

ST 10-12

Tax Type: Sales Tax

**Issue: Audit Methodologies and/or Other Computational Issues
Reasonable Cause on Application of Penalties**

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

THE DEPARTMENT OF REVENUE	)	Docket No.	09-ST-0000
OF THE STATE OF ILLINOIS	)	IBT No.	0000-0000
	)	NTL Nos.	00000000000
	)		00000000000
v.	)		00000000000
ABC	)		00000000000
LIQUOR CORP.,	)	John E. White,	
Taxpayer	)	Administrative Law Judge	

RECOMMENDATION FOR DISPOSITION

Appearances: James Griffin and Kevin Wolfberg, Schain, Burney, Banks & Kenny, appeared for ABC Corp.; Shepard Smith, Special Assistant Attorney General, appeared for the Illinois Department of Revenue.

Synopsis:

Following audit, the Illinois Department of Revenue (Department) issued three Notices of Tax Liability (NTLs) to ABC Liquor Corp. (Taxpayer). Those NTLs assessed Retailers' Occupation Tax (ROT) regarding Taxpayer's sales during the period from July 1, 2002 through and including December 31, 2006. Taxpayer protested the NTLs and asked for a hearing. Pursuant to a pre-hearing order, the parties agreed that the issues would include the correctness of the assessments, and whether late payment penalties should be abated for reasonable cause.

The hearing was held at the Department's offices in Chicago. Taxpayer offered the testimony of two witnesses as well as documentary evidence. I have reviewed the

evidence offered at hearing, and I am including in this recommendation findings of fact and conclusions of law. I recommend that the Director resolve both issues in favor of the Department.

Findings of Fact:

1. Taxpayer operated a retail liquor store in Chicago. Department Ex. 1 (corrections of Taxpayer's returns and NTLs); Department Ex. 2, pp. 2-3 (auditor's comments).
2. The Department conducted an audit of Taxpayer's business for the period from July 1, 2002 through and including December 31, 2006. Department Ex. 1, p. 2. Pamela Besler (Besler) was the auditor who conducted the audit. Department Ex. 2, p. 9; Hearing Transcript (Tr.), pp. 39-40 (Besler).
3. Taxpayer is an S corporation, with two shareholders. Department Ex. 2, p. 2. One of the shareholders, John Doe (Doe) was Taxpayer's manager, and he operated the liquor store on a day-to-day basis throughout the audit period. *Id.*; Tr. p. 7 (Doe).
4. During the audit, Besler received the following books and records from Taxpayer's accountant: general ledgers, bank statements, cancelled checks, purchase invoices, hand-written monthly recap sheets, sales tax returns, financial statements, and income tax returns. Department Ex. 2, p. 4.
5. Taxpayer did not keep, and therefore, did not have available to produce for audit, cash register tapes showing a daily record of Taxpayer's gross amount of sales for the audit period. Department Ex. 2, p. 4; Tr. pp. 8-11, 17 (Doe); 86 Ill. Admin. Code § 130.805(a)(1) (What records constitute minimum records). Additionally, Taxpayer did not keep documents showing all of its purchases of goods for resale during the audit period. Department Ex. 2, pp. 7-8, 28-30.

6. Because Taxpayer did not keep cash register tapes for each day it made sales at retail, Besler could not corroborate the amounts Taxpayer reported on its monthly returns. *See* Department Ex. 2, pp. 4, 7; Tr. p. 42 (Besler).
7. Because Besler could not corroborate the receipts reported on Taxpayer's returns, she prepared a reconciliation of receipts using: the amount of receipts Taxpayer reported on its federal income tax returns; the amount of receipts according to Taxpayer's available books and records; and the amount of receipts reported on Taxpayer's monthly returns. Department Ex. 2, pp. 4, 26.
8. When performing the reconciliation of receipts, Besler determined the books and records figure by totaling the amounts Taxpayer spent to purchase property for resale, and then applying to that sum a mark-up using figures derived from Taxpayer's actual selling prices for different types of property, e.g., liquor, beer and non-alcoholic items, to calculate expected receipts. Department Ex. 2, pp. 4, 7.
9. Besler determined that Taxpayer used a mark-up of 1.10 for non-alcoholic sales, 1.33 for beer, and 1.30 for liquor. Department Ex. 2, pp. 4, 7, 24, 27.
10. Based on the reconciliation of receipts, Besler determined that Taxpayer had more receipts than were reported on the monthly returns it filed during the audit period, and that tax should be assessed on the amount underreported. Department Ex. 2, pp. 4, 7.
11. When calculating the rate of tax to assess on the receipts determined to have been underreported, Besler took into account the fact that Taxpayer sold goods that were taxable at different rates, i.e., some goods were subject to a lower rate of tax, and some to a higher rate. Department Ex. 2, pp. 4, 28-30; Tr. pp. 46-47 (Besler).

