

ST 11-04

Tax Type: Sales Tax

**Issue: Unreported/Underreported Receipts (Non-Fraudulent)
Gross Receipts**

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

THE DEPARTMENT OF REVENUE)	Docket No.	00-ST-0000
OF THE STATE OF ILLINOIS)	Reg. No.	0000-0000
)	NTL Nos.	
v.)		
)		
ABC CORPORATION,)	John E. White,	
Taxpayer)	Administrative Law Judge	

RECOMMENDATION FOR DISPOSITION

Appearances: Kathleen Lach, Arnstein & Lehr, LLP, appeared for ABC Corporation; George Foster, Special Assistant Attorney General, appeared for the Illinois Department of Revenue.

Synopsis: This matter arose after ABC Corporation (ABC Corporation or Taxpayer) protested three Notices of Tax Liability (NTLs) the Illinois Department of Revenue (Department) issued to it after an audit of Taxpayer's business for the months of July 2002 through December 2005 (hereafter, the audit period). The NTLs assessed retailers' occupation tax, penalties and interest as measured by the gross receipts the Department determined ABC Corporation received from selling tangible personal property at retail during the audit period. The NTLs also assessed use tax, penalties and interest, as measured by the cost price of tangible personal property the Department determined Taxpayer purchased and used, in Illinois, as a construction contractor during the audit period.

The issues include whether ABC Corporation had unreported sales, and whether ABC Corporation was subject to use tax on certain purchases, as determined by the Department. After

considering the evidence admitted at hearing, I am including in this recommendation findings of fact and conclusions of law. I recommend that the issues be resolved in favor of the Department, and that the NTLs be finalized as issued.

Findings of Fact:

1. ABC Corporation was a retailer/installer of digital television systems. Department Ex. 1 (copies of NTLs and other Department reports, under cover of the Director's Certificate of Records), p. 4 (Audit Narrative Report).
2. ABC Corporation was incorporated on March 1, 2002, and elected "S" corporation status, effective January 1, 2003. *Id.*
3. ABC Corporation conducted business as 123 Corporation. Taxpayer Ex. 2; Hearing Transcript (Tr.), p. 52 (testimony of John Doe, ABC Corporation's current CEO).
4. The Department conducted an audit of Taxpayer's business for the audit period. Department Ex. 1. Pamela Effertz and Gus Patel (the auditors) conducted the audit for the Department. Department Ex. 1, pp. 7-8.
5. The audit was conducted after Taxpayer stopped doing business, although it remained an active corporation. Department Ex. 1, p. 4; Tr. p. 48 (John Doe).
6. Taxpayer had only very limited books and records available for the Department's auditors to review when conducting the audit. Department Ex. 1, p. 4. Those limited records included copies of the corporation's federal income tax returns for 2002 through 2004, and a schedule of purchases for years 2003 through 2005 and invoice samples. *Id.*
7. During the audit period, Taxpayer filed sales and use tax returns on a quarterly basis. Department Ex. 1, p. 4. Taxpayer self-assessed use tax on its 2002 through 2003 returns. *Id.* Taxpayer reported a tax rate of 6.75% on those returns. *Id.* The auditors determined that

there were no open periods, which means that they determined that Taxpayer filed returns for the entire audit period. *Id.*; Department Ex. 4 (copy of auditor's Schedule of ROT Due, which took into account the amount of the gross sales receipts reported on Taxpayer's filed returns during the audit period).

8. The auditors contacted two individuals during the course of the audit, John Doe and Mr. Smith. Department Ex. 1, p. 4. At hearing, John Doe described himself as an investor in ABC Corporation who took an active role in assisting the Department's audit, once ABC Corporation ceased doing business in Illinois. Tr. pp. 46-48 (John Doe).
9. Since Taxpayer had no books and records to support the amounts reported on its sales tax returns, and had no actual invoices to give to the auditors to review, the auditors used Taxpayer's Illinois purchase schedules for each year in the audit period to estimate Taxpayer's gross receipts. Department Ex. 1, pp. 4-5.
10. The auditors categorized Taxpayer's purchases as being either ROT related or construction related, based on the best available information. Department Ex. 1, p. 5; Department Ex. 2 (copy of auditor's schedule 1, Summary Analysis).
11. When the auditors designated a purchase as being ROT related, that meant that they determined that Taxpayer sold such items, at retail, to customers for use or consumption in Illinois. Department Ex. 1, pp. 5-6; Department Ex. 2. The construction related category meant that the auditors determined that Taxpayer used the items purchased when installing property for a customer. *Id.*
12. To calculate the selling price of the property the auditors categorized as being ROT related, they applied a mark-up to Taxpayer's cost for such property using Taxpayer's cost of goods sold and gross receipts as reported on Taxpayer's federal income tax returns for 2002 through

