

ST 13-09

Tax Type: Sales Tax

Tax Issue: Unreported/Underreported Receipts (Non-Fraudulent)

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

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

v.

**ABC CORPORATION d/b/a
XYZ CASINO**

Taxpayer

Docket # XXXX

Acct ID: XXXX

Letter ID: XXXX

RECOMMENDATION FOR DISPOSITION

Appearances: Matthew Crain, Special Assistant Attorney General, for the Department of Revenue of the State of Illinois; Michael Gras of the Law Office of Christopher Cueto, Ltd. for ABC Corporation d/b/a XYZ Casino

Synopsis:

The Department of Revenue (“Department”) conducted an audit of ABC Corporation d/b/a XYZ Casino (“taxpayer”) for the period of July 1, 2007 through June 30, 2009. At the conclusion of the audit, the Department issued a Notice of Tax Liability (“NTL”) to the taxpayer for additional retailers’ occupation tax (“ROT”) and use tax, plus penalties and interest. The taxpayer timely protested the NTL, and an evidentiary hearing was held. The following issues were raised by the taxpayer: (1) whether the Department’s method for preparing the corrected return was not minimally reasonable

because the taxpayer's books and records were adequate to determine the tax liability; and (2) if the liability must be estimated, whether a different sale price should be used for certain drinks while using the markup method. After reviewing the record, it is recommended that this matter be resolved in favor of the Department.

FINDINGS OF FACT:

1. The taxpayer operates a nightclub known as XYZ Casino. The nightclub is open on Friday and Saturday nights and is located in East St. Louis, Illinois. (Dept. Ex. #1, pp. 4, 13; Tr. p. 11)
2. The taxpayer's president has operated a nightclub since 1989. (Dept. Ex. #1, p. 7; Tr. pp. 37, 70)
3. The taxpayer sells alcoholic and nonalcoholic drinks at the nightclub. Patrons must pay a \$10 cover charge, which does not include a drink.¹ The food service that is provided at the nightclub is operated by another entity, and the food sales are not at issue in this case. (Dept. Ex. #1, p. 13; Tr. pp. 11-12)
4. The Department conducted an audit of the taxpayer's business for the period of July 1, 2007 through June 30, 2009. (Dept. Ex. #1, pp. 1, 4, 13)
5. The auditor reviewed the taxpayer's purchases of consumable supplies and determined that the taxpayer owes \$78 in use tax on three purchases that totaled \$XXXX. The taxpayer has not contested this tax. (Dept. Ex. #1, pp. 13, 17, 24)
6. The auditor also reviewed the books and records that were given to him by the taxpayer concerning the taxpayer's drink sales. The taxpayer gave the auditor a "Sales Record" for each month during the audit period. The Sales Record is a

¹ The taxpayer waives the cover charge for certain people such as for ladies until 2:00 a.m. and for friends, family members, and celebrities. (Tr. pp. 60-63)

- one-page document that has a hand-written amount for the total drink sales for each Friday and Saturday night during the month. The Sales Record also includes a hand-written amount for the cover charges that the taxpayer received from the patrons and the rent the taxpayer received from the food vendor. (Dept. Ex. #1, p. 13; Taxpayer Ex. #2, #9; Tr. pp. 38-39, 84)
7. The taxpayer did not give the auditor cash register tapes, commonly called “Z tapes,” for the drink sales during the audit period. (Dept. Ex. #1, p. 13)
 8. The taxpayer’s Sales Records were the only documents that the taxpayer provided to show the daily sales. The taxpayer used a cash register to record sales but did not provide any of the cash register tapes. (Tr. pp. 59-60, 64-65, 71-72)
 9. The taxpayer’s accountant used the hand-written Sales Records to prepare the monthly Form ST-1s that were filed with the Department. (Dept. Ex. #1, p. 13; Taxpayer Ex. #9; Tr. pp. 12-13)
 10. Because the taxpayer did not give the auditor substantiation for the sales, the auditor estimated the sales by first obtaining the taxpayer’s purchase records for all of the vendors who sold beverages to the taxpayer. (Dept. Ex. #1, pp. 13, 29-32; Taxpayer Ex. #1; Tr. p. 10)
 11. The auditor also obtained a list of the prices (“price list”) at which the taxpayer sold its drinks. At the request of the taxpayer’s president, the president’s wife prepared the price list, and she gave a copy to the auditor. She obtained the prices from the cash register. (Dept. Ex. #1, p. 37; Tr. pp. 13, 55)
 12. For drinks such as beer and Red Bull, which are sold in individual cans or bottles, the auditor determined the cost per drink based on the purchase price of each

