

IT 01-3

Tax Type: Income Tax

Issue: Nexus (Taxable Connection With Or Event Within The States)
Reasonable Cause on Application of Penalties

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

THE DEPARTMENT OF REVENUE
OF THE STATE OF ILLINOIS

v.

ABC MANUFACTURING CO.,

Taxpayer

No. 00-IT-0000
FEIN: 00-0000000
TYE: 11/30/91, 11/30/92
11/30/93

RECOMMENDATION FOR DISPOSITION

Appearances: Ralph Bassett, Special Assistant Attorney General for the Illinois Department of Revenue; John M. Hughes & Matthew S. Klepper of Lord, Bissell & Brook for ABC Manufacturing Co.

Synopsis:

This matter comes on for hearing pursuant to the taxpayer's timely protest of the Notices of Deficiency issued for the tax years ending 11/30/91, 11/30/92 and 11/30/93. The issues in this matter are as follows: (1) whether the Department was correct in determining that ABC Manufacturing Co. (hereinafter referred to as "ABC") had nexus with Illinois within the meaning of P.L. 86-272 and (2) whether the 35 ILCS 5/1005 penalty should be abated due to reasonable cause. After consideration of the evidence

presented at hearing and the parties' post-hearing memoranda of law, it is my recommendation that the Notice of Deficiency be finalized as revised by the abatement of penalties.

FINDINGS OF FACT:

1. The Department's *prima facie* case was established by the admission of the Notice of Deficiency issued to ABC Manufacturing Company for the tax years ending 11/30/91, 11/30/92 and 11/30/93. 35 ILCS 5/904(a); Stip. Ex. 1.
2. ABC Manufacturing is a publicly held company incorporated in the United States that manufactures office supplies. Stip. ¶ 1; Tr. p. 126.
3. ABC filed Illinois Corporation Income and Replacement Tax Returns (IL-1120) for the fiscal years December 3, 1990 to December 1, 1991; December 2, 1991 to November 29, 1992 and November 30, 1992 to November 28, 1993 on a combined unitary basis including ABC Supply Company as a member of ABC's unitary business group. Stip. Exs. 8a, 8b and 8c. Other members included ABC Data Products, XXX Products, ABC Management Co., and XYZ Custom Furniture. Tr. p. 40.
4. ABC Management Inc. was incorporated as a wholly owned subsidiary of ABC and began operations on or about January 23, 1989. Stip. ¶ 2; Stip. Ex. 10.
5. ABC Supply was a 100% subsidiary of ABC Manufacturing or one of its subsidiaries. Tr. p. 52; Stip. Ex. 8a.
6. Prior to fiscal year ending 11/30/90 ABC reported its gross sales in the sales numerator of its Illinois unitary return. For fiscal years ending 11/30/89 and

thereafter through the end of the audit period, ABC continued to file a combined Illinois unitary returns, but excluded its own sales from the Illinois sales factor and included the sales commissions credited to ABC by ABC, XYZ, XXX and Data. Dept. Ex. No. 13; Tr. pp. 126, 208.

7. The Department auditor adjusted the taxpayer's sales factor to include the Illinois destination sales of ABC Manufacturing. Tr. p. 44; Stip. Ex. 1.
8. On December 4, 1989, ABC and ABC entered into separate contracts with ABC Management wherein ABC Management was paid a fee by ABC and ABC SUPPLY to perform certain managerial functions for ABC and ABC SUPPLY. The contract that Management signed with ABC SUPPLY provided that Management would (1) supervise ABC SUPPLY's day to day operations, including selling, marketing, management, and administrative functions; 2) advise and consult with ABC SUPPLY regarding policy decisions; 3) recruit, employ, train, promote, direct and terminate ABC SUPPLY's employees; 4) handle all relations with outside contractors such as consultants, borrowers, lenders, accountants, artist, etc.; 5) act as attorney-in fact and agent for ABC SUPPLY regarding investments, funds, debts, claims and other obligations; 6) obtain and maintain insurance coverage; 7) maintain books and records; 8) coordinate legal matters; 9) prepare tax returns and financial reports; and 10) arrange for other services as Management "may deem reasonable, necessary or desirable" under the agreement. Stip. Ex. 4a and 4b; Stip. ¶ 14.
9. ABC Management entered into contractual agreements with the following corporations to provide management services:

ABC Manufacturing

ABC SUPPLY Supply Company (hereinafter referred to as “ABC SUPPLY”)

XYZ Custom Furniture, Inc. (hereinafter referred to as “XYZ”)

XXX Products Inc. (hereinafter referred to as “XXX”)

ABC Data Products Co. (hereinafter referred to as “Data”)

Stip. ¶¶ 3, 4.

