

ST 10-01

Tax Type: Sales Tax

Issue: Tangible Personal Property

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

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

v.

**ABC, INC. d/b/a XYZ
GROUP, INC.,
Taxpayer**

**No. 00-ST-0000
IBT# 0000-0000
Letter ID# XXXXX
Period 1/04 – 6/06**

**Ted Sherrod
Administrative Law Judge**

RECOMMENDATION FOR DISPOSITION

Appearances: Special Assistant Attorney General George Foster on behalf of the Illinois Department of Revenue; Colman Ginsparg, Esq. of Ginsparg, Bolton & Associates, Ltd., on behalf of ABC, Inc. d/b/a XYZ Group, Inc.

Synopsis:

The Department of Revenue (“Department”) conducted an audit of ABC, Inc. d/b/a XYZ Group, Inc. (the “taxpayer”) for the period January 1, 2004 through June 30, 2006. At the conclusion of this audit, the Department issued to the taxpayer Notice of Tax Liability number XXXXX. This cause has arisen as a result of a request for initial review of this Notice of Tax Liability which was granted pursuant to 86 Ill. Administrative Code, ch. I, §200.175. An evidentiary hearing in this matter was held on

July 9, 2009. During the hearing, the taxpayer contested the Department's determination that tax was due on the taxpayer's sales of tangible personal property, in connection with its performance of custom design services, to ABC Extended Care, and its finding that the taxpayer took improper deductions on returns filed covering the tax period in controversy. After a review of the record in this matter, consisting of testimony received at the evidentiary hearing and documents of record submitted in this case, it is recommended that the Notice of Tax Liability at issue be modified by abating the tax assessed on sales to ABC Extended Care, and that the Notice of Tax Liability, as so modified, be affirmed. In support of this recommendation, I make the following findings of fact and conclusions of law.

Findings of Fact:

1. On May 14, 2008, the Department issued to the taxpayer Notice of Tax Liability Letter ID number XXXXX (the "NTL") covering the period January 1, 2004 through June 30, 2006. Department Exhibit ("Ex.") 1. This NTL shows an aggregate amount of tax due in the amount of \$11,732.90 including interest and penalties. *Id.* This NTL was admitted into evidence under the certification of the Director of the Department and establishes the Department's *prima facie* case. *Id.*
2. The taxpayer is a corporation registered with the Department to conduct business in Illinois, and is engaged in the business of providing interior design services to residential and commercial customers. Department Ex. 1-3; Taxpayer Ex. 2.¹

¹ During the audit period at issue in this case, the taxpayer erroneously registered, and reported tax as, a sole proprietorship. Department Ex. 1.

3. The taxpayer is owned by Jane Doe, the taxpayer's president, and is managed by her husband, John Doe. Department Ex. 1; Taxpayer Ex. 2.
 4. The Department conducted an audit of the taxpayer's business for the period beginning 1/1/04 through and including 6/30/06. Transcript of Hearing Proceedings ("Tr.") p. 19; Department Ex. 1.
 5. ABC Extended Care is an extended care facility and nursing home located in ABC, Illinois. Department Ex. 1; Taxpayer Ex. 1. ABC Extended Care did not possess an exemption from sales and use taxes during the tax period in controversy. Tr. pp. 13, 20. Moreover, the records tendered to the Department's auditor in this case indicated that ABC Extended Care self-assessed use tax on tangible personal property it purchased from the taxpayer. Tr. p. 13; Department Ex. 1-3. ABC Extended Care is registered as a retailer pursuant to the Illinois Retailers' Occupation Tax Act and as a serviceman, pursuant to the Illinois Service Occupation Tax Act. Department Ex. 2.
 6. During the audit period, the taxpayer fulfilled various purchase orders from ABC Extended Care pursuant to which it provided to ABC Extended Care artwork, interior decorating and home furnishings. Specifically, purchase orders tendered by ABC Extended Care provided for the design, furnishing and installation of artwork framing (confirmation order dated July 14, 2004), countertops and related items (confirmation order dated July 14, 2004), wall coverings (confirmation order dated December 1, 2004), carpeting, including carpet tiles and baseboards (confirmation order dated December 28, 2004), custom furniture (confirmation orders dated March 29, 2005 and February 10, 2006), and artwork (confirmation order dated May 5, 2005). None
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of these orders separately state charges for design services (e.g. preparation of design concept, presentation of design concept to customer etc.). Taxpayer Ex. 1. Moreover, none of these purchase orders indicate that sales taxes are due and the taxpayer admitted during the hearing that no sales tax was charged to or collected from ABC Extended Care on any of the taxpayer's sales to it during the tax period in controversy. *Id.*; Tr. p. 38.

