

IT 06-15

Tax Type: Income Tax

Issue: 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.

JIM DOE,

Taxpayer

No. 00-IT-0000
SSN: 000-00-0000
Tax Years 12/31/96 to 12/31/99
Jim E. White,
Administrative Law Judge

RECOMMENDATION FOR DISPOSITION

Appearances: Sean Cullinan, Special Assistant Attorney General,
appeared for the Illinois Department of Revenue.

Synopsis:

This matter arose after *Jim Doe* (*Doe* or taxpayer) protested a Notice of Deficiency (NOD) the Illinois Department of Revenue (Department) issued to him regarding tax years ending on December 31, 1996 through December 31, 1999.

Prior to hearing, the parties agreed that the issue was whether reasonable cause exists for the Department to abate the penalties proposed in the NOD. At hearing, taxpayer offered into evidence certain documents and the testimony of witnesses. I am including in this recommendation findings of fact and conclusions of law. I recommend that the issue be resolved in favor of the Department.

Findings of Fact:

1. During the years at issue, taxpayer was a resident of Illinois. Department Ex. 1 (copy of NOD).
2. Taxpayer did not timely file Illinois income tax returns for tax years 1996 through 1999. Department Ex. 1; Order dated 4/20/05 (stating, in pertinent part, “and the ALJ

being advised by the taxpayer that he has completed his 1996-1999 tax returns and they are being reviewed by the Department’s technical review unit”).

3. On July 30, 2004, the Department issued an NOD in which it proposed to assess tax, penalties and interest regarding tax years 1996 through 1999. Department Ex. 1, pp. 1-2.
4. Taxpayer protested the NOD, and asked for a hearing.
5. Following his protest, taxpayer arranged to have original Illinois returns prepared and submitted to the Department for the years at issue. Order dated 4/20/05; *see also* Department Ex. 3 (copies of schedules and reports prepared by James Barborka (Barborka), setting forth the revised amounts of Illinois income tax, penalties and interest due from taxpayer regarding tax years ending 1996 through 1999); Tr. pp. 20-29 (testimony of Barborka).
6. After reviewing taxpayer’s subsequently-filed returns, the Department reconsidered and revised the amounts of tax, penalties and interest proposed in the NOD. *Compare* Department Ex. 3 *with* Department Ex. 1.
7. The revised amounts of Illinois tax and penalties are:

Year	Revised Amounts of Tax Due	Revised Types & Amounts of Penalties Due			Revised Amounts of Tax and Penalties Due
		Late Filing	Late Payment	Late Payment of Estimated Tax	
1996	200	40			240
1997	246	558	40		844
1998	406	614		48	1,068
1999	- 285	272			- 13
Totals	567	1,484	40	48	2,139

Department Ex. 3.

8. For 1997 through 1999, the revised late filing penalties proposed include the second tier penalty authorized by § 3-3(a-5) of Illinois’ Uniform Penalty and Interest Act

(UPIA). Department Ex. 3, pp. 11 (1997), 15-17 (1998), 21-22 (1999); 35 ILCS 735/3-3.

9. During the years at issue, *Doe* was a responsible officer and employee of *ABC Corp.* (*ABC Corp.*), and *XYZ* , Inc. (*XYZ*). Department Ex. 5 (copy of Investigative Summary Report, dated November 6, 2000); Tr. pp. 141-48 (*Doe*). *Doe*'s father, *Jim Doe (Jim)*, was also a responsible officer of *ABC Corp.* and *XYZ* during those same years. See Department Ex. 3.
10. Agent Kelly Jackowiec of the Department's Bureau of Criminal Investigation (BCI) conducted an investigation of *ABC Corp.*, *XYZ* , *Doe* and his father, regarding the years at issue. Department Ex. 5; Tr. pp. 145-48 (*Doe*).
11. On January 24, 2002, *Doe* pled guilty to one misdemeanor count of failing to pay over Illinois tax withheld by *XYZ* . Department Ex. 4 (copy of completed Criminal Sentence Form in case number 01-CF-001350, Illinois v. Patrick *Doe*).
12. As a result of that plea, *Doe* was sentenced, *inter alia*, to pay restitution equal to the amount of the Illinois income tax withheld from the wages of employees by *ABC Corp.* and by *XYZ* regarding the first quarter of 1995 through and including the fourth quarter of 1999. Compare Department Ex. 5, p 11 (Schedule of Withholding Liability) with Department Ex. 4.
13. *Doe* was also assessed a personal liability penalty, as a responsible officer of *XYZ* , in the amount of the taxes withheld from the wages of that corporation's employees during the first quarter of 1997 through fourth quarter of 1999, and during the second and fourth quarters of 2000. Department Ex. 6 (copy of administrative order closing the contested case having docket number 03-IT-0159, involving NOD No. 4485 issued to *Doe*).
14. After *Doe* pled guilty in 2002, he obtained and reviewed boxes of corporate

documents regarding *ABC Corp.* and *XYZ* . Tr. pp. 75-81, 135-37 (*Doe*).