2004. Department Ex. 1, p. 5.

13. Since Taxpayer did not have available a federal income tax return for 2005, the auditors used the average of the mark-ups percentages from the 2003-2004 years when calculating estimated ROT receipts for 2005. Department Ex. 1, p. 5.
14. After calculating selling prices of the property the auditors determined Taxpayer sold at retail, they calculated Taxpayer's estimated gross receipts by multiplying Taxpayer's cost for such property by the mark-up percentage. Department Ex. 1, p. 5. The auditors then subtracted from that product the total receipts reported on line 1 of Taxpayer's filed returns, and determined that tax was due on the difference, as a disallowed deduction from total taxable receipts. *Id.*; Department Ex. 4.
15. Regarding the auditors' determination of property Taxpayer purchased and used when installing property for customers, the auditors subtracted the amounts Taxpayer reported on its filed returns for such amounts from the total costs of property purchased for construction, and determined that use tax was due on the difference. Department Ex. 1, p. 6; Department Ex. 2.
16. As a result of the audit, the Department made the following determinations:
 - Taxpayer's estimated gross receipts from selling tangible personal property at retail for the audit period sales was \$4,006,282, resulting in additional ROT due of \$270,425.
 - Taxpayer had more taxable purchases of tangible personal property than it reported on its filed returns, and the additional property purchased had a cost price of \$340,260, resulting in additional use tax due of \$21,266.

Department Ex. 1, pp. 1-3, 6; Department Ex. 2.

17. The Department also assessed late payment penalties against Taxpayer. Department Ex. 1, pp. 1-3.
18. During the audit period, Taxpayer purchased tangible personal property from XYZ Systems

(XYZ), a wholesale distributor of electronics products. Taxpayer Ex. 1 (copy of account schedule regarding property Taxpayer purchased from XYZ on January 6, 2003 and on March 3, 2004); Tr. pp. 12-13 (testimony of Mr. Jones, executive vice-president of XYZ); *see also* Department Ex. 1, pp. 4-6 (referring to purchase schedules). The property ABC Corporation purchased from XYZ consisted of different equipment used to receive digital television service. Taxpayer Exs., *passim*.

19. Mr. Jones (Mr. Jones), XYZ’s executive vice-president, described XYZ’s business and its role vis-à-vis XYZ and AAA Company. Tr. pp. 12-45 (Mr. Jones).

20. John Doe identified Taxpayer Exhibit 2 as a copy of a document ABC Corporation’s managers had prepared to submit to the Department’s auditors, in which they sought to describe ABC Corporation’s business model, including how ABC Corporation fit into what the document describes as the “Satellite TV Value Chain.” Taxpayer Ex. 2; Tr. pp. 52-54 (John Doe).

21. The Satellite TV Value Chain, described in Taxpayer Exhibit 2, provides in substantive part:

Satellite TV Value Chain

Satellite TV Companies	Equipment Distributors	Authorized Retailers Reseller	3 rd Party Installers, IC	Customers
XXX Network AAA Company	XYZ BBB Co. CCC CO. DDD CO.	123 Corporation + 30,000 other retailers	Typically Independent Contractors	Residential (not business)

AAA COMPANY Business Model

123 Corporation started selling AAA COMPANY satellite TV services since 2003.

When customer purchases AAA COMPANY service, 123 Corporation charges them at the point-of-sale, the cost of the equipment, if applicable, plus S&H for the equipment. The customer owns the equipment. AAA COMPANY bills them directly for the monthly service going forward.

Depending on the geographic location of the customer, 123 Corporation offers two ways of getting the customer installed and activated to view satellite TV.

1. Ship the equipment to their home directly from Distributor (CCC CO.) and then have a technician from CCC CO. visit and complete the installation.
2. Have the technician bring the equipment with him (123 Corporation Contractor) when he visits the customer for the installation.

See attached CCC CO. contract, Exhibit “B” to see price break down for Freight and for Freight and Installation.

There are three kinds of Equipment packages:

1. Basic (Free): This equipment is ordered from CCC CO.. On this equipment invoice from CCC CO., all equipment is fully reimbursed through internal crediting on the invoice, except for shipping and handling. (Please see sample invoice). This equipment is free of charge to the customer. Customer only pays an upfront charge at the point of sale for shipping and handling plus tax to 123 Corporation for the price of the equipment. If the equipment is not activated (installed) within 90 days, then the distributor will charge 123 Corporation for the price of the equipment. (Chargeback) Basic receiver account for approximately 80% of sales.
2. TiVo or DVR (Equipment Charge): This equipment has to be bought and belongs to the customer. Therefore there is no chargeback associated with this equipment. 123 Corporation charges sales tax on equipment to customer.
3. High Definition (Equipment Charge): This equipment is very expensive and has to be bought and belongs to the customer. Sales of High Definition receivers is marginal. Therefore there is no chargeback associated with this equipment. 123 Corporation Charges sales tax on equipment to customer.

See attached sample CCC CO. invoices to 123 Corporation and also Exhibit “B” for freight and installation prices.

XXX Network Business Model

123 Corporation started to sell XXX Network satellite TV services in Illinois in 2001.

- 2001 95% of total DN sales in IL made under the DHP promo (Equip Lease)**
5% of total DN sales in IL made under the CableBounty promo (Equip Purchase)

NOTE: In 2001, 123 Corporation erroneously charged sales taxes on the \$49.99 upfront fee to 95% of the customers that leased equipment that year. (\$49.99 upfront fee x Sales Tax). This money was reported on our Sales Tax forms and submitted to the IL Dept. of Revenue.