10. The services provided by ABC Management to ABC SUPPLY are similar to the services that it provided to XYZ, XXX and Data. Stip. ¶ 4.
11. During the audit period, ABC and its subsidiaries had interlocking directors and officers. Some of the interlocking officers included the following individuals: JOHN DOE was the chairman of the board of ABC and all of its subsidiaries; RON DOE was the President of ABC and all of the subsidiaries except for XXX; JIM DOE was the vice-president of ABC and all of its subsidiaries. Stip. Ex. 12.
12. ABC Manufacturing employed the following people on its sales force in Illinois at the time ABC SUPPLY was created and their employment was transferred to ABC SUPPLY at that time. Stip. ¶ 5.
13. The individuals listed in Stip. ¶ 5 received certain fringe benefits through their employment with ABC Manufacturing. The same benefits continued with their employment by ABC SUPPLY. Stip. ¶ 6. For the purposes of calculating an employee’s entitlement to fringe benefits based upon seniority, the employees

listed in Stip. ¶ 5 had the same seniority on their first day of employment with ABC SUPPLY that they had with ABC Manufacturing on their last day of employment. Stip. ¶ 7.

14. ABC SUPPLY was incorporated as an Illinois corporation on April 20, 1989. Stip. Ex. No. 2 p. 15. On December 4, 1989 ABC SUPPLY entered into separate, exclusive sales representation contracts between ABC SUPPLY and ABC, XYZ and Data. Stip. Ex. Nos. 5a, 5b and 5d. On May 4, 1990, ABC SUPPLY entered into an exclusive sales representation contract with XXX. Stip. Ex. No. 5c. All of these written agreements provided that ABC SUPPLY would be the Illinois sales representative for ABC, XYZ, XXX and Data. Stip. ¶ 8.
15. These sales representation contracts were drafted by MIKE DOE, an officer of ABC SUPPLY. Stip. ¶ 9. The sales representation agreement signed between ABC and ABC SUPPLY on December 4, 1989 was signed by BOB DOE a corporate officer, for both ABC and ABC SUPPLY. Stip. Ex. 5a; Tr. p. 76.
16. ABC SUPPLY has only one checking account at the National Bank in Anywhere, USA account number XXXXXX. The bank statements were sent to ABC Management in Anywhere. Stip. ¶ 10. The only signatories on this account were ABC SUPPLY officers. Stip. ¶ 11.
17. If a ABC SUPPLY employee in Illinois needed a check, he submitted a check request form for approval to ABC Management in Anywhere. Stip. ¶ 12.
18. The commission that ABC SUPPLY earns for its services to ABC Manufacturing was calculated once a year by ABC Management personnel and an appropriate credit was entered on ABC SUPPLY's account with ABC. Stip. ¶ 13.

19. ABC SUPPLY Supply Company did not have a listing in the phone directory under its own name. Tr. pp. 87, 88. The phone number that was stated on the sales representatives' business cards was listed in the phone directory under the business name "ABC Manufacturing." Tr. p. 88; Ex. No. 11.
20. In June of 1993 and September of 1994, upon calling the phone number of ABC SUPPLY Supply's office, the company's receptionist answered "ABC Manufacturing Company, may I help you." Tr. pp. 89, 90; Stip. Ex. Nos. 2; 13; Tr. p. 230 (MR. SMITH).
21. The name of ABC as well as ABC's logo appears alongside ABC SUPPLY Supply Company's name on the sales representatives' business cards. Tr. p. 147; Stip. Ex. 11.
22. MR. SMITH (hereinafter referred to as "MR. SMITH") was hired by ABC SUPPLY as a sales representative to sell products in Chicago and parts of Wisconsin. Tr. p. 228. He worked out of ABC SUPPLY's office in Anywhere, Illinois which he visited approximately once a month. Tr. p. 228.
23. During the audit period of April of 1993 through November of 1993, MR. SMITH made sales calls to clients including: Boise Cascade Office Products, B.T. Office Products, W.J. Saunders, H.H. Weston, Milwaukee, and S.P. Richards. Tr. pp. 230, 231. MR. SMITH sold products for ABC Data Products Co. Tr. p. 232. MR. SMITH did not sell products for XYZ Custom Furniture, Inc. or XXX Products, Inc. Tr. pp. 231, 232.

