

ST 98-19

Tax Type: SALES TAX

**Issue: Machinery & Manufacturing Equipment Exemption (Agricultural)
Audit Methodologies and/or Other Computational Issues**

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

THE DEPARTMENT OF REVENUE)	
OF THE STATE OF ILLINOIS)	Case No.
)	IBT No.
)	NTL
XZY CORPORATION,)	
Taxpayer)	Administrative Law Judge
)	Mary Gilhooly Japlon

RECOMMENDATION FOR DISPOSITION

Appearances: Kupferberg, Goldberg and Neimark, LLC, by Larry G. Goldsmith and Richard Tworek, on behalf of XZY CORPORATION; Special Assistant Attorney General Alan Osheff, on behalf of the Illinois Department of Revenue.

SYNOPSIS:

This matter comes on for hearing pursuant to the timely protest by XZY CORPORATION (hereinafter "taxpayer") of Notice of Tax Liability ("NTL") No. XXXXX issued by the Department of Revenue (hereinafter "Department") on December 22, 1995 in the amount of \$289,965 for Retailers' Occupation Tax ("ROT"), Use Tax and related taxes, as well as penalty and interest for the period of July 1, 1981 through November 30, 1993. A timely protest to the NTL was filed on behalf of the taxpayer.

At hearing, Messrs. JOHN DOE and JIM DOE testified on behalf of the taxpayer. Ms. Sharon Caise and Mr. Charles Zalapukis testified as adverse witnesses for the taxpayer. Specifically at issue is whether the taxpayer sells dirt at retail, thus incurring Retailers' Occupation Tax, or whether the taxpayer is a construction contractor, thus incurring Use Tax on his cost price of the dirt, or alternatively, subject to Service Occupation Tax based upon a sale of service. In addition, the taxpayer argues that based upon reasonable cause, the six year statute of limitations should be applied to its failure to file tax returns. Furthermore, the taxpayer urges that penalties imposed for late filing and payment should likewise be waived for reasonable cause. Subsequent to the hearing, the parties filed memoranda of law in support of their respective positions, in lieu of closing arguments.

Following the submission of all evidence and a review of the record and briefs filed herein, it is recommended that this matter be resolved in favor of the Department regarding the tax liability, but in favor of the taxpayer in regard to the statute of limitations and penalty issues.

FINDINGS OF FACT:

1. The Department's prima facie case, inclusive of all jurisdictional elements was established by the admission into evidence of a certified copy of the Correction of Returns, showing a tax deficiency of \$11,575, plus 10 percent penalty of \$1,158, for a total due and owing under section 4 of the ROT Act of \$12,733 for the period of April 1, 1992 through March 31, 1994. (Dept. Ex. No. 2; Tr. p. 16).
2. The Correction of Returns also reflects tax delinquencies in the amount of \$127,627, plus a 30 percent penalty in the amount of \$38,080, for a total due and owing under section 5 of the ROT Act in the amount of \$165,707 for the period of July 1, 1981 through March 31, 1992. (Dept. Ex. No. 2; Tr. p. 16).

3. The Correction of Returns, therefore, reflects a total amount of tax and penalties due for the taxable period of July 1, 1981 through March 31, 1994 of \$178,440. (Dept. Ex. No. 2; Tr. p. 16).
4. Based upon a reaudit, the liability was revised to reflect tax due in the amount of \$120,230, penalty in the amount of \$35,032, interest in the amount of \$109,162, for a total due and owing of \$264,424 for the period of July 1981 through March 1994. (Dept. Ex. No. 3; Tr. p. 16).
5. XZY CORPORATION is a sole proprietorship owned by JIM DOE (“JIM DOE”); it has been in business since 1973. (Tr. p. 84).
6. The taxpayer removes dirt from excavation sites. (Tr. p. 21).
7. It does not pay anything for the dirt; nor is the taxpayer paid for the removal of the dirt. (Tr. pp. 21, 60, 90).
8. The taxpayer delivered the dirt via trucks that he either owned or rented. (Tr. p. 61).
9. The taxpayer was in compliance with the tax laws as regards Illinois Income Tax. (Tr. p. 68).
10. The taxpayer did not register with the Department of Revenue to do business in the State of Illinois until April of 1992. (Tr. p. 71).
11. The taxpayer had destroyed records for the period prior to the audit period, as well as the first several months of the audit period. (Tr. pp. 71, 72).
12. Therefore, in conducting the audit, the auditor used information derived from the taxpayer’s own sales and use tax returns filed during the first year after the taxpayer registered to do business in Illinois. (Tr. pp. 71, 72).