7. On January 10, 2005, the taxpayer invoiced Smith Jones for tangible personal property the taxpayer delivered to her. Taxpayer Ex. 2. This invoice is the only example of the taxpayer's invoices to clients for design fees and material that was admitted into evidence in this case. The taxpayer testified that the portion of this invoice sent to clients separately states a charge for delivery but does not separately break out charges for fabric, labor or custom design. Tr. pp. 65-68.
8. The taxpayer filed ST-1 sales tax returns for the 30 months during the audit period, i.e. 1/1/04 through 6/30/06. Tr. p. 19; Department Ex. 1, 3. The taxpayer paid the tax shown to be due on these returns. *Id.*
9. The ST-1 returns the taxpayer completed contained entries claiming deductions for design fees, labor and freight charges. Tr. p. 22; Department Ex. 1, 2. The auditor disallowed these deductions because the taxpayer presented no evidence to show that charges for shipping, labor and design fees were separately contracted for. Tr. pp. 22, 23; Department Ex. 1, 2.
10. The auditor determined that ABC Extended Care did not have a sales tax exemption number or exempt sales certificate during the tax period in controversy. Tr. pp. 13, 20.

11. During the audit, the Department's auditor determined that no tax was paid on \$41,088 in gross receipts from sales to ABC Extended Care. Department Ex. 1. She also determined that ABC Extended Care was authorized to self-assess use tax on these sales, and that ABC Extended Care self-assessed use tax on these sales in the amount of \$25,388.96. *Id.* The Department credited these tax payments against the tax liability found to be due and owing from the taxpayer on these sales. Tr. pp. 21, 22; Department Ex. 1, 2.
12. The Department's auditor used the taxpayer's price charged to ABC Extended Care as the tax base for determining the taxpayer's retailers' occupation tax liability on sales to ABC Extended Care. Tr. p. 22; Department Ex. 2.

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 tangible personal property. 35 ILCS 120/2. The Department of Revenue ("Department") contends that the taxpayer has failed to properly report taxes due pursuant to this tax imposition measure, and issued a Notice of Tax Liability ("NTL") for the tax period January 1, 2004 through June 30, 2006 assessing the taxpayer for additional retailers' occupation tax, penalty and interest due in the amount of \$11,732.90. This NTL was introduced into the record during the hearing in this case, and established *prima facie* proof of the correctness of the amount of tax due as shown therein. 35 ILCS 120/4. The burden shifts to the taxpayer to overcome this presumption of validity once the Department has established its *prima facie* case by submitting the correct return into evidence. A.R. Barnes & Co. v. Department of

Revenue, 173 Ill. App. 3d 826, 832 (1st Dist. 1988). The taxpayer must present sufficient documentary evidence to support its claim. *Id.*

As noted by the parties (Tr. pp. 5-7, 87), this case presents two issues. The first issue is whether the taxpayer was required to collect and remit retailers' occupation tax from one of its principal customers, ABC Extended Care, on sales of tangible personal property to ABC Extended Care incident to custom design services performed for this customer during the tax period in controversy.² The second issue is whether the taxpayer properly deducted design fees, labor and shipping charges from revenues reported on its ST-1 sales tax returns during this tax period.