- 2002 89% of total DN sales in IL made under the FFA/FreeDish promos (Equip Purchase)**

- 11% of total DN sales in IL were made under the DHP promo (Equip Lease)**
- 2003** **60% of total DN sales in IL made under the FFA/FreeDish promos (Equip Purchase)**
40% of total DN sales in IL were made under the DHP promo (Equip Lease)
- 2004** **93% of total DN sales in IL made under the DHP/DHA promo (Equip Lease)**
7% of total DN sales in IL were made under the FFA/FreeDish promos (Equip Purchase)
- 2005** **100% of total DN sales in IL made under the DHA promo (Equip Lease)**

There are two kinds of Equipment packages: Leased equipment and Purchased equipment

DHP/DHA Promo: Leased Equipment

For equip leases such a DHP/DHA, 123 Corporation as a retailer purchases DBS equipment in Illinois from XYZSystems, Inc., a distributor for YYY/XXX Network in the Midwest.

123 Corporation pays the full MSRP for the equipment to XYZ and they in turn do not charge us any sales/use tax on that equipment. 123 Corporation then schedules the installation work to an Independent Contractor or 3rd Party Installation company in Illinois. Upon installation, the customer account is then activated with XXX Network, and they begin to receive satellite TV programming. Since the customer is required to and agrees to sign up for a minimum one year programming commitment, XXX Network offers the customer a free professional installation and the customer leases the equipment. Upon activation, XXX Network pays XYZ all commissions due and XYZ then pays 123 Corporation any commissions and equipment reimbursement fees due per the Retailer Agreement.

The customer pays an upfront \$49.99 Activation Fee to the retailer 123 Corporation at time of ordering satellite TV service. This fee serves as a deposit and is non-refundable if the customer chooses to pre-cancel service, but in fact covers a portion of 123 Corporation's equipment reimbursement. Specifically, it covers the cost of the Satellite Dish and LNBF^[1] required to access signal. 123 Corporation does not charge the customer any sales tax on the \$49.99 as the customer is leasing the equipment. The customer pays a

¹ "LNBF" is satellite television jargon that refers to a Low Noise Block Converter with Integrated Feed, which is a device that amplifies received signals and converts them from microwaves to a different type of signal, which is then sent along a cable to the satellite receiver. See <http://.com/AAA Company/glossary.html> (last viewed on February 3, 2011).

monthly \$5 leasing fee directly to XXX Network as well as any sales taxes that are charged on the customer's monthly satellite programming bill by XXX Network. The \$49.99 upfront fee is then credited back to the customer on their first programming bill by XXX Network and the retailer 123 Corporation retains the \$49.99 charged to the customer as part of its equipment reimbursement to cover the cost of the Dish/LNBF.

NOTE: Receiving Satellite TV programming requires the following equipment/accessories:

Dish assembly, LNBF and Digital Satellite Receivers.

Chargebacks

In the event the customer cancels their programming prior to their one year commitment period, the retailer 123 Corporation receives a chargeback or reversal of commission and equipment payments from XXX Network via XYZ.

FFA/Free Dish and Cable Bounty Promos: Customer purchases the equipment

The key difference between the leased equipment promos such as the DHP/DHA explained above and promos where the consumer ends up purchasing the equipment such as Free for All or Free Dish promos is that the retailer 123 Corporation collects sales tax from the customer on the equipment purchase price. Typically, this upfront fee is \$49.99 for up to two receivers for 2 TVs, but the customer may purchase additional receivers for additional TVs at MSRP and DP charges the customer sales tax on whatever upfront fee the customer pays the retailer to purchase the equipment. That not only drives up the upfront fees but also the sales taxes.

Chargebacks

The chargeback rules are the same as for the other leased equipment promos.

Taxpayer Ex. 2, pp. 2-4 (all emphases original).

22. The materials described within Taxpayer Exhibit 2 as being attachments to that document, for example, the contract ABC Corporation had with CCC CO. regarding AAA Company, and sample CCC CO. invoices, were not offered into evidence at hearing. *See* Taxpayer Exs., *passim*. Nor were any written agreements that John Doe said ABC Corporation had with XXX Network, XYZ, or AAA Company. Tr. pp. 75-77 (John Doe).
23. Although Taxpayer Exhibit 2 provides that 60% of ABC Corporation's Illinois XXX

Network sales involved ABC Corporation's sale of equipment to customers, the record does not include any documents that reflect the total amount of gross receipts that ABC Corporation realized from its Illinois XXX Network sales. *See* Taxpayer Ex. 2, pp. 2-4. Nor is there documentary evidence sufficient to corroborate ABC Corporation's written assertion that 40% of the unknown amount of gross receipts from Illinois XXX Network sales was derived from selling services, only, to customers. *See id.*

24. Similarly, no documents were admitted which detail the total amount of receipts ABC Corporation realized from selling equipment or services regarding AAA Company or CCC CO., in Illinois, during the audit period. *See* Taxpayer Ex. 2, p. 2.
25. During the audit, John Doe asked XXX Network to provide him with something in writing to corroborate his description of ABC Corporation's business. Tr. pp. 54-55. John Doe identified Taxpayer Exhibit 3 as a letter, dated October 28, 2009, that XXX Network wrote in response to his request. *Id.*; Taxpayer Ex. 3. Taxpayer Exhibit 3 provides as follows:

