ST 05-14
Tax Type: **Sales 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.** **04-ST-0000** **IBT#** **0000-0000** **NPL#** **0000** **FEIN:** **00-0000000** **NOD#** **0000** **Period:** **4/Q/98 – 2/Q/99**
v.	
JOHN DOE, as responsible officer	**Ted Sherrod** **Administrative Law Judge**
Taxpayer	

RECOMMENDATION FOR DISPOSITION

Appearances: Special Assistant Attorneys General Jessica O'Brien, Sean Cullinan and Shiel Gupta on behalf of the Illinois Department of Revenue; Thomas J. Murphy, Esq. on behalf of John Doe.

Synopsis:

This matter comes on for hearing pursuant to John Doe's (hereinafter "John Doe" or "taxpayer") protest of Notice of Penalty Liability number XXXX (hereinafter the "NPL") and Notice of Deficiency number XXXX (hereinafter the "NOD") as responsible officer of ABC, LLC (also known as ABC, Inc.) (hereinafter "ABC"). The NPL represents a penalty liability for Retailers' Occupation Tax of ABC due to the Department for the period July, 1995 through May, 1999. The NOD represents a penalty liability for withholding taxes for the fourth quarter of 1998 and the first and second

quarters of 1999. A hearing was held on this matter on March 4, 2005 and March 14, 2005, with John Doe and two other witnesses providing oral testimony. Following the submission of evidence and a review of the record, it is recommended that the NPL and NOD be finalized as issued. In support thereof, the following "Findings of Fact" and "Conclusions of Law" are made.

Findings of Fact:

1. ABC, Inc. ("ABC") was an Illinois corporation registered to do business in Illinois engaged in the business of selling and servicing personal computers and installing and servicing software applications. Tr. pp. 25, 26; Deposition of Ron Doe (hereinafter "Ron Doe Dep.")[1] p. 13; Department Ex. 14.

2. Prior to 1987, Joe Blow and his father owned 100% of the stock of ABC. In 1987, Joe Blow's father died, and Jane Doe became a stockholder of ABC. Jane Doe is the sister of Joe Blow. Tr. pp. 26, 27.

3. In 1987, Joe Blow, who holds a baccalaureate degree from St. Olaf College, became President of ABC and exercised complete control over the operations of this company. Tr. pp. 24, 26, 27.

4. Between 1987 and 1992, ABC employed between 20 and 35 employees. Tr. p. 27.

5. Prior to 1992, John Doe, a graduate of the Kellogg School of Management at Northwestern University (Tr. pp. 8, 422) with an extensive background in the sale of computers and a license to sell Sun Microsystems products (Tr. p. 429), was

[1] Ron Doe did not appear as a witness at the evidentiary hearing in this case. However, the parties agreed to have his deposition admitted into the record as an evidence deposition. Tr. pp. 21-23.

employed by Sun Microsystems as a salesman specializing in the sale of Unix operating systems. Tr. p. 7.

6. In 1992, Joe Blow hired John Doe to form and organize a new division of ABC to be called ABC Open Systems. Tr. pp. 29, 34. This division was formed for the purpose of selling Unix and Sun Microsystems equipment (primarily computer servers) (Tr. pp. 29, 30), and services principally for use in data centers. Tr. p. 30. At the time ABC Open Systems was formed it was contemplated that it would become a separate corporation to be owned, controlled and operated by John Doe. Tr. pp. 31, 32, 37, 38, 45, 46, 324, 325; Department Ex. 11. A plan was agreed upon to accomplish this objective pursuant to which John Doe would be allowed to purchase a majority of the stock in this new company if certain conditions were met. Tr. pp. 49 – 57, 64-67; Department Ex. 12. This plan was memorialized in an "Agreement … for the incorporation of ABC, Inc." dated September 7, 1994 (Department Ex. 12), and a "Preorganization Subscription and Postorganization Management Agreement for ABC, Inc." (hereinafter "Preorganization Agreement") executed December 20, 1994. Department Ex. 13.

7. At its inception, the ABC Open Systems division of ABC consisted of 3 to 4 employees hired or recommended for hiring by John Doe. Tr. pp. 34-36. John Doe ran ABC Open Systems during its entire existence as a division of ABC from 1992 until 1994. Tr. pp. 36, 37, 39, 47.

8. ABC Open Systems became a separate company in 1994, when it was incorporated on December 30, 1994 as ABC, LLC (also known as ABC, Inc.). Department Ex. 3-7. Pursuant to the terms of an agreement to incorporate ABC entered into between

Joe Blow, John Doe, Jane Doe and ABC, Joe Blow and Jane Doe, the owners of ABC, were allocated 49.5% of the shares of ABC, with Joe Blow holding 40.5% of the company's shares and Jane Doe holding 9%. John Doe was allocated 40.5% of the shares. The remaining stock was held as treasury stock to be distributed to future officers and employees of the company. Tr. pp. 163, 326; Department Ex. 12.

