ST 13-10
Tax Type: Sales Tax
Tax Issue: Responsible Corporate Officer – Failure To File Or Pay Tax

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

THE DEPARTMENT OF REVENUE OF THE STATE OF ILLINOIS	**No. XXXX**
	Account ID XXXX
v.	**NPL Penalty ID XXXX (John Doe)**
	NPL Penalty ID XXXX (Jack Black)
	NPL Penalty ID XXXX (Fred Red)
	Period XXXX
JOHN DOE, JACK BLACK & FRED RED, RESPONSIBLE OFFICERS, Taxpayers	**Ted Sherrod Administrative Law Judge**

RECOMMENDATION FOR DISPOSITION

Appearances: Special Assistant Attorney General George Foster on behalf of the Illinois Department of Revenue; Richard Kates, Esq. on behalf of John Doe, Jack Black and Fred Red.

Synopsis:

This matter is before this administrative tribunal as the result of a timely protest by John Doe ("John Doe"), Jack Black ("Jack Black") and Fred Red ("Fred Red") of notices of penalty liability issued to each of them as responsible officers of Happy Company, LLC ("Happy Company"). The notices of penalty liability assessed each taxpayer a penalty equal to Happy Company's unpaid retailers' occupation tax for the months of June 2007 through November 2009. The penalty assessed each of the aforementioned taxpayers was a personal liability penalty levied pursuant to section 3-7 of the Illinois Uniform Penalty and Interest Act, 35 **ILCS** 735/3-1 *et seq.*

A hearing on this matter was held on May 11, 2012. John Doe, Jack Black and Fred Red all testified at the hearing. In addition, testimony was received from Mary Blue and Joe Blow, both of whom were employees of Happy Company, from Peter Purple and William White, company consultants and from Orville Orange, Happy Company' Vice President of Operations. Documentary evidence was also presented on behalf of the taxpayers that were assessed and the Department. I have reviewed the evidence of record, and I am including in this recommendation findings of fact and conclusions of law. I recommend that the Director reconsider and cancel the notices of penalty liability that have been issued to the aforementioned taxpayers. In support of this recommendation, the following findings of fact and conclusions of law are made.

Findings of Fact:

1. The Department's *prima facie* case, including all jurisdictional elements, was established by the admission into evidence of the notices of penalty liability NPL Penalty ID number XXXX issued to John Doe ("John Doe") NPL Penalty ID number XXXX issued to Jack Black ("Jack Black") and NPL Penalty ID number XXXX issued to Fred Red ("Fred Red"), on December 9, 2010. Department Group Ex. 1. These notices of penalty liability arose from the unpaid sales tax liabilities of Happy Company, LLC ("Happy Company") for the period June, 2007 through November, 2009. *Id.*
2. Happy Company, an Illinois limited liability company having its principal place of business in Anywhere, Illinois, was formed in 2005 to acquire the fixtures, retail stores and other assets of Distributors of America. Tr. pp. 17, 59. During the tax period in controversy, this company was engaged in the business of selling and installing kitchen

cabinets, counter tops and related fixtures. Tr. pp. 124, 125; Taxpayer's Ex. 1 (Auditor's Narrative Report). It was also a wholesale distributor of the items it sold at retail. Id. The company ceased business operations in April, 2008 when the company's bank withdrew financing, and on May 22, 2008 entered into an assignment for the benefit of creditors agreement with Jane Doe of ABC Business, Inc. Tr. pp. 24, 25, 85, 86; Taxpayer's Ex. 3. The company made no sales after its stores closed in April 2008. Tr. p. 131. The company was dissolved upon the filing of Articles of Dissolution with the Illinois Secretary of State in 2010. Tr. p. 134.[1]

3. At the time the company commenced, it operated 8 stores in Illinois. Taxpayer's Ex. 1. During the tax period in controversy, it had 17 store locations. *Id.* (Auditor's Narrative Report).

4. Jack Black, Fred Red and Peter Purple were the sole shareholders of Happy Company. Tr. pp. 108, 125, 134. These shareholders were also principals in XYZ Business. Taxpayer's Ex. 1 (Auditor's Narrative Report).

5. Jack Black was Happy Company's majority shareholder. Tr. p. 134. He was also the company's sole manager from the company's inception until its dissolution in 2010. *Id.*; Taxpayer's Ex. 3.

6. Fred Red, an employee and principal of XYZ Business, served as a consultant to Happy Company and was the company's part-time Chief Financial Officer. Tr. p. 107. He was responsible for the financial activities of the company and for setting company strategies. Tr. p. 109. His oversight of the company's financial activities included reviewing the

[1] Revenues continued to be reported and taxes paid on cash collections generated by installment sales that preceded the date on which the taxpayer's stores were closed. Tr. p. 19. Consequently, the assessments for the months after April 2008 pertain to sales made prior to and during that month.

company's financial statements every month, making sure that the company's bills were paid and assuring that the company had adequate financing. Tr. p. 110.

