

IT 14-02

Tax Type: **Income Tax**

Tax Issue: **Properly Determined AGI For Subchapter S Shareholders and Unreported/Underreported Receipts (Non-Fraudulent)**

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

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

v.

**JOHN DOE,  
Taxpayer**

**No. XXXX  
Track No. XXXX  
Letter ID XXXX  
XXXX  
Tax Years 2006, 2007**

**Ted Sherrod  
Administrative Law Judge**

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**RECOMMENDATION FOR DISPOSITION**

**Appearances:** Special Assistant Attorney General Sean Cullinan on behalf of the Illinois Department of Revenue; JOHN DOE, *pro se*.

**Synopsis:**

This matter is before this administrative tribunal as the result of a timely protest by JOHN DOE (“taxpayer”) of Notices of Deficiency the Illinois Department of Revenue (“Department”) issued to him proposing to assess deficiencies for the calendar years ended 12/31/06 and 12/31/07. A hearing to consider the taxpayer’s protest was held at the Department’s offices in Chicago, Illinois on December 3, 2013. The Department’s assessments arise from its determination of the amount of distributive share income the taxpayer received from ABC Business (“ABC Business”), a subchapter S corporation the taxpayer owned during the tax years in controversy. At the hearing the taxpayer introduced federal income tax returns ABC Business filed for the tax years in

controversy, but offered no other corporate books or records related to this entity. Documentary evidence was also introduced into the record by the Department. I have reviewed the evidence the parties have submitted, and I am including in this recommendation findings of fact and conclusions of law. I recommend that the Notices of Deficiency be finalized as issued, with interest to accrue pursuant to statute.

**Findings of Fact:**

1. On December 1, 2011, the Department issued Notices of Deficiency for Form IL-1040, Individual Income Tax Return to JOHN DOE (“taxpayer”) assessing tax, penalty and interest for the tax years ended 12/31/06 and 12/31/07. Department Exhibit (“Ex.”) 1.
2. The audit narrative and supporting schedules accompanying the Notices of Deficiency introduced into the record indicate that the Department determined the taxpayer's taxable income for the tax years at issue by including the taxpayer's distributive share of subchapter S corporation income from ABC Business, an Illinois subchapter S corporation engaged in the sale of wireless communications products having as a sole shareholder the taxpayer. Department Ex. 3, 4.
3. The taxpayer filed an Illinois income tax return for 2006, but failed to file an Illinois income tax return for 2007. Department Ex. 3. Since the taxpayer did not include in its taxable income any distributive share income from ABC Business on its 2006 return, and did not file a 2007 return, the Department determined distributive share income includable in the taxpayer’s taxable income for both of these years. *Id.*

4. The taxpayer's distributive share of ABC Business's income was determined following the Department's Retailers' Occupation Tax ("ROT") audit of ABC Business's business activities during the tax years at issue. Department Ex. 3. At the conclusion of the Department's ROT audit of ABC Business, the Department determined that ABC Business had not reported on its sales tax returns all of its receipts from selling tangible personal property at retail in Illinois. Department Ex. 5. The taxpayer's distributive share of ABC Business's income for 2006 and 2007 was derived from the sales receipts that the Department determined ABC Business realized during these tax years. Department Ex. 3.
5. The Department calculated the taxpayer's distributive share of ABC Business's income includable in the taxpayer's Illinois income for 2006 and 2007 based in part upon ABC Business's gross receipts determined during the Department's ROT audit of ABC Business and ABC Business's cost of goods sold reported by ABC Business on its 2006 and 2007 federal income tax returns. Department Ex. 3, 5.
6. Evidence offered at hearing specifically described how the Department determined the amount of ABC Business's underreported gross receipts during the Department's ROT audit of this company. Department Ex. 5. There is no evidence in the record that these audit results were protested by the taxpayer or revised based upon any administrative hearing or judicial determination.

### **Conclusions of Law:**

In the instant case, the Department determined that the taxpayer owes additional income tax on his distributive shares of income he received from a subchapter S corporation he owned. A subchapter S corporation is a corporation that has in effect an election under section 1362 of the Internal Revenue Code to be taxed as a “pass through” entity passing through to its shareholders all of its items of income, loss, deduction and credit, which are taken into account by its shareholders in computing their individual income tax liabilities pursuant to Internal Revenue Code section 1366. 35 ILCS 5/1501(a)(28). Illinois recognizes a corporation’s subchapter S election for state income tax purposes and taxes all individual Illinois taxpayers on their distributive shares of subchapter S corporation income. 35 ILCS 5/301; 86 Ill. Admin. Code, ch. I, section 100.9750(c).

