

IT 16-10

Tax Type: Income Tax

Tax Issue: Properly Determined AGI for Subchapter S Shareholders

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

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

v.

**JOHN AND JANE DOE,
Taxpayer**

**No. XXXX
Account ID XXXX
Letter ID XXXX
XXXX
XXXX
Tax Years 2007-2009**

**Ted Sherrod
Administrative Law Judge**

RECOMMENDATION FOR DISPOSITION

Appearances: Special Assistant Attorney General Jonathan Pope 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 and Jane Doe (“Taxpayer”) of Notices of Deficiency the Illinois Department of Revenue (“Department”) issued to them proposing to assess deficiencies for the calendar years ended 12/31/07, 12/31/08 and 12/31/09. A hearing to consider the Taxpayer’s protest was held at the Department’s offices in Chicago, Illinois on May 5, 2016. The Department’s assessments arise from its determination of the amount of distributive share income the Taxpayer received from ABC Business, Inc. (“ABC Business”), a subchapter S corporation the Taxpayer held an ownership interest in during the tax years in controversy. At the hearing, John Doe, appearing on behalf of the Taxpayer, testified and produced documentary evidence. Documentary evidence

was also introduced into the record by the Department. I have reviewed the evidence the parties have submitted, and I am including in this recommendation findings of fact and conclusions of law. I recommend that the Notices of Deficiency be finalized as issued, with interest to accrue pursuant to statute.

Findings of Fact:

1. During the period 2007 through 2009, John and Jane Doe (“Taxpayer”) were residents of Illinois residing in Anywhere, Illinois. Department Ex. 1-3.
2. On October 7, 2013, the Department issued Notices of Deficiency for Form IL-1040, Individual Income Tax Return to the Taxpayer assessing tax, penalty and interest for the tax years ended 12/31/07, 12/31/08 and 12/31/09. *Id.* The Department’s Notices of Deficiency were addressed to John Doe, Anywhere, Illinois 60090-6776. *Id.* The Taxpayer timely protested these notices. *Id.*
3. The Department determined the Taxpayer's taxable income for the tax years at issue by including the Taxpayer's distributive share of subchapter S corporation income from ABC Business, Inc. (“ABC Business”), a subchapter S corporation engaged in the sale of gasoline and sales related to its operation of a mini-mart, under the assumed name XYZ Business. Transcript of hearing proceedings May 5, 2016 (“Tr.”) pp. 5-7, 30, 31, 39; Department Ex. 4.
4. During the tax years in controversy, the Taxpayer was a shareholder of ABC Business and owned 40% of the company’s stock. Tr. pp. 7, 30, 38. The remaining 60% of the stock in the company was owned by Jack Black, the company’s President, who was in charge of the company’s operations. Tr. pp. 17, 30, 31, 33.¹

¹ John Doe and Jack Black, ABC Business’ President, are not related. Tr. p. 31.

5. The Taxpayer's distributive share of ABC Business' income was determined following the Department's Retailers' Occupation Tax ("ROT") audit of ABC Business' business activities during the tax years at issue. Tr. pp. 5-7, 37-39; Department Ex. 7. At the conclusion of the Department's ROT audit of ABC Business, the Department determined that ABC Business had not reported on its sales tax returns all of its receipts from selling tangible personal property at retail in Illinois. *Id.* The Department calculated the Taxpayer's distributive share of ABC Business' income includable in the Taxpayer's Illinois income for the tax years in controversy based in part upon ABC Business' gross receipts determined during the Department's ROT audit of ABC Business. *Id.* The Taxpayer's distributive share of ABC Business' income for 2007, 2008 and 2009 was derived from the sales receipts that the Department determined ABC Business realized during these tax years. *Id.*
6. The Department's ROT audit increasing ABC Business' gross receipts resulted in the issuance of Notices of Final Assessment for Form EDA-105-R, ROT Audit Report to ABC Business on June 26, 2013. Department Ex. 5, 6. These notices were issued subsequent to the Department's issuance of its final decision affirming the Department's Notices of Tax Liability ("NTLs") issued in this case. Department Ex. 4. On June 21, 2013, the Department issued a final decision affirming the Department's NTLs based upon conclusions reached during an administrative hearing to consider this matter. *Id.* Gene Green, Esq., an attorney licensed to practice in Illinois, appeared as counsel for ABC Business during the administrative hearing before the Department that resulted in the Department's determination. *Id.*

7. The above-referenced hearing in ABC Business arose from a request for a late discretionary hearing pursuant to 86 Ill. Admin. Code, ch. I, section 200.175 submitted by ABC Business' President, which was granted by the Department on October 25, 2011. Taxpayer's Ex. 1. The letter granting the Taxpayer's request for a late discretionary hearing was addressed to ABC Business, Inc. in care of its President at the address of Happyplace, Illinois 60026. *Id.*

