application Of Penalties

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

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

RECOMMENDATION FOR DISPOSITION

Appearances: Lane Gensburg, Dale & Gensburg, P.C., appeared for ABC Business, Inc.; Michael Coveny, Special Assistant Attorney General, appeared for the Illinois Department of Revenue.

Synopsis:

Following an audit, the Illinois Department of Revenue (Department) issued two Notices of Tax Liability (NTLs) to ABC Business, Inc. (Taxpayer). The NTLs assessed tax, penalties, and interest for the months of July 2007 through and including June 2010. Taxpayer protested the NTLs, and requested a hearing. The parties agreed that the issues to be resolved at hearing include whether the Department's markup analysis was correct, and whether the penalties assessed should be abated for reasonable cause.

At hearing, Taxpayer offered documentary evidence, as well as the testimony of witnesses. 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 revised as described in this recommendation, and finalized as so revised.

Findings of Fact:

Facts Regarding Taxpayer's Business

1. Taxpayer operates a liquor store in Anywhere, Illinois, which also sells some general merchandise and food. Department Ex. 3 (copy of the Department auditor's audit narrative report), p. 1.
2. Taxpayer is registered with the Department as a retailer, and files monthly sales and use tax (ST-1) returns with the Department. Department Ex. 3, p. 1.
3. Taxpayer sells liquor, beer, wine, cigarettes, water, milk, general merchandise, food, soft drinks, medicine, hair products, candy, chips, newspapers, magazines and lottery tickets. Department Ex. 3, p. 1.
4. Taxpayer's two shareholders are John Doe (John Doe), who testified at hearing, and Jack Black (Jack Black). Hearing Transcript (Tr.) p. 60 (John Doe). Jack Black is a passive owner, in that he is not directly involved in operating the store. Tr. pp. 61-62 (John Doe).
5. John Doe is personally and directly involved with all of the store's operations, including purchasing inventory, setting prices, paying bills, and signing checks for the business. Tr. pp. 61-67 (John Doe); *see also* Department Ex. 3, p. 1.
6. Taxpayer's accountant, Gene Green (Gene Green), prepared Taxpayer's monthly ST-1 returns, and Taxpayer's general ledger, using summary sheets John Doe provided to him each month. Department Ex. 3, p. 1; Department Ex. 5 (copy of Berry's audit history worksheet), p. 1. Gene Green also prepared other tax returns for Taxpayer. Department Ex. 3, p. 1.
7. The information John Doe provided to Gene Green included bank statements, cancelled checks, cash purchases, as well as statements of high and low tax sales, food stamps sales,

and lottery sales. Tr. pp. 67-68 (John Doe).

8. Taxpayer's store has three cash registers, two of which are regularly used to ring up sales. Tr. p. 63 (John Doe).

9. Although all of the cash registers in Taxpayer's store were able to produce cash register tapes which would have showed the actual daily receipts rung up at each machine, John Doe did not keep such daily cash register tapes (hereafter, z-tapes). Tr. p. 68 (John Doe).

Facts Regarding the Department's Audit of Taxpayer's Business

10. The Department conducted an audit of Taxpayer for the period of July 2007 through and including June 2010. Department Ex. 3, pp. 1, 3. Denise Berry (Berry) conducted the audit. *Id*., p. 5.

11. Prior to contacting Taxpayer regarding the audit assignment, Berry visited Taxpayer's store as a customer, and reported her impressions on her audit history worksheet, which is a report showing an assigned auditor's tasks, reported in chronological order. Department Ex. 5; Tr. pp. 188-90 (Berry).

12. Regarding her visit to Taxpayer's store on February 5, 2010, Berry included the following entry on her audit history worksheet:

    > This is a liquor store selling grocery items too. I visited the store as a customer. This place has high liquor prices. A 5th of Grey Goose sell for \$XXXX other places sell this for \$XXXX or Binnys for \$XXXX if a sale. Bacardi Limon a 5th is \$XXXX. Korbel extra dry is \$XXXX. This is extremely high prices. Cooks Champaign sells for \$XXXX. Everywhere else it is \$XXXX or \$XXXX.
    >
    > ***

    Department Ex. 5, p. 1.

13. In March 2010, Berry contacted one of Taxpayer's owners by telephone, and thereafter telephoned Gene Green, who Taxpayer named as a representative on a power of attorney

form. Department Ex. 5, p. 1; Department Ex. 2 (copy of letter, dated May 13, 2010, from Berry to Gene Green).

14. In a May 13, 2010 letter to Gene Green, Berry identified the books and records she needed to review during the audit. Department Ex. 2.
15. After speaking with Gene Green, Berry learned that Taxpayer did not have the z-tapes she asked Gene Green to make available for audit. Department Exs. 2, 5; Tr. p. 21 (Berry).
16. Berry examined the following documents when conducting her audit: Taxpayer's federal and Illinois income tax returns for tax years ending 2007 and 2008; Taxpayer's bank statements; Taxpayer's filed ST-1 returns; Taxpayer's general ledger for 2009; Taxpayer's cancelled checks; some invoices of purchases; and completed forms EDA-20. Department Ex. 3, p. 3.
17. Since Taxpayer did not have documents to support the entries reported on the ST-1 returns Taxpayer filed during the audit period, Berry had to use an alternate method of verifying Taxpayer's receipts. Department Ex. 3, pp. 1-2; Tr. pp. 21-26 (Berry).
18. Berry used a purchase markup analysis to estimate the receipts Taxpayer realized from selling tangible personal property (hereafter, goods) at retail, and to compare that estimate to the entries Taxpayer reported on the returns it filed during the audit period. Department Ex. 3, pp. 2-4; Taxpayer Ex. A (copies of Berry's audit schedules titled, Summary Analysis and Global Taxable Exceptions Detailed Report); Taxpayer Ex. B (copy of Berry's markup schedule of Taxpayer's general merchandise purchases regarding 2007 through 2009); Taxpayer Ex. C (copy of Berry's mark-up schedule of Taxpayer's food purchases regarding 2007 through 2009); Taxpayer Ex. D (copy of Berry's mark-up schedule of Taxpayer's purchases regarding 2010); Tr. pp. 13-18 (Berry), 127-43 (testimony of Sue Blue (Sue Blue)).