- drink. The auditor then looked at the price list to find the selling price of the drink and divided that by the cost of the drink to determine the markup.² (Dept. Ex. #1, p. 33, Schedule MS, p. 37; Tr. p. 14)
13. For other drinks such as vodka and whiskey, which are sold by pouring drinks from larger bottles, the auditor first took the total number of ounces in a bottle and subtracted 10% of those ounces from the total to account for spillage. With the remaining ounces, the auditor determined the number of drinks that the taxpayer would have sold, per bottle, with each drink being 2 ounces.³ (Dept. Ex. #1, p. 33, Schedule MS; Tr. p. 14)
14. After determining the number of drinks per bottle, the auditor took the total cost of the bottle and divided that by the number of drinks per bottle to determine the cost per drink of the alcoholic beverage.⁴ (Dept. Ex. #1, p. 33)
15. To determine the markup for these drinks, the auditor took the number of drinks per bottle and multiplied that by the selling price of the drink. The auditor divided that number by the cost of the bottle to determine the markup.⁵ (Dept. Ex. #1, p. 33, Schedule MS, p. 37)
16. According to the taxpayer's price list, Grey Goose drinks were sold for \$7, and Absolut drinks were sold for \$5. The auditor used those prices to determine the markup. (Dept. Ex. #1, pp. 33, 37; Tr. pp. 17-18)

² For example, the taxpayer sold Bud Light for \$3, and the cost per drink was \$.7083, so the markup was 4.24. (Dept. Ex. #1, p. 33, Schedule MS)

³ For example, a bottle of Grey Goose vodka had 33 ounces. After subtracting 3.3 ounces for spillage, the remaining 29.7 ounces were divided by 2 (assuming each drink was 2 ounces). So the number of drinks per bottle was 14.85. (Dept. Ex. #1, p. 33, Schedule MS)

⁴ For Grey Goose, the cost of a bottle was \$38. This was divided by 14.85 to determine the cost of a Grey Goose drink to be \$2.56. (Dept. Ex. #1, p. 33)

17. After determining the markups, the auditor multiplied the taxpayer's purchases from each of its vendors by the markups to determine the total expected sales of the beverages. (Dept. Ex. #1, pp. 29-32, Schedule ES-A; Tr. p. 11)
18. For each month during the audit period, the auditor took the total expected sales and divided that by the tax rate to determine the amount of sales (before taxes) that should have been reported on the taxpayer's Form ST-1s.⁶ The auditor then compared that amount with the amount of sales that were actually reported on the taxpayer's Form ST-1s. (Dept. Ex. #1, p. 34, Schedule ES)
19. After comparing the expected sales with the reported sales, the auditor determined that except for the months of November 2007 and January 2009, the taxpayer under-reported the sales on the Form ST-1s for the remaining months of the audit period. (Dept. Ex. #1, p. 34, Schedule ES; Tr. p. 13)
20. The auditor determined that based on the under-reported sales, the taxpayer owed additional ROT in the amount of \$XXXX. (Dept. Ex. #1, p. 25)
21. The Department prepared Form SC-10-K, Audit Correction and/or Determination of Tax Due, for the taxpayer that showed additional ROT of \$XXXX and use tax of \$XXXX for the total amount due of \$XXXX for the period of July 1, 2007 through June 30, 2009. A copy of the corrected return was admitted into evidence under the certificate of the Director of the Department. (Dept. Ex. #1, p. 4)

CONCLUSIONS OF LAW:

⁵ For Grey Goose, 14.85 drinks per bottle was multiplied by \$7 (the selling price from the price list), and that equaled \$103.95. This number was divided by \$38 (the cost of a bottle), which resulted in a markup of 2.74. (Dept. Ex. #1, p. 33, Schedule MS)

⁶ From July 2007 through December 2008, the tax rate was 8.6%, and from January 2009 through the end of the audit period, it was 8.85%. (Dept. Ex. #1, p. 25) For July 2007, for example, the auditor determined that based on the markups, the sales should have been \$XXXX. That number was divided by 1.086 to get the expected sales (before taxes) of \$XXXX. (Dept. Ex. #1, p. 34)

The Retailers' Occupation Tax Act (“ROTA”) (35 ILCS 120/1 *et seq.*) imposes a tax upon persons engaged in the business of selling at retail tangible personal property. 35 ILCS 120/2. Section 4 of the ROTA provides that the certified copy of the corrected tax return prepared by the Department “shall be prima facie proof of the correctness of the amount of tax due, as shown therein.” 35 ILCS 120/4. The Department is required to correct the tax return according to its “best judgment and information.” *Id.* There is no requirement that the Department substantiate the basis for its corrected return at the hearing. Masini v. Department of Revenue, 60 Ill. App. 3d 11, 14 (1st Dist. 1978). When the corrected return is challenged, however, the method that was used by the Department in preparing the corrected return must meet a minimum standard of reasonableness. *Id.*; Elkay Manufacturing Co. v. Sweet, 202 Ill. App. 3d 466, 470 (1st Dist. 1990).