Conclusions of Law:

In the instant case, the Department determined that the Taxpayer owes additional income tax on its distributive share of income it received from a subchapter S corporation in which it held a 40% ownership interest. A subchapter S corporation is a corporation that has in effect an election under section 1362 of the Internal Revenue Code to be taxed as a "pass through" entity passing through to its shareholders all of its items of income, loss, deduction and credit, which are taken into account by its shareholders in computing their individual income tax liabilities pursuant to Internal Revenue Code section 1366. 35 ILCS 5/1501(a)(28). Illinois recognizes a corporation's subchapter S election for state income tax purposes and taxes all individual Illinois taxpayers on their distributive shares of subchapter S corporation income. 35 ILCS 5/301; 86 Ill. Admin. Code, ch. I, section 100.9750(c).

When the Department introduced the Notices of Deficiency at issue in this case (Department Ex. 1-3) into evidence under the Certificate of the Director, it presented *prima facie* correct proof that the Taxpayer was liable for the tax proposed. 35 ILCS 5/904(a); PPG Industries, Inc. v. Department of Revenue, 328 Ill. App. 3d 16, 34 (1st Dist. 2002). The Department's *prima facie* case is a rebuttable presumption. Filichio v. Department of Revenue, 15 Ill. 2d 327, 333 (1958). A taxpayer cannot overcome this presumption of correctness merely

by denying the accuracy of the Department's assessment. Central Furniture Mart v. Johnson, 157 Ill. App. 3d 907 (1st Dist. 1987); Quincy Trading Post v. Department of Revenue, 12 Ill. App. 3d 725 (4th Dist. 1973). 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, *supra* at 34 (a taxpayer has the burden of overcoming the Department's *prima facie* case using documentary evidence, meaning books and records, and not mere testimony).

In the instant case, the Department determined the Taxpayer's distributive share of income from ABC Business due for the tax years ended 12/31/07, 12/31/08 and 12/31/09 based upon the results of its Retailers' Occupation Tax ("ROT") audit of ABC Business that covered those years. Tr. pp. 5-7, 37-39; Department Ex. 7. Specifically, during its ROT audit of ABC Business covering the tax years at issue in the instant case, it increased the amount of ABC Business' gross receipts above amounts reported by ABC Business on its ROT returns upon finding that ABC Business had made numerous unreported sales of tangible personal property at retail. *Id.* The Department revised ABC Business' gross receipts for income tax purposes to conform to the amounts of gross receipts the Department found to be properly reportable on ABC Business' ROT returns. *Id.* Moreover, because ABC Business was a subchapter S corporation that was partly owned by the Taxpayer, the Department determined that a portion of ABC Business' gross receipts should flow through to the Taxpayer for purposes of determining the Taxpayer's distributive share of ABC Business' income. *Id.*

During the evidentiary hearing in this case, the Taxpayer argued that it did not receive notice of ABC Business' hearing and that it had no opportunity to contest the Department's Notices of Tax Liability ("NTLs") increasing ABC Business' gross receipts at issue in that case.

Tr. p. 8. It further argued that it has evidence showing that the NTLs were incorrect which it would have presented at the hearing had it been properly notified. Tr. p. 41. For the foregoing reasons, it contends that the Notices of Deficiency issued in this case cannot properly be based upon the Department's NTLs issued ABC Business. Tr. pp. 39-41.

It is well settled in Illinois that a taxpayer cannot rely upon a claim that the underlying corporate liability is incorrect as a basis for rebutting a determination of individual liability that is based upon the underlying corporate liability. Department of Revenue v. Dombrowski, 202 Ill. App. 3d 1050 (1st Dist. 1990). Dombrowski stands for the proposition that, where the Department properly issues a final assessment to the corporation incurring the underlying corporate liability, any issues as to the correctness of that final tax deficiency can be challenged only pursuant to the Illinois Administrative Review Act ("ARA"). Dombrowski, *supra* at 1054 ("Having failed to file such an action, he has instead improperly sought judicial review of the Department's action as part of his defense to the instant lawsuit; but because of defendant's failure to comply with the ARA, we are not empowered to review the merits of the Final Assessment or the Revised Final Assessment.").

As a consequence of the Department's administrative hearing decision to affirm the audit determination of ABC Business' gross receipts during the Department's ROT audit of ABC Business, the Taxpayer is barred from again litigating this audit determination as part of the instant case. Because the Department's determination of the amount of ABC Business' gross receipts has become final and is legally binding, the Taxpayer cannot challenge the correctness of the amount of ABC Business' gross receipts that have been passed through to the Taxpayer for purposes of computing the Taxpayer's distributive share income.