7. John Doe was the chief executive officer of Happy Company from June 2005 through May 2008. Tr. p. 124. His principal areas of responsibility concerned sales generation and sales management. Tr. pp. 124, 127.

8. During the tax period in controversy, Jack Black and John Doe participated in monthly meetings at which decisions were made regarding the payment of Happy Company's bills and accounts payable to the company's vendors and to government agencies. Tr. pp. 80, 81. Fred Red did not participate in these meetings. *Id*.

9. Peter Purple ("Peter Purple"), an employee and principal of XYZ Business, owned stock in Happy Company and worked on special projects for this company during the tax period in controversy. Tr. pp. 54, 55, 61, 62, 125. He was responsible for the company's accounting and financial matters. Tr. p. 125. He was also responsible for acquiring tax compliance software and engaging qualified tax accounting specialists for collecting, reporting and paying Happy Company's sales and use taxes. Tr. pp. 55, 56, 59-61.

10. On February 23, 2006, Peter Purple signed the company's REG-1 Illinois Business Registration with the Department on which he indicated that he was the person that was responsible for filing the company's returns and paying the company's taxes. Taxpayer's Ex. 2.

11. Mary Blue ("Mary Blue"), an accountant and Joe Blow ("Joe Blow"), Happy Company's controller from July 2007 through April 2008, both of whom were employees of Happy Company, were responsible for the collection of data necessary to prepare Happy Company's sales taxes returns, the preparation of these returns and the payment of the

company's sales and use taxes. Tr. pp. 17-21, 35, 36, 44-46, 126, 128, 150, 151. The company's tax compliance was supervised by Peter Purple. Tr. pp. 125, 126, 145, 146.

12. Neither John Doe, Jack Black nor Fred Red was involved in the preparation, execution or filing of Happy Company's tax returns or the payment of Happy Company' taxes. Tr. pp. 110, 125, 139, 140, 145, 146. Their oversight of the company's tax compliance function was limited to reviewing the company's financial reports to assure themselves that taxes had been reported and paid. Tr. pp. 110, 111, 136, 138, 139, 143, 144, 146, 147. During the tax period in controversy, all reports they reviewed and other information they received indicated that the company's tax returns were timely filed and all taxes shown to be due and owing on these returns were paid. Tr. pp. 111, 114, 129, 131, 132, 136, 137, 141, 142, 144, 145. After interviewing Mary Blue and Joe Blow, Peter Purple advised John Doe, Fred Red and Jack Black that they possessed the necessary expertise to competently handle Happy Company' tax collection, compliance and payment functions. Tr. p. 55.

13. An Assignment for the Benefit of Creditors agreement was entered into between Jane Doe of ABC Business, Inc. and Happy Company on May 22, 2008. Taxpayer's Ex. 3. Pursuant to the terms of this agreement, Jane Doe, as assignee, agreed to pay all sales and use taxes that were due and owing on sales made by the company prior to the assignment. *Id*. Prior to the assignment, Jack Black received assurances from Jane Doe that all returns due and owing for the period after the assignment for the benefit of creditors would be filed and all taxes shown to be due on them would be paid. Tr. pp. 135, 136.

14. The notices of penalty liability issued to John Doe, Fred Red and Jack Black arose from the unpaid liability of Happy Company determined during an audit of this company in October, 2009. Taxpayer's Ex. 1 (Auditor's Narrative Report).

15. Happy Company's entire unpaid corporate liability reflected on the notices of penalty liability they were issued to the taxpayers arose from audit reports issued on or after October 14, 2009, regarding gross receipts from sales by Happy Company during the period June 2007 through April 2008. Taxpayer's Ex. 1 (Auditor's Narrative Report); Department Ex. 1. The entire final assessment of Happy Company arose from the Department's denial of credits for advance payments made prior to the date on which the sales related to such payments were booked on which no taxes were collected, and deductions for tax exempt sales, which Happy Company had taken on its monthly Illinois sales and use tax returns, but which were disallowed following the Department's audit in October 2009. *Id.*

16. Happy Company closed its business in April 2008 and made no additional sales after that date. Tr. pp. 135. The Department's audit of Happy Company took place in October 2009, more than a year after Happy Company ceased doing business. Taxpayer's Ex. 1 (Auditor's Narrative Report). The notices of penalty liability at issue were issued on December 9, 2010, more than two years after Happy Company closed. Department Ex. 1.

17. Happy Company filed all of its returns that were due in a timely manner, and all taxes shown on these returns to be due were timely paid throughout the tax period in controversy. Tr. pp. 18-21, 25, 26, 84-88, 144, 145, 155.