24. MR. SMITH was paid every two weeks by a direct deposit to his bank account. Tr. p. 233. MR. SMITH also received a copy of his pay stub which indicated that the employer was ABC Manufacturing. Tr. pp. 233, 234.
25. At the end of 1993, MR. SMITH received a W-2 Statement. The name of the company listed as his employer on the W-2 statement was ABC SUPPLY Supply. Tr. p. 234.
26. MR. SMITH did not have the ability to execute contracts on behalf of his clients. Tr. p. 242.
27. If a customer wanted to order a line of goods or product, MR. SMITH would generate a purchase order manually on a purchase order sheet or the customer would generate a purchase order. MR. SMITH would fax, phone or mail the purchase order to ABC's offices in Anywhere. Customer service in Anywhere would then take and forward it to the credit department in ABC's Anywhere office. Approval of the customer's credit was sent back to MR. SMITH. The goods were shipped from ABC Manufacturing in Anywhere within seven to ten working days. Tr. pp. 243, 244.
28. The sales invoice was sent to the customer by ABC's customer service in Anywhere. Tr. p. 243.
29. MR. JONES (hereinafter referred to as "MR. JONES") was a sales representative at ABC SUPPLY Supply from 1991 to 1993. Tr. p. 250. MR. JONES traveled and made sales calls to potential customers. Tr. p. 250.

30. MR. JONES visited the office approximately once a month to pick up samples. Tr. p. 251. When MR. JONES called the office, he remembered that the phone was answered “ABC Manufacturing” by the receptionist. Tr. p. 251.
31. When MR. JONES called on a potential customer he told the customer that he was from ABC or one of its subsidiaries depending on which product the customer was interested in purchasing. For example, if he was calling on a picture frame distributor, MR. JONES would state that he was from XXX Products because XXX manufactures steel dry mount tissues, films and laminates. Tr. p. 257. If the customer was interested in purchasing hardware, MR. JONES would state that he was from Exacto because it handled cutting knives and tools. Tr. p. 257.
32. MR. JONES was paid a commission and a base salary. Tr. p. 258. MR. JONES received monthly reports detailing what his sales were for the various companies. Tr. p. 258.
33. MR. JONES received his base salary twice a month. Tr. p. 258. MR. JONES was issued his commission check around the 15th of the following month. Tr. pp. 258, 259. All of the commissions paid by ABC and its subsidiaries were paid to him in one check. Tr. p. 259.
34. During the period of 1991 through 1992, MR. JONES worked for TOM DOE. Tr. p. 259. TOM DOE helped MR. JONES develop sales projections and sales promotions. Tr. p. 259.
35. When making a sale, MR. JONES would work with the customer to develop a purchase order and the customer would issue him a purchase order number. MR.

- JONES would fax or telephone the purchase order to XXX Products in Connecticut. Tr. p. 260.
36. MR. JONES did not have the authority to execute contracts with customers. Tr. p. 261.
 37. When MR. JONES sent a purchase order to ABC, ABC's credit department in Anywhere would review the order and check the customer's credit. If the customer had good credit, ABC would process the order and ship it. Tr. p. 261.
 38. ABC or XXX would issue a sales invoice when the product was shipped. Tr. p. 262. The customer's payment was made directly to ABC or XXX. Tr. p. 262.
 39. ABC and XXX handled the shipping arrangements. Tr. p. 263.
 40. During the audit period 1991 through 1993, TOM DOE was the regional sales manager at ABC SUPPLY. Tr. p. 269. TOM DOE was responsible for sales activities in the midwest region, including Illinois. Tr. pp. 269, 270. TOM DOE's office was located in Anywhere, Illinois. Tr. p. 270. TOM DOE's duties included hiring new people as sales representatives. Tr. p. 270. TOM DOE's direct supervisor was Tim Doe who worked in Anywhere. Tr. p. 271. Tim Doe supervised all of TOM DOE's activities. Tr. p. 273.
 41. TOM DOE communicated with Sierbert periodically, most often by phone. Tr. pp. 273, 274. TOM DOE would also communicate with Tim Doe by e-mail and written correspondence. Tr. p. 274. TOM DOE communicated with Tim Doe on average, once or twice a week. Tr. p. 274.
 42. TOM DOE did not have check writing authority for ABC SUPPLY Supply. Tr. p. 282.

