ST 99-30
Tax Type: Sales Tax
Issue: Responsible Corporate Officer – Failure to File or Pay Tax
UPIA Willful Failure

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

THE DEPARTMENT OF REVENUE OF THE STATE OF ILLINOIS v. **"JANE DOE"**, as Resp. Officer. Of "Potemkin, Inc.", Taxpayer	No. 98-ST-0000 98-IT-0000 SSN: 000-00-0000 Christine O'Donoghue Administrative Law Judge

RECOMMENDATION FOR DISPOSITION

Appearances: Mr. Gary Stutland, Special Assistant Attorney General for the Illinois Department of Revenue; Mr. Jerome Feldman, Esq. on behalf of "Jane Doe".

Synopsis:

This matter comes on for hearing pursuant to the taxpayer's timely protest of a Notice of Deficiency and a Notice of Penalty Liability issued by the Department of Revenue ("Department") on November 18, 1995 and November 17, 1995, respectively, for Withholding Tax and Retailers' Occupation Tax ("ROT"). Such Notices were issued to "Jane Doe" (hereinafter "Jane" or the "taxpayer") as a responsible officer of "Potemkin, Inc". for the withholding tax not paid for the second and third quarter of 1993 and all four quarters of 1994 and the retailers' occupation tax not paid for the period of November 1992 through December 1994.

The issues to be resolved are 1) whether the taxpayer was a responsible person of "Potemkin, Inc." and 2) whether the taxpayer's failure to pay the tax due was willful. Upon consideration of the evidence, it is my recommendation that both the Notice of Deficiency and the Notice of Penalty should be cancelled.

Findings of Fact:

1. The Department's *prima facie* case, inclusive of all jurisdictional elements, was established by the admission into evidence of the Notice of Deficiency ("NOD") No. 0000, issued on November 18, 1995, for the second and third quarter of 1993 and the four quarters of 1994 and the Notice of Penalty Liability ("NPL"), issued on November 17, 1995, for various months within the period 11/92 through 12/94. The NOD and the NPL reflected a liability of $27,427.57 and $471,019.74, respectively. Tr. pp. 8, 9; Dept. Group Ex. No. 1.
2. "Potemkin, Inc." sells furniture at retail. The taxpayer's husband, "John Doe", has been in the business of furniture sales for 35 years. Tr. p. 115. "John's" family has been in the business of furniture sales for 50 years. Tr. p. 114.
3. "Potemkin, Inc." was formed after "John's" previous business, "Allstar Furniture", filed bankruptcy in 19xx. Tr. pp. 116, 117. "Jane Doe" did not work for "Allstar Furniture" at any time. Tr. p. 117.
4. At the time "Potemkin" was incorporated in July of 1991, "Jane Doe" was named as a director. "John Doe" was named president, secretary, treasurer and director of "Potemkin, Inc." Taxpayer Ex. No. 1, pp. 5, 7; Tr. pp. 13, 88, 121, 131, 139, 143.
5. "Jane" was also named the sole shareholder of "Potemkin, Inc.", which was formed as an S-corporation. Tr. p. 53; Taxpayer Ex. Nos. 1, 4, 5.

6. "Jane Doe" has been a teacher since 1967. She initially was a teacher for two years at "Johnson" High School and left to raise a family. When her children were in junior high school she did volunteer work by teaching English as a second language. Tr. pp. 118, 160, 161, 163. She has worked for various organizations including the "Get Well" Program, "Harvey" College, various junior colleges, and adult education organizations. In 1989 she decided to teach high school. Tr. p. 161. She taught at "Wonderland High" and then taught at "Westbrook North". Tr. pp. 161-163.

7. Taxpayer was employed full-time by Community Unit School District Number 412, 1800 N. "Anywhere" Road, "Someplace", Illinois during the audit period. She has worked there for seven years. Tr. pp. 71, 163; Taxpayer Ex. Nos. 6, 7.

8. "Jane" has never worked at any of the three corporate entities nor did she receive a paycheck at any time. Tr. pp. 118, 133.