19. The forms EDA-20 Berry reviewed regarding 2007 through 2009 were Department forms that she circulated to area vendors from whom Taxpayer purchased goods for resale. Tr. pp. 23 (Berry), 128-29 (Sue Blue). Those EDA-20 forms asked vendors to produce documents or provide information to identify the cost of goods sold to Taxpayer during a given period. *Id*.

20. When reviewing the completed EDA-20 forms returned to her from vendors, Berry noted that the vendors reported selling alcoholic beverages in amounts that were significantly higher than the cost of goods sold Taxpayer reported on its annual federal income tax returns. Department Ex. 3, p. 2; Department Ex. 5, p. 2.

21. When reviewing the completed EDA-20 forms, Berry also noted that Taxpayer purchased food in amounts that, after being marked up, were significantly less than the amounts Taxpayer reported as being subject to tax at the lower statutory rate. Department Ex. 3, p. 2; Tr. p. 28 (Berry); *see also* 35 ILCS 120/2-10 (setting different tax rates for different types of goods).

22. Berry treated the difference between the results of her purchase markup and the amounts reported on Taxpayer's monthly returns as unreported receipts, and determined that tax was due on such receipts. Department Ex. 3, p. 3; Taxpayer Exs. B-C; Tr. p. 27 (Berry).

23. Berry's determination of the markup percentage to use for Taxpayer's general merchandise purchases had two steps. Tr. pp. 20-26, 38-43 (Berry).

24. Berry began her determination by obtaining a gross profit percentage from an almanac titled, Annual Statement Studies, which is published annually by the Risk Management Association (hereafter, RMA Studies), regarding data obtained from or regarding liquor stores operating within the United States. Department Ex. 4, pp. 2-9 (copies of pertinent pages from RMA Studies for 2011, 2010, and 2009); Tr. pp. 20-26, 38-43 (Berry). She then used a document

titled, Markup and Margin, which includes a table that identifies different markup percentages to use to obtain a particular gross profit percentage ─ in this case, to obtain the gross profit percentage she obtained from an RMA Study. Department Ex. 4, p. 1 (copy of Markup and Margin table); Tr. pp. 40-41 (Berry).

25. The RMA Study pages that are included within Department Exhibit 4 for 2011, 2010, and 2009, each consist of two, consecutive pages. Department Ex. 4, pp. 2-3 (2011), 5-6 (2010), 8-9 (2009). The first page for each year sorts data by reference to the amount of assets reported by or obtained for each source (that is, for each liquor store included within the year's study). Department Ex. 4, pp. 2, 5, 8. The second page for each year sorts data by reference to the amount of each source's sales. Department Ex. 4, pp. 3, 6, 9.
26. When asked, during cross-examination, to identify where, on the RMA Study pages included within Department Exhibit 4, Berry began to determine the markup for Taxpayer's general merchandise purchases, Berry identified the first column on page 974 of an RMA Study, on the row, Berry said, pertained to gross profit. Tr. p. 39; Department Ex. 4, p. 2. Page 974 is the first page of the RMA Study for 2011. Department Ex. 4, p. 2.
27. When asked whether she chose the gross profit of 23% from page 974 of the RMA Study, because she made a determination that Taxpayer had assets of between $XXXX to $XXXX, Berry responded that she and her supervisor were looking for the lowest gross profit percentage displayed in the different columns on that page. Tr. pp. 39-40 (Berry); *but see* Department Ex. 4, pp. 2-3.
28. Berry obtained the Markup and Margin table from her supervisor. Tr. pp. 40-41 (Berry); Department Ex. 4, p. 1.
29. When obtaining the markup percentage to be used for Taxpayer's general merchandise

purchases, Berry was using invoices and other information, like the EDA-20's, regarding Taxpayer's general merchandise purchases for the period from 2007 through 2009. Department Ex. 3, p. 3; Taxpayer Ex. B; Tr. pp. 36-37 (Berry), 129 (Sue Blue).

30. Berry determined and used a slightly lower markup of 1.28 (or 28%) for Taxpayer's purchases of food and other low tax rate goods. Department Ex. 3, pp. 1-2; Tr. p. 44 (Berry).

31. At hearing, Berry could not recall where she obtained the food markup percentage she used for the audit. Tr. p. 44 (Berry).

