

IT 10-06

Tax Type: Income Tax

Issue: Income Earned In Illinois/Individual Residency

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

**THE DEPARTMENT OF REVENUE
OF THE STATE OF ILLINOIS**

v.

**JOHN DOE,
Taxpayer**

**No. 09-IT-0000
Tax Years 1998- 2002**

**Ted Sherrod
Administrative Law Judge**

RECOMMENDATION FOR DISPOSITION

Appearances: Special Assistant Attorney General Deborah Mayer on behalf of the Illinois Department of Revenue; John Doe, *pro se*.

Synopsis:

This matter is before this administrative tribunal as the result of a timely protest by John Doe (“Doe”) contesting a Notice of Deficiency issued by the Illinois Department of Revenue (“Department”) assessing Illinois income tax for the tax years 1998 through 2002. During these years, Doe resided in Florida and was not an Illinois resident. He received income from ABC of Anywhere, LLC, an Illinois based partnership¹ during each of these years. The issue in this case is whether Doe owes tax to Illinois on this

¹ During the tax years at issue, ABC of Anywhere, LLC was taxed as a partnership for federal income tax purposes. For this reason, it constituted a partnership for Illinois income tax purposes pursuant to 35 ILCS 5/1501(a)(16),

partnership income. A hearing to consider this issue was held on August 30, 2010 during which both parties presented documentary evidence and Doe and his accountant testified on Doe's behalf. Following a review of the record in this case, it is recommended that this matter be resolved in favor of the Department. In support of this recommendation, the following findings of fact and conclusions of law are made.

Findings of Fact:

1. The Department's *prima facie* case, inclusive of all jurisdictional elements, was established by the admission into evidence of the Department's Notice of Deficiency ("NOD") issued to Doe on June 26, 2009 indicating an amount due including penalty and interest of \$13,558. Department Exhibit ("Ex.") 1 and supporting schedules.
2. In the aforementioned NOD, the Department notified Doe that, after obtaining information from the Internal Revenue Service, the Department determined that Doe earned income from Illinois sources that was properly reportable to Illinois during the tax years 1998 through 2002, and that this income had not been reported to or taxed in this state. *Id.* It further notified Doe that, because of Doe's failure to file returns, the state was imposing non-compliance penalties for each of these years. *Id.*
3. Doe is, and was during the tax years in controversy, a resident of Florida, residing in Anywhere, Florida. Department Ex. 1, 4.
4. During the tax period at issue, Doe was employed by, and held a 25% equity interest in ABC of Anywhere, LLC ("ABC"), an Illinois based limited liability company having its principal place of business in Anywhere, Illinois. Transcript ("Tr.") pp. 12, 34, 35, 40, 41; Department Ex. 1, 5. During the tax years in controversy, ABC was taxed as a partnership for federal income tax purposes. Department Ex. 5.

5. ABC was subject to the Illinois Personal Property Tax Replacement Income Tax (“Replacement Income Tax”), 35 ILCS 5/201(c) which was computed on its net income derived from Illinois during each of the tax years at issue. Department Ex. 2-4. ABC failed to file Replacement Income Tax returns for any of these years. *Id.* The Department determined that ABC derived 100% of its income from Illinois sources and this assessment determination was not contested by ABC. Tr. pp. 6, 7, 29, 30; Department Ex. 3 (Notice of Tax Lien for Replacement Income Tax).²
6. Doe received a distributive share of ABC’s income from ABC during each of the tax years at issue. Department Ex. 1. The income Doe received was computed and reported to the Internal Revenue Service by ABC on an accrual basis rather than on a cash basis. Tr. pp. 12, 13, 34, 36, 37, 40, 41; Department Ex. 5. The amount of Doe’s cash receipts from ABC were less than the accrued but unpaid revenue reported as Doe’s income for federal income tax purposes by ABC. *Id.*
7. Doe reported and paid Federal income tax on his distributive share of ABC’s income during each of the tax years in controversy. Tr. pp. 12, 36. However, Doe failed to report any of this distributive share income to Illinois and paid no Illinois income tax on any of this income. Department Ex. 1.
8. The Department assessed Doe for Illinois income tax and penalties for unreported and unpaid taxes on his distributive share of income received from ABC. *Id.*

Conclusions of Law:

² There was no evidence offered at the hearing that specifically described how the Department calculated the amount of ABC’s Illinois net income.

The issue in this case is whether John Doe (“Doe”), a resident of Florida, was required to pay Illinois income tax on income he received from an Illinois based partnership during each of the tax years 1998 through 2002. For the reasons enumerated below, I conclude that Doe was liable for tax on this income.