When the Department introduced the Notices of Deficiency at issue in this case into evidence under the Certificate of the Director, it presented *prima facie* correct proof that the taxpayer was liable for the tax proposed. 35 ILCS 5/904(a); PPG Industries, Inc. v. Department of Revenue, 328 Ill. App. 3d 16, 33, 34 (1<sup>st</sup> Dist. 2002); Balla v. Department of Revenue, 96 Ill. App. 3<sup>rd</sup> 293, 296-97 (1<sup>st</sup> Dist. 1981). The Department's *prima facie* case is a rebuttable presumption. Fillichio v. Department of Revenue, 15 Ill. 2d 327, 333 (1958). A taxpayer cannot overcome this presumption of correctness merely by denying the accuracy of the Department's assessment. Central Furniture Mart v. Johnson, 157 Ill. App. 3d 907 (1<sup>st</sup> Dist. 1987); Quincy Trading Post v. Department of Revenue, 12 Ill. App. 3d 725 (4<sup>th</sup> Dist. 1973). 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 proposed assessment is not correct. PPG Industries, *supra* at 33-34 (a taxpayer has the burden of overcoming the Department's *prima facie* case using documentary evidence, meaning books and records, and not mere testimony).

In the instant case, the Department determined the taxpayer's distributive share of income from ABC Business due for the tax years ended 12/31/06 and 12/31/07 based upon the results of its ROT audit of ABC Business that covered those years. Department Ex. 3. Specifically, during its ROT audit of ABC Business covering the tax years at issue in the instant case, it increased the amount of ABC Business's gross receipts above amounts reported by ABC Business on its ROT returns upon finding that ABC Business had made numerous unreported sales of tangible personal property at retail. Department Ex. 5. The Department revised ABC Business's gross receipts for income tax purposes to conform to the amounts of gross receipts the Department found to be properly reportable on ABC Business's ROT returns. Department Ex. 3, 5. Moreover, because ABC Business was a subchapter S corporation that was wholly owned by the taxpayer, the Department determined that ABC Business's gross receipts should flow through to the taxpayer for purposes of determining the taxpayer's distributive share of ABC Business's income. Department Ex. 3, 4.

During the evidentiary hearing in this case, the taxpayer argued that his distributive share of ABC Business's income for the tax years at issue must conform to the gross receipts and expenses reported on ABC Business's federal income tax returns for 2006 and 2007. Tr. pp. 12-17. The gross receipts ABC Business reported on these

returns were lower than the gross receipts the Department determined during its ROT audit of ABC Business. Department Ex. 3, 5.

The taxpayer argues that his distributive share of ABC Business's income should be based upon amounts shown on ABC Business's Federal forms 1120S for 2006 and 2007, and that the amounts shown as gross receipts and expenses on ABC Business's returns for these years are correct. *Id.* The gross receipts determined by the Department during its ROT audit of ABC Business exceeded the gross receipts ABC Business reported on its Federal income tax returns. *Id.* The taxpayer disputes the increase in ABC Business's gross receipts determined during the Department's ROT audit of ABC Business above amounts ABC Business reported on its Federal income tax returns.

As previously noted, the taxpayer's distributive share of ABC Business's income for each of the tax years at issue is based on the Department's ROT audit of ABC Business during which the Department determined that ABC Business underreported gross receipts from sales of tangible personal property. Department Ex. 3, 5. During the hearing, the taxpayer admitted that ABC Business failed to contest the Department's finding that ABC Business's gross receipts were underreported by protesting that determination and seeking an administrative hearing. Tr. pp. 18, 19.

It is well settled in Illinois that a taxpayer cannot rely upon a claim that the underlying corporate liability is incorrect as a basis for rebutting a determination of individual liability that is based upon the underlying corporate liability. Department of Revenue v. Dombrowski, 202 Ill. App. 3d 1050 (1<sup>st</sup> Dist. 1990). Dombrowski stands for the proposition that, where the Department properly issues a final assessment to the corporation incurring the underlying corporate liability, any issues as to the correctness of

that final tax deficiency can be challenged only pursuant to the Illinois Administrative Review Act (“ARA”). Dombrowski, *supra* at 1054 (“Having failed to file such an action, he has instead improperly sought judicial review of the Department’s action as part of his defense to the instant lawsuit; but because of the defendant’s failure to comply with the ARA, we are not empowered to review the merits of the Final Assessment or the Revised Final Assessment.”).