32. Berry's Audit Narrative additionally provides, in pertinent part:

> II Background
>
> ***
>
> The 1st markup used was a 1.40. This was originally based on around 8 to 10 items that I had wrote down while visiting the store & went back to the office & came up with a markup. The taxpayers' complained this was too high. The POA wanted a 1.30 or lower. I didn't get enough items at the store. So, I met with my supervisor and we came up with the markup based on the Risk Management Report for liquor stores. A markup of 1.29 was used across the board for all general merchandise (G/M) and the 1.28 markup was used for food.
>
> The taxpayers' have cash payouts that were never accounted for in expenses. The money was taken out of the register to purchases some inventory and the inventory never got listed on the CPA's financial reports prepared for the taxpayers. Mr. Benjamin and I discussed this in detailed.
>
> I explained to Mr. Gene Green that the audit shows more purchases of inventory compared to what was reported on the 1120's for purchases. For the year 2008 there's $XXXX more in purchases and in 2009 $XXXX.
>
> ***
>
> Please note also that the taxpayers' had reported more food receipts than could be accounted for based on reviewing the purchases. There's unreported G/M and overstated food receipts. The total unreported receipts are $XXXX and over stated food receipts were $XXXX.
>
> The total tax due is $XXXX plus interest and penalties.
>
> ***
>
> <u>VI. AUDIT PROCEDURES</u>
>
> <u>Receipts Reconciliation:</u> The taxpayers' files on the receipts basis [i.e., cash basis] for reporting sales (ROT) (B/R) & (FIT).
>
> For the period 7/07 thru 12/07 line 1 was $XXXX for ROT. The B/R's and FIT receipts were $XXXX. The $XXXX (cash payouts) had to be added to

B/R's and FIT columns because it's in ROT. The CPA firm accounting clerk made an error, she never picked up cash payments in the G/L's. Please read the EDC-5 about this. The receipts of $XXXX (for 1/07-6/07) had to back out of B/R & F[IT] columns because it's not in ROT. The unreported net receipt[s] is $XXXX. The additional taxes are $XXXX.

For the year 2008 line 1 was $XXXX for ROT. The B/R's and FIT receipts were $XXXX. The $XXXX (cash payouts) had to be added to B/R's and FIT columns because it's in ROT. The unreported receipts are $XXXX which had to be added back to B/R's and FIT columns. Additional taxes due of $XXXX were added to ROT; B/R's and FIT columns.

For the year 2009 line 1 was $XXXX for ROT and B/R's. The unreported receipts are $XXXX which had to be added to ROT & B/R's columns. The additional taxes due of $XXXX were to ROT & B/R's. The taxpayers never filed the 2009 FIT return.

For the period Jan 2010 thru June 2010 line 1 was $XXXX for ROT and B/R's. The unreported receipts were $XXXX which had to be added to ROT & B/R's columns. The additional taxes due of $XXXX were added to ROT B/R's. The taxpayers never filed the 2010 FIT return.

This area resulted in tax due of $XXXX. The taxpayers are going to the ICB.

***

VIII. AUDIT RESULTS:

Total liability established is as follows:

Tax Type	Tax due	Interest	Penalty	Total
ROT	$XXXX	$XXXX	$XXXX	$260,4XXXX37

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Department Ex. 3, pp. 2-3.

33. Taxpayer reported deductions on its filed returns, and Berry allowed all of them. Department Ex. 3, pp. 3-4.

34. When performing her purchase markup analysis, Berry did not give any allowance for the possibility that some of the goods Taxpayer purchased for resale were not sold, due to breakage or spoilage of such goods. Tr. pp. 45-48 (Berry).

35. In most of the other audits Berry has performed that involved purchase markup analyses, she has allowed that some percentage of the goods purchased for resale may not have been sold due to breakage or spoilage of some goods purchased for resale. Tr. pp. 48-49 (Berry). Berry did not do so, in this case, because she determined that Taxpayer understated its purchases of

goods for resale by over $XXXX, and because Taxpayer produced no regularly kept books and records which documented such claimed losses. *Id*.

36. When performing her purchase markup analysis, Berry did not assume that some of the goods Taxpayer purchased for resale were not sold due to the theft of such goods by shoplifters. Tr. p. 49 (Berry). Berry did not do so, in this case, because Taxpayer produced no regularly kept books and records, such as police reports, which documented the facts regarding such claimed losses. *Id*.
37. When performing her purchase markup analysis, Berry did not assume that Taxpayer's gross profit margin was occasionally reduced because Taxpayer held sales or promotions, at which it reduced the prices at which it sold certain items. Tr. pp. 53-54 (Berry).
38. When performing her purchase markup analysis, Berry did not assume that Taxpayer's gross profit varied depending on the type of alcoholic beverages sold, nor did she attempt to create different purchase markup analyses, using different profit margins, for each type of alcoholic beverages sold, based on the relative quantities of the different alcoholic beverages Taxpayer purchased for resale. Tr. pp. 54-56 (Berry).
39. Other than her initial visit to Taxpayer's store in February 2010, at which she recorded the selling prices of 8 to 10 items offered for sale, Berry did not attempt to make a systematic review of the selling prices of all items offered for sale at Taxpayer's store. Tr. pp. 31-32 (Berry).
40. Berry did not know why the piece of paper on which she said she wrote the selling prices she saw, while visiting Taxpayer's store in February 2010, was not included within the audit file, which was provided to Taxpayer, in discovery. Tr. pp. 32-33 (Berry). At the time of hearing, Berry did not know where that piece of paper was. *Id*.

41. On or about February 25, 2011, after the audit period, and after Berry presented her final audit workpapers to Gene Green, Gene Green gave Berry document(s) purporting to show that Taxpayer's selling prices for items were less than the markup Berry determined as part of the audit. Department Ex. 5, p. 2.

42. Berry did not change her audit determinations, to take into account the information she received from Gene Green in February 2011, because Berry determined that the selling prices for items reflected on the document(s) were less than those Berry observed when she was at Taxpayer's store in February 2010. Department Ex. 5, pp. 1-2.