18. John Doe, Jack Black and Fred Red first learned that the company had unpaid taxes and penalties for the tax period in controversy in December, 2010, when they received the notices of penalty liability at issue in this matter; prior to these notices, they believed that all of Happy Company tax returns that were due had been filed and that all of the taxes due from this corporation had been paid. Tr. pp. 110, 111, 114, 129, 131, 132, 136, 137, 142, 144, 145; Department Ex. 1.

Conclusions of Law:

In the instant case, the Department seeks to impose personal liability for unpaid trust taxes of Happy Company, LLC ("Happy Company") upon John Doe ("John Doe"), Jack Black ("Jack Black"), and Fred Red ("Fred Red") pursuant to section 3-7(a) of the Uniform Penalty and Interest Act ("UPIA"), 35 **ILCS** 735/3-7. Section 3-7 states, in pertinent part, as follows:

> Any officer or employee of any taxpayer subject to the provisions of a tax Act administered by the Department who has the control, supervision or responsibility of filing returns and making payment of the amount of any trust tax imposed in accordance with that Act and who willfully fails to file the return or make the payment to the Department or willfully attempts in any other manner to evade or defeat the tax shall be personally liable for a penalty equal to the total amount of tax unpaid by the taxpayer including interest and penalties thereon.
> 35 **ILCS** 737/3-7(a)

Section 3-7 does not define who has the responsibility for filing returns and making payments, or what constitutes willful failure to pay. However, in applying the penalty tax, the Illinois courts look to federal cases involving section 6672 of the Internal Revenue Code ("IRC") which contains language similar to the aforementioned Illinois statute. Branson v. Department of Revenue, 168 Ill. 2d 247 (1985); Department of Revenue v. Joseph Bublick & Sons, 68 Ill. 2d 568 (1977). The key to liability under IRC section 6672 is control of finances within the taxpaying corporation including the power to control the allocation of funds to other creditors in preference to the company's tax obligations. Haffa v. U.S., 516 F. 2d 931 (7th Cir. 1975). The issue of willfulness is concerned with the state of the responsible person's mind. Sawyer v. U.S., 831 F. 2d 755 (7th Cir. 1987). "Willful failure to pay taxes has generally been defined as involving intentional, knowing and voluntary acts or, alternatively, reckless disregard for obvious or known risks." Branson, *supra* at 255.

During the evidentiary hearing in this case, the Department introduced notices of penalty liability assessing tax pursuant to section 3-7 of the UPIA. Department Group Ex. 1. When the Department introduced these notices of penalty liability into evidence under the certificate of the Department's Director of Revenue, it presented *prima facie* proof of all of the elements necessary for a determination that John Doe, Jack Black and Fred Red were personally liable for the unpaid taxes due and owing from Happy Company, a company where each of these individuals served as officers. Branson, *supra* at 260.

The Department's *prima facie* case is a rebuttable presumption. *Id*. at 262. After the Department introduces its *prima facie* case, the burden shifts to the taxpayer to establish that one or more of the elements required for the imposition of the penalty are lacking. Branson, *supra* at 261-62. A taxpayer cannot overcome the Department's *prima facie* case by merely denying the accuracy of the Department's assessment, or by merely denying conscious awareness that the tax was due from the corporation. Branson, *supra* at 267. Instead, the taxpayer must present evidence that is consistent, probable, and closely identified with its books and records. A.R. Barnes & Co. v. Department of Revenue, 173 Ill. App. 3d 826, 833 (1st Dist. 1988).

ANALYSIS OF STATUS OF JOHN DOE, JACK BLACK AND FRED RED AS RESPONSIBLE OFFICERS

Jack Black

As noted above, under section 3-7(a) of the UPIA, the test for determining whether a person has personal liability as a responsible officer for unpaid taxes incurred by a corporation is whether the person was responsible for accounting for and paying the tax due. In determining whether an individual is a responsible person, the courts have indicated that the focus should be on whether the person has significant control over the business affairs of a corporation and whether he or she participates in decisions regarding the payment of creditors and the disbursal of funds. Monday v. United States, 421 F. 2d 1210 (7th Cir. 1970). Liability attaches to those with the power and responsibility within the corporate structure for seeing that the taxes are remitted to the federal government. *Id.* The key to liability is control of finances within the corporation including the power to control the allocation of funds to other creditors in preference to the company's tax obligations. Haffa, *supra.*

Being a corporate officer does not, *per se,* impose the duty to collect, account for and pay over taxes. Monday, *supra*. However, an officer may have that duty even though he does not have a treasury function. *Id.* He has the duty if he has general control over the corporation's business affairs and participates in decisions concerning the payment of creditors. *Id.*

The courts have found that the following facts are relevant in determining whether a person is responsible: (1) identity of the officers, directors, and shareholders of the corporation; (2) duties of the officer as outlined by the corporate by-laws; (3) ability of the individual to sign checks of the corporation; (4) identity of the individuals who were in control of the financial affairs of the corporation; and (5) identity of the individuals who hired and fired employees. Schwinger v. United States, 652 F. Supp. 464, 467 (E.D.N.Y. 1987) (citing Silberberg v. United