With respect to the first issue, the taxpayer contends that it was not required to collect and remit tax from sales to ABC Extended Care because ABC Extended Care legally self-assessed use tax on tangible personal property it acquired from the taxpayer in lieu of paying ROT to the taxpayer.³ Specifically, the taxpayer testified as follows:

They sent us a copy of the number they were provided by the State, with the notation that they were self-assessed (*sic*) and that they filed their own taxes and that we should not be collecting taxes from them; that they would file their own taxes.
Tr. p. 40.

The record in this case fully supports the taxpayer's claim.

² The taxpayer does not contend that it was engaged in a service occupation or that it was subject to the Service Occupation Tax (35 ILCS 115/1 *et seq.*) rather than the Retailers' Occupation Tax. Tr. p. 83.

³ The taxpayer also argues that its sales to ABC Extended Care were exempt because they constituted sales to the Department of Public Aid, an agency of the government. Tr. p. 38. However, this claim is not supported by any documentation contained in the record.

Department regulation 86 Ill. Admin. Code, ch.I, §130.2120 provides in part as follows:

130.2120. Suppliers of Persons Engaged in Service Occupations and Professions

...b) When Not Liable for Retailers Occupation Tax.

Persons who sell tangible personal property to purchasers who resell the property to others, either as an incident to engaging in a service occupation or profession, or apart from engaging in any such activity, are selling property to purchasers for purposes of resale and do not incur Retailers' Occupation Tax liability when making such sales.

86 Ill. Admin. Code, ch. I, §130.2120

When a buyer has an active registration number or resale number from the Department, gives such number to a seller and claims nontaxable sales for resale, the sales must be made tax-free. 35 ILCS §120/2c; 86 Ill. Admin. Code, ch. I, §130.1415(e).

The record in this case shows that ABC Extended Care was registered under both the Service Occupation Tax ("SOT") and the Retailers' Occupation Tax ("ROT"). Department Ex. 2. Consequently, ABC Extended Care possessed an active ROT registration number (Tr. p. 20) which entitled it to make purchases for resale. 86 Ill. Admin. Code, ch. I, §130.1405. The taxpayer testified that this number was presented to the taxpayer as required by the Department's regulation. Tr. p. 40. Moreover, the auditor checked the Department's records and verified that ABC Extended Care did correctly self-assess tax on its purchases from the taxpayer and was, therefore, not required to pay tax to the taxpayer on these purchases. Tr. pp. 20, 21; Department Ex. 1, 3.

The record in this case does not indicate that the taxpayer obtained resale certificates from ABC Extended Care as required by the Department's regulations. Pursuant to 35 ILCS §120/2c, the absence of these exemption certificates creates a

rebuttable presumption that the taxpayer's sales to ABC Extended Care were taxable. See also 86 Ill. Admin. Code, ch. I, §130.1405. However, I find that the facts enumerated above, indicating that the Department's auditor, after reviewing the Department's records, determined that ABC Extended Care properly self-assessed tax in lieu of paying ROT to the taxpayer, are sufficient to rebut the presumption that tax should have been collected on the taxpayer's sales to ABC Extended Care.

With respect to the second issue, the taxpayer contends that it properly deducted charges for shipping, labor and design fees in computing tax due on its sales during the tax period at issue in this case. With respect to the category of services encompassing labor and design fees, Section 130.450 provides as follows:

Installation, Alteration and Special Service Charges

a) When Taxable

Where the seller engages in the business of selling tangible personal property at retail, and such tangible personal property is installed or altered for the purchaser by the seller (or some other special service is performed for the purchaser by the seller with respect to such property), the gross receipts of the seller on account of his charges for such installation, alteration or other special service must be included in the receipts by which his Retailers' Occupation Tax liability is measured, if such installation, alteration or other special service charges are included in the selling price of the tangible personal property which is sold. This is true whether the charge for the property which is sold and the charge for installation, alteration or other special services are billed by the seller to his customers as separate items (except when the purchaser signs an itemized invoice so as to make it a contract reflecting the intention of both the seller and the purchaser), or whether both items are included in a single billed price.

b) When Not Taxable

On the other hand, where the seller and the buyer agree upon the installation, alteration or other special service charges separately from the selling price of the tangible personal property which is sold, then the receipts from the installation, alteration or other special service

charge are not part of the “selling price” of the tangible personal property which is sold, but instead such charge is a service charge, separately contracted for, and need not be included in the figure upon which the seller computes his Retailers’ Occupation Tax liability.

