

IT 09-2

Tax Type: Income Tax

Issue: Properly Determined AGI for Subchapter S Shareholders

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

THE DEPARTMENT OF REVENUE)	Docket No.	06-IT-0000
OF THE STATE OF ILLINOIS,)	Tax ID No.	000-00-0000
v.)	Tax Years Ending	1999-2004
JOHN & JANE DOE,)		
)	John E. White,	
Taxpayers)	Administrative Law Judge	

RECOMMENDATION FOR DISPOSITION

Appearances: David Daudell, Law Office of David Daudell, appeared for **JOHN & JANE DOE**; Ron Forman, Special Assistant Attorney General, appeared on behalf of the Illinois Department of Revenue.

Synopsis:

This matter involves **JOHN** and **JANE DOE**' (taxpayers or the **DOE**') protest of a Notice of Deficiency (NOD) the Illinois Department of Revenue (Department) issued to them to propose to assess tax deficiencies for calendar years 1999 through 2004. A prior recommendation regarding taxpayers' protest of this NOD was adopted by the Director in February 2008, following which taxpayers requested, and were granted, a rehearing. At the prior hearing, taxpayers were not represented by counsel.

The rehearing was held at the Department's offices in Chicago. The issue is whether the tax proposed in the NOD is correct for the years at issue. At hearing, taxpayers offered books and records, as well as the testimony of **JOHN DOE (DOE)**. I have reviewed that evidence and I am including in this recommendation findings of fact and conclusions of law. I recommend the NOD be finalized as issued, with interest to

accrue pursuant to statute.

Findings of Fact:

1. On July 27, 2006, the Department issued an NOD to taxpayers. Department Ex. 1 (copy of NOD and supporting schedules).
2. In that NOD, the Department notified taxpayers that, after obtaining information from the Internal Revenue Service, the Department adjusted their federal taxable income for the years at issue “to include your distributive share of S-corporation income from **ABC** Ltd. ...” (the **ABC**), an S-corporation in which they were shareholders. Department Ex. 1, p. 2 (Statement); Tr. p. 63 (**DOE**).
3. The taxpayers’ distributive share of the **ABC**’s income was increased following a Department audit of the **ABC**’s business during the years at issue. Tr. pp. 6 (Department’s opening statement), 15-17 (**DOE**). At the conclusion of that audit, the Department determined that the **ABC** had not reported on its monthly sales tax returns all of its receipts from selling tangible personal property at retail in Illinois. Tr. pp. 15-17 (**DOE**). The increased amount of taxpayers’ distributive share of the **ABC**’s income is related to the unreported sales receipts that the Department determined the **ABC** realized during the audit period. *Id.*; *see also* Department Ex. 1, pp. 3-14.
4. Attached to the NOD are copies of auditor-prepared forms EDA-24. Department Ex. 1, pp. 3-14. Those forms identify changes the Department determined should be made to taxpayers’ joint individual Illinois income tax returns for the years at issue, as well as the amounts of tax, penalty and/or interest the Department proposed to be due for such tax years. *Id.*

5. Specifically, those forms identify the increases the Department proposed to make to the taxpayers' joint adjusted gross income (AGI), and the following amounts of tax and penalties proposed to be due regarding the following tax years:

Year	Increase Proposed to Taxpayers' Joint AGI	Additional Tax Proposed	Penalties
1999	195,226	5,856	
2000	124,132	3,724	
2001	207,274	6,219	
2002	205,636	6,169	
2003	398,161	11,945	
2004	166,200	4,986	997
TOTAL	\$1,296,629	\$38,899	\$997

Department Ex. 1, pp. 3-14; Taxpayer Ex. 2 (copy of schedule prepared by Department personnel calculating interest, through December 22, 2007, on amounts of tax proposed due from taxpayers).

6. There was no evidence offered at hearing that specifically described how the Department determined or calculated the increased amount of the **ABC**'s receipts that were distributable to taxpayers for the years at issue. Department Ex. 1, pp. 3-14; Taxpayer Exs. 2-3.
7. The **ABC** conducted business in Chicago. Taxpayer Ex. 1 (copy of the **ABC**'s 2002 federal income tax form 1120S).
8. During the tax years at issue, the **ABC** incurred expenses for utilities, including electricity, gas, and telephone services. Taxpayer Ex. 5 (copies of electric bills and payment receipts for certain months of 2001 through 2005); Taxpayer Ex. 6 (copies of natural gas bills and payment receipts for certain months of 2001-2005); Taxpayer Ex. 7 (copies of telephone bills and receipts for certain months of 2001-2005).
9. The **ABC** paid most of its utility bills with cash. Taxpayer Exs. 5-7.

