IT 99-10
Tax Type: Income Tax
Issue: Responsible Corporate Officer – Failure to File or Pay

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

THE DEPARTMENT OF REVENUE OF THE STATE OF ILLINOIS	**No. 98-IT-0000** **NOD: 0000** **FEIN. 00-0000000**
v.	
"JOHN SMITH" as responsible officer of "Fictitious, Inc.", **Taxpayer**	**Charles E. McClellan** **Administrative Law Judge**

RECOMMENDATION FOR DECISION

Appearances: Mr. Jamie L. Zukosky, of Raleigh, Helms & Finke for "John Smith"; Alan Osheff, Special Assistant Attorney General, for the Department of Revenue.

Synopsis:

This matter involves a Notice of Deficiency ("NOD") issued to "John Smith", ("Smith"), by the Department for the liability of "Fictitious, Inc." ("Fictitious") for the second and third quarters of 1995. A hearing was set for August 18, 1999 at which the parties introduced a stipulation of facts into evidence. Joint Ex. No. 1.

My recommendation is that NOD 0000 be canceled.

Findings of Fact:

1. NOD 0000 was issued to "Smith" on March 25, 1997. Joint Group Ex. No. 1.

2. Upon receipt of the NOD, "Smith" timely filed a protest and request for hearing. Taxpayer Ex. No. 1.

3. The NOD related to Illinois income taxes withheld from employees of "Fictitious" for the second and third quarters of 1995. Dept. Group Ex. No. 1.

4. The NOD was sent to "Smith", the president of "Fictitious" from 1986, through 1996, as the responsible officer of the corporation who was responsible for paying over to the Department the Illinois income taxes withheld from corporate employees during the second and third quarters of 1995, the tax periods at issue. Stip. ¶¶ 2 and 5.

5. During 1991, "Fictitious" obtained a line of credit from First Midwest Bank ("bank") of approximately $900,000. Stip. ¶ 6.

6. During 1992, "Fictitious" borrowed money from the bank to purchase equipment on which "Fictitious", made timely payments. Stip. ¶¶ 6 and 7.

7. During 1994, "Fictitious" experienced a decline in revenue due to radical changes in its industry, lithography. Stip. ¶ 8.

8. During 1994, "Fictitious" entered into negotiations with the bank to ease the debt service requirements of the line of credit. Stip. ¶ 9.

9. Shortly thereafter, the bank informed "Fictitious" that unless "Fictitious" agreed to a lock box agreement, the bank would foreclose on the line of credit. Stip. ¶ 10.

10. Presented with no other options, "Fictitious" agreed to the lock box arrangement with the bank. Stip. ¶ 11.

11. The lock box agreement required all receivables to be processed through the bank. *Id.*

12. Commencing January 1, 1995, all customers of "Fictitious" remitted payments directly to the bank. Stip. ¶ 12.

13. Beginning January 1, 1995, the bank began taking $25,000 per week in principal reduction of the balance due on the line of credit. Stip. ¶ 13.

14. Soon after entering into the lock box arrangement, "Fictitious's" controller informed "Smith" that the bank was not allowing "Fictitious" enough cash to make payments on withholding taxes. Stip. ¶ 14

15. "Smith" immediately informed the bank that the bank was taking money that was earmarked for withholding taxes. *Id.*

16. "Smith" requested that the bank to reduce its principal reduction payments from $25,000 to $12,500 in order to make the required withholding tax payments. Stip. ¶ 15, Tr. p. 42, 43.

17. The bank rejected "Smith's" proposal. *Id.*

18. "Smith" continued to raise the issue with the bank and held two meetings (March 5, 1995 and May 17, 1995) with bank officers regarding the withholding tax issue but the bank ignored "Smith's" concerns. Stip. ¶ 16.

19. In July 1995, the bank filed a foreclosure suit against "Fictitious" and called the line of credit immediately due and payable. Stip. ¶ 17.

20. During all times the lock box arrangement was in effect which include the time periods involved in this case, the bank had full control over funds available to "Fictitious" and refused to release funds to pay the taxes at issue. Stip. ¶ 18.