States, 524 F. Supp. 744, 747 (E.D.N.Y. 1981)). Day to day control of the operations of a company is not necessary for finding liability. *Id.*

Using the criteria followed by the courts in addressing officer liability for taxes, Jack Black was a "responsible officer" for the entire tax period in controversy. The record shows that he was the majority shareholder of Happy Company from the inception of the company in 2004 until its dissolution in 2010. Tr. p. 134; Taxpayer's Ex. 3. Documentation contained in the record indicates that Happy Company was an Illinois manager managed limited liability company pursuant to section 15-1(b)(1) of the Illinois Limited Liability Company Act, 805 **ILCS** 180/15-1(b)(1). Taxpayer's Ex. 3. Jack Black was the sole manager of this company. *Id.* As the sole manager of a manager managed limited liability company, Jack Black, by statute, had the exclusive right to manage the conduct of the company's business affairs and to exclusively decide all matters related to the company's business operations. 805 **ILCS** 180/15-1(b)(2).[2] Accordingly, unless precluded from doing so by the corporation's by-laws, he clearly had the statutory authority to make financial decisions for the company and control the company's financial affairs.

The record in this case indicates that Happy Company also had a chief executive officer. Tr. p. 123. The company's by-laws are not in evidence, and the record does not show what duties and responsibilities were vested in the chief executive officer by them, or whether the by-laws limited the statutory powers vested in Jack Black as the corporation's sole manager. However, the evidence contained in the record completely supports a finding that Jack Black had significant authority over Happy Company' affairs. The record indicates that he supervised the company's management team that was responsible for the company's day to day operations. Tr.

[2] Section 15-1(b) of the Illinois Limited Liability Company Act, 805 **ILCS** 180/15-1(b) provides in relevant part as follows: "[A]ny matter relating to the business of the company may be exclusively decided by the manager or, if there is more than one manager, by a majority of managers."

pp. 149, 150. He also participated in decisions regarding the hiring of personnel (Tr. pp. 150, 151) and in decisions regarding the payment of the company's creditors (Tr. pp. 80, 81). In sum, based upon the evidence indicated above, and for the reasons enumerated herein, I conclude that Jack Black was a responsible officer of Happy Company during the tax period at issue.

Jack Black argues that on May 22, 2008 Jane Doe of ABC Business, Inc. took over Happy Company' operations pursuant to an assignment for the benefit of creditors entered into between Happy Company and Jane Doe on that date. Tr. p. 142. The gravamen of this claim is that, after that date, Jack Black ceased to be a responsible officer of Happy Company and therefore cannot be held liable for the liability Happy Company for periods after that date. I find this contention fails to prove that Jack Black did not remain a responsible officer of Happy Company after the assignment for the benefit of creditors took place.

The assignment for the benefit of creditors by Happy Company to Jane Doe was pursuant to a contractual agreement entered into by Jack Black as sole manager of Happy Company. Taxpayer's Ex. 3. The record contains no evidence that this assignment was legally mandated or occurred by operation of law. Rather Jack Black, as the sole manager of Happy Company, chose to allow Jane Doe any and all authority she exercised, and, decided that he would subordinate his statutory authority under the Limited Liability Company Act noted above in favor of her. There is no evidence that Jack Black did not have access to all of Happy Company' books and records during this time or that he could not have continued to speak to Jane Doe, the assignee about Happy Company' finances in his continuing capacity as Happy Company' sole manager during this time. The Assignment for the Benefit of Creditors Agreement (Taxpayer's Ex. 3) contains no evidence that it gave Jane Doe the right to act in Jack Black's stead on these matters. Accordingly, the fact that Jack Black exercised no influence over Happy Company after the assignment is based solely upon his election not to do so. Since Jack Black, as the sole manager of Happy Company, continued to have the statutory authority to participate in the governance of Happy Company' financial affairs after the assignment for the benefit of creditors, and maintained his title as sole manager of Happy Company throughout this period, I find that he continued to be a responsible officer of this company after the assignment for the benefit of creditors took place.

Fred Red

As previously noted, by Illinois statute, personal liability will be imposed upon a person who: (1) is responsible for filing corporate tax returns and/or making the tax payments; and (2) "willfully" fails to file returns or make tax payments. UPIA section 3-7. In determining whether an individual is a responsible person, the courts have indicated that the focus should be on whether the person has significant control over the business affairs of a corporation and whether he or she participates in decisions regarding the payment of creditors and the disbursal of funds. Monday, *supra.* Liability attaches to those with the power and responsibility within the corporate structure for seeing that the taxes are remitted to the government. *Id.*

Based upon the evidence of record, I conclude that Fred Red was a responsible party under the statute. By his own admission, Fred Red served as the Chief Financial Officer of Happy Company. Tr. p. 107. Indeed, he is the only chief financial officer of this company that is identified in the record. Happy Company's by-laws are not in evidence and the record does not show what responsibilities were vested in the office of "chief financial officer" by them. However, Fred Red's testimony contained in the record shows that he was in charge of the "financial activities" of the company. Tr. p. 109. He testified that his duties included arranging for company financing, monitoring cash flow to assure sufficient company liquidity, "reviewing the financial statements on a monthly basis" and "ensuring there were adequate controls in the company [and] all of our bills were paid…[.]" Tr. pp. 110, 111.

