

ST 07-2
Tax Type: Sales Tax
Issue: Disallowed General Deductions

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

THE DEPARTMENT OF REVENUE
OF THE STATE OF ILLINOIS

v.

JOHN DOE d/b/a ABC

Taxpayer

Docket # 05-ST-0000
IBT # 0000-0000
NTL # 00 00000000000000
NTL # 00 00000000000000
NTL # 00 00000000000000

RECOMMENDATION FOR DISPOSITION

Appearances: Kent Steinkamp, Special Assistant Attorney General, for the Department of Revenue of the State of Illinois; Dwight H. O’Keefe III of Brown, Hay & Stephens, LLP for *John Doe d/b/a ABC*.

Synopsis:

The Department of Revenue (“Department”) conducted an audit of *John Doe d/b/a ABC* (“taxpayer”) for the period of January 2000 to December 2002. At the conclusion of the audit, the Department issued three Notices of Tax Liability (“NTL’s”) to the taxpayer for additional retailers’ occupation tax (“ROT”) and use tax. The taxpayer timely protested the NTL’s, and an evidentiary hearing was held. The taxpayer operates a garden center, and he owns an adjacent building that he lets patrons use for events such as parties or weddings. The taxpayer alleged that he included the amount of

money that he received for the use of the building in the amount of total retail sales on his ROT returns for the audit period. The taxpayer then took a deduction on his returns titled “rent” for this amount. The auditor concluded that the taxpayer should not have deducted this amount on his returns.¹ At the pre-trial conference, the sole issue raised by the parties was whether the “rent” was properly deducted on the returns. For the following reasons, it is recommended that this matter be resolved in favor of the Department.

FINDINGS OF FACT:

1. The taxpayer operates a garden center. He purchased an adjacent parking lot with a building in order to expand the parking for his business. (Tr. pp. 29-30)
2. Before the taxpayer purchased the building, it had been used as a skating rink. It was later used for wedding receptions, parties, and concerts. When the taxpayer purchased the property to obtain the parking lot, he decided to continue to use the building for similar events. The building is known as the Club (“Club”). (Tr. pp. 29-30)
3. There are generally three types of events that take place at the Club. For the first type, a group, such as a church group, may use the building, but the bar that is in the building is not used. For the second type, a group may use the building for a party or a concert, and the bar in the building may be open for soft drinks or alcohol. The third type of event involves catering, which is primarily for wedding receptions. (Tr. pp. 31-33)
4. A cash register is located at the bar, and the sales are recorded there. (Tr. p. 32)

¹ The auditor also concluded that the taxpayer owed additional ROT of \$1,556 for underreported tax on employee purchases and owed use tax of \$180 on assets that he had purchased. The taxpayer does not dispute these findings. (Dept. Ex. #3; Tr. pp. 6, 30-31)

5. The Department conducted an audit of the taxpayer's business for the period of January 2000 through December 2002. The auditor determined that the taxpayer improperly deducted "rent" from the total sales on the ROT return. The amount that the auditor determined should not have been deducted was \$250,478. The auditor assessed additional ROT of \$18,160 for this amount. (Dept. Ex. #3)
6. On April 27, 2005, the Department issued a corrected tax return for the taxpayer that shows total additional tax due in the amount of \$19,896. A copy of the corrected return was admitted into evidence under the certificate of the Director of the Department. (Dept. Ex. #2, p. 3)

CONCLUSIONS OF LAW:

The Retailers' Occupation Tax Act ("ROTA") (35 ILCS 120/1 *et seq.*) imposes a tax upon persons engaged in the business of selling at retail tangible personal property. 35 ILCS 120/2. Sections 4 and 5 of the ROTA provide that the certified copy of the corrected return issued by the Department "shall be prima facie proof of the correctness of the amount of tax due, as shown therein." 35 ILCS 120/4; 120/5. Once the Department has established its prima facie case, the burden shifts to the taxpayer to overcome this presumption of validity. A.R. Barnes & Co. v. Department of Revenue, 173 Ill. App. 3d 826, 832 (1st Dist. 1988). To prove his case, the taxpayer must present more than his testimony denying the accuracy of the Department's assessment. See Mel-Park Drugs, Inc. v. Department of Revenue, 218 Ill. App. 3d 203, 217 (1st Dist. 1991); Sprague v. Johnson, 195 Ill. App. 3d 798, 804 (4th Dist. 1990); A. R. Barnes & Co., *supra*, at 833-34. The taxpayer must present sufficient documentary evidence to support his claim. *Id.*

The taxpayer contends that the deduction for “rent” on his ROT returns included several items. First, the taxpayer claims this included the fees that he received for the use of the space, which the taxpayer claims totaled \$114,863. He also asserts that the “rent” included gratuity that was paid to the employees of the catering company, which totaled \$6,590.25, and it included the tax that was paid to the caterers, which totaled \$43,935. Finally, the taxpayer claims that the deduction for “rent” included items that were “passed through” to the customers, such as napkins, linens, and silverware.