9. John Doe signed the Department's NUC-1 Illinois Business Registration form for ABC, thereby accepting personal responsibility for filing sales tax returns and paying the taxes incurred by the company. Department Ex. 3.

10. At the time of the incorporation of ABC, ABC capitalized ABC by loaning ABC $116,951. Tr. p. 137; Department Ex. 12. It also contributed assets to ABC in return for a note in the amount of approximately $138,000. Department Ex. 13. John Doe was also given the right to purchase additional shares of ABC upon the satisfaction of the following conditions: i) principal and interest payable to ABC to be fully paid; ii) lines of credit extended from ABC to ABC to be clear; and iii) ABC cash reserves to be equal to 90 days of working capital. Tr. pp. 49, 50, 350; Dept. Ex. 12. These conditions were never formally satisfied. Tr. pp. 184, 350, 351. Moreover, neither the $116,951 loan to ABC from ABC nor the note given ABC for ABC assets ABC received when it was incorporated was ever formally repaid. Tr. pp. 350, 379.

11. Pursuant to the terms of an employment agreement between John Doe and ABC, dated January 1, 1995, John Doe was employed as President, Chief Executive Officer and Chairman of the Board of ABC. Tr. p. 74; Department Ex. 15. The employment agreement expressly authorized John Doe to acquire property, hire, fire, evaluate and determine the compensation, titles and responsibilities of employees, hire outside

attorneys, accountants and other consultants, enter into sales, consulting and other contracts on the company's behalf and develop marketing and business plans for the company. Tr. pp. 74 – 93. However, this agreement expressly withheld power to fire Joe Blow, who was designated as treasurer of ABC pursuant to the Preorganization Agreement between John Doe, Joe Blow and Rood. Tr. p. 76; Department Ex. 13, 15. During his tenure as President, Chief Executive Officer and Chairman of the Board, John Doe performed all of the functions authorized by the employment agreement except the selection and rental of the company's offices, which was arranged by ABC in accordance with the terms of an Administrative Support and Reimbursement Agreement between ABC and ABC dated January 1, 1995. Tr. pp. 80, 90, 91, 334, 335; Department Ex. 14.

12. Pursuant to the terms of the employment agreement, John Doe was authorized to handle, and handled the finances of ABC. Tr. pp. 86–88; Department Ex. 14. Specifically he was an authorized signatory on the ABC bank account (Tr. pp. 56, 79, 447; Ron Doe Dep. p. 26; Department Ex. 13, 14), having authority to sign checks up to $5,000 without a consigner (Department Ex. 12, 13), oversaw the payment of creditors and exercised final authority over which creditors were and were not paid (Tr. pp. 229–233, 277, 278; Ron Doe Dep. 47–52), supervised the chief financial officer with respect to matters concerning ABC (Tr. pp. 86, 100–102; Ron Doe Dep. 187, 188) and had complete access to the Chief Financial Officer's ("CFO") accounting records including his summary of unpaid tax and other bills (Tr. pp. 116-134, 141, 145, 218, 227, 234, 235, 240–242, 264–266, 295, 296, Ron Doe Dep. p. 37; Department Ex. 19, 21). He also supervised and received reports from ABC's outside

accountants, which included information concerning sales and withholding taxes that were due. Tr. pp. 115–120, 122, 124, 141–145, 200, 261, 262, 475, 476; Ron Doe Dep. pp. 64–65.

13. Joe Blow, as treasurer, did not exercise control over ABC's finances. Tr. pp. 55, 56, 90, 91, 93, 94, 99; Ron Doe Dep. pp. 22, 23. While John Doe was technically required by the terms of the Preorganization Agreement (at section 7.2) to obtain Joe Blow's consent before entering into transactions "if the aggregate cost for the Corporation to perform such transaction would exceed $5,000 in a single transaction or $15,000 in the aggregate over a six month period" (Tr. p. 400; Department Ex. 13), this requirement did not, in practice, limit John Doe's control over the company's finances. Ron Doe Dep. 164–166. Moreover, while the Preorganization Agreement (at section 7.4) also makes Joe Blow responsible for "government reporting", John Doe rather than Joe Blow actually supervised this function to the extent it concerned tax compliance and reporting for ABC. Tr. pp. 217, 218, 228, 229, 264, 265, 295, 466 – 475; Ron Doe Dep. pp. 64–67.

14. John Doe's authority under his employment agreement with ABC included the power to hire employees and outside consultants, and he hired Smith and Jones, owners of XYZ (Tr. p. 110), an early stage, high growth technology consulting firm (Tr. p. 337), to assist in planning and oversight of ABC. Tr. pp. 54, 59, 110. Smith and Jones were also members of the ABC Board of Directors (Tr. p. 110), along with Jane Doe, John Doe and Joe Blow. Tr. pp. 164, 165. John Doe met privately with Smith and Jones at least once a month. Ron Doe Dep. pp. 196, 197. Neither Joe Blow nor ABC's CFO were involved in these meetings. *Id.* John Doe also hired ABC

employees including Employee #1 as technical director of ABC, and Employee #2 as director of sales. Tr. pp. 95, 96. Although the Presubscription Agreement placed restrictions on John Doe's ability to hire employees without Joe Blow's consent (Exhibit 13, section 7.2), John Doe did not obtain Joe Blow's permission before hiring Employee #1, Employee #2 or any other ABC employee. Tr. pp. 95–97; Ron Doe Dep. pp. 22, 42.