The taxpayer has called into question the method used by the Department to correct its tax return. The taxpayer contends that the Department’s method was not minimally reasonable because the Department was not justified in going outside the taxpayer’s books and records to estimate the liability. The taxpayer believes that it offered sufficient books and records to conduct the audit. As the following discussion indicates, this argument is not persuasive.

According to the taxpayer, its hand-written Sales Records, which include a total of the daily sales, were sufficient to determine the tax liability pursuant to section 130.801 of the Department’s regulations. That section concerns “General Requirements” for Books and Records and provides, in relevant part, as follows:

Every person engaged in the business of selling tangible personal property at retail in this State shall keep records and books of all sales and purchases of tangible personal property, including all sales and purchase invoices, purchase orders, merchandise records and requisitions, inventory

records prepared as of December 31 of each year or otherwise annually, as has been the custom in the specific trade, credit memos, debit memos, bills of lading, shipping records, and all other records pertaining to any and all purchases and sales of goods whether or not the retailer believes them to be taxable under the Act; and the retailer shall also keep summaries, recapitulations, totals, journal entries, ledger accounts, accounts receivable records, accounts payable records, statements, tax returns with all schedules or pertinent working papers used in connection with the preparation of such returns, and other documents listing, summarizing or pertaining to such sales, purchases, inventory changes, shipments or other transactions. For a description of what records constitute the minimum required, including the use of machine-sensible records and electronic data interchange, see Section 130.805 of this Part. 86 Ill. Admin. Code §130.801(a). (See also 35 ILCS 120/7).

Section 130.805 of the Department's regulations concerns "What Records Constitute Minimum Requirement" and states, in relevant part, as follows:

In General. A taxpayer shall maintain all records that are necessary to a determination of the correct tax liability under the Act. All required records must be made available on request by the Department. Where a taxpayer's business consists exclusively of the sale of tangible personal property at retail, the following records will be deemed by the Department to constitute a minimum for the purposes of the Act:

- 1) Cash register tapes and other data which will provide a daily record of the gross amount of sales.
- 2) A record of the amount of merchandise purchased. To fulfill this requirement, copies of all vendors' invoices and taxpayers' copies of purchase orders must be retained serially and in sequence as to date.
- 3) A true and complete inventory of the value of stock on hand taken at least once each year. 86 Ill. Admin. Code §130.805(a).

The taxpayer believes that the present case is similar to another case that was decided by one of the Department's administrative law judges ("ALJs"), Department of Revenue v. "Stromboli, Inc.", ST 98-35. In that case, the auditor used a markup method to determine the taxpayer's under-reported sales because the auditor believed that the taxpayer had not retained sufficient back up material, such as cash register tapes, to support the reported sales. *Id.* at 10. At the hearing, the taxpayer provided cash register

Z tapes, and the ALJ found that pursuant to section 130.805, the taxpayer had kept sufficient records to support its sales. “Stromboli”, at 2-3, 11. Because the taxpayer had adequate books and records, the ALJ found that the auditor should not have estimated the liability. *Id.*

Unlike the taxpayer in “Stromboli”, the taxpayer in the present case did not provide cash register Z tapes during the hearing, and the taxpayer has not provided adequate books and records to determine the tax liability. The law mandates that the taxpayer keep accurate records of all of its sales. See 35 ILCS 120/7. The only documents that the taxpayer provided for its sales were the hand-written Sales Records that summarized the total sales for each day. (Taxpayer Ex. #2, #9) The taxpayer’s president testified that at the end of each night, he would total up the cash register sales and put the amount on the Sales Record. (Tr. pp. 38-39, 65) The president’s hand-written amounts, however, cannot be verified without the tapes. Without substantiation, it is impossible to verify the accuracy of the Sales Records.