43. After the audit, the Department issued two NTLs to Taxpayer. Department Ex. 1.

44. The NTLs assessed the following amounts of tax, penalties and interest:

Tax Periods	Tax Unpaid Balance *	Late-payment penalty	Negligence Penalty	Interest	Total
7/07 - 6/09	XXXX	XXXX	XXXX	XXXX	$ XXXX
7/09 - 6/10	XXXX	XXXX	XXXX	XXXX	$ XXXX

Department Ex. 1, pp. 1-2. *Unpaid Balance gives credit for prior payments.

Facts Regarding Taxpayer's Alternative Estimates of Taxable Gross Receipts and Tax Due for the Audit Period

45. After the audit, and in anticipation of hearing, Taxpayer caused to have schedules prepared to provide an alternate estimate of the amount of gross receipts Taxpayer realized from selling at retail, and an alternate statement of tax due for the audit period. Taxpayer Exs. E, G-H, J, L-M; Tr. pp. 89 (John Doe), 140-59 (Sue Blue).

46. Sue Blue (Sue Blue) prepared the schedules, using the same amounts of purchases Berry used on her audit schedules of Taxpayer's purchases for 2007-2009. *Compare* Taxpayer Exs. B-D *with* Taxpayer Exs. E, G-H, J, L-M; Tr. pp. 128-37 (Sue Blue).

47. Sue Blue is an accountant and an attorney who is an associate at Taxpayer's attorney's law

firm. Tr. pp. 126-27 (Sue Blue).

48. Taxpayer's alternate schedules take into account assumptions Berry did not make when conducting her audit. Taxpayer Exs. G-H, J, L; Tr. pp. 143-48 (noting Berry's decision not to use what Taxpayer represented as its actual selling prices for different items during the audit period, and Berry's decisions not to allow any deductions or allowances for waste, theft, and sales at or below Taxpayer's purchase price), 156-66 (Sue Blue).
49. Sue Blue' schedules also take into account the selling prices shown on photographs John Doe took, in March and June 2011, of items like those referred to in purchase records Berry reviewed when performing her markup analysis. Taxpayer Ex. F, pp. 1-22 (copies of purchase invoices), 23-49 (copies of photos); Taxpayer Ex. I, pp. 1-4 (copies of purchase invoices), 5-13 (copies of photos); Taxpayer Ex. M; Tr. pp. 150, 153-55, 164, 182 (Sue Blue).
50. The purchase prices Sue Blue used in her schedules of markups used for different categories of goods purchased for resale were based on vendor invoices issued to Taxpayer after the audit period, and on John Doe's statements to her that Taxpayer's markups of items during the audit period were historically consistent. Taxpayer Exs. F, I; Tr. pp. 149-164 (Sue Blue).
51. Taxpayer's alternate schedules, which show that Taxpayer did not sell 10% of its purchases, due to either theft or waste/spoilage, are premised on John Doe's estimates of Taxpayer's sales over the course of the audit period. Taxpayer Ex. L, p. 1 (nn. 2-4); Tr. pp. 77-81 (John Doe), 150-51, 164, 167-68 (Sue Blue).
52. Taxpayer's alternate schedules, which show that Taxpayer had different profit margins for different types of goods sold, are premised on John Doe's estimate that the selling prices shown on photographs he took in 2011 were consistent with the selling prices Taxpayer

charged for similar goods sold during the audit period. Taxpayer Ex. L, p. 1 (n. 6); Tr. pp. 83-87 (John Doe), 154, 157 (Sue Blue).

53. The assumptions Sue Blue accepted when preparing the alternate schedules are reflected in the text of and notes to Taxpayer Exhibit L, and include, in part:

ABC Business
ROT Audit 7/07 through 12/07
Purchase Markup Analysis

		7/07-12/07	
2007 Unreported Sales	**Liquor (High)**	**Cigar. (High)**	**Food (Low)**
Purchases Per Auditor (EDA-20)	xxxx [1]	xxxx [1]	xxxx [1]
Credit for spoilage/breakage (5% food/liquor, 1% cig)	(xxxx) [2]	(xxxx) [3]	(xxxx) [2]
Credit for Theft (5%)	(xxxx) [4]	0.00	(xxxx) [4]
Adj. Purchases Available for Sale	xxxx	xxxx	xxx
Less: Clearance/Promos (4.5% No Mkp)	(xxxx) [5]	0.00 [5]	(xxxx) [5]
Purchases for Regular Sale (pre-Markup)	xxxx [5]	xxxx [5]	xxxx [5]
Weighted Markup factor	xxxx [6]	xxxx [1]	xxxx [7]
Marked Up Purchases	xxxx	xxxx	xxxx
Add: Clearance/Promos (4.5% No markup)	xxxx	0.00	xxxx
Projected Sales	xxxx	xxxx	xxx
Less Food Stamp Sales	0.00	0.00	(xxxx) [1]
Projected Taxable Sales	xxxx	xxxx	xxxx
Projected Taxable Sales (Consolidated)		**xxxx**	**xxxx**
Reported Taxable sales		xxxx [1]	xxxx [1]
Unreported Sales 7/07-12/07		**xxxx**	**(xxxx)**
Tax Rate – 7/07-12/07		xxx%	xxx%
Tax Due -7/07-12/07		xxxx	(xxxx)
Total Tax Due 7/07-12/07		xxxx	

54.

[1] Per EDA-105-R ROT Audit Report dated February 7, 2011, attached as Exhibit A.