13. The auditor used the percentage that the taxpayer said constituted taxable sales on its returns and projected this amount during the taxable period. (Tr. pp. 71, 72).
14. Pursuant to the reaudit in this case, an adjustment was made in the use tax originally assessed due to documentation provided by the taxpayer. (Tr. p. 78).
15. At the audit level, the taxpayer was not given any relief from penalties based upon reasonable cause because it could not present any written form of professional advice upon which it contends it relied. (Tr. p. 80).
16. The taxpayer makes sales to landscape garden centers for purposes of resale. (Tr. p. 85).
17. The taxpayer receives resale certificates from the garden centers. (Tr. p. 85).
18. No tax has been assessed regarding the sales for resale. (Tr. p. 85).
19. According to the taxpayer, the balance of the taxpayer's business involves construction contracts with owners and contractors with respect to construction job sites. (Tr. p. 85).
20. The taxpayer's principal testified that before the taxpayer delivers the dirt to a customer, it pulverizes it; that is, the dirt is run through a machine to remove the lumps. (Tr. p. 87).
21. The taxpayer's principal testified that when the taxpayer delivers the dirt to a construction site, it unloads it from the truck, and spreads and grades it for the customer. (Tr. pp. 88, 91, 92).
22. Spreading and grading the dirt involves tailgating by the truck. (Tr. p. 92).
23. Tailgating allows the truck driver to control the amount of dirt spread at the site, as well as the amount of space over which the dirt is spread. (Tr. pp. 92- 94).
24. According to the taxpayer's principal, after the dirt is delivered to a construction site, and spread and graded, it is indistinguishable from the dirt already present at the site. (Tr. pp. 91, 92, 130, 145).

25. According to the testimony of the taxpayer's principal, approximately one-third of the construction contracts performed by the taxpayer involves preparing an absorption field for septic systems. (Tr. p. 117).
26. Preparing an absorption field involves plowing a field with a chisel plow, and spreading topsoil to a certain depth over the entire field. (Tr. p. 116).
27. The taxpayer's principal testified that approximately 80 percent of all of taxpayer's construction contracts involve spreading and grading work. (Tr. p. 118).
28. The taxpayer's principal testified that the invoices issued by the taxpayer's office do not indicate that the dirt that was delivered to a site was also spread at the site, because spreading the dirt is part of the business. (Tr. pp. 127, 129).
29. As part of his business, the taxpayer testified that it also installs culverts and builds berms. (Tr. p. 130).
30. JIM DOE, principal of XZY CORPORATION, has only a high school education. (Stip.)
31. Before becoming sole proprietor of XZY CORPORATION, JIM DOE was a truck driver and heavy equipment operator. (Tr. p. 84).
32. Since the taxpayer first filed its sales tax returns beginning April 1992, it has consistently filed said returns. (Stip.).
33. The taxpayer has complied with all other Illinois tax filings, including federal and state income tax returns and payroll taxes, through the end of the audit period. (Stip.; Tr. p. 133).
34. The taxpayer was subject to a federal tax audit at one time; it resulted in a small refund for the taxpayer. (Tr. p. 134).
35. The taxpayer admittedly did not know anything regarding tax laws, so he hired accountants. (Tr. p. 131).

36. The taxpayer's original certified public accountant was JIM DOE's childhood friend. (Tr. p. 131).
37. In the early 1990's the taxpayer realized that there might, in fact, be a sales tax issue. (Tr. p. 134; Taxpayer's Ex. Nos. 1 & 2).
38. The accountant advised the taxpayer that it did not need to file sales tax returns. (Tr. pp. 132, 133).
39. In addition, an attorney hired by the taxpayer informed JIM DOE that he had no tax liability. (Tr. p. 141).
40. In 1992 the taxpayer hired a new accountant as XZY CORPORATION had outgrown the services offered by the original accountant. (Tr. p. 137).
41. The new accounting firm was not certain whether the taxpayer should be charging sales tax and filing returns. (Tr. p. 138).
42. To be safe, however, they advised the taxpayer to do so. (Tr. p. 138).
43. The taxpayer did not know that it could have asked the Department of Revenue to issue a ruling letter regarding whether tax was due in its situation. (Tr. pp. 139, 140).
44. The taxpayer did not know that it was to file returns for previously unfiled periods. (Tr. p. 144).
45. The taxpayer did not know that liability could attach for the period prior to the time it started filing returns. (Tr. p. 144).
46. The taxpayer considers itself to be a construction contractor. (Tr. pp. 144, 145).