15. In June 1999, *Jim* and *Doe* hired *Smith Jones* (*Smith Jones*) to perform payroll services for their business, *XYZ* . Department Ex. 5, p. 8 (setting forth the substance of BCI Agent Jackowiec's interview with *Smith Jones* on July 26, 2000).
16. As part of *Smith Jones*'s provision of payroll services to *XYZ* , *Smith Jones* processed payroll checks, prepared federal and Illinois quarterly withholding returns, including IL-501 (Illinois Withholding Income Tax Payment) forms, unemployment wage reports and W-2 reports. Department Ex. 5, p. 9.
17. *Smith Jones*'s ordinary contacts with *XYZ* were with *Jim Doe*. Department Ex. 5, p. 9. Specifically, *Jim* picked up the payroll checks & withholding and other forms once *Smith Jones* completed them, and *Jim* was the person that he would contact to ask any questions or obtain information regarding *XYZ* 's financial operations. *Id.*
18. Both *Jim* & *Doe* asked *Smith Jones* to prepare individual Illinois income tax returns for them, but they never provided him with the information required to prepare such returns. Department Ex. 5, p. 9.
19. Both *Jim* and *Doe* informed *Smith Jones* that they had received wages from *XYZ* that had not previously been reported as wages on quarterly withholding returns. Department Ex. 5, p. 9. *Jim* gave *Smith Jones* a detailed list of such income, including check numbers, dates, amounts and bank accounts. Department Ex. 5, p. 9.
20. In late August 2002, *Doe* fired *Jim* from another company in which both were officers and shareholders. Taxpayer Ex. 20 (copies of 2 letters written by *Doe* to *Jim*); Tr. pp. 75-81, 133-37 (*Doe*).
21. *Doe* fired *Jim* from that company for the following reasons:
 - Not timely informing *Doe* of the corporation's payables
 - Falsifying documents in an effort to make it appear that *Jim* held the office of president
 - Preparing credit applications to XXXX Services, Inc., XXXX Bank and other

- companies in which *Jim* identified himself as president of the corporation
- Attempting to remove *Doe*'s name as the owner of the corporation from the corporation's checking account and telephone service contracts
- Opening credit accounts and cell phone service agreements under the company's name without the owner's knowledge

Taxpayer Ex. 20, p. 1; Tr. pp. 133-36 (*Doe*).

Conclusions of Law:

When the Department introduced the Notice of Deficiency into evidence under the certificate of the Director, it presented prima facie proof that *Doe* was liable for the late filing, late payment and late payment of estimated tax penalties proposed in the NOD. Branson v. Department of Revenue, 68 Ill. 2d 247, 261, 659 N.E.2d 961, 968 (1995). The Department's prima facie case is a rebuttable presumption. See Branson, 68 Ill. 2d at 261, 659 N.E.2d at 968 ("After the Department presents a prima facie claim for tax penalty liability, our construction of section 13½ places the burden on the taxpayer to establish that one or more of the elements of the penalty are lacking."). A taxpayer cannot overcome the presumption merely by denying the accuracy of the Department's assessment, or merely by denying knowledge of a tax deficiency. See Branson, 68 Ill. 2d at 267, 659 N.E.2d at 971. 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 penalty assessment is not correct. PPG Industries, Inc. v. Department of Revenue, 328 Ill. App. 3d 16, 33, 765 N.E.2d 34, 48 (1st Dist. 2002) (a taxpayer challenging a penalty has the burden of overcoming the Department's *prima facie* case using documentary evidence, meaning books and records, and not mere testimony).

Doe does not contest the Department's determination of tax due. The only issue is whether the penalties proposed should be abated for reasonable cause. Most of the penalties at issue here were assessed for taxpayer's late filing of his 1996 through 1999 individual income tax returns. Department Ex. 3 (\$1,484 of the penalties were proposed for late-filing, \$88 in penalties proposed for late payment).

Doe asserts that his failure timely to file his individual Illinois income tax returns was the direct result of the fraud his father committed against him and the corporations over which he and his father presided. Tr. pp. 220-25 (closing argument). *Doe*, in fact, offered credible evidence that, at the very least, *Jim* committed forgery by signing *Doe*'s name as the payee/endorser on corporate checks that *Jim* drew and made payable to *Doe*, and which checks were then presented for payment with *Doe*'s forged signatures. Taxpayer Exs. 5-7; Tr. pp. 120-31 (*Doe*). *Doe* offered further credible documentary evidence that *Jim* was, during the years at issue, regularly transferring funds between different bank accounts, the source of which *Doe* testified was the revenues derived from the sales of services by *ABC Corp.* and/or *XYZ* . Taxpayer Exs. 5-7. It is not unreasonable to conclude, as *Doe* alleges, that *Jim* was the person who arranged for these fund transfers, and that *Jim* arranged for those transfers for the purpose of converting *ABC Corp.*'s and/or *XYZ* 's revenues to his own use.