15. In the exercise of powers authorized by his employment agreement with ABC, and pursuant to an Administrative Support and Reimbursement Agreement ("Administrative Support Agreement") (Department Ex. 14; see also Tr. pp. 70–73) between ABC and ABC dated January 1, 1995, John Doe participated in joint purchases of property with ABC and jointly hired employees who ABC and ABC agreed would be shared employees. Tr. pp. 147–149, 151; Ron Doe Dep. pp. 14–16. The expense of these joint purchases and employees, and other shared expenses were allocated between ABC and ABC pursuant to a reimbursement percentage (Tr. p. 71) and other terms set out in the Administrative Support Agreement. Department Ex. 14.

16. In accordance with the Administrative Support Agreement, where ABC paid the entire cost of salaries or purchases on behalf of ABC and ABC, the portion of this charge attributable to ABC was charged back to ABC. Tr. pp. 134, 135, 236–238; Ron Doe Dep. pp. 24, 52–54. An account payable in favor of ABC was then created on the books of ABC and a counterpart account receivable placed on the books of ABC. *Id*. These amounts were captured in a separate account entitled the "Due to/Due From ABC Account" on the books of ABC. Department Ex. 25. The amounts

due to or from ABC as a result of intercompany loans and capital contributions were also captured in this account on ABC's books. Tr. p. 239. As part of his responsibilities as President and Chief Executive Officer of ABC, John Doe kept track of amounts shown as due and owing to and from ABC in the "Due to/ Due From ABC Account", which were reported to him for his review on a monthly basis by the CFO. Tr. pp. 240, 241, 295.

17. The Chief Financial Officer, and all of his subordinates were shared employees. Tr. pp. 279, 382-386; Department Ex. 3, 17. Between fifty and seventy percent of the Chief Financial Officer's salary was paid by ABC and between thirty and fifty percent of his salary was paid by ABC. Tr. pp. 382, 383.

18. Joe Blow, as treasurer of ABC, was also an authorized signatory on the ABC bank account. Tr. pp. 55, 56. However, he rarely exercised these powers, and signed checks only when John Doe or the Chief Financial Officer of ABC was not available. *Id.*

19. ABC generated between $12 million and $18 million in sales in 1997. Tr. pp. 282, 335. The company's pre-tax profit in that year was between $300,000 and $400,000. Tr. p. 139. It used approximately $350,000 of these proceeds to reduce indebtedness to ABC. Tr. pp. 340, 341; Taxpayer Ex. 5. The company also had between $17 million and $18 million in sales in 1998. Tr. pp. 335, 336.

20. Toward the end of 1997, ABC began to experience financial problems. Tr. p. 161. John Doe was fully aware of this situation. *Id.* Both ABC and ABC determined that new lines of credit from banks were needed to address cash flow concerns at both companies (Tr. pp. 149, 150), and felt that a new Chief Financial Officer would be

needed to accomplish this because the financial records prepared by Ron Doe, who was then CFO of both companies, were found to be unacceptable to prospective lenders. Tr. p. 149. Accordingly John Doe and Joe Blow agreed to hire Employee #3 to replace Ron Doe (Tr. pp. 151, 152), and Employee #3 was hired in February 1998. Tr. pp. 209, 210. Pursuant to the Administrative Support Agreement, the new Chief Financial Officer was hired to work for both ABC and ABC. Tr. pp. 210, 211; Department Ex. 14.

21. Employee #3, who holds a baccalaureate degree in accounting from the University of Illinois and is a licensed certified public accountant, had a background in accounting having worked with Arthur Andersen. Tr. pp. 209, 210. Employee #3 was initially retained as a contract employee. Tr. pp. 149, 210, 211. He subsequently assumed the role of CFO and became responsible for the company's day-to-day financial activities and the generation of financial reports in June, 1998. Tr. pp. 218, 219.

22. As part of the process of obtaining outside financing, prospective lenders reviewed the financials and books and records of ABC. Tr. pp. 150, 151. In going through these books and records to prepare them for such review, Employee #3 discovered that they were not being kept properly and were unreliable. Tr. pp. 225–227. He also determined that sales tax returns had not been filed for some time. Tr. p. 228. He further concluded that the company was in bad financial condition, and these conclusions were communicated to John Doe. Tr. pp. 227, 235. To assist in rectifying the company's books and records, ABC hired Employee #4 as the firm's new accountants. Tr. pp. 151, 300, 301.