12. When comparing Taxpayer's purchase records with its filed returns, Besler determined that Taxpayer's monthly returns overstated the amount of receipts that were subject to tax at the lower rate, and understated its high rate sales receipts. Tr. p. 46 (Besler).
13. When calculating the amount of tax to be assessed, Besler separated Taxpayer's receipts into those taxable at the lower rate, and those taxable at the higher rate. Department Ex. 2, pp. 7-9.
14. During the course of the audit, Taxpayer asked Besler to take into account its claim that it passed on to customers savings in the form of lower selling prices when Taxpayer was offered discounts from its vendors. *See* Department Ex. 2, p. 7; Taxpayer Ex. 2 (copy of Besler's mark-up schedule, with changes made by Taxpayer's accountant, Smith Jones); Tr. pp. 21, 35-36 (Smith Jones). Besler did not reduce the amount of underreported sales receipts, because Taxpayer could not offer any documentary evidence to corroborate that it reduced its selling prices for goods when it obtained such discounts from vendors. *See* Department Ex. 2, p. 7.
15. Besler did not disallow any of the deductions Taxpayer claimed on its monthly returns for state and county tax collections, low rate sales, food stamps, and newspapers. Department Ex. 2, pp. 5-6.

Conclusions of Law:

The Department introduced the NTLs it issued to Taxpayer into evidence under the certificate of the Director. Department Ex. 1, pp. 4-6. Pursuant to § 4 of the Retailers' Occupation Tax Act (ROTA), those NTLs constitute the Department's prima facie case in this matter. 35 ILCS 120/4, 7. The Department's prima facie case is a rebuttable presumption. 35 ILCS 120/7; Copilevitz v. Department of Revenue, 41 Ill. 2d 154, 157, 242 N.E.2d 205, 207 (1968); DuPage Liquor Store, Inc. v. McKibbin, 383 Ill. 276, 279, 48 N.E.2d 926, 927 (1943).

A taxpayer cannot overcome the statutory presumption merely by denying the accuracy of the Department's assessment. A.R. Barnes & Co. v. Department of Revenue, 173 Ill. App. 3d 826, 833, 527 N.E.2d 1048, 1053 (1st Dist. 1988). Instead, a taxpayer has the burden to present evidence that is consistent, probable and closely identified with its books and records, to show that the assessment is not correct. Fillichio v. Department of Revenue, 15 Ill. 2d 327, 333, 155 N.E.2d 3, 7 (1958); A.R. Barnes & Co., 173 Ill. App. 3d at 833-34, 527 N.E.2d at 1053.

Both parties waived closing arguments, so this record does not reflect Taxpayer's specific arguments regarding how the evidence offered at hearing relates to the issues the parties agreed were to be resolved at hearing. *See* Tr. p. 52; Pre-hearing Order. Notwithstanding that waiver, the issues remain, and will be addressed. Pre-hearing Order.

As to the first issue, whether Taxpayer is liable for the assessed tax for the audit period, Taxpayer offered evidence in an attempt to show that its average mark-ups for beer and liquor were not as high as Besler calculated them to be. Specifically, Taxpayer calculated that its average mark-ups for beer and liquor were, respectively, 1.26 and 1.24,

for a total average mark-up of 1.25. Taxpayer Ex. 2; Tr. pp. 24-25, 34-35 (Smith Jones). In slight contrast, Besler's analysis put Taxpayer's average mark-ups for beer and liquor at 1.33 and 1.30, for a total average mark-up of 1.31. Department Ex. 2, p. 27. To the extent Smith Jones's testimony and Taxpayer Exhibit 2 were offered as a challenge to the reasonableness of the Department's audit method, I address that challenge here.