9. "Jane" never received shares of stock. Tr. pp. 120, 150, 166. There were never any stockholder's meetings or directors' meetings during the existence of "Potemkin, Inc." Tr. pp. 154, 166, 167.

10. "Jane" never signed any loan agreements or any other documents on behalf of "Potemkin, Inc." Tr. pp. 121, 177.

11. During the audit period, the taxpayer was not aware if the sales and withholding taxes were paid. Tr. p. 173.

12. From the time the corporation was formed in July of 1991 until February of 1995, "Jane" never knew that she was a shareholder or a director of "Potemkin". Tr. pp. 147, 172. "Jane" first learned that she was a shareholder and director of "Potemkin, Inc." in 1995 when "John" asked her to sign a document after the

business had closed. Tr. pp. 120, 167. She did not understand the significance of the document. Tr. pp. 167, 180, 181.

13. This document was an assignment for the benefit of creditors. Tr. pp. 133, 134; Dept. Group Ex. No. 4.

14. "Jane" and "John" filed joint US1040s during the audit period. "Jane" signed these tax returns without reviewing the contents because she trusted her CPA and her husband. Tr. pp. 168, 178.

15. Throughout their marriage the "Does" did not discuss the day to day operations of "Potemkin, Inc.". Tr. p. 172. "John" and "Jane" would discuss business in general terms, for example, business was "good or bad." Tr. pp. 132, 138, 139, 172. "John" handled the business affairs of "Potemkin, Inc." and "Jane" raised the two children and taught school. Tr. p. 177. "John" handled all of the household finances. Tr. p. 138.

16. "John" never consulted with "Jane" regarding the filing of corporate tax returns or the payment of state taxes for "Potemkin, Inc." Tr. pp. 132, 173.

17. "Jane Doe" met "Mary Jones", "Potemkin's" office manager, when she was married in 1965. The only occasions she would see "Mary" or "Harry Hull", the company's CPA, would be at Christmas parties. Tr. p. 174.

18. The only time she stopped by one of the "Potemkin, Inc." stores was at the beginning of their marriage when she was dropped off at the store located at 189th St. and "Scrudland" after teaching at a school close by. She would sit and grade papers while she waited for "John". Tr. p. 174. "Jane Doe" did not drive a car at this time. Tr. pp. 174, 175.

19. At various times throughout their marriage “Jane” was aware that money was tight. Tr. p. 177.

20. When she received her W-2 statements from her employer she gave them to her husband. Tr. p. 179.

21. At the outset the business needed additional funds to purchase inventory, so “John” attempted to obtain a SBA loan through a bank that specialized in loans to minorities. Tr. p. 119. “John” met with the owner of “Anonymous” Bank to attempt to discuss a possible loan. Tr. pp. 128, 129. “Jane” did not attend this meeting. Tr. p. 128.

22. “John” named “Jane” as “Potemkin, Inc.’s” shareholder to qualify for such a loan. Tr. pp. 120, 141. Only “John” signed the loan application. Tr. p. 142. “John” never informed his wife that he named her as the stockholder. Tr. p. 120. The loan was ultimately not approved. Tr. p. 153.

23. “John” signed all corporate tax returns. Tr. pp. 144, 145. “John” supplied the information that is contained on the corporate tax returns to the accountant. Tr. p. 145.

24. “John Doe” and “Mary Jones” were the only signatories on the corporate bank account at “Fictitious” Bank. Taxpayer Ex. No. 2; Tr. p. 33.

25. “John Doe” and “Mary Jones” were the only signatories on the corporate bank account at “Anywhere” Bank. Taxpayer Ex. No. 3; Tr. pp. 34, 35.

26. From 1991 to 1995 “John” or “Mary” signed all corporate checks. Tr. p. 122. “Mary” has worked for the various “Potemkin, Inc.” entities and has been the signatory on the corporate bank accounts for approximately 40 years. Tr. pp. 28, 122.

27. "Mary" was the bookkeeper, cashier and office manager. Tr. pp. 29, 35.