23. In an effort to secure outside financing to ease ABC' and ABC's cash flow problems, Employee #3 developed various financial restructuring plans involving use of the "Due to/ Due From ABC Account." Tr. pp. 242-246; Department Ex. 22, 24; Taxpayer Ex. 1. As part of these plans, Employee #3 at times proposed major shifts of assets and liabilities between ABC and ABC to improve the financial presentation of one or the other in an effort to secure bank financing. Tr. pp. 238, 239, 257. When attempts were made to secure borrowing for ABC, shifts in favor of ABC involving the forgiveness of ABC debt to ABC were undertaken or proposed. Tr. pp. 238, 239, 247.

24. One of the restructuring proposal developed by Employee #3 involved a proposed shift of $500,000 to $600,000 of ABC indebtedness to equity through forgiveness of indebtedness in this amount by ABC. Tr. pp. 243-249, 257, 258, 287-291, 388, 389; Department Ex. 22, 24; Taxpayer Ex. 1. The purpose of this shift was to make the ABC debt to equity ratio look better and thus improve its ability to obtain a loan. Tr. pp. 243-249. This would benefit ABC by making ABC less reliant on ABC's cash flow to survive and also because it involved the cancellation of ABC's indebtedness to ABC resulting from the manner in which ABC was capitalized. Tr. pp. 290, 291. To the extent such transfers were effected, Joe Blow, on behalf of ABC and John Doe for ABC agreed to allow these transfers to take place. Tr. pp. 238, 239, 249, 257, 258. Such transfers were negotiated between John Doe and Joe Blow, and were not effected unless they both agreed to them. Tr. pp. 256, 257, 288; Department Ex. 22. As a result of these types of book transfers, the amount due to ABC from ABC shown

in the "Due to/ Due From ABC Account" grew substantially between 1997 and 1998. Department Ex. 25.

25. Both entities realized that a loan was the only way to obtain operating capital necessary to continue to survive. Tr. pp. 389, 390. ABC's forgiveness of indebtedness was intended to reduce the amount of debt shown on the ABC books in order to make it easier for ABC to obtain a loan. Tr. pp. 244, 245, 389. ABC was deemed to be a better candidate for borrowing than ABC because it had a history of banking relationships. Tr. pp. 389, 390. Moreover, ABC and Joe Blow had for most of ABC's existence been responsible for providing cash for ABC. Tr. pp. 331, 391–393.

26. As a result of its financial difficulties, ABC was unable to pay all of its creditors and was forced to prioritize creditor payments. Tr. pp. 161, 162, 229, 230. In order to address this problem, ABC developed an order of priority or "pecking order" for paying bills. Tr. pp. 162, 163, 229, 230. The highest priority was given to paying product suppliers. Tr. pp. 230, 231. Payroll to cover employees and contractors was also high on the priority list. Tr. pp. 231, 232. ABC frequently encountered problems meeting its payroll. Tr. p. 232. Even after ABC was audited in 1998, and determined to owe Illinois a substantial amount of taxes, unpaid taxes did not become the company's highest priority on the priority list. Tr. pp. 265– 267. As a consequence, while other company bills, including payroll of approximately $300,000 to $340,000 (Tr. p. 312), and a payment to John Doe in lieu of his scheduled salary, were being paid in late 1998, tax liabilities were not. Tr. pp. 273–277; Department Ex. 10. John

Doe and Employee #3, his CFO, developed this prioritization for ABC. Tr. pp. 230, 278.

27. To alleviate cash flow problems, Employee #3 entered into an agreement to factor receivables with Banker's Capital in 1998. Tr. pp. 193, 352, 353. Pursuant to this agreement, money from factored receivables was deposited into a lock box controlled by the factoring financial organization and ABC was paid an agreed percentage of receivables collected. Tr. pp. 309-311. Funds generating receivables were paid to suppliers and none of these funds were used to pay sales taxes. *Id.*

28. Employee #3 expressly advised John Doe that the company had significant sales tax delinquencies and that sales tax returns had not been filed for a long period of time. Tr. pp. 225–228. John Doe authorized Employee #3 to hire additional tax consultants to determine the amount of the company's tax liabilities. Tr. pp. 228, 229.

29. ABC lacked sufficient cash to continue operations without obtaining a bank loan. Tr. p. 353. It could not obtain a loan due to its lack of banking relationships and impaired balance sheet. *Id.* After an unsuccessful attempt by John Doe to sell the business, ABC filed for bankruptcy in April 1999. Tr. pp. 353, 354.

30. ABC's bankruptcy petition was denied. Tr. p. 364. Subsequently, on May 10, 1999, ABC ceased to do business, and ABC's management agreed to an assignment for the benefit of creditors, which ultimately resulted in the transfer of all of its assets and most of its employees to Central Design Systems. Tr. p. 353; Taxpayer Ex. 12. The assets assigned included over $1 million in receivables and $130,000-$150,000 in cash. Tr. p. 359. This transfer was booked as a sale of assets, and the sale price was $147,000. Tr. p. 391.