CONCLUSIONS OF LAW:

The Department prepared corrected returns for XZY CORPORATION for Retailers' Occupation Tax ("ROT") deficiencies and delinquencies pursuant to sections 4 and 5 of the ROT Act, respectively. Section 4 of the Act provides in pertinent part as follows;

As soon as practicable after any return is filed, the Department shall examine such return and shall, if necessary, correct such return according to its best judgment and information. ... In the event that the return is corrected for any reason other than a mathematical error, any return so corrected by the Department shall be prima facie correct and shall be prima facie evidence of the correctness of the amount of tax due, as shown therein.

Proof of such correction by the Department may be made at any hearing before the Department or in any legal proceeding by a reproduced copy ... in the name of the Department under the certificate of the Director of Revenue. ... Such certified reproduced copy ... shall without further proof, be admitted into evidence before the Department or in any legal proceeding and shall be prima facie proof of the correctness of the amount of tax due, as shown therein. (35 ILCS 120/4).

The relevant provision of section 5 of the ROT Act states as follows:

In case any person engaged in the business of selling tangible personal property at retail fails to file a return, the Department shall determine the amount of tax due from him according to its best judgment and information, which amount so fixed by the Department shall be prima facie correct and shall be prima facie evidence of the correctness of the amount of tax due, as shown in such determination. ... Proof of such determination by the Department may be made at any hearing before the Department or in any legal proceeding by a reproduced copy or computer print-out of the Department's record relating thereto in the name of the Department under the certificate of the Director of Revenue. ... Such certified reproduced copy or certified computer print-out shall, without further proof, be admitted into evidence before the Department or in any legal proceeding and shall be prima facie proof of the correctness of the amount of tax due, as shown therein. (35 ILCS 120/5).

The Department prepared the corrected return and issued a Notice of Tax Liability based upon its determination that the taxpayer, XZY CORPORATION, was engaged in retail sales of

dirt. The taxpayer does not dispute the methodology employed by the Department in conducting the audit. Rather, he contends that based upon alternative theories, he is not subject to the Retailers' Occupation Tax Act. It is his position that he is engaged in the sale of a service, and thus, subject to Service Occupation Tax (SOT), rather than subject to ROT based upon the sale of tangible personal property at retail. According to the taxpayer, the service consists of pulverizing dirt, delivering it to the customer, spreading and grading it, or otherwise distributing and shaping it according to customers' instructions. If SOT were to apply, the tax would be assessed on the cost price of the dirt to the taxpayer, which in the instant case is zero.

An alternative theory suggested by the taxpayer is that it is a construction contractor, operating pursuant to construction contracts, incorporating dirt into a structure as an integral part thereof. As the end user of the dirt, the taxpayer is not subject to ROT, but rather is taxable on the cost price (zero) of the tangible personal property that it purchases and incorporates into real estate.

Finally, should it be determined that the taxpayer is in fact subject to Retailer's Occupation Tax, the taxpayer urges that the assessment be limited by the six year statute of limitations found in 35 **ILCS** 735/3-10(b), and that penalties be waived for reasonable cause in accordance 35 **ILCS** 735/3-8.

In order to make a determination in this case as to whether the Notice of Tax Liability should be affirmed, it is necessary to review the facts, as well as the applicable law. It must be noted that most of the evidence in this case is testimonial in nature, offered by JIM DOE himself, and supported infrequently by documentary evidence. It is accepted as fact that the taxpayer initially received the dirt free of charge, as the excavator who gave dirt to the taxpayer testified to that effect. Evidence admitted into the record consists of a single invoice for plowing a septic

field, and delivering and spreading 400 cubic yards of sandy loam. In addition, a map of a septic field was admitted into evidence, as well as a document from the taxpayer's insurance company. This document details workers' compensation coverage applying to XZY CORPORATION employees involved in clerical work and in the grading of land for the policy period of June 28, 1996 to June 28, 1997. It is noted, however, that this time frame is outside of the taxable period.