Fees for Use of Building

The taxpayer argues that he should receive a credit for the tax that he paid on the amount that he received (\$114,863) for the use of the Club. The taxpayer believes that the following regulation requires a finding that this amount is not taxable:

- 1) Cover Charges
 - A) Cover charges are not included in the taxable receipts of persons operating restaurants, hotels and other places of business which come within the Act, where such cover charges are made exclusively for the privilege of occupying space within such eating place, and where the payment of a cover charge by a patron does not entitle such patron to use or consume any food or beverage or other tangible personal property.
 - B) In such an instance, the cover charge is a receipt on account of a service rendered, whether such service be entertainment or otherwise, and does not accrue on account of the sale of tangible personal property at retail. 86 Ill. Admin. Code §130.2145(c).

In response, the Department states that the ROT is based on the total gross receipts, and a deduction is not allowed for costs. The Department refers to the following regulation:

In computing Retailers' Occupation Tax liability, no deductions shall be made by a taxpayer from gross receipts or selling prices on account of the cost of property sold, the cost of materials used, labor or service costs, idle time charges, incoming freight or transportation costs, overhead costs, processing charges, clerk hire or salesmen's [sic] commissions, interest paid by the seller, or any other expenses whatsoever. Costs of doing business are an element of the retailer's gross receipts subject to tax even if separately stated on the bill to the customer. 86 Ill. Admin. Code §130.410.

As an example, the Department states that the taxpayer charged a group \$500 for using the premises, and that charge included cleanup. During the event, the taxpayer operated the bar as well. The Department notes that all receipts, including bar receipts were included in gross receipts on the ROT return, and the taxpayer then deducted the \$500 from gross receipts. The Department argues that sales of tangible personal property were being made at the bar, and tables and chairs were provided. The Department claims that the deduction for the cost of using the premises should not be allowed because it is a deduction for overhead and cleanup. (Dept. brief, p. 3) The Department maintains that separately billing a customer for costs does not permit a deduction for those costs. The Department notes that the auditor testified that he reviewed all of the taxpayer's books and records and found no separate billing or accounting for costs. The rent figure that the taxpayer deducted was only an entry on the business ledger. (Tr. p. 27)

The Department agrees that a meal vendor may exclude "cover charges" from taxable gross receipts. The Department states that if cover charges are correctly identified, they are not included in gross receipts and do not need to be deducted from gross receipts. Nevertheless, the Department claims that this exclusion from gross receipts is not available to the taxpayer because the taxpayer has not produced books and records showing that cover charges were billed.

As previously mentioned, the ROT is imposed upon persons engaged in the business of selling at retail tangible personal property. 35 ILCS 120/2. "Sale at retail" means any transfer of the ownership of or title to tangible personal property to a purchaser, for the purpose of use or consumption, and not for the purpose of resale. 35 ILCS 120/1. This tax clearly applies to the sale of tangible personal property at the taxpayer's garden center, and it also applies to the sale of the drinks at the bar in the Club. If a patron pays a fee strictly for the use of the Club, however, this would not involve a transfer of tangible personal property. This money would be received in exchange for something intangible, which is the use of the property. These fees are not gross receipts from the sale of tangible personal property.

From the evidence presented, it is difficult to discern how the taxpayer accounted for his receipts from the sale of tangible personal property, his receipts for the use of the Club, or his expenses related to these transactions. During cross-examination, the taxpayer indicated that all receipts from his business were included in gross retail sales on his ROT returns. (Tr. pp. 39-40) From the arguments that he has raised, it appears as though the taxpayer may have included all receipts in the gross retail sales figure despite the fact that not all of the receipts were from the sale of tangible personal property.

In order to determine whether the taxpayer is entitled to a deduction from gross receipts for an amount that was improperly included in gross receipts, the taxpayer must first explain what transactions were included in gross receipts. He must do this with his books and records, which were not presented by the taxpayer during the hearing. Without proper documentation of what was included in gross receipts, it cannot be determined whether various deductions from gross receipts are appropriate.