31. During an audit of ABC covering the period July 1, 1995 through August 31, 1998, the Department discovered a deficiency of $211,397, excluding penalties and interest. Department Ex. 10. The auditor found that the sales tax deficiency resulted from the "irregular application" of sales tax and a failure to collect tax on some transactions. Tr. p. 495. John Doe signed an amended return admitting to the amount of liability determined on audit in March 1999. Tr. pp. 398, 399; Department Ex. 9.

Conclusions of Law:

The issue in this case is whether John Doe ("John Doe") was a responsible person who willfully failed to file and pay retailers' occupation tax and withholding tax for ABC, LLC (a/k/a ABC, Inc.) ("ABC"), as required by statute. The admission into evidence of Notice of Penalty Liability number XXXX (Department Ex. 2) and Notice of Deficiency number XXXX (Department Ex. 1), the assessments at issue in this case, establish the Department's *prima facie* case with regard to both the fact that John Doe was a "responsible" officer and the fact that he "willfully" failed to file and/or pay the pertinent taxes. Branson v. Department of Revenue, 168 Ill. 2d 247, 262 (1995). Once the Department has established a *prima facie* case, the burden shifts to the taxpayer to overcome the Department's finding. Masini v. Department of Revenue, 60 Ill. App. 3d 11 (1st Dist. 1978). To overcome the Department's *prima facie* case, the taxpayer must present consistent, probable evidence, closely identified with books and records. Copilevitz v. Department of Revenue, 41 Ill. 2d 154 (1968); Central Furniture Mart v. Johnson, 157 Ill. App. 3d 907 (1st Dist. 1987); Vitale v. Department of Revenue, 118 Ill. App. 3d 210 (3d Dist. 1983). Oral testimony without corroborating books and records is

insufficient to overcome the Department's *prima facie* case. Mel-Park Drugs v. Department of Revenue, 218 Ill. App. 3d 203 (1st Dist. 1991).

There are two types of taxes at issue in this case. The Department seeks to impose personal liability on John Doe pursuant to section 1002(d) of the Illinois Income Tax Act for the failure to pay withholding taxes. 35 **ILCS** 5/1002(d). In addition, the Department seeks to impose personal liability for failure to remit Retailers' Occupation Tax ("ROT"). The personal liability penalty for both taxes is imposed by section 3-7 of the Uniform Penalty and Interest Act, which provides in 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 wilfully fails to file the return or make the payment to the Department or wilfully 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. The Department shall determine a penalty due under this Section according to its best judgment and information, and that determination shall be prima facie correct and shall be prima facie evidence of a penalty due under this Section. 35 **ILCS** 735/3-7.

It is clear from this statute that personal liability will be imposed on one who is "responsible" for the filing of returns and for the payment of the taxes shown to be due thereon, and who willfully fails to file and/or pay taxes.

The statute defines neither "responsible" person nor "willful" conduct. However, the Illinois Supreme Court, in cases wherein it has considered personal liability, has referred to interpretations of similar language in section 6672 of the Internal Revenue Code (26 U.S.C.A. §6672), which imposes personal liability on corporate officers who willfully fail to collect, account for, or pay over employees' social security and Federal income withholding taxes. Branson, *supra*; Department of Revenue v. Heartland

Investments, Inc., 106 Ill. 2d 19 (1985); Department of Revenue v. Joseph Bublick & Sons, Inc., 68 Ill. 2d 568 (1977).

Federal courts have addressed officer/employee liability with respect to who is considered "responsible" for §6672 purposes. These courts have considered specific facts in determining whether individuals were "responsible" for the payment of employment taxes, to wit: 1) the duties of the officer as outlined by corporate by-laws; 2) the ability of the individual to sign checks of the corporation; 3) the identity of the officers, directors, and shareholders of the corporation; 4) the identity of the individuals who hired and fired employees; and, 5) the identity of the individuals who were in control of the financial affairs of the corporation. Monday v. United States, 421 F. 2d 1210 (7th Cir. 1970), cert. den. 400 U.S. 821 (1970); Gephart v. United States, 818 F. 2d 469 (6th Cir. 1987); Peterson v. United States, 758 F. Supp. 1209 (N.D. Ill. 1990).

In determining whether an individual is a responsible person the courts have indicated that the focus should be on whether that 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. See Monday, *supra*. Liability attaches to those with the power and responsibility within the corporate structure for seeing that the withholding taxes are remitted to the Government. *Id*. Moreover, the law does not confine liability to the single most responsible person. Gephart, *supra*. Rather, any corporate officer or employee with the power and authority to avoid a default or to direct payment of taxes is a responsible person. Feist v. United States, 221 Ct. Cl. 531, 539, affirmed Feist v. United States, 607 F. 2d 954, 960 (1979).