Throughout his testimony, Fred Red attempted to underplay his position and responsibilities at Happy Company. He testified that he was an employee of XYZ Business throughout his tenure as chief financial officer (Tr. p. 109), that he was never employed by Happy Company (id), and that he served as chief financial officer only on a part-time basis (Tr. p. 108).

Fred Red's testimony as to his lack of responsibility at Happy Company is self-serving and not credible. More importantly, section 3-7 of the UPIA does not require that a responsible officer spend a majority of his time managing the affairs of a corporation in order to be liable as a responsible officer.

Fred Red's principal contention is that he was not a responsible party during the tax period in controversy because he ceased to have any involvement with the company after 2006 which was prior to the tax period at issue in this case. Tr. p. 107. I do not find this testimony to be credible because the record does not indicate who performed the critical chief financial officer function for the company after Fred Red claims he ceased to be involved with it. Moreover, the record shows that he continued to be a shareholder of Happy Company after the date he contends he ceased to be affiliated with the company. Tr. p. 108.

Furthermore, Fred Red's claim that he ceased to be involved with the company after 2006 is not documented by any corporate minutes, corporate filings or any other company books, records or memoranda. Essentially, the claim that Fred Red left the company in 2006 is mere testimony uncorroborated by any books and records. The Illinois courts have repeatedly held that such evidence is insufficient to rebut the presumed correctness of the Department's determination. Mel-Park Drugs Inc., *supra*; PPG Industries Inc. v. Department of Revenue, 328 Ill. App. 3d 16, 34 (1st Dist. 2002). For the aforementioned reasons, I find that Fred Red was a responsible officer of Happy Company during the tax period at issue in this case.

John Doe

As previously noted, in the present case, the Department's *prima facie* case with respect to John Doe's status as a responsible officer was established when the Department's certified record relating to the notice of penalty liability at issue was admitted into evidence. Branson, *supra*. In response, John Doe presented testimony, but no documentary proof, that he did not have control over the payment of Happy Company' tax liabilities.

Unfortunately, John Doe, who bears the burden of proof sufficient to rebut the Department's *prima facie* case, submitted insufficient evidence to support his claim. As noted above, the taxpayer must present evidence that is supported by the taxpayer's books, records or other documents showing that the taxpayer did not have control over the payment of taxes. The only documentary evidence presented that has any bearing on John Doe's responsibilities during the tax period at issue is Happy Company' Illinois Business Registration, which shows that Peter Purple rather than the John Doe attested to having control over and responsibility for the payment of the corporation's taxes on this document. Taxpayer's Ex. 2. However, in a corporation there may be more than one responsible officer. Monday, *supra*. Section 3-7 of the UPIA does not confine liability to only one person in the corporation or to the person most responsible. Consequently, the aforementioned documentary evidence only proves that Peter Purple was a responsible officer, and fails to prove that John Doe was not also a responsible officer of Happy Company.

Moreover, the record in this case indicates that John Doe was the chief executive officer of the company. The chief executive officer ordinarily has significant control over a corporation's affairs, and this documentary evidence does not negate the inference to be drawn from John Doe's title that he had significant authority at Happy Company.

With the exception of the Illinois Business Registration noted above, the only other evidence supporting the taxpayer's claim that he was not a responsible officer is the taxpayer's own testimony that he was not in control of the company's finances or tax preparation and filing, This evidence is insufficient to overcome the Department's *prima facie* case. Jefferson Inc. Co. v. Johnson, 139 Ill. App. 3d 626 (1st Dist. 1985); Mel-Park Drugs v. Department of Revenue, 218 Ill. App. 3d 203 (1st Dist. 1991); A.R. Barnes & Co. v. Department of Revenue, 173 Ill. App. 3d 826 (1st Dist. 1988); Masini v. Department of Revenue, 60 Ill. App. 3d 11 (1st Dist. 1978); Copelivitz. V. Department of Revenue, 41 Ill. 2d 154 (1968). To prove his claim, the taxpayer needed to present corroborating documentation such as corporate by-laws or the taxpayer's employment agreement delineating the duties and responsibilities vested in the chief executive officer, or bank cards or other bank records showing that the taxpayer did not have the authority to direct the payment of bills during the tax period at issue. Without such evidence, it must be found that John Doe has not rebutted the Department's finding that he was a responsible officer of Happy Company during the tax period at issue. *Id*.