43. TOM DOE did not have direct account responsibility, however, he regularly accompanied his sales staff to meet with the customers during the audit period. Tr. pp. 287, 288.
44. TOM DOE and his sales representative would determine which products a customer was interested in purchasing and would then associate themselves with the product line and its manufacturer. Tr. p. 290. During the period of 1991 through 1993, TOM DOE did not generally inform customers that he was employed by ABC SUPPLY Supply. Tr. p. 292.
45. At no time did ABC SUPPLY seek to represent any company other than ABC or its subsidiaries. Tr. p. 299. (TOM DOE)
46. TOM DOE had to seek approval on personnel issues from his supervisor, Tim Doe. Tr. p. 300. He needed approval to change a sales representative's territory. Tr. p. 301. TOM DOE also sought his supervisor's approval on whether ABC SUPPLY ought to participate in a particular trade show. Tr. p. 301.
47. Tim Doe participated in the final interview when hiring new personnel. Tr. p. 302.
48. During 1991 through 1993, TOM DOE was unaware of an entity called ABC Management. Tr. p. 306.
49. ABC SUPPLY Supply Company was stated as the employer on TOM DOE's W-2 statement. Tr. p. 306.
50. Jane Doe was ABC SUPPLY's secretary. Tr. pp. 279, 280. Jane Doe's responsibilities included handling ABC SUPPLY Supply's bills. Tr. p. 281. Generally, Jane Doe forwarded the bills to Anywhere. Tr. p. 281. Jane Doe would also submit check requests to ABC. Tr. p. 282.

CONCLUSIONS OF LAW:

The issues in this case, as established in the pre-trial order are as follows: 1) whether the Department was correct in determining that ABC Manufacturing had nexus with Illinois within the meaning of P.L. 86-272 and 2) whether the Section 1005 penalty should be abated due to reasonable cause. On examination of the record in this case, the taxpayer has not presented competent evidence to prove that it is exempt from Illinois tax under P.L. 86-272 codified as 15 USCA § 381. However, it did present sufficient evidence for a determination that the penalties proposed should be abated for reasonable cause. Accordingly, under the reasoning given below, the Notice of Deficiency should be finalized as revised by the abatement of penalties. In support thereof, I make the following conclusions.

During the audit period, ABC Manufacturing Co. and its subsidiaries filed three Illinois tax returns on a combined unitary basis. ABC and its subsidiaries engaged in the manufacture, marketing and distribution of office supplies, office furniture and equipment. ABC, XYZ, XXX and ABC Data were the manufacturing subsidiaries. ABC SUPPLY Supply Company was formed in 1989 to solicit sales for ABC and ABC's manufacturing subsidiaries within its unitary group. Taxpayer did not report Illinois sales for ABC Manufacturing on its combined unitary IL-1120s during the audit period since it claimed that ABC Manufacturing did not have nexus with Illinois. Upon audit, the auditor adjusted the sales factor to include Illinois destination sales of ABC Manufacturing based upon the Department's determination that ABC did indeed have nexus with Illinois.

After the Department presented its case, including the admission of the NOD into evidence, taxpayer moved for a directed verdict based upon the doctrine of collateral estoppel.¹ ABC argues that the Department is collaterally estopped from arguing ABC SUPPLY is not an independent contractor during the 1991 through 1993 tax years because the same issue was raised in the hearing for the prior audit cycle. Further, it contends that the facts developed in this matter could have been raised by the Department in the previous hearing whereupon the matter was resolved in favor of ABC. ABC argues that collateral estoppel applies because 1) the issue(s) are identical, 2) the prior action resulted in a final judgment on the merits, and 3) the party against whom an estoppel is asserted is a party or is in privity with a party to the prior adjudication. ABC Brief p. 4.