During the tax years 1998 through 2002 at issue in this case, Doe held an ownership interest in ABC of Anywhere, LLC (“ABC”). ABC, a limited liability company, was taxed as a partnership for federal income tax purposes. Department Ex. 5. As a consequence, it constituted a partnership for Illinois income tax purposes. 35 ILCS 5/1501(a)(16).

Doe held a 25% equity interest in ABC and was entitled to a distribution of 25% of the partnership’s earnings. Tr. pp. 12, 13, 34, 36, 37, 40, 41. During each of the tax years at issue, Doe received a distributive share of ABC’s income. Tr. p. 12; Department Ex. 5. He reported his distributive share of ABC’s income on his federal income tax returns during each of these years. *Id.* However, he failed to file any Illinois returns reporting this income in Illinois and paid no Illinois income tax on any of this distributive share income from ABC.

While partnerships deriving income from Illinois are not taxable under the general provisions of the Illinois Income Tax Act (“IITA”), partners in such partnerships are subject to tax on their distributive shares of partnership income. 35 ILCS 205(b).³ These

³ Partnerships are not subject to the Illinois income tax. 35 ILCS 5/205(b). However, in addition to an income tax, Illinois also imposes a Personal Property Tax Replacement Income Tax pursuant to 35 ILCS 5/201(c). Partnerships are subject to this Personal Property Tax Replacement Income Tax. *Id.* A partnership’s Personal Property Tax Replacement Income Tax is based upon the partnership’s net income. *Id.*

partners are required to include partnership income in their Illinois income tax returns. 2009 Form IL-1040 Instructions.

The IITA expressly provides that non-residents deriving income from partnerships that is taxable in Illinois must file Illinois returns reporting their distributive share of income to Illinois if the partnership does not file a return for them. 35 **ILCS** 5/305; 35 **ILCS** 5/502(a), (f). Non-residents deriving income from Illinois who are partners in a partnership may avoid filing individual returns in this state by including their income in what is called an IL-1023-C “composite” return. 35 **ILCS** 5/502(f); 86 Ill. Admin. Code, ch. I, sec. 100.5100; 86 Ill. Admin. Code, ch. I, sec. 100.5130. This return includes the composite income of all non-resident partners electing to report income to Illinois as part of a single return filed on the partners’ behalf by the partnership. *Id.* When the partnership does not file a composite return, each individual is required to file a separate non-resident return reporting partnership income derived from Illinois. 35 **ILCS** 5/502(a). The record in this case contains no evidence that a composite return reporting Doe’s income was ever filed.

On June 26, 2009, the Department issued a Notice of Deficiency (“NOD”) to Doe for failure to file returns and pay taxes due and owing on his distributive share of income earned in Illinois from his interest in an Illinois based partnership during the tax years at issue. Department Ex. 1. The Department also assessed penalties pursuant to 35 **ILCS** 735/3-3(a-5) and 35 **ILCS** 735/3-3(a-10) of the Uniform Penalty and Interest Act (“UPIA”), 35 **ILCS** 735/3-1 *et seq.* for failure to file returns and pursuant to section 735 **ILCS** 3-3(b-5) of the UPIA for failure to make required estimated payments. *Id.* Doe

timely protested this NOD and requested an administrative hearing, which was conducted by phone on August 30, 2010.

The Department's determination is presumed correct. 35 ILCS 5/904(a); PPG Industries v. Department of Revenue, 328 Ill. App. 3d 16 (1st Dist. 2002); A.R. Barnes and Co., v. Department of Revenue, 173 Ill. App. 3d 826 (1st Dist. 1988). Once the presumed correctness of the assessment is established, the burden shifts to the taxpayer to prove that the determination was in error. 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); Masini v. Department of Revenue, 60 Ill. App. 3d 11 (1st Dist. 1978); PPG Industries, supra; A.R. Barnes and Co., supra.

When the Department introduced the NOD into evidence, it presented *prima facie* proof that Doe was liable for the tax and penalties in this determination. Branson v. Department of Revenue, 168 Ill. 2d 247, 261 (1995). The Department's *prima facie* case is a rebuttable presumption. *Id.* However, a taxpayer cannot overcome this presumption merely by denying the accuracy of the Department's assessment. 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. PPG Industries, Inc., supra (a taxpayer challenging an assessment has the burden of overcoming the Department's *prima facie* case using documentary evidence, meaning books and records, and not mere testimony).

Doe does not contest the Department's determination that he was a non-resident of Illinois that derived income from Illinois by virtue of his 25% interest in an Illinois

based partnership. However he does object to the Department's determination of the amount of income he derived from Illinois. Tr. pp. 29, 30.

