

ST 98-17

Tax Type: SALES TAX

Issue: Responsible Corp. Officer - Failure to File or Pay Tax

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

THE DEPARTMENT OF REVENUE
OF THE STATE OF ILLINOIS

v.

JOHN DOE, as responsible officer of
ABC CORPORATION, d/b/a PDQ
Kitchens Of Chicago

No.

NPL #

Mimi Brin
Administrative Law Judge

RECOMMENDATION FOR DISPOSITION

Appearances: Mr. Clifford Shapiro of Sachnoff & Weaver, Ltd., for JOHN DOE; Mr. John Alshuler, Special Assistant Attorney General, for the Illinois Department of Revenue

Synopsis:

This matter comes on for hearing pursuant to JOHN DOE's (hereinafter referred to as "DOE"¹ or the "Taxpayer") protest of Notice of Penalty Liability No. XXXX (hereinafter referred to as the "NPL") issued by the Department against DOE, as a responsible officer or employee of ABC CORPORATION, d/b/a XYZ CORPORATION (hereinafter referred to as "ABC" or the "Corp") for the period of March, 1991 through and including April 30, 1992 but excluding May, 1991 (hereinafter referred to as the "tax period"). A hearing was held in this matter on January 22, 1998, with DOE providing the only oral testimony. Following the submission of all evidence and a review of the record, it is recommended that this matter be resolved in favor of the Department. In support thereof, the following findings of fact and conclusions of law are made:

Findings of Fact:

¹ The transcript of the hearing records taxpayer's name as John Doe. However, all documents of record submitted by the taxpayer show the spelling of his surname to be DOE and the Notice of Penalty Liability issued in this cause also shows DOE. For purposes of this recommendation, I shall use DOE.

1. The Department's *prima facie* case, inclusive of all jurisdictional elements, is established by the admission into evidence of the Notice of Penalty Liability No. XXXX showing a penalty for the tax liability of ABCs Corp., d/b/a XYZ CORPORATION, of \$228,744.49, with interest calculated through June 2, 1994, for the period of March, 1991 through and including April 30, 1992, but excluding May, 1991. Department Ex. No. 1
2. On October 26, 1988, DOE was the sole director of ABC, and, as such, appointed, *inter alia*, himself to be the Chairman of the Board, JIM DOE as President and RON ROE as Vice President and Secretary. Taxpayer Ex. No. 20 (Consent in Lieu of the Organization Meeting of the Sole Director of ABC CORPORATION); Tr. pp. 49-50
3. Of 1,000 shares of stock issued in the corp, DOE owned 650 shares with RON ROE holding 300 shares and DAVE DOE holding 50 shares. *Id.*; Transcript ("Tr.") p. 13
4. DOE guaranteed a bank loan for the corp for its initial operation expenses. Tr. pp. 18-19 He also made personal loans to the corp into late, 1990. Tr. pp. 57-60
5. ABC was in the business of selling, at retail, kitchens to homebuilders and homeowners. Tr. p. 23
6. The corp became a distributor for PDQ Corporation of Canada (hereinafter referred to as "PDQ") after DOE and RON ROE were approached by PDQ's national sales manager in 1988. Tr. pp. 14, 21
7. When one purchased a PDQ kitchen, ABC installed it. Tr. pp. 23-24
8. RON ROE was DOE's brother-in-law, married to DOE's sister. Tr. p. 16
9. DOE brought RON ROE from New York and hired him to run LMN, INC., a business in which DOE had an investment. Tr. pp. 15-16, 31, 81 DAVE DOE was also an officer and an investor in this business. Tr. p. 36
10. DOE intended that RON ROE run the day-to-day operations of ABCs. Tr. p. 50
11. DOE became acquainted with SMITH through RON ROE. Tr. pp. 20, 50 SMITH resigned as corp President effective March 24, 1989. Taxpayer Ex. No. 21; Tr. pp. 22, 52-53