[2] Taxpayer conservatively estimates that its spillage/breakage losses for food and liquor are 5%.

[3] Taxpayer estimates that its spoilage losses for cigarettes is 1%.

[4] Taxpayer conservatively estimates theft losses to be 5%. Taxpayer is located in a high crime area, and has had several break-ins. Therefore, theft losses may be higher than 5%.

[5] Taxpayer estimates that 4.5% of daily liquor and food sales are sold at heavily discounted selling prices (equal to or below cost) due to clearance and promotions. See Exhibit E, summarizing a recent wine sale's discounts, and photos of the sales price of the discounted items. As such, the taxpayer assigned no markup to 4.5% of its Adjusted Purchases Available for Sale.

[6] Per Analysis of High-Tax Cost-to-Sale Price and supporting documentation substantiating the cost and sale price of most popular liquor items, attached as Exhibit B.

[7] Per Analysis of Low-Tax Cost-to-Sales Price and supporting documentation substantiating the cost and sale price of most popular grocery items, attached as Exhibit

C.

Taxpayer Ex. L, p. 1.

<u>Conclusions of Law:</u>

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 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; <u>Copilevitz v. Department of Revenue</u>, 41 Ill. 2d 154, 157, 242 N.E.2d 205, 207 (1968); <u>DuPage Liquor Store, Inc. v. McKibbin</u>, 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.* <u>Branson v. Department of Revenue</u>, 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. <u>A.R. Barnes & Co. v. Department of Revenue</u>, 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. <u>Fillichio v. Department of Revenue</u>, 15 Ill. 2d 327, 333, 155 N.E.2d 3, 7 (1958); <u>A.R. Barnes & Co.</u>, 173 Ill. App. 3d at 833-34, 527 N.E.2d at 1053.

Issue and Arguments

Taxpayer asserts that the purchase markup analysis Berry performed in her audit had significant flaws, and was used simply to inflate Taxpayer's sales. Tr. pp. 203, 206 (closing argument). First, it faults her use of an RMA Study to determine the markup percentage to be used for Taxpayer's liquor sales, instead of using the actual selling prices of items displayed and sold in Taxpayer's store. *Id*., pp. 203-04. Taxpayer argues that Berry should have instead performed a comprehensive listing of the selling prices of items Taxpayer sold, as part of her audit. *Id*., p. 204. It calls Berry's inability to articulate where she obtained the markup percentage she used for food items as proof that such a percentage was arbitrary. *Id*., pp. 204-05. Finally, Taxpayer contends that its alternate schedules provide a better estimate of Taxpayer's gross receipts, because they are based on what it says were the actual selling prices of items in Taxpayer's store, based on John Doe's personal knowledge of such actual selling prices, during the audit period. *Id*., p. 205.

The Department responds that Taxpayer did not rebut the presumptive correctness of the Department's determinations. Tr. p. 206. The Department urges that Taxpayer's alternative schedules are based on the selling price stickers shown on photographs which were taken after the audit period, and on John Doe's mere assertions that the selling prices shown on such photos were consistent with Taxpayer's actual selling prices for similar goods sold during the audit period. It contends that John Doe's photographs are not the type of regularly kept books and records that a taxpayer must present, to rebut the Department's prima facie case. *Id*.

Analysis

Do Taxpayer's Schedules Rebut the Department's Prima Facie Case

After the Department presents a prima facie case, a taxpayer has the burden 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, Taxpayer offered the testimony of John Doe, who took photos of goods after the audit period, and of Sue Blue, who used those photos, and John Doe's estimates, to prepare schedules in an attempt to show, on one hand, why the Department's audit was defective, and on the other hand, the extent to which the Department's audit overstated the amount of any underreporting that might have occurred. I have reviewed the schedules Sue Blue prepared, and while I do not doubt the mathematical accuracy of her computations, I give no weight to her schedules, for the following reasons.

Sue Blue' testimony, and her schedules, reflect that the schedules are based on:

- John Doe's "conservative[ ] estimates that [Taxpayer's] spillage/breakage losses for food and liquor are 5%";
- his "estimates that [Taxpayer's] spoilage losses for cigarettes is 1%";
- and his "estimates that 4.5% of daily liquor and food sales are sold at heavily discounted selling prices (equal to or below cost) due to clearance and promotions."

Taxpayer Ex. L, p. 1 (nn. 2-5); Tr. pp. 146, 150, 167-68 (Sue Blue). Further, the documentation that Taxpayer's alternate schedules claim as "substantiating the cost and sale price of most popular grocery [and liquor] items …" (Taxpayer Ex. L, p. 1 (nn. 6-7)), consist of copies of photos that John Doe took almost a full year after Berry began her audit. Taxpayer Ex. F, pp. 23-49; Taxpayer Ex. I, pp. 5-13; Tr. pp. 89-91, 94 (John Doe), 150, 153, 164 (Sue Blue).

Evidence can be admissible for one purpose, and not for another purpose. <u>People v. Lucas</u>, 132 Ill. 2d 399, 429, 548 N.E.2d 1003, 1015 (1989). Here, the photos that were part of Taxpayer Exhibits F and I were admitted because they formed part of the bases for Taxpayer's alternative schedules. *See* Tr. pp. 101-02. They corroborate or document some of the information Sue Blue took into account when preparing Taxpayer's alternate schedules. Taxpayer Exs. F, I, M; Tr. pp. 150, 153, 164 (Sue Blue). John Doe testified that he took the photos so that Taxpayer's counsel could prepare schedules to offer into evidence as an alternative measure of

Taxpayer's sales and taxable gross receipts for the audit period, and to compare that alternate with the auditor's determinations. Tr. pp. 89-91, 94 (John Doe).