This prior hearing covered the tax years ending 11/30/89 and 11/30/90. Stip. Ex. 13. The NOD issued in that case was based upon a similar audit adjustment, i.e., the sales factor was adjusted to include ABC's Illinois sales in the sales factor numerator. ABC also protested this prior NOD based upon the grounds that it was protected under P.L. 86-272 because ABC SUPPLY Supply qualified as an independent contractor.

In Commissioner of Internal Revenue v. Sunnen, 333 U.S. 591, 598, 68 S.Ct. 715 (1948), the Court stated that:

Income taxes are levied on an annual basis. Each year is the origin of a new liability and of a separate cause of action. Thus if a claim of liability or non-liability relating to a particular tax year is litigated, a judgment on the merits is res judicata as to any subsequent proceeding involving the same claim and the same tax year. But if the later proceeding is concerned with a similar or unlike claim relating to a different tax year, the prior judgment acts as a collateral estoppel only as to those matters in the

¹ A motion for directed verdict asks the judge in a jury case to rule on whether the plaintiff has presented a *prima facie* case, i.e., whether it has presented evidence to establish every element needed for its cause of action. The evidence must be viewed most favorably to the nonmoving party. 735 ILCS 5/2-1202.

second proceeding which were actually presented and determined in the first suit.

The Department did develop new facts at this hearing that were not established at the hearing concerning the prior audit cycle. First, it pointed out that ABC SUPPLY was only credited with its commissions once a year, while other sales representatives ABC dealt with were paid monthly. Stip. Ex. 16. It was established that during the current period ABC SUPPLY listed its phone number in the phone directory under the name, ABC Manufacturing. It was also established that during the years under audit, ABC SUPPLY's personnel answered its phone "ABC Manufacturing, may I help you." The Department clearly showed at this hearing that ABC SUPPLY's compensation was only credited to ABC SUPPLY on ABC's accounting books, as it was never deposited into ABC SUPPLY's checking account in Anywhere. Stip. ¶¶ 10, 13. Further, employees transferred from ABC to ABC SUPPLY received the same fringe benefits under ABC SUPPLY as they received under ABC with no loss of seniority that they had acquired at ABC. Stip. ¶¶ 6, 7.

Further, pursuant to 35 ILCS 5/904(a), the Notice of Deficiency ("NOD") submitted as Dept. Stip. Ex. 2 is *prima facie* correct and constitutes *prima facie* evidence of the correctness of the amount of tax due as shown thereon. Thus, the Department established its *prima facie* case upon the admission of the NOD, whereupon the burden shifted to the taxpayer to show that such determination is incorrect. Balla v. Department of Revenue, 96 Ill. App. 3d 293 (1st Dist. 1981). Since the Department without a doubt, established its *prima facie* case pursuant to IITA Section 904(a), the taxpayer's motion for directed verdict must be denied.

Taxpayer contends that P.L. 86-272 affords the taxpayer protection from liability since ABC SUPPLY qualified as an independent contractor under this federal statute. If ABC SUPPLY does not qualify as an independent contractor under P.L. 86-272 its Illinois activities would result in attributional nexus for ABC Manufacturing.

P.L. 86-272 codified as 15 U.S. C. § 381 provides in relevant part that:

a person shall not be considered to have engaged in business activities within a State during any taxable year merely by reason of sales in such State, or the solicitation or orders for sales in such State, of tangible personal property on behalf of such person by one or more independent contractors, or by reason of the maintenance of an office in such State by one or more independent contractors whose activities on behalf of such person in such State consist solely of making sales or soliciting orders for sales, of tangible personal property.

14 U.S.C. § 381(c).

The phrase “independent contractor” is later defined in the statute to mean:

a commission agent, broker, or other independent contractor who is engaged in selling, or soliciting orders for the sale of tangible personal property for more than one principal and who holds himself out as such in the regular course of his business activities.

Id. § 381 (d)(1).

Courts have looked to common law to aid its interpretation of P.L. 86-272. Herff Jones v. State Tax Commission, 430 P.2d 998(Or. Sup. Ct. 1967); Tonka Corporation v. Commissioner of Taxation, 169 N.W. 2d 589 (Min. Sup. Ct. 1969). In Herff Jones, the Oregon Supreme Court found that the term “commission agent” was not an alternative to the term “independent contractor” under P.L. 86-272 since such an interpretation broadened the scope of the exemption granted by P.L. 86-272 beyond legislative intent.