Doe argues that, because of his father's actions, he was unable to account for the true amount of revenues derived from the operations of the businesses he ran with his father. That inability, in turn, prevented him from completing those portions of his returns in which he was required to report the profit or loss from the "S" corporations in which he was a shareholder. Tr. pp. 9-10, 79. It was reasonable for *Doe* to delay his filing of such returns, he argues, because to file them without including such information on those returns would constitute tax evasion. Tr. p. 230.

The Department responds that it is obvious from the evidence that there was an emotional struggle going on between *Doe* and his father for control over the corporations during the years at issue, but that that dispute does not constitute reasonable cause to excuse *Doe*'s failure to file individual income tax returns during those years. Tr. pp. 73-80 (objection and colloquy), 226-29 (closing argument). The Department contends that most of the income *Doe* received during those years was from wages he received from working at *ABC Corp.* and

XYZ , and that he should have been able to timely file returns based on the documentation he received as a result of obtaining those company checks. Tr. pp. 226-29. The Department further asserts that, as president of the corporations, *Doe* should have been able to obtain the corporate books and records that *Doe* said that his father kept from him. Tr. pp. 226-29.

Section 3-8 of the UPIA provides, *inter alia*, that, “[t]he penalt[y] imposed ... [by] ... § 3-3 ... of this Act ... shall not apply if the taxpayer shows that his failure to file a return ... was due to reasonable cause. Reasonable cause shall be determined in each situation in accordance with the rules and regulations promulgated by the Department.” 35 ILCS 735/3-8. The Department exercised the authority expressly granted to it by § 3-8 of the UPIA, and its regulation on reasonable cause provides, in pertinent part:

§ 700.400 Reasonable Cause

b) The 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.

c) A taxpayer will be considered to have made a good faith effort to determine and file and pay his proper tax liability if he exercised ordinary business care and prudence in doing so. A determination of whether a taxpayer exercised ordinary business care and prudence is dependent upon the clarity of the law or its interpretation and the taxpayer’s experience, knowledge, and education. Accordingly, reliance on the advice of a professional does not necessarily establish that a taxpayer exercised ordinary business care and prudence, nor does reliance on incorrect facts such as an erroneous information return.

d) The Department will also consider a taxpayer’s filing history in determining whether the taxpayer acted in good faith in determining and paying his tax liability. Isolated computational or transcriptional errors will not generally indicate a lack of good faith in the preparation of a taxpayer’s return.

e) Examples of Reasonable Cause. The following non-exclusive list of situations will constitute reasonable cause for purposes of the abatement of penalties:

4) Inability to timely obtain records necessary to determine the amount of tax due to reasons beyond the taxpayer's control. For example, some taxpayers, particularly those with income from banks, partnerships, trusts, estates or Subchapter S corporations, must secure information from those entities in order to properly compute the amount of tax due.

f) Relevant factors used by the Department in determining the existence of reasonable cause.

1) Could the taxpayer's federal filing status have caused confusion about his or her Illinois filing requirements? Under Illinois law, many taxpayers that are not required to file with the Internal Revenue Service are required to file with the Department.

2) Does the taxpayer's reason address the penalty assessed? For example, if a taxpayer was assessed both a late filing and late payment penalty for the same return, the taxpayer's explanation of the failure to file and pay may apply to one penalty, but not the other.

3) Does the length of time between the reason cited and the actual violation support abatement? If the taxpayer cites a specific event or set of events (e.g., illness, unexpected absence, or natural disaster) or set of events that led to the imposition of the penalty, the Department will determine whether those events are directly related to the return or payment under review.

4) Could the event cited have been reasonably anticipated? Was the event one that should have been anticipated (e.g., a vacation or scheduled absence) or was it unexpected, unavoidable, or otherwise unplanned (e.g., an emergency or disaster).

5) Was ordinary business care and prudence exercised? In the absence of new or unusual circumstances, most filing and payment requirements are common knowledge or are readily available to most taxpayers. If the taxpayer did all that could be reasonably expected of him or her and was still unable to file or pay on time, reasonable cause may be present.

86 Ill. Admin. Code § 700.400.

I agree with the Department that *Doe* has not established that he exercised ordinary business care and prudence when attempting to file his returns timely regarding the years at issue. The law presumes that ordinary individuals are aware of tax deadlines. United States v. Boyle, 469 U.S. 241, 251, 105 S.Ct. 687, 693, 83 L.Ed.2d 622 (1985) ("one does not have to be a tax expert to know that tax returns have fixed filing dates and that taxes must be paid

when they are due.”); 86 Ill. Admin. Code § 700.400(f)(5) (“In the absence of new or unusual circumstances, most filing and payment requirements are common knowledge or are readily available to most taxpayers.”). *Doe*, moreover, did not testify that he was unaware of the deadlines for filing his Illinois returns.