Since the photos were taken in anticipation of litigation, however, they were not admitted, nor were they admissible, as regularly kept business records, which documented Taxpayer's actual selling prices of items sold during the audit period. *See e.g.*, In re N.W., 293 Ill. App. 3d 794, 688 N.E.2d 855 (1997) (a document is prepared in anticipation of litigation if it is prepared with an eye toward pending or anticipated litigation of any kind). Business records are considered reliable because of the regular, prompt, and systematic manner in which they are kept and the fact that they are relied upon in the operation of the business. In re A.B., S.B., A.B., J.B., and T.B. v. C.B., 308 Ill. App. 3d 227, 719 N.E.2d 348, 356 (2d Dist. 1999). A business record is "admissible as evidence of the act, transaction, occurrence, or event [described in the record]." Illinois Supreme Court Rule § 236(a).

Here, an example of a regularly kept business record of Taxpayer's actual receipts from selling goods would have been a cash register receipt ─ made during the audit period ─ showing the price for such goods, or "other data which … provide a daily record of the gross amount of sales." 86 Ill. Admin. Code § 130.805(a). Taxpayer offered no such business records because it had no such records. Department Exs. 2, 5; Tr. pp. 68-69 (John Doe). Instead, it offered the testimony of John Doe and Sue Blue, and Sue Blue' schedules.

Whether proffered evidence has a tendency to prove a fact in controversy or render a matter in issue more or less probable must be tested in light of logic, experience, and accepted assumptions as to human behavior. Dayan v. McDonald's Corp., 125 Ill. App. 3d 972, 982, 466 N.E.2d 958, 966 (1st Dist. 1984) (citing Marut v. Costello, 34 Ill. 2d 125, 127, 214 N.E.2d 768 (1966)). In this case, even though the photos were admitted and admissible for one purpose, to document what Sue Blue took into account when preparing her schedules, I give the photos no weight at all as being documentary evidence of the prices at which Taxpayer sold any of the items displayed in a photo on any given day in the audit period. Of course, Taxpayer wants even more ─ it wants me to treat John Doe's post audit photos as evidence of the actual amounts Taxpayer realized from selling similar goods *throughout* the audit period. In essence, the photos, and Sue Blue' schedules, are based primarily on John Doe's mere testimonial assertion that he had personal knowledge ─ throughout the entire audit period ─ of: the prices at which Taxpayer sold items like those reflected on John Doe's photos; the quantity of goods Taxpayer purchased for resale that were not sold because they were spoiled, broken, or stolen; and the quantity of goods Taxpayer purchased for resale that were sold at cost or less, because of Taxpayer's sales. Taxpayer Ex. M.

I certainly accept the possibility that, during the audit period, Taxpayer did not sell some of the goods it purchased for resale due to waste, spillage or theft. But I do not believe that John Doe had the actual ability to recall each such incident, or the willingness accurately to narrate personal knowledge of them, throughout a three year audit period. As to the latter point, when considering John Doe's willingness accurately to narrate his own personal knowledge of Taxpayer's sales, I am compelled to take into account that John Doe is a 50% owner of Taxpayer. Department Ex. 3; Tr. pp. 60-61 (John Doe). Further, the subject of his testimony was his claimed personal knowledge of Taxpayer's actual sales ─ at a time when Taxpayer failed to keep records that would have documented such amounts. In short, John Doe's self-interest is patent, and his implied claim of near-perfect recollection is incredible.

Further, when considering Taxpayer's argument that Berry unreasonably refused to account for losses of goods Taxpayer purchased for resale, due to waste, spillage or theft, I must also take into account that no documentary evidence was offered to show that any such losses actually occurred in this case. *See* Tr. pp. 26, 45, 47-48 (Berry); *see also id*. pp. 146, 167-68 (basis for Sue Blue' determination that Berry erred by not assuming some percentage of loss due to breakage or spoilage was John Doe's statements to Sue Blue that Taxpayer incurred such losses). Absent documentary evidence, there is simply no way to corroborate John Doe's interested testimony that the claimed losses occurred. Tr. pp. 73-77 (John Doe). Perhaps more importantly, even if the fact-finder was persuaded that it is reasonable to assume that some losses due to waste, spillage or theft *always* occur, in *every* business, there is no credible, documentary evidence, in this record, from which I could estimate the extent of such losses, in this case.

The statutory recordkeeping provisions of the ROTA are mandatory. Copilevitz v. Department of Revenue, 41 Ill. 2d 154, 157-58, 242 N.E.2d 205, 207 (1968); Mel-Park Drugs, Inc. v. Department of Revenue, 218 Ill. App. 3d 203, 214, 577 N.E.2d 1278, 1285 (1st Dist. 1991). John Doe's mere statements — including his own, sworn, testimony — cannot substitute for such records. 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 rebut the Department's prima facie case). Nor can Sue Blue' schedules, which rely on John Doe's mere statements. *Compare* Taxpayer Ex. M *with* Mel-Park Drugs, Inc., 218 Ill. App. 3d at 222, 214, 577 N.E.2d at 1290 ("While Mel-Park may have sketched out an alternative theory for estimating its gross receipts, it has not met its burden to overcome the prima facie case.").