It reasoned that companies should not be afforded protection under P.L. 86-272 simply because they pay their salesmen on a commission basis. Id. at 1000.

In Illinois, the courts have looked at the extent to which the principal has the right to control the activities of the agent or independent contractor as a means to distinguish the two. The courts have held that the agency determination turns upon whether the principal has the right to control the manner and method in which work was performed by the agent and the agent has the right to engage in legal transactions on behalf of the principal. Letsos v. Century 21 – New West Realty, 285 Ill. App. 3d 1056 (1st Dist. 1996); Israel v. National Canada Corp., 276 Ill. App. 3d 454 (1st Dist. 1995); Knapp v. ABC SUPPLY, 276 Ill. App. 3d 276 (1st Dist. 1995). This “right to control” test has been followed in subsequent Illinois cases and is followed in federal cases.

In Illinois, a subsidiary is not deemed an agent of its parent corporation, merely due to stock ownership or through common officers and directors. To find that a subsidiary corporation is an agent of its parent corporation, the facts must show that a subsidiary’s activities are controlled by the parent. Main Bank of Chicago v. Baker, 86 Ill. 2d 188 (1981). Further, a number of states have determined with respect to the collection of use taxes that mere common ownership, officers and directors in not conclusive on the determination of whether a subsidiary is an agent for its parent corporation. Bloomington’s By Mail, Ltd. V. Commonwealth Department of Revenue, 567 A.2d 773 (Pa. Commonwealth Ct. 1989); SFA Folio Collections, Inc. v. Bannon, 585 A.2d 666 (Conn. 1991).

Under federal law, whether an individual is an “independent contractor” or whether an employer/employee relationship exists depends upon the existence of a

number of factors all of which ultimately go to the issue of control. These factors have been articulated by courts and the Internal Revenue Service. Ware. v. United States, 850 F. Supp. 602 (W.D. Mich., 1994), aff'd, 67 F.3d 574 (6th Cir. 1995); Rev. Rul. 87-41, 1987-23.

Factors that are relevant to the employee/independent contractor issue can be found in Revenue Ruling 87-41 which discusses these factors with respect to employment tax. Rev. Ruling 87-41 indicates that the relevant factors in the employee/independent contractor determination relate to the degree of control exerted over the activities. Some of the factors found in Rev. Ruling 87-41 are irrelevant in this matter since they relate solely to the determination of whether a particular individual qualifies as an independent contractor. The factors which are relevant to the determination of whether a corporation is an independent contractor are discussed below:

1. Instructions. First, it must be determined to what extent did the principal instruct its representative with respect to its operations. ABC's officers ratified and approved decisions for ABC SUPPLY while simultaneously acting as officers for ABC. For example, Bob Doe signed the sales agreement for ABC and ABC SUPPLY. Stip. Ex. 5a; Tr. p. 76. The Internal Revenue Service has ruled that generally an officer of a corporation cannot be an independent contractor engaged by that same corporation. Rev. Rul. 71-86, 1971-1 C.B. 285.
2. Training. ABC SUPPLY employees were trained by ABC Manufacturing prior to ABC SUPPLY's formation in April of 1989 and the transfer of

employees over to ABC SUPPLY. ABC SUPPLY's employees continued to be trained by ABC Management. Stip. Ex. 4b, Para. 2.1(c).

3. Integration. It must also be determined whether the representative's activities are integrated with the business. ABC SUPPLY made sales for ABC and ABC's subsidiaries. ABC and ABC SUPPLY filed on a unitary basis during the audit period because their business operations were functionally integrated.
4. Hiring, Supervising and Payment of Assistants. ABC's officers were also officers of Management, a wholly owned subsidiary of ABC. These officers participated in the hiring, supervising and payments of ABC SUPPLY's assistants. Stip. Ex. 4b, ¶¶ 2.1(a) and (c).
5. Continuing Relationship. If the worker and the person for whom the services are performed have a continuing relationship it is evidence that an employer-employee relationship exists. Rev. Rul. 78-41, 1987-1 C.B. 296. The longer the duration of the relationship between the principal and the worker and the more consistent the workload the more likely an employer-employee relationship exists. In the instant case, the relationship between ABC SUPPLY and ABC existed since ABC SUPPLY's formation in 1989 and continued throughout the current audit period. ABC SUPPLY has never provided any services for another company besides ABC or members of ABC's unitary business group.
6. Full Time Work Required. "If the worker must devote substantially full time to the business of the person . . . for whom the services are performed, such