WHETHER JOHN DOE, JACK BLACK AND/OR FRED RED WILLFULLY FAILED TO FILE RETURNS AND/OR PAY TAXES

As previously noted, by Illinois statute, personal liability will be imposed upon a person who: (1) is responsible for filing corporate tax returns and/or making the tax payments; and (2) "willfully" fails to file returns or make tax payments. UPIA section 3-7. The Department's *prima facie* case presumes willfulness. Branson, *supra* at 262. To rebut this presumption, the person defending against the penalty must adduce sufficient evidence to disprove willful failure to file returns and pay taxes. *Id*. A responsible officer cannot prove his lack of willfulness simply by denying conscious awareness of a tax deficiency that could have been easily investigated by an inspection of corporate records. *Id*. at 267.

In McLean v. Department of Revenue, 326 Ill. App. 3d 667 (1st Dist. 2001), the appellate court provided a further, concise description of Illinois law regarding willful conduct by a responsible officer:

> Under Illinois law, if a responsible officer uses collected retailers' occupation taxes to pay other creditors of the corporation, while knowing that he or she was obligated to file the returns and remit the taxes, the "willful" element of section 13½ is satisfied. *Branson,* 168 Ill. 2d at 259. 615, 659 N.E.2d at 967; *Estate of Young*, 316 Ill. App. 3d at 378.654, 734 N.E.2d at 953. "A finding of willfulness under section 13½ does not require a showing of actual knowledge of nonpayment. Reckless disregard for obvious or known risks will suffice. [Citation.] If a responsible person in a position to easily discover nonpayment clearly ought to have known of a grave risk of nonpayment but did nothing, a finding of willfulness is justified." *Estate of Young,* 316 Ill. App. 3d at 375, 654. A corporate officer who is responsible for filing retailers' occupation tax returns and remitting the collected taxes may not avoid personal liability for tax penalties for nonpayment of such taxes merely by delegating bookkeeping duties to third parties and failing to inspect corporate records or otherwise failing to keep informed of the status of retailers' occupation tax returns and payments. See Branson, 168 Ill. 2d at 267. 615, 659 N.E.2d at 971.

McLean, *supra* at 675-76.

Further, as previously noted, when construing Illinois tax statutes imposing penalties for a responsible person's willful failure to file returns or pay taxes, Illinois courts have looked to federal cases construing and applying federal tax penalty statutes. Branson, *supra* at 261. Consistent with Illinois courts' construction of the type of action that would fall within the undefined term "willful," as used in Illinois statutes, is the federal court of claim's reasoning in

Ghandour v. United States, 36 Fed. Cl. 53 (1996):

B. *Willfulness*

[A]fter it has been determined that an individual was a "responsible person," the court must next ascertain whether that person acted "willfully" in failing to collect, truthfully account for, and pay over the withheld payroll taxes. I.R.C. § 6672(a). The Supreme Court has construed § 6672 as requiring an element of "personal fault" before an individual can be held liable for the penalty. *Slodov*, 436 U.S. at 254, 98 S.Ct. at 1788. As the Court of Claims explained, however-

> it is not necessary that there be present an intent to defraud or to deprive the United States of taxes due, nor need bad motives or wicked design be proved in order to constitute willfulness.

White, 372 F.2d at 521. On the other hand, "mere negligence" is insufficient to constitute willfulness under I.R.C. § 6672. *Godfrey*, 748 F.2d at 1577. Rather, the requisite "personal fault" may be shown in one of two ways: (1) "a deliberate choice voluntarily, consciously and intentionally made to pay other creditors instead of paying the Government," *White*, 372 F.2d at 521, *quoted in Godfrey*, 748 F.2d at 1577, or (2) "reckless disregard of a known or obvious risk that [the taxes] may not be remitted to the Government." *Godfrey*, 748 F.2d at 1578 (quoting *Mazo*, 591 F.2d at 1154).

1. *The "Deliberate Choice" Standard*

First, an individual has acted willfully if he made a deliberate and intentional choice to prefer other creditors over the government. Because the required preference of other creditors over the government must have been deliberate, *i.e.*, voluntary and intentional, it follows that the deliberate choice standard of willfulness can only be met if the responsible individual had *actual knowledge* of the specific tax delinquency for which the penalty was assessed. It is not sufficient that a responsible person knew of an earlier delinquency that was paid in full. *See Godfrey*, 748 F.2d at 1577. Moreover, if the choice by a corporate official to pay others instead of the taxes is to be found to have been deliberate, it follows that there must have been unencumbered funds available to pay the taxes at the time the taxes came due. If, on the other hand, when a responsible person learns of the taxes due, there are no funds available to pay over said owing taxes to the IRS, he need not "order the impossible," and the failure to pay the taxes will not be deemed willful under the deliberate choice standard. *Id.*