[XXX Network logo]

October 28, 2008

ABC Corporation dba 123 Corporation
Attn: Saurabh John Doe

RE: ABC Corporation ([]) Audit for Periods 9/2003, 9/2004 and 12/2005

Dear Saurabh,

Concerning the above referenced audit of ABC Corporation, Inc, please accept this letter. XXX Network, LLC ("DISH") is a nationwide, Fortune 300 company that provides satellite television service to its subscribers. In order to meet the demand for its service efficiently, DISH often supplements its own internal installation and sales force with the help of local retailers. DISH requires each of these retailers to sign its standard Retailer Agreement, which states that the retailer will sell DISH service as well as install the equipment necessary to receive such service on behalf of XXX Network.

The leased equipment that the retailer installs, including leased receiver systems, remain the property of DISH and DISH bills the customer directly for the lease of such equipment. Because DISH owns these leased system [*sic*] it pays applicable use taxes on this leased equipment when it places that

equipment in service. The retailers only take possession of this leased equipment in order to install it on behalf of DISH, and do not own or lease this equipment to the subscribers themselves.

DISH remits use taxes on the equipment it leases to its subscribers when it places the equipment in service, but it is not responsible for any other equipment that the retailer may sell or lease to the subscriber in conjunction with or separate from its sale of DISH service. Any tax on items that the retailer leases or sells that are not owned by or sold directly by DISH are the responsibility of the retailer.

Sincerely,

[signature]

Martin Noli
Sr. Tax Manager, Sales/Use

9601 South Meridian Boulevard
Englewood, Colorado 80112

Taxpayer Ex. 3.

Conclusions of Law:

The Department introduced the NTLs it issued to ABC Corporation into evidence under the certificate of the Director. Department Ex. 1. Pursuant to § 4 of the Retailers' Occupation Tax Act (ROTA), those NTLs constitute the Department's prima facie case in this matter. 35 ILCS 120/4, 7. The Department's prima facie case is a rebuttable presumption. 35 ILCS 120/7; Copilevitz v. Department of Revenue, 41 Ill. 2d 154, 157, 242 N.E.2d 205, 207 (1968); DuPage Liquor Store, Inc. v. McKibbin, 383 Ill. 276, 279, 48 N.E.2d 926, 927 (1943). The presumption of correctness that attaches to the Department's prima facie case extends to all elements of taxability. Branson v. Department of Revenue, 68 Ill. 2d 247, 258, 659 N.E.2d 961, 966-67 (1995) (Department's introduction of Notice of Penalty Liability establishes prima facie proof that taxpayer acted with the required mental state); Soho Club, Inc. v. Department of Revenue, 269 Ill. App. 3d 220, 232, 645 N.E.2d 1060, 1068 (1st Dist. 1995) (Department's introduction of Notice of Tax Liability establishes prima facie proof that taxpayer is engaged in the occupation

that is subject to taxation).

A taxpayer cannot overcome the statutory presumption merely by denying the accuracy of the Department's assessment. A.R. Barnes & Co. v. Department of Revenue, 173 Ill. App. 3d 826, 833, 527 N.E.2d 1048, 1053 (1st Dist. 1988). Instead, a taxpayer has the burden to present evidence that is consistent, probable and closely identified with its books and records, to show that the Department's determinations are not correct. Fillichio v. Department of Revenue, 15 Ill. 2d 327, 333, 155 N.E.2d 3, 7 (1958); A.R. Barnes & Co., 173 Ill. App. 3d at 833-34, 527 N.E.2d at 1053.

Issues and Argument

Taxpayer's fundamental argument is that it was engaged in the business of selling services, and therefore, the Department's determination that it had a large amount of unreported taxable sales at retail must be disregarded. Tr. pp. 5-6 (opening statement); Taxpayer ABC Corporation Inc's Opening Brief in Support of Taxpayer's Protest to Notices of Tax Liability (Taxpayer's Brief), pp. 1-2. Taxpayer also disputes the Department's determination that it owed any additional use tax and penalties related to either tax assessments. Taxpayer's Brief, p. 2.

Before addressing whether the evidence admitted at hearing supports Taxpayer's arguments, this section will briefly summarize how Illinois taxes retailers versus servicemen. The ROTA imposes a tax (ROT) on all persons engaged in the business of selling, at retail, tangible personal property. 35 ILCS 120/21; Mel-Park Drugs, Inc. v. Department of Revenue, 218 Ill. App. 3d 203, 213, 577 N.E.2d 1278, 1284-85 (1st Dist. 1991). Although tax is imposed on the occupation of retailing, the tax is measured as a percentage of the retailer's gross receipts from selling tangible personal property. 35 ILCS 120/2-10; H.D., Ltd. v. Department of Revenue, 297 Ill. App. 3d 26, 34, 696 N.E.2d 1163, 1168 (2d Dist. 1998).