The Department contends that Doe's entire distributive share of income from ABC is attributable to ABC's business activities in Illinois. *Id.*; Tr. pp. 6, 7. It contends that all of ABC's income producing activity was conducted in Illinois and that, as a consequence, all of its income is attributable to this state. Tr. pp. 29, 30.

Doe disagrees with the Department's finding that ABC derived all of its income from Illinois. *Id.* Doe contends that his distributive share of ABC's income may have resulted from ABC's business activities in several different states and that neither all of the partnership's income nor all of his distributive share of this income should be treated as having been derived exclusively from Illinois. *Id.* For the reasons indicated below, I find that the Department's determination that ABC derived all of its income from Illinois has not been refuted by Doe.

The record in this case indicates that Doe's tax liability is based upon the Department's determination that ABC derived all of its income from Illinois. Tr. pp. 6, 7. Based upon this finding, the Department has concluded that all of the income ABC distributed to Doe was derived from Illinois. *Id.*

The Department has based its conclusion that ABC derived all of its income from Illinois during the tax years at issue on its assessment of ABC for unpaid Replacement Income Tax. Tr. pp. 6, 7; Department Ex. 2-4. In arriving at ABC's Replacement Income Tax liability for the tax years at issue, the Department found that all of ABC's income was derived from Illinois. Tr. pp. 6, 7; Department Ex. 2-4. ABC did not contest the Department's determination of its tax liability and the Department's decision

became an enforceable judgment. Department Ex. 3 (Notice of Tax Lien for unpaid Replacement Income Tax due from ABC for 1998 through 2002). Since it had already been finally determined legally that ABC derived all of its income from Illinois during the tax years at issue, the Department concluded that all of the income Doe received from ABC during these years was also attributable to Illinois. Tr. pp. 6, 7.

Doe has presented no evidence of any kind to refute the Department's uncontested Replacement Income Tax determination that ABC derived all of its income from Illinois and that ABC owes Replacement Income Tax on all of this income. Nor has he given any explanation for his claim that ABC did not derive all of its income from this state. For this reason, I find no basis for concluding that any less than 100% of ABC's income was derived from Illinois sources. Since the record fully supports a finding that ABC derived all of its income from Illinois, Doe's entire distributive share of income from ABC was properly attributed to this state.

Doe also contends that the assessment determination should be abated because he was never notified of his obligation to file Illinois returns or of the amount of Illinois tax due and owing and therefore had no knowledge of the taxes due resulting in the deficiency that has been assessed. Tr. pp. 12, 13, 33-35. A partnership deriving income from Illinois is required to notify its partners of their obligation to pay Illinois tax and advise them of the amount of tax due on their share of partnership income. Schedule K-1-P(1) Partnership's and S Corporation's Instructions. However, a partnership's failure to comply with its obligation to notify a non-resident partner of the amount of tax due to Illinois as a result of the partnership's activities in this state does not relieve its non-resident partner of its responsibility to report and pay tax on Illinois income derived from

its partnership interest. Department of Revenue Publication 129, Pass-through Entity Income, 12/1/06 (“If your [non-resident] clients receive pass-through income from a partnership or subchapter S corporation, your clients still have an Illinois Income Tax obligation and must file an Illinois income tax return showing the pass-through income as taxable to Illinois.... If your clients have not filed an Illinois Income Tax return and should have, you should encourage your clients to file the necessary tax return and schedules as soon as possible. If any tax is owed to Illinois, penalty and interest may be assessed.”). Moreover, the Illinois courts have held that a taxpayer’s denial that he had any knowledge of taxes due giving rise to a tax assessment is insufficient to rebut the correctness of the Department’s *prima facie* determination of liability. Branson at 267.

The gravamen of Doe’s argument against a finalization of liability in this case is that he was not aware that the income he received was from a partnership that had a connection with Illinois. I do not find this claim to be credible. The record here clearly indicates that Doe received Federal K-1 forms reporting his distributive share of partnership income from ABC. Department Ex. 5. Each of these K-1 forms contained the following information:

Partnership’s name, address, and ZIP code
ABC of Anywhere, L.L.C.
000 S. Anywhere Road
Anywhere, IL
Id.

This information clearly indicates that ABC’s business address was in Illinois during the tax years at issue and reasonably should have led Doe to conclude that he might have income from an Illinois source. Moreover, Doe was assisted in his tax compliance by Scott Sandfort, a Certified Public Accountant possessing almost 20 years of professional

experience (Tr. p. 22) who clearly would have understood the need to investigate ABC's Illinois tax exposure as a result of the business address of ABC shown on the K-1s Doe received. I conclude that Doe knew or reasonably should have known that he was receiving income from an entity that was engaged in business in Illinois and therefore potentially subject to taxation in this state.