10. The **ABC** maintained a checking account during 2003 through 2005. Taxpayer Exs. 8-10 (copies of checking account statements, with copies of checks drawn on the **ABC**'s account and negotiated, for, respectively, 2003 through 2005).
11. On line 19 of its 2002 federal form 1120S, the **ABC** reported an amount as "Other Deductions." Taxpayer Ex. 1. p. 1 (line 19). It also caused to have prepared a schedule to specifically identify the different expenses included within its Other Deductions, which schedule was filed as an attachment to that 2002 form. *Id.*, p. 5.
12. The **ABC**'s 2002 Other Deductions schedule includes an entry for utility expenses in the amount of \$7,200, and an entry for telephone expenses in the amount of \$1,500. Taxpayer Ex. 1. p. 5.
13. On its 2002 federal form 1120S, the **ABC** calculated its "Total Income" by subtracting its "Cost of Goods Sold" from its "Gross Receipts or Sales." Taxpayer Ex. 1, p. 1. It then calculated its "Ordinary Income from Trade or Business Activities" by subtracting its "Total deductions" from its Total Income. *Id.* Included within the **ABC**'s Total Deductions were the total amounts it reported as having spent on utilities and telephone for that year. Taxpayer Ex. 1. pp. 1, 5.
14. The evidence admitted at hearing does not reflect whether the **ABC** filed Illinois income tax returns during or regarding the tax years at issue. Tr. pp. 65-68 (**DOE**). Other than for 2002, the record does not reflect whether the **ABC** filed federal income tax returns regarding the tax years at issue. Taxpayer Ex. 1; Tr. pp. 65-68 (**DOE**).
15. The evidence admitted as parts of Taxpayer Exs. 5-7 for 2002 includes original electric, natural gas, and telephone bills. Taxpayer Exs. 5-7. Attached to each such original bill is an original receipt showing payment of such bill in the following

amounts. Taxpayer Exs. 5-7.

Month	Utilities		Telephone
	Electricity	Gas	
January	353.80	321.89	77.34
February	340.62	413.30	81.76
March	382.06	321.66	122.28
April	386.89		109.14
May	526.97	212.56	133.68
June	501.54	282.88	74.73
July	688.58	4.11	103.17
August	990.33		84.61
September	923.14		114.22
October	843.34		104.78
November	408.91	82.21	61.12
December	436.44	259.52	147.00
TOTAL	\$6,782.62	\$1,898.13	\$1,213.83

Taxpayer Exs. 5-7 (Taxpayer Ex. 6 did not include a natural gas bill and accompanying receipt for every month in 2002).

Conclusions of Law:

When the Department introduced the NODs into evidence under the certificate of the Director, it presented prima facie proof that the **DOE**' were liable for the tax proposed. 35 **ILCS** 5/904; PPG Industries, Inc. v. Department of Revenue, 328 Ill. App. 3d 16, 33, 765 N.E.2d 34, 48 (1st Dist. 2002); Balla v. Department of Revenue, 96 Ill. App. 3d 293, 296-97, 421 N.E.2d 236, 239 (1st Dist. 1981). The Department's prima facie case is a rebuttable presumption. Fillichio v. Department of Revenue, 15 Ill. 2d 327, 333, 155 N.E.2d 3, 7 (1958). A taxpayer cannot overcome the presumption merely by denying the accuracy of the Department's assessment, or merely by denying knowledge of a tax deficiency. Balla, 96 Ill. App. 3d at 296-97, 421 N.E.2d at 239. 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 proposed assessment is not correct.

PPG Industries, Inc., 328 Ill. App. 3d at 33, 765 N.E.2d at 48 (a taxpayer has the burden of overcoming the Department's *prima facie* case using documentary evidence, meaning books and records, and not mere testimony).

Here, the Department adjusted the **DOE'S** joint AGI for the years at issue, by determining that some measure of the increased amount of gross receipts that it previously determined that the **ABC** realized from making unreported sales of property at retail should flow through as taxpayers' own, personal, income. Department Ex. 1; Taxpayer Ex. 2; Tr. p. 6. At hearing, taxpayers argued that the Department must reduce the amount by which it increased taxpayers' AGI by the amount of the **ABC's** expenses that it paid during those years. Tr. pp. 7-10; 72-74; Taxpayer Ex. 3. The Department countered that the evidence offered by taxpayers does not rebut the Department's *prima facie* case because it does not establish that the Department did not already take into account the **ABC's** allowable deductions when calculating the increases proposed to taxpayer's AGI for the applicable tax years. Tr. pp. 69-72.