The Service Occupation Tax Act (SOTA) imposes a tax (SOT) on all persons engaged in the business of making sales of service, which the SOTA defines and classifies as servicemen (35 ILCS 115/3), on all tangible personal property transferred as an incident of a sale of service. 35 ILCS 115/3. As is the case under the ROTA, while the SOT is imposed on the occupation of making sales of service, the tax is measured as a percentage of the selling price of the tangible personal property the serviceman transfers to the customer as an incident to the service provided. 35 ILCS 115/3-10. Under either the ROTA or the SOTA, if a particular transaction consists solely of the sale of service, with no property being either sold or transferred to the purchaser, no tax is imposed on the gross receipts realized from the transaction. 86 Ill. Admin Code §§ 130.120(d), 140.125(c). Although receipts from such sales of services, whether rendered by a retailer or a serviceman, are not subject to either ROT or SOT, the respective acts place the burden on the service provider to document which particular gross receipts are not taxable because they were realized from selling services only. 35 ILCS 120/7; 35 ILCS 115/12; H.D., Ltd., 297 Ill. App. 3d at 34, 696 N.E.2d at 1168.

Specifically, § 7 of the ROTA provides, in part:

To support deductions ... authorized under this Act, on account of receipts from isolated or occasional sales of tangible personal property, on account of

receipts from sales of tangible personal property for resale, on account of receipts from sales to governmental bodies or other exempted types of purchasers, on account of receipts from sales of tangible personal property in interstate commerce, and on account of receipts from any other 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 nontaxable 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 on upon the person who would be required to remit the tax to the Department if such transaction is taxable. ***

35 ILCS 120/7. The legislature also incorporated § 7 of the ROTA into the SOTA. 35 ILCS 115/12.

The instructions to the return form required to be used by both servicemen and retailers (see 35 ILCS 86 Ill. Admin. Code §§ 140.101, 140.401(a)) further direct a taxpayer to report, on lines 1 through 3 of the return, as follows:

Step 2: Taxable Receipts

When completing this form, please round to the nearest dollar by dropping amounts of less than 50 cents and increasing amounts of 50 cents or more to the next higher dollar.

Line 1 Write the amount you received from all sales of merchandise and service, including service charges and taxes collected. Do not include purchases of merchandise on which you are paying use tax in Step 5.

Line 2 Write the total amount of deductions plus tax collected. Use the Worksheet for Line 2 on the back of Form ST-1 to figure this amount. The amount on Line 2 cannot be more than the total receipts you wrote on Line 1. If so, you must file a claim for credit (ST-1-X).

Line 3 Subtract Line 2 from Line 1.

Illinois Department of Revenue ST-1 Instructions (rev. July 2004) (available to view via the Department's web site at <http://tax.illinois.gov/TaxForms/Sales/ST-1-Instr.pdf>).

The instructions for the worksheet part of the return form provide that one of the deductions that a taxpayer is entitled to include within the total deductions to be reported on line 2 of its return is for the gross receipts it realized from making sales of service. *Id.*, p. 2 (instructions regarding line 9 of the ST-1 worksheet). So, the return form requires persons whose business includes both making retail sales and making sales of services to identify the gross receipts that are subject to tax and those that are not, after which the taxpayer may deduct the latter from its total receipts. I take the foregoing statutes and filing procedures into account because Illinois law is clear that "... when a taxpayer claims that he is exempt from a particular tax, or where he seeks to take advantage of deductions or credits allowed by statute, the burden of proof is on the taxpayer." Balla v. Department of Revenue, 96 Ill. App. 3d 293, 296, 421 N.E.2d 236, 238 (1st Dist. 1981) (*citing* Telco Leasing, Inc. v. Allphin, 63 Ill. 2d 305, 347 N.E.2d 729 (1976); Bodine Electric Co. v. Allphin, 81 Ill. 2d 502, 410 N.E.2d 828 (1980)).

There is no doubt that, if ABC Corporation realized receipts in exchange for selling services only, such receipts were not intended to be subject to either ROT or SOT. 35 ILCS 120/2 ("A tax is imposed upon persons engaged in the business of selling at retail tangible personal property"); 86 Ill. Admin. Code § 130.120(d) ("The [ROT] does not apply to receipts from sales: ... of personal services, where rendered as such. ***"). Just as surely, the Illinois legislature intended to place the burden on persons who are engaged in an occupation that is subject to either ROT or SOT, like ABC Corporation, to document any claim it might have that particular receipts or transactions are not taxable. 35 ILCS 120/7; 35 ILCS 115/12. By statute, such documentary evidence must consist of "entries in ... books, records or other pertinent papers or documents ... in detail sufficient to show ... 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 nontaxable character of such transaction[s]” 35 ILCS 120/7. Further, the presumption is that all receipts are taxable, unless the taxpayer supports its claim that particular receipts are not subject to, or exempt from, tax. 35 ILCS 120/7; H.D., Ltd., 297 Ill. App. 3d at 34, 696 N.E.2d at 1168.