Section 7 of the ROTA requires the taxpayer to maintain records of all sales of tangible personal property and provides in part as follows:

“Every person engaged in the business of selling tangible personal property at retail in this State shall keep records and books of all sales of tangible personal property, together with invoices, bills of lading, sales records, copies of bills of sale, inventories prepared as of December 31 of each year or otherwise annually as has been the custom in the specific trade and other pertinent papers and documents. * * * All books and records and other papers and documents which are required by this Act to be kept shall be kept in the English language and shall, at all times during business hours of the day, be subject to inspection by the Department or its duly authorized agents and employees.” (35 ILCS 120/7)

The Department’s regulations state that a “taxpayer shall maintain all records that are necessary to a determination of the correct tax liability under the Act.” 86 Ill. Admin. Code §130.805(a). The Income Tax Act includes a similar provision requiring taxpayers to keep records to substantiate their income and expenses. See 35 ILCS 5/501.

As the taxpayer noted in his brief, his attorney asked the following questions during cross-examination of the auditor:

Q Did you differentiate the records between the rental only where the hall was just rented without any other facilities being provided by ABC and the Club?

A Those records were not made available to me.

Q Okay. Did you differentiate then --- thank you. Did you differentiate then between the --- they have – my understanding is at the facility there is a bar. Now, it’s not a bar like XXXX’s or what we have here. It’s – if you rent the hall, you can go in and receive, you can order Cokes and what have you there. Did you review the individual tapes of the – of the receipts there as opposed to the receipts from the hall itself?

A Those records were not available to me.

Q Similarly on catered events where an outside caterer was brought in, did you differentiate the tips that were paid to employees or did you just review the gross receipts?

A The tip information and bar receipts and banquet records were not made available to me. (Tr. pp. 22-23)

The taxpayer failed to provide the auditor with records that he was required to keep, and the taxpayer failed to present these documents during the hearing. In order to prove his claim, the taxpayer must first present books and records that substantiate the amounts that were included in gross receipts. In order to receive a deduction for amounts that may have been improperly included in gross receipts, the taxpayer must then provide documents that substantiate the amounts that he claims should be deducted from gross receipts. The documents that are necessary to prove the taxpayer's claim are documents that the taxpayer is required to maintain.

The taxpayer presented five documents during the hearing. One of the documents was an invoice that was sent to two of his customers that showed the total cost for their wedding reception. The invoice shows as follows:

Linens	\$ 79.55
Napkins	28.08
Glasses	126.36
Kegs	260.20
Buffet w/ china	2,389.14
Champagne	144.36
Cleanup/setup	100.00
Bartenders	120.00
D.J.	150.00
Room Rental	200.00
15% Gratuity	419.06
Total	\$4,016.75 (Taxpayer Ex. #4)

Another document presented by the taxpayer was a worksheet that was prepared by his accountant that allegedly shows the total amount of money that he received for the use of the building. (Taxpayer Ex. #1) According to the worksheet, the taxpayer received \$114,863 for the use of the building. His accountant testified that he reviewed the

taxpayer's receipts to prepare the worksheet, but the receipts were not provided at the hearing. (Tr. p. 44) The taxpayer did not present any documents that substantiate the figures on the worksheet.

Because the taxpayer has failed to provide documents to show what was included in his gross receipts and failed to provide documents to substantiate the amount that he claims was for the use of the building, it cannot be found that the taxpayer has overcome the Department's *prima facie* case. The taxpayer, therefore, is not entitled to a deduction for fees received for the use of the building.

Gratuity

The taxpayer also argues that, pursuant to the following regulation, he is entitled to a credit for the gratuity that he paid on the catered events:

Mandatory gratuities are not included in the taxable receipts of persons operating restaurants, hotels and other places of business which come within the Act, if such mandatory gratuity is added to banquet or dinner checks in the form of a percentage of the total bill, or as a flat rate, to the extent that *the proceeds of the service charge are in fact turned over as tips or as a substitute for tips to the employees who participate directly in preparing, serving, hosting or cleaning up the food or beverage function with respect to which the service charge is imposed.* (Section 2-5(15) of the Act) If any part of the service charges are used to fund or pay wages, labor costs, employee benefits or employer costs of doing business, that part of the service charge is includable in gross receipts. (emphasis in original, 86 Ill. Admin. Code §130.2145(d)).

The taxpayer claims that the total amount for the catered events during the audit period was \$43,935, and 15% of that amount (\$6,590.25) was for the gratuity. The taxpayer contends that his witnesses stated that this was paid directly to the employees and was not used to augment the overhead. The taxpayer believes that he should receive a credit of \$477.79 ($\$6,590.25 \times 7.25\%$) for the gratuity that was paid to the employees.