person [has] control over the amount of time the worker spends working and impliedly restrict[s] the worker from doing other gainful work.” Rev. Rul. 87-41. In this case, ABC SUPPLY worked full-time for ABC and the other members of ABC’s unitary business group. Stip. ¶ 8. Tom Doe, an officer of ABC SUPPLY, testified that he did not need additional customers for ABC SUPPLY nor did his supervisor ever instruct him to look for such customers. Tr. pp. 298-300.

7. Worked Performed on Business Premises. If work is performed on the employer’s premises, the worker is more likely an employee than an independent contractor. ABC SUPPLY’s operations were conducted at what were formerly ABC’s Illinois sales offices before ABC SUPPLY’s formation.
8. Reports Required. Tom Doe admitted that he communicated with his supervisor, Mr. Tim Doe in Anywhere, about once or twice a week either by phone or in writing. Tr. pp. 273, 274. Tom Doe also needed Tim Doe’s approval for many significant decisions.
9. Payment by the Hour, Week or Month. ABC only calculated ABC SUPPLY’s payments once a year. Even then, the compensation was not transferred into ABC SUPPLY’s bank accounts, instead it was merely credited to ABC SUPPLY on ABC’s accounting books. Stip. ¶ 13. In contrast, payment to ABC Sales and Marketing and Sales Inc., two companies which also acted as sales representatives for ABC, was made monthly. Ex. 16, Indep. Repr. Contract, p. 2.

10. Furnishing Tools and Equipment. Workers who purchase expensive tools to complete their work typically may be independent contractors. There is no evidence that reflects that ABC SUPPLY purchased any major assets during the audit period.
11. Significant Investment. If a worker makes a significant investment in tools and equipment it is an indicator that the worker is an independent contractor. There is no evidence that ABC SUPPLY invested in any assets other than what it received from ABC at the time of its incorporation. ABC SUPPLY's assets (real, personal and intangible property) were listed as zero on ABC's 11/28/93 Illinois Unitary Return. Stip. Ex. 8c, Statement of Combined Ending Balance Sheet).
12. Realization of Profit or Loss. An independent contractor may experience a profit or a loss if there are extensive expenses incurred. In the case at hand, all of ABC SUPPLY's profits went to ABC. Stip. Ex. 8a, 8b and 8c.
13. Working for More than One Firm at Once. A contractor who works for only one principal is economically dependent on that principal. ABC SUPPLY made no attempt to locate other principals unrelated to ABC to represent. Tr. pp. 298-300.
14. Service Provided to the Public. Generally, independent contractors provide their services to the public or at least to a target market. Here, ABC SUPPLY does not offer its services to the public, it restricted its clientele to one corporation and its wholly owned subsidiaries.

15. Power to Discharge Service Provider. The power to discharge a worker tends to show that the worker is an employee as it is an indicia of the power to control. ABC had the power to discharge ABC SUPPLY at will with 60 days notice. Stip. Ex. 5a, ¶ 8(a). Since it was its sole shareholder, ABC could also simply liquidate or dissolve ABC SUPPLY.
16. Right to Terminate. If a worker has the ability to terminate the relationship without incurring liability, it is an indication that it is not an independent contractor. Rev. Rul. 87-41. Here, ABC SUPPLY could terminate the sales contract with ABC on 60 days notice as long as the top officers at ABC directed the termination. Stip. Ex. 5a, ¶ 8(a).