Evidence Offered by Taxpayer

Here, Taxpayer had no regularly kept books and records of its own to offer into evidence. The only such records it offered into evidence consisted of XYZ’s, its vendor’s, books and records. Taxpayer Exs. 1, 4-6. Mr. Jones, XYZ’s executive director, was the person who authenticated Taxpayer Exhibit 1, and he identified it as a copy of two pages of a spreadsheet that referred to certain transactions XYZ had with Taxpayer, on two days, during the audit period. Taxpayer Ex. 1; Tr. pp. 17-18, 33-41 (Mr. Jones). On its face, the exhibit does not indicate whether each page included all of the transactions XYZ had with ABC Corporation for each of the two days. Taxpayer Ex. 1. Mr. Jones said that the file from which the two pages included as Taxpayer Exhibit 1 was taken was approximately 6,000 pages long. Tr. p. 17 (Mr. Jones).

Mr. Jones also offered testimony regarding XYZ’s business relationship with ABC Corporation. Mr. Jones described XYZ as a wholesale distributor of electronic products. Tr. p. 11. He described ABC Corporation as an independent satellite retailer. *Id.* pp. 11-12. When asked to describe the process by which equipment went from XYZ to ABC Corporation, Mr. Jones said that ABC Corporation would buy electronic products from XYZ, pay for the products, and XYZ would ship the products to ABC Corporation. *Id.* p. 12. XYZ invoiced ABC Corporation for the products. Tr. pp. 12-13; 26-27. When asked to explain what he meant when he said ABC Corporation would buy products from XYZ, since the word “buy” implied that ABC Corporation would pay XYZ directly for the product XYZ sent to it, Mr. Jones answered,

“That is correct.” Tr. p. 13.

Mr. Jones also explained that XYZ was a distributor for XXX Network. *Id.* He said that XYZ would be reimbursed by XXX Network for equipment that was activated by customers of ABC Corporation. *Id.* pp. 13, 27-28. He explained that, depending what promotion was going on, XYZ would send hardware to a particular retailer, like ABC Corporation, who would then go out and sell their systems and receivers to a consumer. *Id.*, pp. 13-14. Mr. Jones said customers would purchase XXX Network’s services through its web site. Tr. p. 14. He said that XXX Network had all of the business rules, and, once XXX Network approved a particular customer, ABC Corporation would install the system. *Id.* Mr. Jones recalled that XXX Network leased the majority of their product that XYZ’s retailers sold to the consumer. *Id.* He said that, once an installed system was activated, XYZ would get paid, and XYZ would then pass on the amount of the reimbursement to ABC Corporation. Tr. pp. 14, 27-28. Mr. Jones repeated that most of the equipment that came from XYZ’s warehouse to retailers, like ABC Corporation, was leased, and that the lease was between XXX Network (as the lessor) and the customer. Tr. pp. 21-22.

When reviewing Taxpayer Exhibit 1, Mr. Jones identified it as a sample of XYZ’s records of its reimbursements to ABC Corporation for the equipment ABC Corporation purchased from XYZ. Tr. pp. 17-20. Mr. Jones could not identify the meaning of all of the column headings on Taxpayer Exhibit 1, or what all of the particular entries under all of the headings meant. Tr. pp. 41-44. In addition to Mr. Jones’ testimony that he could not recall what all of the particular entries and headings listed on Taxpayer Exhibit 1 meant, I also note that the entries and headings on that exhibit are not plain on their face. *See* Taxpayer Ex. 1. That is to say, I was unable to look at the exhibit and immediately grasp the nature of the information included within the entries. *See id.* Mr. Jones acknowledged that Taxpayer Exhibit 1 does not

reflect any of the payments XYZ received from ABC Corporation, following ABC Corporation's purchases of equipment from XYZ. Tr. pp. 42-43.

Taxpayer also offered other documents into evidence, all of which were identified and authenticated by John Doe. John Doe identified Taxpayer Exhibit 2 as a copy of a report prepared by ABC Corporation managers to explain ABC Corporation's business model to the Department's auditors. Tr. pp. 51-52. John Doe identified Taxpayer Exhibit 3 as a copy of a letter John Doe asked XXX Network to provide to him so he could give it to the Department's auditors. Taxpayer Ex. 3; Tr. pp. 54-55. When the copy of that letter was offered as Taxpayer Exhibit 3, Department counsel acknowledged that it was hearsay, but offered no objection to its admission. Tr. p. 69.

John Doe identified Taxpayer Exhibits 4 through 6 as copies of XYZ reports showing invoices to ABC Corporation for 2003, 2004 and 2005, respectively. Taxpayer Exs. 4-6; Tr. pp. 61-65 (John Doe). John Doe said that copies of those exhibits were provided to the Department's auditors. Tr. p. 61 (John Doe). John Doe said that many of the entries on the reports refer to payments made to ABC Corporation that were not related to any equipment obtained from XYZ, but that most of the invoice amounts are equipment related. Tr. pp. 62-64 (John Doe). As an example, John Doe identified an entry on Taxpayer Exhibit 5 regarding an invoice for June 18, 2004, which referenced an amount of \$746,726.60. Tr. pp. 63-64 (John Doe); Taxpayer Ex. 5 (unnumbered page 8, invoice number 100275254). John Doe explained that that invoice amount was for a penalty assessed against ABC Corporation by both XXX Network and XYZ because of ABC Corporation's prior errors in claiming advertising and marketing expense reimbursements, and that that amount had nothing to do with the equipment it obtained from XYZ. Tr. pp. 63-64 (John Doe).