28. "Mary" prepared the sales tax returns and the IL-941 tax returns under "John Doe's" direction. Tr. p. 29. She gave these returns to "John" for his signature. Tr. pp. 33, 34. Although the tax returns were always filed, payment was not always made. Tr. p. 132.

29. During her employment, "Mary" never issued any checks to "Jane Doe". Tr. pp. 30, 31. "Mary" did not recall that "Jane" ever appeared at the business office. Tr. p. 31.

30. "Mary" maintained that "Jane Doe" never signed any papers in "Mary's" presence during the three and a half years that "Potemkin, Inc." was in business. Tr. p. 37.

31. "Harry Hull" was the accountant for "Potemkin, Inc.". Tr. p. 36. "Hull" prepared year-end income tax returns and provided accounting services on an as-needed basis for "Potemkin, Inc." Tr. pp. 41-43

32. During the years 1991 through early 1995, "Hull" generally visited the store every other month, and at year-end he spent a week at the business to close the books. Tr. pp. 43, 44. During these visits he did not see "Jane" at the office. Tr. p. 44. In general, "Hull" worked with "Mary Jones". Tr. p. 44.

33. During his twenty years of association with the various "Potemkin, Inc." entities "Hull" never consulted with "Jane Doe" concerning any business or tax matters. Tr. pp. 42, 44.

34. "John Doe" was "Hull's" primary contact at the company. Tr. p. 46. "Hull" also prepared the individual tax returns for "Jane" and "John Doe". Tr. p. 46. "Jane" has been a teacher as long as "Hull" has known her. Tr. p. 46.

35. "Hull" listed "Jane Doe" as the tax matters person on the US1120S because the IRS requires that a shareholder be named and "Jane" was "Potemkin, Inc.'s" sole shareholder. Tr. pp. 48, 49; Taxpayer Ex. No. 4.

36. The accountant did not mail the Schedule K-1 form to "Jane Doe". He mailed it to the corporate address. Tr. pp. 96, 97.

37. "John" learned that the Department of Revenue was attempting to close its business sometime in December of 1994. Tr. p. 134. The company gathered a sum of money and "Hull" attempted to negotiate a settlement with the Department but was ultimately unsuccessful. Tr. p. 134.

38. "John's wages are presently being garnished by the Illinois Department of Revenue. Tr. p. 131. He personally owes the State over a half million dollars. Tr. p. 131.

39. Around December 4, 1995, "Hull" became aware that the Department of Revenue had filed a wage deduction or garnishment against "Jane Doe's wages. Tr. p. 104. "John" requested that "Hull" seek a restraining order against the Department's levy pending review of the case. Tr. pp. 104, 107; Dept. Ex. No. 2.

40. The NUC-1, Illinois Business Registration form, states as follows in Section 2, No. 12: "I accept personal responsibility for the filing of returns and the payment of taxes due." "John Doe" signed the NUC-1 on March 20, 1992 and accepted such responsibility. Taxpayer's Ex. No. 9.

Conclusions of Law:

The Department seeks to impose personal liability on the taxpayer pursuant to Section 1002(d) of the Illinois Income Tax Act, 35 **ILCS** 5/100, *et seq.* and Section 3-7

of the Uniform Penalty & Interest Act ("UPIA"), 35 **ILCS** 735/3-7, *et seq.* Section 3-7 states in pertinent part:

> 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 payments 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
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> …

35 **ILCS** 735/3-7[1]

Once the Department introduced the NPL and the NOD into evidence under the Director's certificate, its prima facie case was made. 35 **ILCS** 735/3-7; Branson v. Dept. of Revenue, 168 Ill.2d 247 (1995). In Branson, the Illinois Supreme Court held that the admission of the Notice of Penalty Liability into evidence established all of the statutory elements required for imposition of the penalty, including willfulness. The court was addressing the Retailers' Occupation Tax Act, however, the holding in Branson should apply to both retailers' occupation tax and withholding tax matters since not only are the underlying policies of the ROT section and section 1002(d) similar but the language of the two sections encompasses both responsibility and willfulness. Thus, the burden of proof then shifted to the taxpayer to offer competent evidence that successfully rebutted the Department's *prima facie* case.