86 Ill. Admin. Code, ch. I, section 130.450(a), (b).

The auditor in the present case testified that she disallowed the deductions for labor and design fees that the taxpayer claimed because the taxpayer presented no invoices or contracts on which charges for labor or design fees were separately stated and no other documentary evidence showing that these services were separately contracted for. Tr. pp. 22, 23.

The taxpayer contends that its normal procedure was to separately state charges for shipping and design fees on invoices and contracts sent to its customers. Tr. p. 51. In support of this claim, the taxpayer presented a single invoice covering the sale of materials and services with respect to home furnishings billed to Smith Jones on January 10, 2009. Taxpayer Ex. 2.⁴ This invoice provides for a lump sum charge, but also contains two columns at the far right hand side of the invoice which separately state the costs of fabric, labor and design. *Id.* With respect to these separately stated amounts, Mr. John Doe, the taxpayer’s manager, stated as follows:

(Q.) Let me ask a clarifying question. Were I simply to cover up the last two columns –on this document, would the remainder of the document be identical to what went out to the client?

(A.) Yes. Yes.

Tr. pp. 73, 74.

⁴ Other documents introduced into the record by the taxpayer, including an invoice for only materials dated December 16, 2005 (Taxpayer Ex. 2), and an agreement that only covers services dated November 10, 2005 (*id.*) do not provide evidence concerning transactions involving the provision of both materials and services at issue in this case.

This testimony indicates that a breakdown of separate charges for labor and design fees taken as deductions by the taxpayer was not indicated on the invoices the taxpayer sent to its customers. Accordingly, the documentary evidence contained in the record does not support the taxpayer's claim that its normal procedure was to separately identify these charges on invoices it sent to its customers. Moreover, as indicated by regulation 130.450 quoted above, a showing that these items were separately enumerated on invoices to customers is not enough to show that these charges are deductible in the absence of contracts or other evidence proving that these charges were separately contracted for or agreed upon by the parties. 86 Ill. Admin. Code, ch. I, §130.450.

I find credible the taxpayer's claim that invoices were presented to the auditor during the audit of the taxpayer's returns for the tax period in controversy. Tr. p. 100. The auditor refers to these invoices in her audit report. Department Ex. 1. However, the evidence contained in the record as to what information these invoices contained (Taxpayer Ex. 2) supports the auditor's finding that this evidence was insufficient to show that labor and design fees were separately contracted or arranged for as required to deduct such charges by regulation 130.450.

The invoice example presented by the taxpayer (Taxpayer Ex. 2) does show a separate charge for shipping. With respect to shipping charges, 86 Ill. Admin. Code, ch. I, §130.415 provides as follows:

130.415. Transportation and Delivery Charges.

- a) Transportation and delivery charges are considered to be freight, express, mail, truck or other carrier conveyance or delivery expenses. These charges are also many times designated as shipping and handling charges.

b) The answer to the question of whether or not a seller, in computing his Retailers' Occupation Tax liability, may deduct, from his gross receipts from sales of tangible personal property at retail, amounts charged by him to his customers on account of his payment of transportation or delivery charges in order to secure delivery of the property to such customers, or on account of his incurrence of expenses in making such delivery himself, depends not upon the separate billing of such transportation or delivery charges or expense, but upon whether the transportation or delivery charges are included in the selling price of the property which is sold or whether the seller and the buyer contract separately for such transportation or delivery charges by not including such charges in such selling price. In addition, charges for transportation and delivery must not exceed the costs of transportation or delivery. If those charges do exceed the cost of delivery or transportation, the excess amount is subject to tax.

c) If such transportation or delivery charges are included in the selling price of the tangible personal property which is sold, the transportation or delivery expense is an element of cost to the seller within the meaning of Section 1 of the Retailers' Occupation Tax Act, and may not be deducted by the seller in computing his Retailers' Occupation Tax liability.