In its brief, the taxpayer acknowledges that with respect to ROT cases, the best evidence is in the form of books and records, and that in the instant case, a substantial portion of the taxpayer's evidence is in the form of oral testimony, rather than books and records. It is true that the regulations pertaining to construction contractors acknowledge the use of oral, as well as written contracts. However, construction contractors do not incur Retailers' Occupation Tax only in limited circumstances. Pursuant to 86 Ill. Admin. Code Ch. I, Sec. 130.1940(c),

[a] construction contractor does not incur Retailers' Occupation Tax liability as to receipts from labor furnished and tangible personal property (materials and fixtures) incorporated into a structure as an integral part thereof for an owner when furnished and installed as an incident of a construction contract.

Landscape contractors are considered to be construction contractors. (86 Ill. Admin. Code ch. I, Sec. 1940(a)). As with a construction contractor, a landscape contractor does not incur ROT on his receipts when he incorporates tangible personal property into real estate as an integral part thereof for an owner as when furnished and installed as an incident of a landscape contract. No tax applies to receipts from selling and planting trees, shrubs, sod, and other plants, including fertilizer, mulch, and soil incorporated into the ground in connection with such planting. (86 Ill. Admin. Code ch. I, Sec. 1940(c)).

The Retailers' Occupation Tax and Service Occupation Tax Acts specifically provide that it is presumed that all sales of tangible personal property are subject to tax under said Acts,

unless the contrary is proven by the taxpayer. (35 ILCS 120/7; 35 ILCS 115/12). Without documentary evidence to corroborate the testimony of the taxpayer's sole proprietor, it is not possible to make a determination that XZY CORPORATION is a construction or landscape contractor. Nor is it reasonable to conclude that the taxpayer is engaged in the sale of service. At the very least, in the absence of documentary evidence in the form of books and records, there should be testimonial evidence from customers of the taxpayer to evidence what the taxpayer does with the dirt. In the absence of such supporting evidence, it is certainly reasonable to conclude that the taxpayer does in fact sell the dirt at retail.

Case law is abundant and clear that once the corrected return is admitted into evidence, the Department has established a prima facie case. It is the taxpayer's burden to overcome this presumption of validity with competent evidence in the form of books and records to show that the Department's returns were incorrect. (American Welding Supply Co. v. Department of Revenue, 106 Ill. App. 3d 93 (1982)). If there was documentary evidence, as well as credible testimonial evidence from the taxpayer himself, that would be sufficient to overcome the prima facie case and shift the burden back to the Department. (Quincy Trading Post, Inc. v. Department of Revenue, 12 Ill. App. 3d 725 (1973)). However, in a situation wherein the evidence consists of the taxpayer's oral testimony without corroborative evidence, the prima facie case stands un rebutted. (A.R. Barnes and Co. v. Department of Revenue, 173 Ill. App. 3d 826 (1st Dist. 1988)).

The court in Quincy Trading Post, *supra*, concisely stated the relevant law as it applies to the present circumstance:

In Copilevitz [citation], the supreme court said that the Act and its regulations are 'explicit in its demand for documentary evidence' The language of that case indicates that evidence corroborating statements of the taxpayer and other supporting data

is necessary. A taxpayer has all of his books and records, so, if wrongfully assessed, he could easily overcome the prima facie case of the department at the hearing procedures provided. In short, the plaintiff may not prevail by merely saying its own return was correct, and that the revenue department must prove its return correct. Simply questioning the Department of Revenue's return or denying its accuracy does not shift the burden to the Department of Revenue. (12 Ill. App. 3d 725, 730-31).

In addition, in determining whether a taxpayer is engaged in the business of rendering a service, as opposed to selling tangible personal property at retail, the applicable standard is stated as follows:

If the article sold has no value to the purchaser except as a result of services rendered by the vendor and the transfer of the article to the purchaser is an actual and necessary part of the service rendered, then the vendor is engaged in the business of rendering service and not in the business of selling at retail. If the article sold is the substance of the transaction and the service rendered is merely incidental to and an inseparable part of the transfer to the purchaser of the article sold, then the vendor is engaged in the business of selling at retail. (Kellogg Switchboard and Supply Corp. v. Department of Revenue, 14 Ill.2d 434, 437-8 (1958)).

Certainly, in order to make a determination that the dirt has no value to the purchaser except as a result of the services rendered by the taxpayer, there must at least be testimony from customers of the taxpayer to substantiate this position. Testimony proffered solely by the taxpayer is certainly not sufficient to support a determination that the taxpayer is engaged in a service occupation.