The ROTA does not require the Department to substantiate the basis for the corrected return or produce the auditor who computed it in order to support its prima facie case. Fillichio, 15 Ill. 2d at 333, 155 N.E.2d at 7. Where a corrected return is challenged, the record must only demonstrate that the Department's method of preparing the corrected return meets some minimum standard of reasonableness. Elkay Manufacturing Co. v. Sweet, 202 Ill. App. 3d 466, 470, 559 N.E.2d 1058, 1060 (1st Dist. 1990). The reasonableness standard is based upon § 4 of the ROTA, which requires the Department to correct returns according to its best judgment and information. Mel-Park Drugs, Inc. v. Department of Revenue, 218 Ill. App. 3d 203, 208, 577 N.E.2d 1278, 1281 (1st Dist. 1991); Masini v. Department of Revenue, 60 Ill. App. 3d 11, 14, 376 N.E.2d 324, 327 (1st Dist. 1978).

Here, Smith Jones, Taxpayer's accountant, testified that he was involved in the preparation of Taxpayer Exhibit 2. Tr. pp. 23-24 (Smith Jones). Smith Jones said that he prepared that exhibit using some of the same figures Besler used in her mark-up schedule. *Id.*; compare also Taxpayer Ex. 2 with Department Ex. 2, p. 27. Smith Jones twice summarized how he prepared that exhibit. First, he testified that:

Q: Now, on Exhibit Number 2, the top half of the document is identified as Schedule of Mark-up Per Taxpayer. Do you see that?

A: Yes.

Q: And were you involved in calculating or reviewing that information?

A: I had some input, yes.

Q: What was your input?

A: Well, the selected items were what was taken by the examining officer [Besler]. The selling price numbers were the numbers that came from the examining officer. I went over the cost numbers with John [Doe] to confirm his calculation of what was used to determine the cost and that's how we came up with this calculation.

Tr. pp. 23-24 (Smith Jones). He later testified as follows:

Q: Do you have any — having reviewed this matter, are there any issues that you have identified with the method the Department used to calculate the mark-up?

A: Well, in reviewing this calculation, again using the Department's test sample and using the Department's selling price, which I didn't independently confirm, I just used their numbers, I reviewed the cost numbers with John [Doe] to come up with this calculation and the average mark-up as a result of that was consistent with what — the figures that we had seen and had been using in terms of preparation of the sales tax return. And when I extrapolated this to the reported income, it was consistent.

Tr. pp. 34-35 (Smith Jones).

Here, the reason why the average mark-ups for beer and liquor on Taxpayer Exhibit 2 were less than as calculated by Besler was because on the former, the cost prices were often reported as being greater than as reported by Besler on her schedule. *Compare* Taxpayer Ex. 2 *with* Department Ex. 2, p. 27. But even though Taxpayer Exhibit 2 was admitted without objection, I cannot conclude that that exhibit and Smith Jones's testimony rebuts the Department's prima facie case. *See Jackson v. Department of Labor*, 105 Ill. 2d 501, 508, 475 N.E.2d 879, 883 (1985) (“when hearsay evidence is admitted without an objection, it is to be considered and given its natural probative effect.”).

I give no weight to Taxpayer Exhibit 2, in part, because it is not a record that was kept in the ordinary course of business. *See* Tr. pp. 23-24 (Smith Jones). Rather, it was

prepared in anticipation of hearing. *Id.* In contrast, an invoice from a vendor to Taxpayer, documenting the sale of either beer or liquor from the vendor to Taxpayer, might well constitute such a business record. Where a document is admitted as a business record, that document constitutes “evidence of the act, transaction, occurrence, or event” Kimble v. Earle M. Jorgenson Co., 358 Ill. App. 3d 400, 414, 830 N.E.2d 814, 827 (1st Dist. 2005).