d) If the seller and the buyer agree upon the transportation or delivery charges separately from the selling price of the tangible personal property which is sold, then the cost of the transportation or delivery charge is not a part of the "selling price" of the tangible personal property which is sold, but instead is a service charge, separately contracted for, and need not be included in the figure upon which the seller computes his Retailers' Occupation Tax liability. Delivery charges are deemed to be agreed upon separately from the selling price of the tangible personal property being sold so long as the seller requires a separate charge for delivery and so long as the charges designated for transportation or delivery or shipping and handling are actually reflective of the costs of such shipping, transportation or delivery. To the extent that such charges exceed the costs of shipping, transportation or delivery, the charges are subject to tax. The best evidence that transportation or delivery charges were agreed to separately and apart from the selling price, is a separate and distinct contract for transportation and delivery. However, documentation which demonstrates that the purchaser had the option of taking delivery of the property, at the seller's location, for the agreed purchase price, or having delivery made by the seller for the agreed purchase price, plus an ascertained or ascertainable delivery charge, will suffice.

86 Ill. Admin. Code, ch. I, section 130.415

Pursuant to the aforementioned regulation, the separate enumeration of charges for shipping on invoices sent to customers is insufficient evidence to show that the shipping charges were separately contracted for or agreed to between the taxpayer and its clients. Since evidence of the separate enumeration of these charges is the only evidence the taxpayer has presented to support its claim, I find that the taxpayer has failed to prove that deductions for freight or shipping charges were properly taken on its ST-1 sales tax returns filed during the tax period in controversy.

Section 7 of the ROTA expressly enumerates the type of documentation that must be maintained to support deductions taken for exempt or non-taxable transactions, providing in part as follows:

To support deductions made on the tax return form, or authorized under this Act, on account of receipts from any kind of transaction that is not taxable under this Act, entries in any books, records or other pertinent papers or documents of the taxpayer in relation thereto shall be in detail sufficient to show the name and address of the taxpayer's customer in each such transaction, the character of every such transaction, the date of every such transaction, the amount of receipts realized from every such transaction and such other information as may be necessary to establish the non-taxable character of such transaction under this Act. It shall be presumed that all sales of tangible personal property are subject to tax under this Act until the contrary is established, and the burden of proving that a transaction is not taxable hereunder shall be upon the person who would be required to remit the tax to the Department if such transaction is taxable.

35 ILCS 120/7

Moreover, as noted above, the ROTA provides that the correction and/or determination of tax due issued by the Department is *prima facie* proof of the correctness of the amount of tax due shown in the Department's determination. 35 ILCS 120/4. It is well-settled Illinois law that in order to overcome the presumption of validity attached to the Department's corrected returns the taxpayer must produce competent evidence, in the

form of books and records showing that the Department's returns are incorrect. Copilevitz v. Department of Revenue, 41 Ill. 2d 154 (1968); Masini v. Department of Revenue, 60 Ill. App. 3d 11 (1st Dist. 1978). Oral testimony alone is insufficient to overcome the *prima facie* correctness of the Department's determinations. Mel-Park Drugs, Inc. v. Department of Revenue, 218 Ill. App. 3d 203 (1st Dist. 1991).

In the instant case, the taxpayer has failed to produce documentation sufficient to show that it separately contracted for shipping charges, labor and design fees taken as deductions on its ST-1 sales tax returns for the tax period in controversy as required in order to take such deductions by 86 Ill. Admin. Code, ch. I, sections 130.450 and 130.415. Moreover, the taxpayer's testimony that it obtained documentation supporting these deductions from its clients is insufficient, as a matter of law to support the taxpayer's claim and therefore rebuts neither the statutory presumption of taxable sales pursuant to section 7 of the ROTA nor the Department's *prima facie* case.

WHEREFORE, for the reasons stated above, it is my recommendation that the tax assessed with respect to the taxpayer's sales to ABC Extended Care be abated and that, as so modified, the NTL at issue in this case be affirmed.

Ted Sherrod
Administrative Law Judge

Date: October 8, 2009