In summary, to overcome Taxpayer's failure to make and keep z-tapes that would have actually documented the prices at which it sold items at retail, Taxpayer wants the fact-finder to accept John Doe's mere word that he has personal knowledge of, and can accurately recall, the prices at which Taxpayer sold scores of different goods at retail, over an almost three year long audit period, as well as the amounts of the different goods it sold. *See* Taxpayer Ex. F, pp. 1-22; Taxpayer Ex. I, pp. 1-4; Taxpayer Ex. M; Tr. pp. 150, 153-55, 164, 182 (Sue Blue). Since I do not believe that John Doe has that ability, I give no weight to the alternative schedules Sue Blue prepared. John Doe's estimates are just a different way of denying the accuracy of the Department's assessment. *See* A.R. Barnes & Co., 173 Ill. App. 3d at 833, 527 N.E.2d at 1053. Even though Taxpayer's attorneys were able to quantify John Doe's estimates, in the form of written schedules, Illinois law is clear such evidence is not sufficient to rebut the Department's prima facie case. Mel-Park Drugs, Inc., 218 Ill. App. 3d at 222, 214, 577 N.E.2d at 1290; Balla, 96 Ill. App. 3d at 296-97, 421 N.E.2d at 239.

Does the Best Information Available to the Department Support the Markup Used During Audit

To recap, the process Berry used to determine the markup used in the audit of Taxpayer had two-steps. First, she obtained a gross profit margin figure from an RMA Study of liquor stores in the United States, and she then referred to a table which identifies a markup percentage to be used to arrive at a particular gross profit margin. Tr. pp. 38-43 (Berry). More specifically, Berry testified that she obtained a gross profit margin of 23% from page 974 of the pages included within Department Exhibit 4. Tr. pp. 38-39. She then used the table on page 1 of Department Exhibit 4, which shows that, to obtain a gross profit margin of 23%, one should use a markup of 29.5%. Department Ex. 4, p. 1; Tr. pp. 38-41 (Berry). That is how Berry determined to use a 29% markup to multiply the cost of Taxpayer's general merchandise purchases.

The Department has the duty, "[a]s soon as practicable after any return is filed, … [to] examine such return and …, if necessary, correct such return according to its best judgment and information." 35 ILCS 120/4. Although Taxpayer has not offered any documentary evidence to rebut the reasonableness of the audit method Berry used, the evidence does support a conclusion that the particular markup percentage determined by Berry should be reduced, to coincide with the evidence admitted at hearing.

When making this recommendation, I begin by noting that, when considering a markup percentage to use against the cost of Taxpayer's purchases, Berry was reviewing invoices and forms EDA-20 reflecting Taxpayer's purchases during the period from 2007 through 2009. Department Ex. 3, p. 3; Taxpayer Ex. B; Tr. pp. 36-37 (Berry), 129 (Sue Blue). At hearing, however, Berry identified the 2011 RMA Study as being the starting point of her determination of the markup to use. Tr. pp. 38-39 (Berry); Department Ex. 4, p. 2; *but see* Department Exs. 3, 5.

In contrast with that hearing testimony, Department Exhibits 3 and 5 reflect, and Sue Blue testified, that Berry used a 2008 RMA Study to start the process of determining the markup percentage to use. Department Exs. 3, 5; Tr. p. 135 (Sue Blue). However, the 2008 RMA Study was not included in Department Exhibit 4. Tr. pp. 38-40 (Berry). As a result, when reviewing Berry's decision to use markup percentages of 29% for Taxpayer's high tax items, and 28% for its low tax items, the best information currently available to the fact-finder, and to the Director, include the documents included in Department Exhibit 4.

Department Exhibit 4 was offered, and admitted, in part, to demonstrate the process Berry used to arrive at the markup she used when correcting Taxpayer's returns. Department Ex. 4; Tr. pp. 20-21, 38-41 (Berry). Department Exhibit 4 includes RMA Studies for 2011, 2010, and 2009. Department Ex. 4, pp. 2-3 (2011), 5-6 (2010), 8-9 (2009). The first page of each year's report sorts data by reference to the amount of assets reported by or obtained for each source.

Department Ex. 4, pp. 2, 5, 8. The second page for each year sorts data by reference to the amount of each source's sales, or revenues. Department Ex. 4, pp. 3, 6, 9.

The gross profit margins included within the different columns of each RMA Study differ by class. For example, the first page of the 2011 RMA Study has entries for gross profit margins for liquor stores with assets of between 0-500,000 dollars, those with assets between 500,000-2 million dollars, between 2-10 million dollars, and between 10-50 million dollars. Department Ex. 4, p. 2. The gross profit margins displayed in the different columns on that page vary from 23.6 to 28.1%. *Id*. The second page of the 2011 RMA Study has entries for liquor stores with sales revenues of between 0-1 million dollars, between 1-3 million dollars, between 3-5 million dollars, between 5-10 million dollars, between 10-25 million dollars, and those with revenues of 25 million dollars and over. *Id*., p. 3. The gross profit amounts on that second page vary from 22.6 to 27.9%. *Id*. The gross profit margins also varied depending on the year of the particular study. Department Ex. 4, pp. 2-3, 5-6, 8-9.

When Berry was asked, during cross-examination, about the process she followed when determining the markup, she said that she obtained a gross profit margin of 23% from page 974 of an RMA Study, and pointed to that page, which was the first page for the RMA Study for 2011. Tr. p. 38 (Berry). She was then asked whether she chose that entry because she determined that Taxpayer had the level of assets from which the percentage appeared on that page. Tr. p. 39. Berry responded that she and her supervisor were not looking at assets, but were instead looking for the least amount of gross profit margin within the columns on the page of the RMA Study. Tr. pp. 39-40 (Berry).