The Department contends that the taxpayer is not entitled to a deduction for gratuities. The Department acknowledges that “mandatory gratuities” may be excluded from gross receipts, but the Department claims that the taxpayer has not met the conditions for this exclusion. The Department argues that the taxpayer’s books and records do not prove that the gratuity was paid entirely to the employees.

The one invoice that the taxpayer presented concerning gratuity is the one previously itemized (Taxpayer Ex. #4), which shows an amount for “15% Gratuity.” Because the taxpayer has failed to present evidence showing what was included in gross receipts, it is not clear whether the gratuity was included in that figure. The taxpayer has also failed to provide other invoices supporting the amount that he claims was paid as gratuity. Although the taxpayer and his accountant testified that the entire amount is given to the employees (Tr. pp. 36, 50-51), without further substantiation, it cannot be found that the taxpayer is entitled to a deduction for the gratuity.

Tax Paid to Caterers

The taxpayer contends that he is entitled to a deduction for tax paid to his caterers. He states that the invoices that he received from the two caterers that he uses include the tax paid to them. The taxpayer provided one invoice from XXXXX (Taxpayer Ex. #2) and one from XXXXXX (Taxpayer Ex. #3) that show that tax was paid to each caterer. The taxpayer claims that when he paid the tax, he deducted that amount from the gross receipts amount on the ROT returns. The taxpayer believes that he is entitled to a credit for this tax, which he determines to be the total amount for the catered events (\$43,935) times 7.25%, which equals \$3,185.29. The Department has responded by simply

asserting that the two invoices provided by the taxpayer are not sufficient to overcome the Department's *prima facie* case.

From what the taxpayer has presented, it is impossible to determine how the taxpayer accounted for the payments to the caterers. It is not clear whether the taxpayer charged his customers the amount that he was charged by the caterers, or whether there was a markup for the charges. Because the taxpayer has not substantiated his gross receipts figures, it is not clear whether these amounts were included in gross receipts. In addition, one of the invoices that the taxpayer provided simply states "tax included," but the specific amount of tax is not shown. (Taxpayer Ex. #2) The other invoice shows tax paid in the amount of \$88.24 (Taxpayer Ex. #3), but the taxpayer did not provide other documents to verify the total amount paid as tax to the caterers. Without documents to show how the taxpayer accounted for these charges, a credit cannot be given.

Other Deductions

Finally, the taxpayer argues that the charges to his catering customers for linens, napkins, and glasses should be deducted from the gross receipts because those charges were simply passed through to the customers. The taxpayer states that he does not have a kitchen in the building and does not have the equipment to wash the dishes or launder the linens. He states that these items "simply go back to the provider," and there was no sale at retail for these items. (Taxpayer brief, p. 4) The taxpayer refers to Robertson Products Co. v. Nudelman, 389 Ill. 281 (1945), where the court found that the sale of items such as paper napkins, towels and drinking cups, etc. to hotels and office buildings was a sale subject to the ROT. The taxpayer asserts that in the present case, the caterers supply the napkins, utensils, and dishes, but they also retain those items when the event is finished.

The taxpayer claims that there is no sale at retail, and the taxpayer simply charges his customers for the “rental” of those items.

The Department believes that the Robertson Products case is not applicable to the present case because the provision of tables, chairs, napkins, silverware, glasses, and dishes is the cost of doing business for a dining club. The Department maintains that the cost of these items is not deductible from the gross receipts of the taxpayer’s business.

The Department’s regulations provide, in part, as follows:

Persons who, under bona fide agreements, rent or lease the use of * * * towels or linens or other tangible personal property to others are, to this extent, not engaged in the business of selling tangible personal property to purchasers for use or consumption within the meaning of the Retailers’ Occupation Tax Act and are not required to remit Retailers’ Occupation Tax measured by their gross receipts from such transactions. 86 Ill. Admin. Code §130.2010(b).

Once again, it is not clear how the taxpayer accounted for these items. The only evidence provided by the taxpayer concerning linens, napkins, and glasses is the one invoice that was previously itemized (Taxpayer’s Ex. #4). If the taxpayer had a bona fide agreement to rent the use of these items, then he is not required to remit ROT from the receipts of these transactions. Nevertheless, the taxpayer has again failed to first establish that these amounts were included in gross receipts, and he has failed to establish that he is entitled to the deduction.

Recommendation:

Because the taxpayer has failed to present sufficient evidence to overcome the Department's *prima facie* case, it is recommended that the Notices of Tax Liability be affirmed.

Linda Olivero
Administrative Law Judge

Enter: December 15, 2006