12. The corp was located in Chicago, and was next door to the building occupied by LMN, INC..
Tr. p. 21
13. DOE was one of the investors who owned both buildings. Tr. pp. 21-22
14. On December 13, 1990, Messrs. DOE, RON ROE and DAVE DOE held an annual meeting of the corp shareholders whereat Chairman DOE submitted a financial report and summary of projected estimated income and expense of the corp. The financial report was approved. Taxpayer Ex. No. 24 (Minutes of the Annual Meeting of the Shareholders of ABC CORPORATION) At that same meeting, RON ROE became the second corp director, joining DOE. *Id.*; Tr. p. 26 RON ROE was President of the corp at that time. JANE DOE was identified as Treasure/Controller and DON DOE was named a Vice President at that time. Taxpayer Ex. No. 25 (Minutes of the Annual Meeting of the Shareholders of ABC Corp); Tr. p. 61
15. At the annual shareholders' meeting in December, 1990, the three shareholders ratified, confirmed and approved "in all respects all actions and proceedings of the officers and sole director of the corporation since the last meeting of the shareholders of the corporation." Taxpayer Ex. No. 25
16. The Board held annual meetings each year, toward the end of the year. Tr. p. 43
17. During 1989-90, the corp had increasing sales. Tr. pp. 56-58
18. In February, 1992, DOE received a letter from PDQ stating that "the distributorship was in danger of being terminated for non-payment of kitchens". Tr. pp. 24-25, 65
19. At that time, RON ROE advised DOE that there were "a lot of back bills" and that the corp was also behind in payments of sales taxes, federal taxes and to some suppliers. Tr. pp. 25, 40, 65 DOE did not demand, nor did RON ROE provide him with a list of the creditors at this time or at any other time. Tr. p. 40
20. DOE was still the Chairman of the Board, Director and majority shareholder of the corp at this time. Tr. p. 26

21. Following receipt of this information, DOE contacted PDQ and met with its president and vice president of operations to discuss the problem. Tr. pp. 26, 38, 66
22. There was no written agreement that allowed PDQ to take over the operations of the corp. Tr. p. 38
23. DOE agreed to allow PDQ to send someone into the corp to operate it. Tr. pp. 38, 66
24. RON ROE was never terminated from working at the corp. Tr. pp. 39-40, 67
25. The accounting firm that prepared the income tax returns for ABCs was the same one that prepared returns for other businesses in which DOE had an interest. Tr. p. 41 After it prepared the corp's income tax returns, it sent a copy to an accountant that worked for DOE. *Id.*
26. PDQ terminated the corp's distributorship effective in April, 1992. Tr. p. 42
27. DOE had access to the corp's books and records at all times, and could have seen them upon request. Tr. p. 44
28. DOE was an investor in many different types of businesses, including extensive real estate investments, involving millions of dollars. Tr. pp. 45-47
29. From late, 1990, through the tax period, DOE had serious concerns regarding a specific, substantial real estate investment. Tr. pp. 58-59
30. Throughout the tax period, RON ROE continued to be responsible for the day-to-day operations of the corp. Tr. pp. 62, 64, 68
31. DOE did not sign any of the Retailers' Occupation Tax (hereinafter "ROT") returns for the tax period at issue. Taxpayer Ex. Nos. 1-10, 11, 12, 13
32. JENNY DOE appears as the preparer of the ROT returns during the tax period, with the majority of the returns signed by RON ROE. *Id.*
33. During the tax period, RON ROE and JANE DOE signed the majority of checks. Taxpayer Ex. No. 33
34. During the tax period, some creditors were being paid. *Id.*

35. During the tax period, DOE signed checks. (check #1989 (cash); 2118 (code service); 2123; 2124; 2125; 2126; 2127; 2128; 2129; 2130; 2131 (DON DOE); 2132-2133 (DON DOE); 2134; 2135; 2136; 2137; 2138; 2139; 2140; 2141 (JENNY DOE); 2142; 2145; 2143-2144 (JANE DOE); 2146 (Cash); 2148; 2198; 2291; 2292-2293; 2294; 2295; 2296; 2297 (cash); 2330; 2331; 2332; 2333; 2334; 2335; 2336; 2337; 2338; 2339; 2340 (DON DOE); 2341; 2342; 2343; 2344; 2345-2346 (JENNY DOE); 2347; 2348; 2349; 2352; 2353; 2355; 2356; 2357; 2358; 2359; 2360 (DON DOE); 2361; 2362; 2363; 2364; 2365; 2366 (JENNY DOE); 2367 *Id.*;
36. Checks #2331, 2332, 2333, 2335, 2336, 2337, 2338, 2339, 2340, 2341, 2342, 2343, 2344, 2345, 2346, 2347, 2348, 2349 are noted as being for final pay or final vacation. *Id.*
37. Checks #2359-2365 are noted as being for expenses. *Id.*
38. DOE also signed the following checks, which appear to be for payroll: #4,934-4,958, all dated April 27, 1992. *Id.*
39. DOE, personally, lost money as a result of corp losses. Tr. p. 41
40. The parties agree that corp payments made to the Department, evidenced by Taxpayer Ex. No. 30 (March 20, 1992-\$4,500); 31 (January 29, 1992-\$4,500); 32 (February 18, 1992-\$4,500), are to be credited to any liability which may be found against any “NPL that exists”. Tr. p. 76