Taxpayers' argument is that the Department did not properly calculate the amount of their distributive share of the **ABC's** income during the years at issue when proposing additional Illinois income tax, yet it offered no evidence to show how the Department made that calculation. Taxpayers could have asked, and certainly had the opportunity to demand, through discovery, that the Department state how it calculated the measure of the **ABC's** additional receipts that it proposed should flow through to the taxpayers, as the **ABC's** shareholders. Order, dated April 23, 2008 ("No discovery was issued prior to the granting of a re-hearing. ... The Taxpayers' representative indicated that he will issue discovery to the Department."); 86 Ill. Admin. Code §§ 200.125, 200.130.

Subchapter S corporations are not subject to Illinois' income tax, but they are subject to Illinois' personal property replacement tax, and are, therefore, required to file an annual return to report that tax liability. 35 **ILCS** 5/201(d) (1996); Continental Illinois Nat'l Bank & Trust Co. of Chicago v. Zagel, 78 Ill. 2d 387, 394, 401 N.E.2d 491, 495 (1979). Subchapter S corporations report their Illinois replacement tax liability by filing a form IL-1120-ST, Small Business Corporation Replacement Tax Return, with accompanying schedules. During the years at issue and currently, the starting point for calculating a subchapter S corporation's Illinois replacement tax liability is the corporation's federal ordinary income or loss, as reported on line 21 of the corporation's federal return. *E.g.* 1999 Form IL-1120-ST (viewable online at <http://www.revenue.state.il.us/taxforms/incm1999/bus/small/il1120st.pdf>) (last viewed on December 11, 2008); Instructions for 1999 Form IL-1120-ST (viewable online at <http://www.revenue.state.il.us/taxforms/incm1999/bus/small/1120stin.pdf>) (last viewed on December 11, 2008). Thus, if everything is done properly, the corporation's expenses will have been deducted when calculating the corporation's ordinary income, before that income flows through to the AGI of each respective individual shareholder.

The documentary evidence reflecting the **ABC**'s or taxpayers' payments of expenses related to the operation of the **ABC** during the tax years at issue is the type of evidence that would support deductions claimed on the **ABC**'s or taxpayers' returns, like the **ABC**'s federal income tax return filed for 2002. *Compare* Taxpayer Ex. 1 *with* Taxpayer Exs. 5-9. Thus, if the **ABC** did not file corporate returns with either the IRS or with the State of Illinois, then the increased amounts of the **ABC**'s receipts as determined by the sales tax audit would properly be offset by the deductions authorized by federal

law, and reflected on the evidence admitted at hearing, with the resulting, and newly determined, federal ordinary income of the **ABC** then flowing through to the taxpayers in accordance with their relative percentage of shares in the **ABC**. *See* Taxpayer Exs. 1, 4-9. But, other than its filing of a federal return for 2002, I have no idea whether the **ABC** did or did not file returns with the IRS or with Illinois during the tax years at issue.

Nor do I have before me documentary evidence that credibly corroborates what taxpayers assert here — that the Department did not take into account the expenses that are properly deductible from the **ABC**'s revenues that it reported to the IRS, or the revenues that the Department determined were properly reportable to the IRS, if the **ABC** filed no federal return. For tax year 2002, moreover, it is clear that the expenses that taxpayers claim the Department did not take into account were, in fact, already taken into account *by the ABC* when *it* reported to the IRS its ordinary income or loss from a business, on line 21 of its return for that year. Taxpayer Ex. 1.

In a tax case, a taxpayer's mere claim that "the Department counted wrong" is not sufficient to rebut the statutory presumption of correctness that attaches to the Department's prima facie case. 35 **ILCS** 5/904(a)-(b); Fillichio, 15 Ill. 2d at 333, 155 N.E.2d at 7; Balla, 96 Ill. App. 3d at 296-97, 421 N.E.2d at 239. Taxpayers have not satisfied their burden to rebut the Department's presumptively correct determination of tax due. Fillichio, 15 Ill. 2d at 333, 155 N.E.2d at 7; Balla, 96 Ill. App. 3d at 296-97, 421 N.E.2d at 239.

Conclusion:

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

January 13, 2009
Date

John E. White, Administrative Law Judge