Here, the record reflects that Besler prepared her mark-up schedule after reviewing Taxpayer’s own, incomplete, purchase records, as well as records she obtained from Taxpayer’s vendors reflecting their sales to Taxpayer. Those documents were the source for the amounts she then entered onto her schedule as Taxpayer’s costs for purchasing different types and quantities of beer and liquor. Department Ex. 2, pp. 7-8, 27-30. On Taxpayer Exhibit 2, Smith Jones used some of the same cost figures that Besler used on her schedule, but he also used other cost amounts that were different than the ones Besler used. Taxpayer Ex. 2. But the only source for the different costs figures that Smith Jones used on Taxpayer Exhibit 2 were figures that he arrived at following his consultations or discussions with Doe. Tr. pp. 24-25, 34-35 (Smith Jones). Neither Taxpayer nor Smith Jones identified any regularly kept books and records as being the source for such different cost entries used on Taxpayer Exhibit 2.

As was mentioned earlier, a taxpayer cannot overcome the Department’s prima facie case merely by denying the accuracy of the Department’s assessment. A.R. Barnes & Co., 173 Ill. App. 3d at 833, 527 N.E.2d at 1053. Yet that is precisely what Taxpayer offers here — Smith Jones’s mere testimony that Taxpayer purchased beer and liquor at costs that were different than those shown on the books and records reviewed by the

Department's auditor. Tr. pp. 24-25, 34-35 (Smith Jones). Since Taxpayer offered no documentary evidence to show that the cost prices Smith Jones used on Taxpayer Exhibit 2 were Taxpayer's actual costs for such goods, that exhibit is entitled to no weight. Mel-Park Drugs, Inc., 218 Ill. App. 3d at 222, 577 N.E.2d at 1290. Taxpayer has not shown that Besler's audit methods were unreasonable, in any way.

The remaining issue is whether Taxpayer demonstrated reasonable cause to abate late payment penalties assessed. *See* Pre-Hearing Order. Each of the three NTLs assessed a late payment penalty. Department, Ex. 1, pp. 4-6. Together, those penalties total \$8,321. *Id.*; Pre-Hearing Order.

Section 4 of the ROTA permits the Department to assess penalties as part of a Notice of Tax Liability in accordance with Illinois' Uniform Penalty and Interest Act (UPIA). 35 ILCS 120/3. Section 3-3(b) of the UPIA authorizes the assessment of a penalty for late payment of tax when due. 35 ILCS 735/3-3(b). Section 3-8 of the UPIA provides that a penalty imposed by UPIA § 3-3, *inter alia*, "shall not apply if the taxpayer shows that his failure to file a return ... at the required time was due to reasonable cause." 35 ILCS 735/3-8.

The Department has adopted a regulation regarding reasonable cause which provides that, "[t]he determination of whether a taxpayer acted with reasonable cause shall be made on a case by case basis taking into account all pertinent facts and circumstances. The most important factor to be considered in making a determination to abate a penalty will be the extent to which the taxpayer made a good faith effort to determine his proper tax liability and to file and pay his proper liability in a timely fashion." 86 Ill. Admin. Code § 700.400(b). The regulation further provides that, "[a]

taxpayer will be considered to have made a good faith effort to determine and file and pay his proper tax liability if he exercised ordinary business care and prudence in doing so. A determination of whether a taxpayer exercised ordinary business care and prudence is dependent upon the clarity of the law or its interpretation and the taxpayer's experience, knowledge, and education. ****” 86 Ill. Admin. Code § 700.400(c). The burden rests on the taxpayer to show that it acted with ordinary business care and prudence when filing its returns and paying the correct amount of tax when due. Hollinger International, Inc. v. Bower, 363 Ill. App. 3d 313, 328, 841 N.E.2d 447, 460 (1st Dist. 2005).

Here, there was no evidence offered to show that Taxpayer acted with ordinary business care and prudence during this audit period. And again, there was not even an argument to that effect. Based on the record, Taxpayer has not borne its burden to show that the Department's assessment of a late filing penalty was inappropriate here.

Conclusion:

I recommend that the Director finalize the NTLs as issued, with interest to accrue pursuant to statute.

July 21, 2010
Date

John E. White, Administrative Law Judge