This record includes evidence of Taxpayer's annual revenues (Department Ex. 3, pp. 2-3), but no evidence of its assets. Since the gross profit margins varied depending on whether data was sorted by a liquor store's assets versus its sales revenues, and since the record contains evidence of Taxpayer's revenues, and no evidence of its assets, Berry's markup determination should have begun with the gross profit margins displayed on the second page of the most appropriate RMA Study, and not with one of the margins displayed on the first page.

Next, the most appropriate RMA Study would be the one that includes data that most closely corresponds to the period related to the invoices and EDA-20 forms Berry was reviewing. Since Berry was reviewing invoices and EDA-20's regarding Taxpayer's purchases during 2007 through 2009, the best information available, in this record, to show gross profit margins for liquor stores for 2007 through 2009 is the 2009 RMA Study. Department Ex. 4, p. 9; Tr. pp. 36-37 (Berry), 129 (Sue Blue). The lowest gross profit percentage displayed in the different columns on the second page of the 2009 RMA Study is 21.3. Department Ex. 4, p. 9. Based on the evidence, Berry's markup should be revised to begin with a gross profit margin of 21%, instead of 23%. Department Ex. 4, pp. 1, 9; Tr. pp. 39-40 (Berry).

The table that is on page 1 of Department Exhibit 4 correlates a particular markup percentage with a given gross profit margin percentage. Department Ex. 4, p. 1. It shows that, to get a profit margin of 23%, the mark up should be 29.5%. *Id*. Based on that table, Berry determined that the markup for Taxpayer's high tax items should be 29%. Department Exs. 3, 5; Tr. pp. 38-41 (Berry). The table also shows that, to get a gross profit margin of 21%, the markup should be 26.6%. Department Ex. 4, p. 1. Just as Berry truncated the table's markup, from 29.5% to the 29% she used in the audit, I recommend the Director do the same. That is, I recommend that the NTLs be revised so that they are based on a 26% markup, instead of the 29% Berry used. *Id*.; *see also* Taxpayer Exs. B-D (Berry's markup schedules for general merchandise, and food, for 7/2007 through 2009, and for both high and low rate purchases for 1/2010 through 6/2010).

Finally, because Berry could not recall how she arrived at a markup of 28% for low tax items (Tr. p. 44 (Berry)), the best information currently available to review the correctness of that audit determination is also the 2009 RMA Study. Department Ex. 4, pp. 8-9. As a result, I recommend that the revised markup of 26% be applied to Taxpayer's purchases of both high and low tax items, as reflected on Taxpayer Exhibits B-D, except for cigarettes, which both parties agreed had a markup of 10%. Taxpayer Exs. B-D, L; Tr. p. 70 (Sue Blue).

Should the Penalties Assessed Be Abated for Reasonable Cause

Here, the NTLs assessed two different types of penalties: late payment and negligence. Department Ex. 1. Late payment penalties are authorized by § 3-3 of the Uniform Penalty and Interest Act (UPIA), and the negligence penalty is authorized by § 3-5 of the UPIA. 35 ILCS 735/3-3; 35 ILCS 735/3-5. Negligence includes any failure to make a reasonable attempt to comply with the provisions of any tax Act and includes careless, reckless, or intentional disregard of the law or rules. 35 ILCS 735/3-5(b).

Section 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 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 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. 35 ILCS 735/3-8; Hollinger International, Inc. v. Bower, 363 Ill. App. 3d 313, 328, 841 N.E.2d 447, 460 (1st Dist. 2005). To satisfy that burden, it must offer documentary evidence showing ordinary business care and prudence, and not mere testimony. PPG Industries, Inc. v. Department of Revenue, 328 Ill. App. 3d 16, 33, 765 N.E.2d 34, 48 (1st Dist. 2002).

At hearing, Taxpayer offered no evidence tending to show that it made a good faith effort to timely pay all of the tax required to be shown due on its returns. Nor did it offer any evidence tending to show that its admitted underreporting was not caused by negligence. To the contrary, Taxpayer conceded that it failed to keep required records (Tr. pp. 68-69 (John Doe)), which, on its face, is evidence showing a "careless … disregard of the law or rules." 35 ILCS 735/3-5(b); 35 ILCS 120/7; 86 Ill. Admin. Code § 130.805(a)(1). Further, Taxpayer offered considerable evidence asking the Director to accept its claim that it underreported tax in roughly half the amount the Department assessed. *Compare* Taxpayer Ex. D (Berry's schedule showing total tax due of $142,212 for audit period) *with* Taxpayer Exs. L, M (Sue Blue' schedule showing total tax due of $78,847.22 for audit period).

Since there is no evidence in this record which supports abating the penalties assessed, they should finalized, after taking into account the revised amount of tax due.

Conclusion:

I respectfully recommend that the Director revise the NTLs so that they are based on a markup percentage of 26% instead of 29%, for both high and low tax goods sold, except for cigarettes, which both parties agreed had a markup of 10%. Taxpayer Exs. B-D, L; Tr. p. 70 (Sue Blue). I do not recommend that Taxpayer be given any allowances for losses of goods purchased for resale, because Taxpayer offered no documentary evidence to corroborate its mere argument that such losses occurred. Based on the recommended revisions, the penalties assessed should also be reduced, but only to take into account the reduced amount of tax due. Finally, I recommend that the NTLs be finalized as so revised, with interest to accrue pursuant to statute.

December 4, 2014

John E. White
Administrative Law Judge