It appears that John Doe's testimony on this point — that not all of the charges on the invoices referenced within Taxpayer Exhibits 4-6 were related to ABC Corporation's purchases of equipment from XYZ— was offered to show that the Department improperly measured the tax base. *See* Tr. pp. 61-65 (John Doe). But the audit schedule the auditors prepared to document their estimate of Taxpayer's receipts that were subject to ROT shows that the Department determined that, for June 2004, ABC Corporation purchased \$159,203 worth of equipment for resale. Department Ex. 4, p. 1. Similarly, the schedule documenting the global exceptions the auditors used to estimate Taxpayer's purchases of equipment that were subject to use tax does not include the penalty amount identified by John Doe on Taxpayer Exhibit 5. *Compare* Taxpayer Ex. 5 (unnumbered page 8, invoice number 100275254) *with* Department Ex. 3. The evidence does not support ABC Corporation's suggestion that the auditors improperly measured the tax base by including expenses that were not related to ABC Corporation's purchases of property for resale at retail.

Did The Evidence Taxpayer Offered Rebut The Department's Prima Facie Case

During his testimony, Mr. Jones opined that the hearing was being held with the wrong people, because XXX Network, and not ABC Corporation, owned the equipment that ABC Corporation installed at a customer's location, and XXX Network leased that equipment to a customer. Tr. pp. 15-16; *but see id.*, pp. 27-28. I mention this not because I considered Mr. Jones' opinion testimony to be probative regarding some fact at issue. Rather, Mr. Jones testified that ABC Corporation purchased equipment from XYZ, yet thereafter testified that XXX Network then leased that same equipment to customers for whom ABC Corporation caused to have such equipment installed. One rational way of reconciling Mr. Jones' testimony with his opinion would be if ABC Corporation was purchasing equipment from XYZ, and then

installing it for customers to whom XXX Network leased it, because ABC Corporation was acting as XXX Network's agent, or on its behalf. *See* 86 Ill. Admin. Code § 130.1915 (2000).²

But the evidence most probative of whether ABC Corporation was acting as XXX Network's agent, as well as the scope of such agency, if it existed, would be the retailer's agreement John Doe testified ABC Corporation entered into with XXX Network (Tr. p. 75 (John Doe)), and which agreement is expressly referred to in the letter John Doe said was written by XXX Network. Taxpayer Ex. 3. That written agreement was not offered as evidence at hearing.

² The ROT regulation regarding agents provides:
Section 130.1915 Auctioneers and Agents

a) When Persons Act As Agent

1) Every auctioneer or agent, acting for an unknown or undisclosed principal, or entrusted with the possession of any bill of lading, custom house permit or warehouseman's receipt for delivery of any tangible personal property, or entrusted with the possession of any such personal property for the purpose of sale, is deemed to be the owner thereof, and upon the sale of such property to a purchaser for use or consumption, he is required to file a return of the receipts from the sale and to pay to the Department a tax measured by such receipts.

2) The receipts from any such sale, when made by an auctioneer or agent who is acting for a known or disclosed principal, are taxable to the principal, provided the principal is engaged in the business of selling such tangible personal property at retail. For a sale to qualify under this subsection (a)(2), the principal must be clearly disclosed to the purchasers by the auctioneer or agent so that the purchasers are able to determine who owns the goods that are being sold.

3) The same rule applies to lienors such as storagemen and pawnbrokers.

b) When Principal is Disclosed

For the purposes of this Section, a principal is deemed to be disclosed to a purchaser for use or consumption only when the name and address of such principal is made known to such purchaser at or before the time of the sale and when the name and address of the principal appears upon the books and records of the auctioneer or agent. A verbal announcement of the principals' names at the auction is not sufficient to document disclosure. Acceptable evidence of disclosure includes:

1) naming the principals and their addresses (city only is sufficient) in newspapers and other public advertising;

2) posting a written list of the principals' names and their addresses (city only is sufficient) at the auction site;

3) distributing sale bills or brochures that name the principals and their addresses (city only is sufficient);

4) recording the principals' names and their addresses (city only is sufficient) on legal documents regarding the item that is sold, such as automobile titles; or

5) other methods that provide a permanent, written record of the disclosure of the names and addresses (city only is sufficient) of the principals.

86 Ill. Admin. Code § 130.1915 (2000).

Indeed, ABC Corporation never claimed to have been acting as XXX Network's agent, at hearing or in its briefs. *See* Taxpayer's Brief.

The problem with ABC Corporation's argument that it did not sell most of the equipment it purchased from XYZ to customers, and that XXX Network, instead, leased that equipment to customers, is that the evidence offered at hearing was clear that ABC Corporation purchased the equipment described on Taxpayer Exhibit 1 from XYZ, and paid XYZ for the equipment. Taxpayer Ex. 1; Tr. pp. 12-13 (Mr. Jones). Ordinarily, when one person purchases tangible personal property from another, pays for the property, and then takes receipt of that property, a reasonable onlooker would conclude that there has been a transfer of ownership of, and title to, the property purchased. *See, e.g., Sprague v. Johnson*, 195 Ill. App. 3d 798, 801-02, 552 N.E.2d 436, 438 (4th Dist. 1990) (discussing the UCC's title-passing provision, § 2-401(2) in the context of middle-men); 810 ILCS 5/2-401.