In assessing willfulness under I.R.C. § 6672, the focus is on "the taxpayer's diligence in attending to the duty to pay

> employment taxes." *Hammon,* 21 Cl.Ct. at 27. In this connection, the use of "*available* corporate money for other business purposes," *Powell v. United States*, 9 Cl.Ct. 58, 62 (1985) (emphasis added), when a responsible person has knowledge of a current tax liability, will constitute a "willful" failure to collect, account for, and pay over the due employment taxes, under the deliberate choice standard.
>
> 2. *The "Reckless Disregard" Standard*
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> Second, where a responsible person recklessly disregards a known or obvious risk that the taxes will not be paid to the IRS, and the taxes are in fact not paid, he has been "willful" as that term is used in I.R.C. § 6672, and may be assessed a penalty under that section. In *Hammon,* 21 Cl.Ct. at 29-30, the Claims Court laid out the test for recklessness under § 6672, delineating the following three elements:
>
> > (1) the responsible person's knowledge (or reason to know) of a risk that taxes will not be paid, (2) a reasonable opportunity to discover and remedy the problem, and (3) a failure to undertake the reasonable efforts to ensure payment.
>
> *See also Whiteside,* 26 Cl.Ct. at 573-74. The Seventh Circuit, in *Wright v. United States*, 809 F.2d 425, 427 (7th Cir. 1987), expounded a very similar test, holding that-the "responsible person" is liable if he (1) clearly ought to have known that (2) there was a grave risk that withholding taxes were not being paid and if (3) he was in a position to find out for certain very easily.
>
> Under either formulation, it is clear that the responsible individual must have had at least constructive knowledge of a *risk* that the employment taxes would not be paid, and must have had an opportunity to act on that knowledge to discover any problems in payment.
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> ***

Ghandour, 36 Fed. Cl. at 62-63 (emphases original).

In the instant case, the tax originally assessed against Happy Company was not based on the corporation's failure to file returns, or based on its failure to pay the taxes shown due on such returns. Taxpayer's Ex. 1 (Auditor's Narrative Report). The tax liabilities derivatively assessed against John Doe, Jack Black and Fred Red, therefore, are not like the unpaid corporate liabilities imposed on the taxpayers in Branson, *supra* at 963 ("The corporation had collected the taxes from its customers but failed to remit the collected taxes to the State[.]"); or McLean, *supra* at 672 ("In

February 1992, … the Corporation was behind in paying its sales taxes [and] federal taxes …[.]"). Thus, this is not a case where John Doe, Jack Black or Fred Red made a deliberate choice to pay other vendors or creditors of Happy Company at a time when they knew that Happy Company was not filing Illinois tax returns, or not paying the amount of tax shown due on those filed returns. During the time these officers of Happy Company presided over the company there was no period when Happy Company did not timely file returns, or failed to pay taxes shown to be due on the returns it filed. Tr. pp. 18-21, 25, 26, 84-88, 144, 145, 155.

Moreover, during the tax period in controversy, all reports the taxpayers reviewed and all other information they received indicated that the company's tax returns were timely filed and all taxes shown to be due and owing on these returns were paid. Tr. pp. 111, 114, 129, 131, 132, 136, 137, 142, 144, 145. It was not unreasonable for John Doe, Jack Black and Fred Red to rely on this information, given that these officers had been informed by their subordinate, Peter Purple, the person in charge of the company's tax function, that the persons in charge of tax compliance and the software and systems established to handle this task were sound. Tr. pp. 55, 131, 143, 144. Consequently, the record does not support a finding that either John Doe, Jack Black or Fred Red recklessly disregard any known risk that Happy Company would not pay its Illinois tax liabilities.

The claims by John Doe, Jack Black and Fred Red that they should not be considered to have willfully failed to pay Happy Company' tax liabilities draws upon the same elements that the federal courts use when determining whether a responsible person has acted willfully by acting recklessly. Under the federal court's analysis of "recklessness" as willfulness, there should be, at a minimum, evidence that a responsible officer had: (1) a reason to know of a risk that taxes would not be paid; (2) a reasonable opportunity to discover the problem; and (3) failed to undertake reasonable efforts to ensure payment. Ghandour, *supra* at 62-63. Here, John Doe, Jack Black and Fred Red all testified that, during their entire tenure at Happy Company, they never had any knowledge of the errors the Department's audit determined were being made on Happy Company' monthly returns. Tr. pp. 111, 114, 129, 131, 132, 136, 137, 142, 144, 145. This testimony is corroborated by documentation showing that the Department's initial determination of liability for one of the first months during the audit period in controversy was first tendered to Happy Company after the auditor completed his schedules and work papers on October 14, 2009, which was more than a year after the company had ceased its operations in April 2008. Taxpayer's Ex. 1. If they had possessed knowledge of the errors that the Department's auditor determined before the business closed, they would have had an opportunity to see whether the audit determinations were correct, and could have changed the way the company's receipts were reported and taxed on Happy Company' returns. However, because these errors were not identified until after the business closed, their due diligence and oversight of the company's affairs did not afford them this opportunity.