Under P.L. 86-272, it is required that an independent contractor hold himself out as such to the world. The contractor cannot hide his independent status nor masquerade as an employee or division of the principal. The evidence of record suggests that the sales representatives told customers that they were from ABC or its subsidiaries depending on the potential customer's prospective purchases. The individual sales representatives' W-2 statements stated ABC SUPPLY Supply, however, the name on the sales representatives' paychecks stated ABC. Tr. pp. 225, 233-234. ABC SUPPLY chose not to list its own name in the telephone directory, instead it listed its phone number under the name of ABC Manufacturing. Tr. pp. 87-88. The receptionist at ABC SUPPLY Supply answered its phone "ABC Manufacturing Company, may I help you?" (Tr. pp. 89, 90), as supported by the auditor's testimony that he called ABC SUPPLY twice, once on June 25, 1993 and once in September of 1994. Tr. pp. 87-89; Ex. 13, Stip. Ex. 2. ABC SUPPLY's sales representatives, MR. SMITH and MR. JONES, also

testified that ABC SUPPLY's office telephone was answered "ABC Manufacturing." Tr. pp. 230, 251. Further, ABC SUPPLY's Form UC-3/40 for the quarter March 31, 1991 filed with the Illinois Department of Employment Security was written "ABC SUPPLY Supply Company, Anywhere, USA." ABC SUPPLY's IL-941 for the tax period ending 3/31/91 was filed under the name "ABC SUPPLY Supply Co., c/o ABC Manufacturing Co." Stip. Ex. No. 9.

ABC attempts to argue that it does not control ABC SUPPLY because ABC Management, its wholly owned subsidiary, is contractually obligated to manage ABC SUPPLY. During the audit period, however, ABC Management also had a similar management agreement with ABC. Further, the top officers at ABC, ABC Management and ABC SUPPLY are the same people. *See*, Ex. No. 12, p. 18. This, in addition, to the factors outlined under Rev. Rul 87-41 is evidence that ABC SUPPLY did not act independently during the audit years. Once the Department has established its *prima facie* case, the burden is on the taxpayer to produce "credible evidence to the contrary" that rebuts the *prima facie* correctness of the Department's determination, thereby shifting the burden to the Department which must then prove its case by a "preponderance of the evidence." Balla, *supra*. After a review of the evidence of record, it is clear that the taxpayer did not produce sufficient competent evidence to rebut the Department's determination that ABC SUPPLY did not act as an independent contractor during the audit period.

Finally, under the sales representative agreements, ABC SUPPLY's sales representatives did handle faulty goods to a degree. At hearing, a sales representative, MR. JONES, testified that upon notification that a customer had a faulty product, he

would go in and inspect the merchandise and fill out a return goods authorization, an (“RGA”). MR. JONES would complete the RGA and fax it back to Anywhere if it was for a product that was shipped out of that warehouse. Tr. p. 264. If the product was from XXX Products, MR. JONES would fax the RGA back to XXX. Tr. p. 264. MR. JONES maintained that XXX or ABC would determine the necessary shipping arrangements. Tr. p. 265. No documentary evidence was submitted by the taxpayer with regards to its handling of customer complaints.

In Wisconsin Department of Revenue v. William Wrigley, Jr., Co., 505 U.S. 214 (1992), the Supreme Court identified the activities protected by P.L. 86-272, as solicitation, those activities entirely ancillary to solicitation and de minimus activities. Activities related to customer complaints are neither solicitation nor ancillary to solicitation. Thus, the manner by which ABC SUPPLY’s sales representatives handled customer complaints means ABC SUPPLY and ABC are not afforded protection under P.L. 86-272.

Finally, it must be determined whether the IITA Section 1005 penalty should be abated due to reasonable cause. Section 1005(a) of the IITA provides penalties for the underpayment of taxes unless it is shown that such failure is due to reasonable cause. 35 **ILCS** 5/1005(a) (*formerly* Ill. Rev. Stat. Ch. 120, ¶ 10-1005). The existence of reasonable cause justifying abatement of a penalty is a factual determination that is decided on a case by case basis. Rohrbaugh v. United States, 611 F.2d 211, 215 (7th Cir. 1979). Reasonable cause generally has been interpreted to mean the exercise of ordinary business care and prudence. *See, DuMont Ventilation Co. v. Department of Revenue*, 99 Ill.App.3d 263, 266 (3d Dist. 1981). Given the complexity of the issue in this matter and

the lack of judicial opinions in interpreting the meaning of “independent contractor” for purposes of P.L. 86-272, it is apparent that the taxpayer made a good faith effort to determine the correct tax liability. As a result, it is recommended that the penalties be abated due to reasonable cause.

Wherefore, it is my recommendation that the Notice of Deficiency be finalized as revised by the abatement of penalties.

Date: April 16, 2001

Administrative Law Judge