[1]Prior to January 1, 1994, officer liability for unpaid ROT was provided for under 35 ILCS 120/13.5.

In the instant matter, the taxpayer was named as director and shareholder of "Potemkin, Inc.", the underlying corporation. In Illinois, a director of a corporation has been found to be a corporate officer. (Laughlin v. Geer, 121 Ill. App. 534). Further, directors are generally embraced within the term "officers" as used in statutes. 2 Fletcher, Cyc. Corp. (Perm. Ed.) §271. While it is true there are exceptions to this rule, they generally arise only when a statute obviously does not contemplate a director to be an officer. *See*, Laughlin, *supra*. Thus, the Court in Laughlin held that although a director is a corporate officer, a director is not embraced within a statute providing that the directors may remove any "officers" when the interest of the corporation shall require. Id. at 537.

Section 3-7 of the UPIA obviously contemplates that directors and shareholders be encompassed within the personal liability section. In Joseph Bublick & Sons, Inc., 68 Ill. 2d 568, the Illinois Supreme Court stated the statutory purpose underlying the imposition of personal liability upon individuals for unpaid retailers' occupation tax was to prevent state funds from being used to pay corporate debts and to impose a high level of responsibility for the stewardship of public revenue. The focus in determining responsibility under the statute is on reaching the individuals responsible for the corporation's failure to pay over its taxes. Thus, if a person holding the titles of shareholder and/or director has significant control over the business affairs or participates in decisions regarding the payment of creditors and disbursal of funds, he or she should be subject to the imposition of person liability. This interpretation furthers the statutory purpose and parallels the language of 1002(d) of the IITA and the long line of federal personal liability cases under §6672 of the IRC.

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 disbursal of funds. *See e.g.*, Monday v. United States, 421 F.2d 1210 (7th Cir. 1970), cert. denied 400 U.S. 821 (1970). Liability attaches to those with the power and responsibility within the corporate structure for seeing that the taxes are remitted to the Government. Id. Responsibility is a matter of status, duty or authority, not knowledge of the tax liability. Mazo v. United States, 591 F. 2d 1151 (5th Cir. 1979). This duty to ensure that the taxes are paid stems from an individual's authority and power within a company to direct how a company conducts its financial affairs. Bowlen v. United States, 956 F.2d 723 (7th Cir. 1992); Purdy Co. of Ill. V. United States, 814 F.2d 1183 (7th Cir. 1987).

Factors which are indicative of responsibility include whether the person: 1) is an officer or member of the board of directors, 2) owns shares or possesses an entrepreneurial stake in the company, 3) is active in the management of day to day affairs of the company, 4) has the ability to hire and fire employees, 5) makes decisions regarding the prioritization of the payment of creditors or taxes, 6) exercises control over bank accounts and disbursement records and 7) has check signing authority. Barnett, 988 F.2d at 1455; *see also*, Silberberg v. United States, 524 F.Supp 744 (E.D. New York 1981); Hochstein v. United States, 900 F.2d 543 (2nd Cir. 1990). A review of the decisions regarding personal liability for trust-fund taxes reflects that the question of responsibility must be answered in light of the totality of the circumstances; no one factor is determinative.

In the case at hand, although "Jane" was a shareholder and director, she did not control the payment of "Potemkin, Inc.'s creditors nor did she direct the financial decisions of the corporation. "Jane" never signed nor was she ever authorized to sign the checks of "Potemkin, Inc.". The signatory cards in evidence indicate that "John Doe" and "Mary Jones" were the only signatories on "Potemkin, Inc.'s corporate bank accounts during the entire period. "Jane" did not earn a salary from "Potemkin, Inc." and "John", "Mary Jones" and "Henry Hull" all testified that "Jane" did not work at the business nor was she consulted regarding any of "Potemkin, Inc.'s business affairs including decisions regarding the hiring or firing of employees or the payment of bills. It appears from the record that "John" was the driving force within the corporation and possessed the ultimate authority over "Potemkin, Inc.'s business operations in every respect. Control over the payment of taxes and creditors lay solely with "John" and the couple only discussed the general condition of the business on a superficial level.