As it is my determination that the taxpayer has not overcome the Department's prima facie case of tax liability due to the fact that there was negligible documentary or other corroborative evidence to support the testimony offered by the taxpayer, I will next address the issue of reasonable cause as it concerns limiting the liability period to six years, as well as waiver

of penalties. The taxpayer asserts that he acted with “reasonable cause” in neither filing ROT returns, nor paying sales taxes. He bases this position in part upon his belief that he is not subject to the Retailers’ Occupation Tax Act, but rather, that he is a serviceman in the business of rendering services, or alternatively, a construction contractor likewise not subject to sales tax.

As additional support for his position, the taxpayer reiterates that he has no education beyond high school, and that he started out as a truck driver and heavy equipment operator. He retained accountants for professional advice because he had no knowledge regarding tax laws. His original accountant and an attorney advised him that he did not have to file sales tax returns, or pay sales tax. When he was advised by a subsequent accountant that his situation concerning whether he was subject to the ROT Act was unclear, he followed what he considered to be a safe course of action, and commenced filing returns and paying the tax due. He has been in compliance with all other tax laws, and in fact received a small refund pursuant to the only other audit he experienced.

The Illinois Uniform Penalty and Interest Act (UPIA) provides a six year statute of limitations if the failure to file a return is due to reasonable cause. (35 ILCS 735/3-10(b)). “Reasonable cause” as it relates to the limitations period is not defined in the UPIA, nor have any regulations been adopted in this respect. Section 3-8 of the UPIA provides for the waiver of penalties if reasonable cause exists. Said section provides that “[r]easonable cause shall be determined in each situation in accordance with the rules and regulations promulgated by the Department”.

The issue of reasonable cause as it pertains to late filing and late payment is discussed in 86 Ill. Admin. Code, ch. I, Sec. 700.400. Said section provides in pertinent part as follows:

- (b) The determination of whether a taxpayer acted with reasonable cause shall be made on a case by case basis taking into

account all pertinent facts and circumstances. The most important factor to be considered in making a determination to abate a penalty will be the extent to which the taxpayer made a good faith effort to determine his proper tax liability and to file and pay his proper liability in a timely fashion.

- (c) A taxpayer will be considered to have made a good faith effort to determine and file and pay his proper tax liability if he exercised ordinary business care and prudence in doing so. A determination of whether a taxpayer exercised ordinary business care and prudence is dependent upon the clarity of the law or its interpretation and the taxpayer's experience, knowledge, and education. Accordingly, reliance on the advice of a professional does not necessarily establish that a taxpayer exercised ordinary business care and prudence, nor does reliance on incorrect facts such as an erroneous information return.
- (d) The Department will also consider a taxpayer's filing history in determining whether the taxpayer acted in good faith in determining and paying his tax liability....

It is my determination that the instant taxpayer did, in fact, make a good faith effort to determine its proper tax liability, and then filed and paid its liability in a timely fashion. The evidence indicates that JIM DOE hired accountants from the outset because he was aware of his limited education, particularly as it concerned tax law. He changed accountants when he realized that his business had outgrown the services offered by the original accountant, who was a childhood friend.

When he was still with his original accountant, JIM DOE became aware of a potential sales tax issue upon receiving a letter from the Landscape Contractors' Association, an organization of which he was a member. (Taxpayer's Ex. No. 1). His original accountant advised him that there was no liability, as did an attorney. As his subsequent accountant was not sure if there was sales tax exposure, the taxpayer was advised to be on the safe side by filing and paying tax. Of course, the taxpayer had no idea that he could be liable for previous unpaid periods, nor was he aware that he could have requested a ruling letter from the Department. The

taxpayer otherwise has a history of compliance with tax laws, and the only other audit with which he was involved resulted in a tax refund.

Certainly, taking into account all the facts and circumstances, it appears that the taxpayer acted with reasonable cause in his failure to timely file and pay tax. The taxpayer considers himself to be a contractor, yet has not proven his position with sufficient evidence. However, the law concerning landscape contractors was apparently in a state of flux at the time when JIM DOE was seeking advice concerning his tax exposure as is evident from the letter from the Illinois Landscape Contractors' Association, as well as the letter from its attorney. (Taxpayer's Ex. Nos. 1 and 2). It is therefore my determination that the audit period be limited to six years, and that penalties be waived for reasonable cause.

RECOMMENDATION:

It is my recommendation that NTL No. XXXXX be revised in accordance with the reaudit, but limited to six years after the original due date of each return required to have been filed. Furthermore, it is my recommendation that penalties be waived.

Enter:

Administrative Law Judge