Doe also contends that the Department should reduce the amount of tax assessed to one-half of the amount shown as income on K-1s Doe received because Doe actually received only half of the amount shown on the K-1s as a cash distribution during each of the tax years at issue. Tr. pp. 12, 13, 34, 36, 37, 40, 41. Consequently, while Doe held a 25% equity interest in ABC, ABC's cash distribution was only 12 ½% of ABC's income rather than the 25% of income to which Doe was entitled based upon his equity interest. The K-1s, however, reported taxable income distributed to Doe and subject to federal income tax as 25% of the partnership's net income. *Id.*; Department Ex. 5.

Doe's argument is essentially that he should be taxed on the basis of cash he actually received (i.e. using the cash method of accounting) rather than on the basis of revenue he legally accrued and was entitled to receive as his distributive share of partnership income (i.e. using the accrual method of accounting). In Illinois, a taxpayer must use the same accounting method (cash or accrual) that it uses for federal income tax purposes. 35 ILCS 5/402. Consequently, to prevail on his claim that he should be taxed only on cash received from ABC, Doe needed to present documentary evidence indicating that he elected to be taxed using the cash method of accounting for federal tax purposes, which he has not done.

Moreover, even if Doe could show that he elected to be taxed using a cash method of accounting, for the reasons indicated below, he would nevertheless be required to report his income from ABC using the accrual method of accounting on which the Department's assessment is based. The K-1s Doe received from ABC indicate that ABC reported income federally using the accrual method of accounting. These forms reported the amount of federal tax due from Doe on his distributive share of ABC income based upon the amount of income that legally accrued to him shown on ABC's books and records. Tr. pp. 12, 13, 34, 36, 37, 40, 41.

Doe was required to use the same accounting method to account for his distributive share of ABC income that ABC used in arriving at the amount of his distributive share even if he reported all of his other income using a different method. See Merten's § 13:12 ("Generally, a taxpayer on the cash basis method of accounting reports income and expenses when such amounts are received or paid[.] However, a cash basis taxpayer who is a partner in an accrual basis partnership will report his distributive share of partnership income, expenses, and other partnership items on the accrual basis notwithstanding that the taxpayer is a cash basis taxpayer ...[.]"); Hayden v. C.I.R., 204 F. 3d 772 (7th Cir. 2000). ABC used the accrual method of accounting to determine Doe's tax on his distributive share of ABC income. Consequently, even if Doe could show that he was otherwise permitted to report his income using the cash method of accounting, the record indicates that Doe must nevertheless be taxed on his distributive share of income from ABC using the accrual method of accounting because this is the method ABC used to determine his distributive share. Accordingly, the Department's use of an accrual method rather than a cash method of accounting to arrive at Doe's tax

liability on his distributive share would have been proper even if Doe had shown that he was using the cash method to report all of his other income.

Doe also claims that he could have “written off” the difference between the amount he was owed by ABC and the amount he was paid by ABC in each of the tax years at issue in this case. Tr. pp. 12, 13, 40, 41. This claim is incorrect. In order to write off the 12 1/2 % income distribution from ABC he was entitled to, based on his equity interest, but did not receive, Doe needed to liquidate his interest in ABC. Internal Revenue Code § 731, 26 U.S.C.A. § 731. However, the record indicates that Doe retained his interest in ABC throughout the tax years at issue in this case and did not liquidate his interest in ABC until 2003. Tr. pp.41-44.

During the hearing, Doe submitted into the record a copy of Doe’s tax return for 2003 purporting to show that he reduced the basis of his equity interest in ABC when he liquidated his interest in ABC in 2003 to reflect accrued but unpaid distributive share income from ABC due him from 1997 through 2002, resulting in a capital loss on his divestment of this equity interest. *Id.*; Taxpayer’s Ex. 1. I find that Doe’s 2003 return is irrelevant to this case because it relates to an adjustment to Doe’s income tax liability for 2003, a year that is outside of the tax period before me in the instant case. During the hearing, Doe failed to show how his 2003 tax return pertained to this case.

Doe has been assessed penalties for failure to file tax returns by the due date and for failure to make the required estimated payments. Department Ex. 1. The penalties imposed do not apply if a taxpayer shows that the failure to file a return or make estimated payments was due to reasonable cause. 35 **ILCS** 735/3-8; 86 Ill. Admin. Code, ch. I, § 700.400. Doe has failed to show any reasonable cause for penalty abatement in

this case and the penalties assessed for failure to file income tax returns and failure to pay estimated taxes should not be abated.

WHEREFORE, for the reasons stated above, it is my recommendation that the Department's NOD at issue in this case be finalized.

Ted Sherrod
Administrative Law Judge

Date: October 26, 2010