The taxpayer did not prepare or sign the company's IL-941 and sales tax returns during the period. It is apparent from the record that taxpayer had no knowledge of whether the taxes were being paid or not and she was not apprised or aware of the day to day operations of the company. "Mary" prepared these tax returns under "John's direction and presented them for his review and signature. Taxpayer maintained that not only did she not sign the tax returns, she did not sign any documents on behalf of "Potemkin, Inc." during the period at issue, a contention that is supported by each of the other witnesses' testimony and there is no evidence which contradicts this assertion.

"Hull", the CPA for the various "Potemkin, Inc." entities throughout the years, testified that his main contact was "John" and he also worked closely with "Mary", the office manager, throughout the tax period. In fact, "Hull" testified that in all the years

that he provided services for "Potemkin, Inc." he did not observe "Jane" working there in any capacity nor did he consult her on any business or tax matters. "Hull" also gave a thoroughly reasonable explanation as to why "Jane" was named the tax matters person upon the US1120S tax return by pointing out that the IRS requires that a shareholder be designated, a requirement which is also evidenced by the plain language on the tax return. Since "Jane" was the sole shareholder, the choice was obvious.

"Mary Jones", a "Potemkin, Inc." employee for approximately forty years, corroborated "Jane's testimony that "Jane" did not work at "Potemkin, Inc.". In fact, "Mary" stated that she never saw her at the place of business, nor did "Jane" sign any documents in "Mary"' presence during her many years with "Potemkin, Inc.".

Most importantly, I found "Jane's" testimony entirely credible when she contended that she only became aware that her husband had named her shareholder and director in February of 1995, after the business closed. Apparently "John" needed her to sign an assignment for the benefit of creditors and the signing took place in the trustee's office so "John" could not sign his wife's name as he had admittedly done in the past. Moreover, it is entirely reasonable that "Jane", a teacher by profession, did not understand the legal significance of this document nor is there any evidence to reflect that she was aware of a corporate tax deficiency upon signing. Further, the circumstances were not such that she ought to have been aware of the tax liability.

"Jane's" ignorance of her status within the corporation is conceivable given her husband's admission that she was named shareholder solely in an attempt to obtain a SBA loan for minority entrepreneurs. "Hull", "Potemkin, Inc.'s" CPA, further corroborated the Steinbergs' testimony when he indicated that he always mailed the corporate tax returns and the Schedule K-1 to "John's" attention at "Potemkin, Inc.". The

Schedule K-1 outlines each shareholder's share of income, credits, deductions, etc. and it is the tax preparer's responsibility to send this form to the corporate taxpayer who thereafter must distribute the schedule to the S-corporation's shareholders. Although "Jane" admitted that she signed their jointly filed US1040 each year, she testified that she did not review each schedule nor would she have understood it if she had. She trusted both her husband and her CPA to take care of these matters and she signed as requested. Moreover, "Jane's" status as shareholder and director would not be readily apparent to a layperson from a mere review of the couple's joint return without carefully reading the supporting schedules.

The Department argues that "Jane", the director and sole shareholder of an S-corporation, is vested with control and management of the corporate affairs and, thus, has a duty to ensure that the taxes are paid. While case law has held that those vested with the ultimate control cannot escape liability merely by delegating responsibility, (Bowlen v. United States, 956 F.2d 723 (7th Cir. 1992)), a person must be aware of her standing within a corporation before a duty to "collect, account for, and pay over the taxes" should be imposed.

Wherefore, the evidence of record does not supply a basis for determining that "Jane" was a responsible person under either statute, thus, it is my recommendation that the Notice of Penalty Liability and the Notice of Deficiency should be cancelled.

Date: August 13, 1999

Christine O'Donoghue
Administrative Law Judge

Corporate Officer Liability
UPIA Penalty