Moreover, the underlying premise of the Taxpayer's claim for relief is erroneous. The gravamen of the Taxpayer's claim is that the Taxpayer, as a 40% shareholder of ABC Business, was entitled to receive notice of the evidentiary hearing scheduled to consider the NTLs issued ABC Business by the Department. For the reasons enumerated below, this premise is incorrect.

Regulation 200.110(a) of the Department's rules and regulations governing its administrative hearing proceedings provides as follows:

At hearings or pre-trial matters before the Department, a party to the proceeding may represent himself or he may be represented by any person who is admitted to practice as an attorney at law by, and is in good standing before, the Supreme Court of Illinois, or who is permitted by a circuit court granting leave to appear pro hac vice to practice law in a case before the Department. A corporation may be represented by an officer, or other authorized employee, in any matter wherein the contested tax liability or claim does not exceed \$2,500.00, exclusive of penalty and interest.
86 Ill. Admin. Code, ch. I, section 200.110(a)

The record indicates that the NTLs issued ABC Business, affirmed by the Department's administrative hearing decision noted above, assessed tax in the amount of \$XXXX (Department Ex. 5, 6) and that, as a consequence, ABC Business was required to retain counsel to represent it pursuant to regulation 200.110(a). In fulfillment of this requirement, the record indicates that Gene Green, Esq. was retained by ABC Business to represent it in the proceedings contesting the Department's NTLs. Department Ex. 4. Gene Green appeared as counsel for ABC Business during the administrative hearing that resulted in the Department's affirmation of the aforementioned NTLs.

Section 120/12 of the Retailers' Occupation Tax Act provides as follows:

Whenever notice is required by this Act, such notice may be given by United States registered or certified mail, addressed to the person concerned at his last known address, and proof of such mailing shall be sufficient for the purposes of this Act. ... Following the initial contact of a person represented by an attorney, the Department shall not contact the person concerned but shall only contact the attorney representing the person concerned.

35 ILCS 120/12

Pursuant to the foregoing provision, after a taxpayer's initial contact with the Department's office of administrative hearings (in this case, ABC Business' request for late discretionary hearing submitted by its President, Taxpayer's Ex. 1), the Department was required to address all correspondence concerning ABC Business' administrative hearing proceedings to Gene Green, Esq., the company's duly authorized legal counsel. Consequently, it was the responsibility of Gene Green, ABC Business' lawyer, rather than the Department, to notify the Taxpayer of the hearing in ABC Business' case. This is because the Department was legally barred from corresponding with anyone other than ABC Business' legal counsel by section 120/12 of the Retailers' Occupation Tax Act, noted above. Based upon the foregoing, I find no merit in the Taxpayer's claim that it had a right to be notified by the Department of ABC Business' administrative hearing on the NTLs issued to it by the Department in order for the Department's affirmation of these NTLs to be a basis for the Notices of Deficiency at issue.

During the hearing in this case, the Taxpayer offered no evidence to show in what manner the Department erred in determining the Taxpayer's individual income tax liability for the tax years at issue reflected in the Notices of Deficiency issued to the Taxpayer. A Taxpayer's mere assertion that the Department erred in computing the Taxpayer's tax liability is not sufficient to rebut the statutory presumption of correctness that attaches to the Department's *prima facie* correct audit determination. Central Furniture Mart, *supra*; Quincy Trading Post, *supra*. To rebut the Department's determination, a taxpayer must produce accounting books and records that demonstrate the amount of tax a taxpayer claims to be properly due. PPG Industries, *supra* at 35. In the instant case, the Taxpayer has not satisfied its burden to rebut the Department's

presumptively correct determination by introducing documentary evidence of this nature.²

Conclusion:

It is recommended that the Director finalize the Notices of Deficiency at issue, with interest to accrue pursuant to statute.

Ted Sherrod
Administrative Law Judge

Date: June 26, 2016

² The Taxpayer also contends that ABC Business' Personal Property Tax Replacement Income Tax ("replacement tax") liability pursuant to 35 ILCS 5/201(c) was not lawfully and properly determined. Tr. pp. 40, 41. A determination of ABC Business' replacement tax is relevant to a finding of the Taxpayer's deficiencies at issue because information concerning each shareholder's *pro rata* portion of a subchapter S corporation's net income is reportable on schedule B of Form IL-1120-ST, Small Business Corporation Replacement Tax Return. See Department Publication 129, "Pass-through Entity Income" issued 12/1/06 and Form IL-1120-ST Instructions-Small Business Corporation Replacement Tax Return. However, the Taxpayer has produced no evidence to support its claim that ABC Business' replacement tax liability was improperly addressed or determined by the Department. The Taxpayer's mere allegation to this effect is not sufficient to rebut the statutory presumption of correctness that attaches to the Department's *prima facie* case. PPG Industries, *supra* at 34.