Conclusions of Law:

Illinois law provides that the Department may assess a tax penalty against certain individuals for the unpaid Retailers' Occupation Tax liability of a retail corporation. Ill. Rev. Stat. 1991, ch. 120, par. 452½² (hereinafter “§452½”) This liability, which survives the dissolution of the corporation, attaches to:

Any officer or employee of any corporation subject to the provisions of this Act who has the control, supervision or responsibility of filing returns and making payment of the amount of tax herein imposed...and who wilfully fails to file such return or to make such payment to the Department or willfully attempts in any other manner to evade or defeat the tax shall be personally liable for a penalty equal to the total amount of tax unpaid by the corporation, including interest and penalties thereon... .

² This personal liability penalty was replaced by §3-7 of the Uniform Penalty and Interest Act (35 **ILCS** 735/3-1 *et seq.*) effective January 1, 1994. 35 **ILCS** 735/3-7

Id.

It is clear that personal liability is imposed on one who is “responsible” for the filing of ROT returns and for the payment of the taxes shown to be due thereon, and who willfully fails to file and/or pay such taxes. The statute defines neither “responsible” person nor “willful” conduct. However, the Illinois Supreme Court, in cases wherein it considered personal liability, has referred to interpretations of similar language in section 6672 of the Internal Revenue Code (26 U.S.C. §6672), which imposes personal liability on corporate officers who willfully fail to collect, account for, or pay over employees’ social security and Federal income withholding taxes. Branson v. Department of Revenue, 168 Ill.2d 247 (1995); Department of Revenue v. Heartland Investments, Inc., 106 Ill.2d 19 (1985); Department of Revenue v. Joseph Bublick & Sons, Inc., 68 Ill.2d 568 (1977)

The Notice of Penalty Liability issued herein against DOE establishes the Department’s *prima facie* case that he was a responsible officer who willfully failed to pay taxes due from the corp. Branson v. Department of Revenue, *supra*. The burden then shifts to the taxpayer to overcome the presumption of liability through sufficient evidence that the person was either not a responsible officer or employee, or that his actions were not willful. *Id.*

Taxpayer divides this case into two distinct time periods. DOE argues that during the period of March, 1991 through January, 1992, he was not a responsible officer for §452½ purposes. For the period from February, 1992 through to the end of the liability period, taxpayer argues that he did not act willfully in failing to remit the pertinent taxes.³ Therefore, taxpayer argues, §452½ liability cannot attach to him. Tr. pp. 83-85

Federal courts have addressed officer/employee liability with respect to who is considered “responsible” for §6672 purposes. Courts have considered specific facts in determining whether individuals were “responsible” for the payment of employee taxes, to wit: 1) the duties of the officer as outlined by corporate by-laws; 2) the ability of the individual to sign checks of the corporation; 3) the identity of the officers, directors, and shareholders of the corporation; 4) the identity of the individuals who hired and fired employees; and, 5) the

identity of the individuals who were in control of the financial affairs of the corporation. Monday v. United States, 421 F.2d 1210 (7th Cir. 1970), cert. den. 400 U.S. 821 (1970); Gephart v. United States, 818 F.2d 469 (6th Cir. 1987); Peterson v. United States, 758 F. Supp. 1209 (N.D. Ill. 1990)

Responsible persons may include officers who can borrow money on behalf of the corporation (Peterson v. United States, *supra*), and may be those with check writing authority who may or may not be the ones with the responsibility for accounting, bookkeeping or the making of payments to creditor. Monday v. United States, *supra*; Wright v. United States, 809 F.2d 425 (7th Cir. 1987); Calderone v. United States, 799 F.2d 254 (6th Cir. 1986) There may be more than one responsible person in a corporation. Monday v. United States, *supra*; Williams v. United States, 931 F.2d 805, 810 n.7 (11th Cir. 1991).

Using the criteria followed by courts in addressing officer liability for taxes, DOE is a “responsible” officer. During the tax period, he was the majority stockholder, Chairman of the Board, and a director of the corp who had the authority and, in fact, negotiated loans for it. He had the authority to, and, in fact, did, hire employees, specifically, RON ROE, whom he directed to run the business. He chose not to terminate RON ROE from his position of running the corp in spite of his admitted knowledge of financial difficulties during RON ROE’ tenure operating the business. Tr. pp. 39-40 He had access to the books and records of the business at any time and signed checks for payroll, for “cash” and for business creditors during the liability period. Tr. p. 44

DOE was an experienced businessman, with investments of considerable value. Corp accountants, who also did the accounting work for other DOE businesses, (Tr. p. 41), provided corp income tax returns to an accountant who worked for DOE. The fact that DOE chose to delegate to others the decisions as to what creditors were to be paid, or chose not to be more involved in the day-to-day operations of the business does not make him less of a “responsible” officer. Responsibility is a matter of status, duty and authority, not necessarily knowledge. Mazo v. United States, 591 F.2d 1151 (5th Cir. 1979) I find, therefore, that DOE was a responsible officer during the entire liability period.