As a consequence of ABC Business’s failure to contest the Department's audit determination of its gross receipts during the Department’s ROT audit of ABC Business, the taxpayer is barred from contesting this audit determination. Because the Department’s determination of the amount of ABC Business’s gross receipts has become final and is legally binding, the taxpayer cannot challenge the correctness of the amount of ABC Business’s gross receipts that have been passed through to the taxpayer for purpose of computing the taxpayer’s distributive share income.

Implicit in the taxpayer’s contention that ABC Business’s federal income tax returns for 2006 and 2007 were correct is the taxpayer’s claim that the Department did not properly calculate the amount of ABC Business’s cost of goods sold and other expenses when determining the amount of the taxpayer’s distributive share of ABC Business’s income during the tax years at issue. However, during the hearing, the taxpayer offered no evidence to show in what manner the Department erred in determining ABC Business’s cost of goods sold and other expenses.

Moreover, the record indicates that, in determining ABC Business’s costs of goods sold that flowed through to the taxpayer for purposes of computing the taxpayer’s distributive share, the Department used the cost of goods sold amounts reported on ABC

Business's 2006 and 2007 federal income tax returns. Department Ex. 5. This is evidenced by the auditor's use of "ABC Business's base income per audit" to determine the taxpayer's distributive share of ABC Business's income in 2006 and 2007. Department Ex. 3. ABC Business's base income encompasses its taxable income properly reportable for Federal income tax purposes. 35 ILCS 5/203(b); 35 ILCS 5/203(e).

ABC Business's Federal income tax returns indicate that the cost of goods sold constituted an expense deducted in determining ABC Business's Federal taxable income for 2006 and 2007. Taxpayer's Ex. 1, 2. The auditor's narrative concerning the Department's ROT audit of ABC Business expressly states that the auditor used the cost of goods sold from ABC Business's Federal income tax returns in arriving at ABC Business's ROT liability. Department Ex. 5, p. 4 ("The Cost of Goods sold listed on the Federal Income Tax Returns were used to help determine sales."). Consequently, ABC Business's cost of goods sold reported on its Federal income tax returns for 2006 and 2007 were includable in "ABC Business's base income per audit" used by the Department's auditor in computing the taxpayer's distributive share of ABC Business's income. Department Ex. 3. Since the taxpayer contends that the cost of goods sold shown on ABC Business's 2006 and 2007 federal returns were correct and these same costs of goods sold were used by the Department in arriving at the taxpayer's distributive share of ABC Business's income, there is no basis for the taxpayer's claim that the Department improperly computed ABC Business's costs of goods sold in arriving at its audit determination.

With respect to the amount of expenses other than costs of goods sold that were included in ABC Business's Federal income tax returns for 2006 and 2007 and passed through to the taxpayer, since the Department's determination of such expenses is deemed to be *prima facie* correct, it was incumbent upon the taxpayer to produce documents showing the basis for the deductible expenses it contends should have been used. PPG Industries, *supra*. However, during the hearing, the taxpayer offered no evidence to show in what manner the Department erred in determining ABC Business's expenses for the tax years at issue. Again it must be emphasized that, in a tax case, a taxpayer's mere assertion that Department erred in computing the taxpayer's tax liability is not sufficient to rebut the statutory presumption of correctness that attaches to the Department's *prima facie* correct audit determination. Central Furniture Mart, *supra*; Quincy Trading Post, *supra*. To rebut the Department's determination, the taxpayer must produce accounting books and records of its business activities that demonstrate the amount of tax the taxpayer claims to be properly due. PPG Industries, *supra* at 35. In the instant case, the taxpayer has not satisfied his burden to rebut the Department's presumptively correct determination by introducing documentary evidence of this nature.

**Conclusion:**

It is recommended that the Director finalize the Notices of Deficiency at issue, with interest to accrue pursuant to statute.

**Ted Sherrod**  
**Administrative Law Judge**

**Date: March 11, 2014**