Conclusions of Law

The issue in this case is whether "John Smith" is a responsible person who willfully failed to file and pay retailers' occupation taxes for "Fictitious" as required by statute. Once the Department introduced into evidence the NPL under the Director's certificate (Dept. Ex. No. 1), its *prima facie* case was made. Branson v. Dept. of Revenue, 168 Ill.2d 247 (1995). The burden then shifted to "Smith" to over come the Department's case. 168 Ill.2d at 261. The record shows that he has succeeded.

Section 1002(d) of the Illinois Income Tax Act ("IITA") imposes the penalty at issue, in relevant part, read as follows:

> Any person required to collect, truthfully account for, and pay over the tax imposed by this Act who willfully fails to collect such tax or truthfully account for and pay over such tax or willfully attempts in any manner to evade or defeat the tax or the payment thereof, shall, in addition to other penalties provided by law, be liable for the penalty imposed by Section 3-7 of the Uniform Penalty and Interest Act.
> 35 ILCS 5/1002(d).

Section 3-7(a) of the Uniform Penalty and Interest Act ("UPIA"), in relevant part, provides 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. 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. Proof of that determination by the Department shall be made at any hearing before it or in any legal proceedings by reproduced copy or computer printout of the Department's record relating thereto in the name of the Department under the certificate of the Director of Revenue. . . .
> 35 ILCS 735/3-7(a)

These two sections, taken together, prescribe three tests to determine if an individual is personally liable for unpaid withholding tax. First, IITA Section 1002(d) requires that the person must be responsible for the collection and payment of the tax. Second, under both provisions, the person must be responsible for accounting for the tax and paying the tax due. Third, the individual must willfully fail to file or pay the tax shown to be due on the payroll tax return.

In this case, "Smith" was president of "Fictitious" during the periods in which the underlying tax returns and tax liabilities were due. He has not argued that he was not a responsible person. He does, however, allege that, at the time the underlying taxes were due and payable, he did not willfully fail to pay the taxes in question.

The statute does not define the concept of willful failure. However, in applying the penalty tax, the Illinois courts look to federal cases involving § 6672 of the Internal Revenue Code[1] which contains language similar to the Illinois statute. Branson v. Dept. of Revenue, 168 Ill.2d 247 (1995), Dept of Revenue v. Joseph Bublick & Sons, 68 Ill.2d 568 (1977). The key to liability under IRC § 6672 is control of finances within the employer corporation including the power to control the allocation of funds to other creditors in preference to the withholding 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 state of mind. Sawyer v. U.S., 831 F.2d 755 (7th Cir. 1987) "Willful failure to pay taxes

[1]. 26 U.S.C. § 6672.

has generally been defined as involving intentional, knowing and voluntary acts or, alternatively, reckless disregard for obvious or known risks." 168 Ill.2d at 255.

Where a lender has complete control over an employer's funds under a "lock box 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.), *aff'd sub nom*. U.S. v. Security Pacific Business Credit, Inc., 956 F.2d 703 (7th Cir. 1992).

In this case, when "Fictitious" began having financial difficulties, the bank insisted that "Fictitious" enter into a lock box agreement that required that, from January 1, 1995 forward, all of the collections on its receivables flow directly to the bank. Soon after entering into the lock box agreement, "Fictitious's" controller informed "Smith" that the bank was not allowing "Fictitious" enough cash to pay withholding taxes. "Smith" told the bank that it was taking money that was earmarked for withholding taxes, and he requested that the payments from the lock box account being credited to "Fictitious's" loan with the bank be reduced so that it the withholding taxes could be paid. The bank ignored "Smith's" concerns and thwarted his efforts to pay the taxes. In July of 1995 it filed a foreclosure suit against "Fictitious" calling the line of credit immediately due and payable. These facts show that "Smith" did not willfully fail to file the withholding tax returns nor did he willfully fail to pay the withholding taxes. The

bank did that. Therefore, “Smith” has overcome the Department’s *prima facie* case so the NPL issued to “Smith” should be canceled.

WHEREFORE, I recommend that NPL 0000 be canceled.

9/22/99 ENTER:

_____

Administrative Law Judge