³ In February, 1992, taxpayer personally received correspondence alerting him that the corp owed PDQ monies, and, further learned that there were other outstanding debts including taxes due to the State.

As to the willful element, although the pertinent statute fails to define willful conduct, Illinois courts have provided guidance for its determination beginning with Department of Revenue v. Joseph Bublick & Sons, Inc., 68 Ill.2d 568 (1977) and culminating in Branson v. Department of Revenue, 168 Ill.2d 247 (1995). In effect, the Illinois Supreme Court accepts as indicia of willfulness, a showing of “reckless disregard for obvious or known risks” as set forth in cases dealing with section 6672 of the Internal Revenue Code. Branson v. Department of Revenue *supra*; Department of Revenue v. Heartland Investments, 106 Ill.2d 19, 29 (1985); Monday v. United States, 421 F.2d 1210, 1215 (7th Cir. 1970) In the case of Wright v. United States, 809 F.2d 425, 427 (7th Cir. 1987), the Seventh Circuit Court of Appeals stated that:

But bearing in mind that if a high degree of recklessness were required the purpose of the statute would be thwarted, just by compartmentalizing responsibilities within a business (however small) and adopting a “hear no evil-see no evil” policy, we think gross negligence is enough to establish reckless disregard. Concretely we hold that the ‘responsible person’ is liable if he (1) clearly ought to have known that (2) there was a grave risk that withholding taxes were not being paid and if (3) he was in a position to find out for certain very easily.

This statement is reflective of federal court determinations which consistently find that willfulness may be established with a showing that the “responsible party clearly ought to have known of a ‘grave risk of nonpayment’ and who is in a position to easily find out, but does nothing.” Branson v. Department of Revenue, *supra* at 255 (citing Ruth v. United States, 823 F.2d 1091 (7th Cir. 1987)) Further, it is without contest that “[w]illfulness is present if the responsible person had knowledge of the tax delinquency and knowingly failed to rectify it when there were available funds to pay the government.” Gephart v. United States, *supra* at 475

DOE admits that from February, 1992, he had personal knowledge that the corp was suffering financially to such an extent that creditors and taxes were unpaid. His knowledge resulted from his receipt of a letter from PDQ stating that the corp was in default of the distributorship agreement for non-payment of inventory. RON ROE, when confronted by DOE, confessed to the delinquencies. DOE and RON ROE met with PDQ’s representative from Canada and DOE agreed to allow PDQ’s representative to operate the business, reporting to RON ROE. Further, he testified that the parties agreed that if the corp did not contest the termination of the franchise agreement, PDQ had the right to all of the corp’s receivables and that the corp was given a nominal sum with which to pay its bills. Tr. p. 43

Even at this point and with this knowledge, DOE professes that, except for signing some checks when RON ROE was unavailable, he had no involvement with the corp's operations-that the responsibility for the daily operations of the corp remained with RON ROE, with the decisions as to who would be paid being made by PDQ's representative and JENNY DOE, a corp employee. Tr. p. 72

It is clear from the above that, in spite of being the corp's majority shareholder, Chairman of the Board and director, DOE abdicated any responsibility for unpaid taxes to his brother-in-law, a corp employee and the distributor. It is based upon this abdication, that he claims that he was not willful in the failure to pay current or delinquent taxes. However, courts have simply not allowed this defense to win the day. As mentioned, *supra*, a responsible person cannot escape his obligation to ensure that taxes are paid by delegating this responsibility to others. Wright v. United States, *supra*; Mazo v. United States, *supra*.

Willfulness also includes "failure to investigate or to correct mismanagement after having notice that withholding taxes have not been remitted to the Government." Peterson v. United States, *supra* at 1217 A person acts willfully if "when after he or she gains actual knowledge that the taxes are delinquent, liquid funds are available from which the taxes can be paid and he or she, having the ability to pay the taxes, fails to do so." *Id.* at 1216 And, a person acts willfully in failing to pay delinquent taxes if he prefers other creditors to the State. Department of Revenue v. Heartland Investments, Inc., *supra*; Calderone v. United States, *supra*

DOE is guilty of all of the above. He clearly knew taxes were delinquent, and, the delinquency occurred under RON ROE' watch. Yet, he allowed him to remain as president of the corp and to oversee its operations. DOE took part in the discussions with the distributor and he permitted PDQ's representative to operate the corp and to dictate what creditors would be paid. In fact, as a result of DOE's majority interest in the business and his positions of authority, he had to be the person who made the decision to allow PDQ to collect the corp's receivables and to allow the corp a nominal amount of funds with which to pay creditors. The fact that during the tax period, one of DOE's significant investments was also in serious financial straits does not lessen his responsibility for the taxes owed herein nor does it make him less willful in relinquishing all authority to others without seeing to it that the taxes were paid. Pertinent case law simply does not support this position.