I also agree that as president of the corporations, *Doe* had the power, and under the circumstances the duty, to obtain the corporate books and records sufficient to prepare the returns Illinois law required to be timely filed. A person holding the office of president is invested in both powers and duties. *See* 805 ILCS 5/8.50 (Illinois’ Business Corporation Act (BCA)). *Doe* was also a major shareholder of both *ABC Corp.* and *XYZ* . Tr. p. 79 (Michelle). Section 7.75 of the BCA requires corporations to keep correct and complete books and records of account (805 ILCS 5/7.75(a)), and further provides shareholders of corporations with a court-enforceable remedy in the event a corporation refuses to allow a shareholder to review such books and records. 805 ILCS 5/7.75(b)-(c). *Doe*, however, testified that he waited until 2002, which was after both he and his father pled guilty to crimes of failing to file returns on behalf of *XYZ* , before he forcibly seized records from his father regarding a subsequently formed corporation in which both he and his father were shareholders. Taxpayer Ex. 20 (letters from *Doe* to *Jim* dated in 2002); Tr. pp. 75-81, 135-37 (*Doe*). It was during that 2002 seizure that *Doe* gleaned evidence that he asserts shows that *Jim* concealed information from him regarding *ABC Corp.* and *XYZ* ’s true financial status. Tr. pp. 75-81, 135-37 (*Doe*). Thus, that seizure took place more than 2 years *after* the due date for the return for the final tax year at issue. *Id.*; *see also* 35 ILCS 5/505(a)(2) (return for 1999 was due on April 16, 2000, since the 15th fell on a Sunday).

As president of *ABC Corp.* and *XYZ* , *Doe* had a duty to ensure that corporate financial records were kept and accessible, so that the corporations could comply with its obligations imposed by the BCA, as well as its obligations imposed by the IITA. Department

Exs. 4-5; 35 ILCS 5/704, 5/913; *see also* Malacuso v. Jenkins, 95 Ill. App. 3d 461, 466, 420 N.E.2d 251, 254 (2d Dist. 1981) (sole managing director's failure to create and keep corporate records was factor in court's decision to uphold jury's verdict to pierce corporate veil). Where a president of a corporation waits more than four years before actually taking control of and examining the books and records of a corporation over which he presides, at a time when he knows that he has not filed his own individual income tax returns that required the income/loss from that corporation to be reported thereon, that inaction is not consistent with a claim that he acted with ordinary business care and prudence.

Finally, I reject *Doe's* argument that filing his individual returns without including the amount of the income and/or loss from *ABC Corp.* and/or *XYZ* would have constituted tax evasion, so long as *Doe* clearly stated on those returns that he may have realized taxable income and/or loss from a business during the appropriate tax year, but that the correct amount of such income/loss was not yet known. A distinguishing characteristic of tax evasion is willful concealment. Holland v. United States, 348 U.S. 121, 133, 75 S.Ct. 127, 99 L.Ed. 150 (1954); United States v. Valenti, 121 F.3d 327, 333 (1997). Stating that such income or loss was realized, but that the amount of such income/loss has not yet been calculated, is, if true, perfectly straightforward, and the antithesis of evasion.

Perhaps the most common example of this type of reporting occurs when an individual taxpayer notifies the IRS that he is seeking an extension of the due date for filing his return. *See* 35 ILCS 5/505(b) (granting automatic extension of time to file a return to an Illinois taxpayer that files with the Department a copy of the extension filed with the IRS). Under those circumstances, a taxpayer exercising ordinary business care and prudence pays the amount of tax reasonably anticipated to be due, based on the information to be set forth in that later filed return, at the time he files the request for extension. 35 ILCS 5/601 (tax payment due when return is due, regardless whether taxpayer has been granted an extension to file

return). But the extension request must be filed, or else the taxpayer will have ignored the statutory due date for filing the return. 35 ILCS 5/505(b). Here, the record is clear that *Doe* did not complete and submit his Illinois returns until after the NOD was issue. Order dated 4/20/05; Department Ex. 3; Tr. pp. 20-29 (Barborka). I conclude that *Doe* has not satisfied his burden to show that he made a good faith effort to file his individual income tax returns timely for tax years 1996 through 1999.

Conclusion:

I recommend that the Director finalize the NOD issued to *Doe* as revised by the Department and set forth in Department Ex. 3, with interest to accrue pursuant to statute.

Date: 7/31/2006

Jim E. White
Administrative Law Judge