In the case at hand, the evidence clearly proves that John Doe had significant control over the corporation's business operations and employees. John Doe entered into a contract designating him as President and Chief Executive Officer of ABC and expressly authorizing him to exercise the following powers: 1) acquisition of property; 2) hiring, firing, evaluation and determination of the compensation, titles and responsibilities of employees; 3) hiring attorneys, accountants and outside consultants; 4) entry into sales, consulting and other contracts on the company's behalf; 5) development of marketing and business plans for the company; and 6) handling the company's finances. Tr. pp. 74 – 93; Department Ex. 13, 15. Moreover, John Doe exercised virtually all of these powers during the entire tax periods in controversy. Tr. pp. 80, 90, 91, 334, 335. John Doe hired his entire staff, including his senior ABC managers Employee #1, and Employee #2. Tr. pp. 95-97; Ron Doe Dep. pp. 22, 42. While he was technically required to obtain the approval of Joe Blow, President of ABC, before hiring employees earning more than $40,000, pursuant to a Preorganization Agreement entered into with Joe Blow and Jane Doe, owners of ABC at the time ABC was incorporated, Joe Blow testified that this requirement never prevented John Doe from hiring any employees of his choosing. Tr. pp. 95–97. John Doe also enlisted the services of business consultants, including Smith and Jones who served on the Board of ABC, and reported exclusively to John Doe. Tr. pp. 54, 109, 110, 432-434; Ron Doe Dep. pp. 196, 197.

John Doe also was a signatory on the ABC bank account and had authority to execute checks up to $5,000 without a cosigner. Department Ex. 12, 13 (at section 6.7). He also had final authority over which creditors would and would not be paid. Tr. pp. 229–233, 277, 278; Ron Doe Dep. pp. 47–52.

The record also clearly shows that John Doe supervised the company's tax compliance. Tr. pp. 217, 218, 228, 229, 265, 295; Ron Doe Dep. pp. 64-67. By his own admission, he conferred with the Chief Financial Officer regarding tax liabilities and decided what amount of taxes would be paid. Tr. pp. 466-472. He also authorized the retention of tax consultants to assist the company. Tr. pp. 228, 229. While the Preorganization Agreement provided that Joe Blow was to be responsible for "government reporting", there is nothing in the record to show that he ever exercised this responsibility.

Using criteria followed by the federal courts in addressing officer liability for taxes, and accordingly applicable in construing Illinois "responsible officer" statutes, the foregoing evidence clearly establishes that John Doe was a responsible officer during the income tax and sales tax periods in controversy. Monday, *supra*; Gephart, *supra*; Peterson, *supra*. Moreover, the taxpayer expressly assumed personal responsibility for filing these returns when he signed the applicable section of the application for an Illinois business registration certificate at the time ABC was incorporated. Department Ex. 3.

John Doe contends that he was not a responsible officer because he never had authority or control over ABC's finances. Tr. pp. 523–525. In support of this claim, he points to the Preorganization Agreement, which expressly limits John Doe's authority to make bill payments without the approval of Joe Blow, the chief executive officer of ABC. *Id*. ABC began as a division of ABC prior to its incorporation in 1994, and John Doe contends that it continued to operate as a division of ABC rather than as a separate company even after it was separately incorporated. *Id*.

The record in this case does not support John Doe's claim that ABC was under the control of Joe Blow, the President of ABC. Rather, the record is replete with evidence that John Doe exercised unfettered control over ABC's affairs. Tr. pp. 98–100; Ron Doe Dep. 115-117, 164–166, 191–199. Note in particular, the following testimony from Ron Doe:

> Q. As your boss was John the type of person – John Doe the type of boss who needed to know what's going on in every component of his operation?
>
> A. Yes.
>
> Q. Why do you say that?
>
> A. He got involved with all the sales, all of the – and shouting matches with almost everybody about their transactions. And he was a very hands-on person.
>
> Q. So he controlled every single part of the business?
>
> A. In essence, yes.
> Ron Doe Dep. p. 188.

In light of this evidence, I am not persuaded by John Doe's contentions.

The taxpayer further contends that Joe Blow's control over ABC can be inferred from the fact that one million dollars[2] was allegedly transferred from ABC to ABC, the

[2] The $1 million alleged transfer from ABC to ABC represents the amount allegedly owed ABC by ABC at the end of 1997 ($417,331) and the amount allegedly owed ABC by ABC by 1998 ($600,000). Tr. pp. 155-157. Assuming ABC paid ABC $417,331 to extinguish its debt and ABC borrowed $600,000 from ABC, the amount transferred to ABC from ABC would be slightly more than $1 million.

company Joe Blow headed. Tr. pp. 524-526. As a preliminary matter, it is unclear from the record whether this transfer actually took place. While significant transfers of assets, using special accounts showing transactions between ABC and ABC, were proposed from time to time, it is unclear whether all of these transactions were effected. There is explicit testimony in the record from ABC's CFO that book entries showing such transfers are unreliable and stating that some of these transfers, including part of the alleged transfer of one million dollars to ABC, may have only been book entries which were reversed. Tr. pp. 251–257; see also Tr. pp. 157, 199, 200 (Joe Blow's testimony denying this transfer occurred).