Although the taxpayer had cash register tapes, the tapes were not kept and were not given to the auditor. The taxpayer’s accountant testified that cash register tapes are necessary in order to verify the sales. (Tr. p. 93) Although the taxpayer’s president testified that his accountant did not ask him to keep records other than the Sales Records (tr. pp. 39-40), his accountant testified that he told the taxpayer to keep the tapes, and the accountant told all his clients to keep the tapes in the event that they were audited. (Tr. pp. 87, 92-95) The taxpayer’s president did not follow the advice of his accountant and did not provide any document to substantiate the daily sales for its business. It is not sufficient for the taxpayer to maintain only summaries of its sales; the taxpayer must

provide adequate records showing its actual sales. The taxpayer failed to produce documentary evidence that meets the minimum standards of recordkeeping required of retailers.

Because the taxpayer did not provide cash register tapes or other substantiation of the daily sales, the auditor was justified in going outside the taxpayer's books and records to determine the liability. The auditor used a markup method that has been used by the Department in audits when the taxpayer fails to maintain adequate records. See Vitale v. Department of Revenue, 118 Ill. App. 3d 210 (3rd Dist. 1983); Fillichio v. Department of Revenue, 15 Ill. 2d 327 (1958). The Department's audit techniques were reasonable and were necessary only because the taxpayer failed to maintain adequate books and records. The Department's method for preparing the corrected return was minimally reasonable, and therefore, the corrected return is *prima facie* correct.

Once the Department has established its *prima facie* case, the burden shifts to the taxpayer to overcome this presumption of validity. A.R. Barnes & Co. v. Department of Revenue, 173 Ill. App. 3d 826, 832 (1st Dist. 1988). To overcome the *prima facie* case, the taxpayer must present more than mere testimony denying the accuracy of the Department's assessment. Mel-Park Drugs, Inc. v. Department of Revenue, 218 Ill. App. 3d 203, 217 (1st Dist. 1991). The taxpayer must produce competent evidence, identified with the taxpayer's books and records, showing that the Department's corrected returns are inaccurate. Vitale, at 213. Suggesting hypothetical weaknesses in the Department's case is not sufficient to meet the taxpayer's burden. *Id.* The taxpayer must show through documentary evidence that the suggested hypothetical weaknesses are relevant to the taxpayer's business. *Id.*

The taxpayer has suggested that if it had sold Grey Goose and Absolut drinks for \$2, then the Department's corrected return would be inaccurate because it would overstate the expected sales. The auditor used the selling price of \$7 for Grey Goose drinks and \$5 for Absolut drinks in order to determine the markup, and he took those prices from the taxpayer's price list. The taxpayer contends, however, that it usually had "drink specials" when it sold those drinks for \$2. The taxpayer's president testified that the drink specials included selling all "white alcohol"⁷ for \$2, and he only infrequently charged the full price of \$7 for Grey Goose drinks. (Tr. pp. 43-44) He said that Grey Goose and Absolut drinks were approximately 50 to 60 percent of the taxpayer's sales. (Tr. p. 47) He also said that when a customer ordered one of these drinks, he would "ring it up" on the cash register under "miscellaneous, under juice and soda for \$2." (Tr. pp. 45, 60) Although the cost of a Grey Goose drink was \$2.56 (Dept. Ex. #1, p. 33) and selling the drink for \$2 would result in a loss, the taxpayer claims that getting more people to come to the nightclub and pay the high cover charge allowed it to sell those drinks for \$2. (Tr. pp. 45-48)

It seems unlikely that the taxpayer would be able to maintain its business by selling its primary product at a loss, and the taxpayer did not provide any documentary evidence, identified with its books and records, to show that it actually sold these alcoholic drinks for \$2. The taxpayer provided a few advertisements showing a \$2 price for these drinks, but the ads are dated outside of the audit period (9/24/10, 9/25/10, 5/16/10, and 6/3/11). (Taxpayer Ex. #3, #4, #5) Even if the ads were during the audit period, there is still no documentary evidence to show how often or how many of these drinks were sold for \$2. Even if the taxpayer had kept the cash register tapes, the tapes

⁷ The "white alcohol" included Grey Goose, Absolut, Bombay and Patron. (Tr. p. 44)

would not show the \$2 vodka drinks because the cash register was not programmed for \$2 alcoholic drinks. It is, therefore, impossible to confirm whether these drinks were actually sold for \$2. Because there is nothing in the record to support the taxpayer's contention that the vodka drinks were sold for \$2, the taxpayer has not met its burden of proof, and the Department's *prima facie* case must be upheld.

Recommendation:

For the foregoing reasons, it is recommended that the Notice of Tax Liability be upheld.

Enter: June 12, 2013

Linda Olivero
Administrative Law Judge