It is for these very same reasons that DOE is liable for the corp's delinquent taxes for the periods prior to February, 1992. DOE was no stranger to financial reports, and, in particular, he saw them for this business. He provided for the record evidence that he submitted a financial report and summary of projected estimated income and expense of the corp at the December, 1990 annual shareholders' meeting. This was for the period immediately preceding the liability period herein. Although DOE testified that there were annual meetings each year toward the end of the year, he did not provide a record of the events of the annual meeting for the year ending December, 1991, that is, for the time during which taxes were not being paid to the State. Assuming, reasonably, that a 1991 meeting would have involved the same types of reports and summaries as previously provided, DOE would have been aware of the delinquencies before receiving the PDQ letter. That DOE may not have seen such reports during or at the end of 1991 results from DOE's choice not to see them, rather than from his inability to have them presented to, at least, his accountants.

What is of greatest concern, however, is that even after he knew of the tax problems, he did not demand an accounting of the situation. He simply told others to make decisions regarding creditor payments and did not direct that the tax delinquencies be addressed foremost, or even that, at the very least, all taxes collected theretofore should be remitted, which apparently, they were not. Nor did he inspect the corporate records or insist upon being kept informed of the status of the State tax situation. Certainly, he did not direct that any monies which were available for creditors be used to reduce the significant State tax delinquency.

At the time that he confesses knowledge of the problem, he had the power, status and authority to dictate the order of debt payments, for debts incurred as long as the business remained open, as well as for debts which existed. It was his choice to have others make those decisions and it was his choice to allow PDQ, a corp creditor, to collect the receivables and to dole out monies for other corp debts.

Unfortunately, once again, delegation of responsibility to others does not provide absolution. Putting one's head in the sand does not equate to lack of willfulness for existing debts to any lesser degree than for debts to be incurred. To take that position would be to legally permit a responsible person to ignore existing tax liability at a time when that deficiency might be rectified. Under that circumstance, no responsible person

would ever attempt to pay the State monies due for delinquent retailers' occupation tax incurred prior to the time that person became aware of the delinquencies, even if monies were available to address the taxes owed.

This is an untenable posture to assume because a retail business, such as this corp, collects use tax from its customers intended, by law, exclusively for the State. Although the retailer must remit to the State the use taxes it collects, it is entitled to use this collected money to satisfy its own retailers' occupation tax liability.⁴ In effect, not only did the corp not remit to the State the use taxes it collected, but, none of the taxes incurred by the corp, itself, needed to be expended from any of it's own funds, as the retailers' occupation tax is a pass through tax, paid for by the retailer with use tax monies it collects from its customers. Turner v. Wright, 11 Ill.2d 161 (1957)

Thus, when a responsible person does not attend to past liability and is only held accountable for future debts, the corporation and those benefiting therefrom, profit from that use tax collected and not remitted. This flies in the face of the underlying intent of officer penalty provisions, and, there is no legal authority of which I am aware that supports this position.⁵

WHEREFORE, for the reasons stated above, it is my recommendation that the Notice of Penalty liability at issue herein be finalized, as issued, against JOHN DOE, with credits as provided in the findings of facts herein.

6/1/98

Mimi Brin
Administrative Law Judge

⁴ The Use Tax Act, 35 ILCS 105/1 *et seq.*, specifically, 105/3-45, 105/8

⁵ I note that in the case of Branson v. Department of Revenue, *supra*, the appellate court determined that Branson, the sole shareholder of the delinquent corporation, was not liable for tax liabilities incurred before he took over the daily bookkeeping responsibilities and payment of creditors. The Department did not appeal this determination, therefore, the Illinois Supreme Court specifically stated that: However, in leaving intact the vacation [by the appellate court] of the penalty from June 1 through October 31, 1986, we do not intend to imply that a corporate officer who is responsible for filing retailers' occupation tax returns and remitting the collected taxes may avoid personal liability under section 13½ merely by delegating bookkeeping duties to third parties and failing to keep informed of the status of the retailers' occupation tax returns and payments.

Id. at 267