Moreover, the record plainly shows that John Doe was fully aware of all transfers, which would have been reflected in ABC's "Due to/ Due From ABC Account" which he reviewed with his CFO at least monthly. Tr. pp. 240, 241, 295. There is also evidence in the record that John Doe actually approved inter-company transfers forgiving ABC indebtedness to ABC as part of refinancing plans designed to better position ABC to obtain bank lines of credit. Tr. pp. 238, 239, 244, 245, 249. ABC almost exclusively financed ABC (Tr. pp. 44, 50, 331), and the record shows that ABC did not have access to banking resources and could not obtain bank lines of credit on its own. Tr. p. 353. Since ABC lacked sufficient cash to continue operations at the time these plans to bolster the ABC books and position it for a loan were proposed, ABC's continued existence depended upon the success of ABC in obtaining the new financing it was seeking. *Id.* Thus, it was plainly in John Doe's and ABC's interest that the ABC balance sheet be improved through inter-company book entries. For the foregoing reasons, I find unconvincing John Doe's claim that Joe Blow exercised control over ABC to move one

million dollars of ABC cash onto the books of ABC, or the implication that this was somehow done without John Doe's consent.

John Doe also contests the Department's finding that he willfully failed to pay taxes during the tax periods in controversy. The Illinois statutes do not define the concept of willful failure for purposes of applying Section 3-7 of the Uniform Penalty and Interest Act, 35 **ILCS** 735/3-7. However, as previously noted, in applying the penalty tax, the Illinois courts look to federal cases involving § 6672 of the Internal Revenue Code which contains language similar to the Illinois statute. Branson, *supra*; Joseph Bublick & Sons, *supra*. Federal case law indicates that the issue of willfulness concerns the responsible person's state of mind and thus requires a voluntary and knowing act or omission. Sawyer v. U.S., 831 F. 2d 755 (7th Cir. 1987). The key factor in finding liability for willful conduct under § 6672 is control of finances within the employer corporation including the power to control the allocation of funds to other creditors in preference to tax obligations. Brown v. United States, 591 F. 2d 1136 (5th Cir. 1979); Haffa v. U.S., 516 F. 2d 931 (7th Cir. 1975). A voluntary, conscious and intentional act sufficient to constitute willfulness includes reckless disregard of a known risk that trust funds might not be remitted. Brown, *supra*. In sum, "(W)illful 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.

The record clearly evidences John Doe's conscious decision to follow the recommendations of his CFO and approve the use of available funds of ABC to pay other creditors and corporate liabilities rather than the corporation's taxes. Compare Tr. pp. 229–232, 265, 266, 272–278, 312 and Tr. pp. 466-472. John Doe and his CFO concocted

a "pecking order" of creditor payments that preferred suppliers and payroll and wage liabilities to tax payments. Tr. pp. 230–232, 265, 266. Indeed, even when substantial tax liabilities were uncovered during the Department's audit of ABC, the "pecking order" was not revised to make taxes a higher priority. Tr. pp. 265, 266. Preferring other creditors to company tax liabilities is conclusive evidence of willful failure to pay taxes under both state and federal case law construing responsible officer liability. Heartland Investments, Inc., *supra*; Bublick & Sons, Inc., *supra*; Ruth v. United States, 823 F. 2d 1091 (7th Cir. 1987). Yet it is precisely this type of conduct in which John Doe engaged.[3]

John Doe argues that he did not willfully fail to pay taxes during the tax periods at issue, because the tax compliance function was under the complete control of Joe Blow, President of ABC during these tax periods, pursuant to the terms of the Preorganization Agreement. Tr. pp. 523-525. In support of this claim, he contends that Joe Blow and ABC entirely controlled the receipt and disbursement of ABC's revenues pursuant to a "lock box" arrangement whereby all payments to ABC were deposited into an account over which ABC exercised complete control and discretion. Tr. pp. 342–345. While the record in this case is quite voluminous, there is no documentary evidence that any such "lock box" account ever existed. Moreover, this claim is contradicted by John Doe's admission that ABC had its own operating account throughout its existence (Tr. p. 421), and evidence in the record that transfers from ABC to ABC required John Doe's approval. Tr. pp. 256, 257, 288.

[3]While Employee #3 testified that John Doe may not have known that other creditors were being paid rather than the company's tax liabilities (Tr. pp. 272-278), I find this testimony inconsistent with John Doe's admission that he decided what, if any, taxes would be paid during the period payments to other creditors were being made. Tr. pp. 466-472.

As evidence of a "lock box" arrangement, John Doe points to the Preorganization Agreement which he claims gave John Doe absolute control over ABC's finances. Tr. pp. 478, 479. While this is far from clear from the terms of this agreement, even if one assumes that John Doe did delegate all financial control to Joe Blow pursuant to the Presubscription Agreement, the Illinois and federal courts have repeatedly held that responsible officers are liable for willfully failing to remit taxes if they delegate such responsibilities but fail to inspect corporate records or otherwise fail to keep informed of the status of tax returns and payments. Branson, *supra* at 267; Thomsen v. United States, 887 F. 2d 12 (1st Cir. 1989).