In the absence of such information, the officers reasonably relied upon the competence and experience of the company's tax compliance staff[3], and their due diligence which verified that all returns that were due had been filed and all taxes shown to be due on them paid. Based on the foregoing, I cannot conclude that the minimum prerequisites for a finding of reckless conduct as outlined in the federal case law, i.e. evidence of a reason to know of a risk that taxes were not being paid and a reasonable opportunity to discover and remedy the problem, have been satisfied in this case.

The foregoing analysis is not intended to imply that the Department failed to satisfy its

[3] The record indicates that both Mary Blue and Joe Blow, the company's principal tax compliance personnel, had served in this capacity at the company's predecessor, Distributors of America prior to being hired to perform tax compliance for Happy Company. Tr. pp. 17, 45, 59, 60.

initial evidentiary burden. The statutory presumption of correctness inures to all elements of the Department's penalty assessment, including willfulness. Branson, *supra* at 258 ("Under the plain terms of [the statute], nothing more [than the certified copy of the notice of penalty liability] is needed to prove the Department's claim for a tax penalty against the corporate officer or employee."). However, the documentary evidence of record tends to show that the parties that have been assessed the penalty liabilities at issue did not willfully fail to file Happy Company' returns, fail to pay the taxes due, or willfully attempt to evade or defeat the collection of Happy Company's post cessation of business determined unpaid tax liability. This is clearly evident from the fact that the assessment issued to Happy Company giving rise to the penalty liabilities at issue was not determined until one year after the business closed. Taxpayer's Ex. 1.

The record indicates that John Doe, Jack Black and Fred Red first learned of the liability giving rise to the penalty liabilities at issue upon receipt of penalty liability notices after the business operations of Happy Company had been closed for over two years (Tr. p. 114; Department Ex. 1), and this testimony is corroborated by the date on which the Department's initial audit deficiency for the audit period in controversy was arrived at. Compare Department Group Ex. 1 and Taxpayer's Exhibit 1.

In Branson, *supra*, the Illinois Supreme Court concluded as follows:

> …{W]e do not intend to imply that a corporate officer who is responsible for filing retailers' occupation tax returns and remitting the collected taxes may avoid personal liability … merely by delegating bookkeeping duties to third parties and failing to inspect corporate records or otherwise failing to keep informed of the status of the retailers' occupation tax returns and payments.
> …Although plaintiff claims he did not actually know or become consciously aware of the tax deficiency until after the business was closed in late January 1987, lack of willfulness is not proved simply by denying conscious awareness of a tax deficiency that could have been easily investigated by an inspection of corporate records.
> Branson, *supra* at 267 (emphasis added).

Branson involved a conscious and deliberate failure to pay taxes on the part of a company that prioritized other creditors over the Department. Given the company's financial plight, the court found that its officers should have been aware of a risk that the company's taxes were not being paid. Unlike Branson, in the instant case, the taxpayers that have been assessed introduced sufficient competent evidence to show that they had no reason to suspect that errors were being made in the preparation of the company's tax returns or the remission of its tax payments. This case, therefore, does not involve a situation similar to Branson where the officer could have easily discovered that the corporation was not filing returns or paying its retailers' occupation tax liabilities, merely by reviewing the company's books and records. Branson, *supra* at 264. I cannot conclude that any of the parties that have been assessed as responsible officers pursuant to the penalty liabilities in controversy could have discovered Happy Company' unpaid liabilities merely by reviewing the company's books and records. Such a review would not have revealed any patent tax deficiencies or delinquencies similar to those at issue in Branson.

In sum, the documentary evidence of record here corroborates the claims made by John Doe, Jack Black and Fred Red that they did not willfully fail to pay Happy Company's Illinois tax liabilities. That documentary evidence, together with their own credible testimony, rebuts the Department's *prima facie* case as to the element of willfulness.

After a taxpayer introduces evidence sufficient to rebut the Department's *prima facie* case the burden shifts to the Department to prove its case by a preponderance of the competent evidence. Goldfarb v. Department of Revenue, 411 Ill. 573, 580 (1952). Here, after the taxpayers that have been issued notices of penalty liability rested, the Department introduced no evidence that any of them ever willfully attempted to evade or defeat the collection of taxes the Department determined were due after Happy Company ceased operations. Consequently, the

Department has failed to carry its burden of proof arising from the evidence rebutting the Department's *prima facie* case that the taxpayers have proffered.

Conclusion:

For the reasons stated above, I recommend that the Director reconsider and cancel the notices of penalty liability that have been issued to John Doe, Jack Black and Fred Red in this case.

Ted Sherrod
Administrative Law Judge

Date: June 4, 2013