ABC experienced financial difficulties and cash flow problems throughout much of its existence. Ron Doe Dep. p. 87; Taxpayer Ex. 3. The record also indicates that John Doe was very aware of these financial problems. Department Ex. 23; Taxpayer Ex. 3. In looking to federal precedent for guidance, (Branson, *supra*; Heartland Investments, *supra*), the Illinois Supreme Court has effectively adopted, as indicia of willfulness, a showing of "reckless disregard for obvious or known risks" as set forth in cases dealing with section 6672 of the Internal Revenue Code. Monday, *supra*; Wright v. United States, 809 F. 2d 425 (7th Cir. 1987). In Wright, *supra* at 427, the Seventh Circuit stated that:

> But bearing in mind that if a high degree of recklessness were required the purpose of the statute would be thwarted, just by compartmentalizing responsibilities within a business (however small) and adopting a "hear no evil-see no evil" policy, we think gross negligence is enough to establish reckless disregard. Concretely we hold 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.

This statement is reflective of federal court determinations which consistently have found that willfulness may be established with a showing that the "responsible party clearly ought to have known of a 'grave risk of nonpayment' and who is in a position to easily find out, but does nothing." Branson, *supra* at 255 (citing Ruth, *supra*).

John Doe had ready access to all of ABC's financial books and records throughout his tenure as President and Chief Executive Officer of ABC. Tr. pp. 116-134, 141, 145, 218, 227, 234, 240-242, 264-266, 295, 296; Ron Doe Dep. p. 37; Department Ex. 19, 21. Moreover, he was clearly aware of ABC's ever-present financial problems, and was advised by Employee #3 of the company's tax liabilities and non-compliance soon after Employee #3 completed his initial review of the company's books. Tr. pp. 218, 225-229. Certainly by mid-1998, a point when ABC had enough money to pay its accumulated taxes (Tr. p. 312)[4], John Doe had reason to believe that the company's financial problems were affecting its ability to meet its tax obligations. Tr. pp. 218, 228, 229. However, there is no evidence in the record that John Doe ever attempted in any way to see to it that tax payment responsibilities, including any that may have been delegated to Joe Blow, were being fulfilled. John Doe's failure to act in this manner, given every reason to suspect taxes may not have been handled properly, is itself willful conduct. Monday, *supra*; Wright, *supra*. His claim that his responsibilities were delegated to Joe Blow is no defense. A responsible officer cannot escape a finding of reckless failure to address a "grave risk" that taxes were not being paid simply by claiming to have delegated his responsibility for taxes to others. Wright, *supra*.

[4] The record shows that ABC covered a payroll of between $300,000 and $350,000 during the second half of 1998. Tr. p. 312.

Moreover, even if John Doe could conclusively prove a delegation of duties to Joe Blow by virtue of the "lock box" arrangement he alleges existed, such evidence alone would not be exculpatory. The courts have, indeed, held that where a lender has complete control over a debtor's funds under a "lock box" or similar agreement and the lender is aware of the tax obligations of the debtor but prefers other creditors in disbursing the debtor's funds, it is the lender who is willfully failing to pay over the taxes due. See U.S. v. Vaccarella, 735 F. Supp. 1421 (S.D. Ind. 1990), *aff'd sub nom.* U.S. v. Security Pacific Business Credit, Inc., 956 F. 2d 703 (7th Cir. 1992). However, there is insufficient evidence in the record to apply this precedent here.

Specifically, even if it is assumed that a "lock box" arrangement existed and that all of ABC's resources were controlled by Joe Blow, there is no evidence in the record that John Doe ever told Joe Blow that ABC was taking money earmarked for sales and income tax withholding taxes, or that John Doe ever requested that a portion of ABC's funds be set aside to pay taxes. Such evidence is essential to come within the holding in Vaccarella, *supra*, since the debtor's officers absolved in that case made numerous efforts to get the lender to meet the debtor's tax obligations. Vaccarella, *supra* at 1424–1428.

In sum, John Doe's control over ABC's financial affairs, including tax compliance, by virtue of duties exercised by him as President and Chief Executive Officer of ABC, plainly identifies him as a "responsible officer" of ABC. Moreover, his failure to address the "grave risk" that ABC taxes were not being paid, and his approval of a "pecking order" that preferred other creditors over ABC's tax liabilities constitute willful conduct that is proscribed by 35 **ILCS** 735/3-7. John Doe's claim that he lacked sufficient control over ABC to see to it that taxes were paid is not supported by evidence

in the record. Accordingly, I find that John Doe has failed to rebut the Department's *prima facie* case that he willfully failed to pay taxes during the tax periods in controversy.

WHEREFORE, for the reasons stated above, it is my recommendation that Notice of Penalty Liability number XXXX and Notice of Deficiency number XXXX be finalized as issued.

Ted Sherrod
Administrative Law Judge

Date: June 9, 2005