If ABC Corporation was not purchasing at least *some* of the equipment ABC Corporation purchased from XYZ on XXX Network's behalf, it is unclear how XXX Network, ABC Corporation and XYZ can all claim that XXX Network subsequently leased some of the equipment ABC Corporation bought from XYZ. What gives XXX Network the right to lease equipment ABC Corporation presumably owned, after it purchased such equipment from XYZ? To be sure, a contract might create such rights, but no such contract was offered or admitted into evidence.

Nor does the writing on XXX Network's letterhead, Taxpayer Exhibit 3, provide a substitute to the retailer's agreement when it comes to proving that XXX Network owned and leased any specific amount of equipment ABC Corporation purchased from XYZ. The last paragraph of that letter exemplifies what I mean:

DISH remits use taxes on the equipment it leases to its subscribers when it places the equipment in service, but it is not responsible for any other equipment that the retailer may sell or lease to the subscriber in conjunction with or separate from its sale of DISH service. Any tax on items that the retailer leases or sells that are not owned by or sold directly by DISH are the responsibility of the retailer.

Taxpayer Ex. 3.

Taxpayer Exhibit 3 distinguishes between XXX Network's lease of equipment to customers, and ABC Corporation's sales of equipment to customers for use or consumption. XXX Network's letter thus implies its ability to distinguish between the equipment that was its to lease, and the equipment that was ABC Corporation's to sell. But there must be some evidence — other than the ipse dixit contained in Taxpayer Exhibit 3 — to support ABC Corporation's mere claim that XXX Network owned and leased property that this record shows ABC Corporation purchased from XYZ. *See* Taxpayer Exs. 1, 4-6; Tr. pp. 12-13 (Mr. Jones). Again, it might well be true that ABC Corporation purchased equipment from XYZ on XXX Network's behalf, that is, for XXX Network. But in the absence of a writing expressly articulating such an agreement, Illinois law presumes that, upon completion of XYZ's delivery of equipment to ABC Corporation, title to that equipment passed to ABC Corporation, the purchaser who paid for it. 810 ILCS 5/2-401(2); Sprague, 195 Ill. App. 3d at 801-02, 552 N.E.2d at 438. Without benefit of the retailer's agreement between XXX Network and ABC Corporation, Taxpayer Exhibit 3 is not sufficient to rebut the presumptive correctness of the Department's determination that ABC Corporation's purchases of equipment from XYZ were purchases of property for resale at retail.

In its brief, ABC Corporation argues that it rebutted the Department's prima facie case with competent evidence, including the testimony of a third party, and third party records.

Taxpayer's Brief, p. 9. It cites for this proposition Goldfarb v. Department of Revenue, 411 Ill. 573, 104 N.E.2d 606 (1952), Miller v. Department of Revenue, 408 Ill. 574, 97 N.E.2d 788 (1951), and Novicki v. Department of Finance, 373 Ill. 342, 26 N.E.2d 130 (1940). Taxpayer's Brief, p. 9.

In Goldfarb, the Court summarized the facts in the following way: "The taxpayer [after a request by Department auditors] thereupon turned over all his records to them, consisting of his cash receipts and sales books, bank deposit books, disbursement records, retailer occupation tax returns, accounts receivable ledger, cancelled checks, bank's statements, income tax returns, purchase invoices, and general ledger. According to the testimony of the auditors, they ignored all the taxpayer's records except his purchase invoices and the inventories as shown on his income tax reports, and proceeded to make their audit from these latter records alone and the oral statements made to them by the taxpayer." Goldfarb, 411 Ill. at 575-76, 104 N.E.2d at 607. In Miller, the Department, at hearing, "conceded that the record of daily sales kept by [Miller] was sufficient, as to form, to meet the requirements of the Department, and that extensive records pertaining to the operations of the business were kept and made available to the Department's auditor." Miller, 408 Ill. at 578-79, 97 N.E.2d at 791. And finally, in Noviki, the taxpayer offered into evidence, "a book showing daily receipts and disbursements from July 1, 1933, to December 31, 1935, and another book with a like showing for the remainder of the period. He testified the entries were made by him daily, that they were true and correct, and that he kept no other books." Novicki, 373 Ill. at 343, 345-46, 26 N.E.2d at 131.

Here, in contrast, ABC Corporation does not have books and records which show the source and amounts of *any* of its receipts. And by that I mean, it does not have books and records which "provide a daily record of the gross amount of sales." 86 Ill. Admin. Code §

130.805(a). The evidence in this case, therefore, is not like the evidence presented by the taxpayers in Goldfarb, Miller and Noviki. Each of the taxpayers in those cases kept a record of its daily sales — ABC Corporation has no such records. *See* Taxpayer’s Brief, p. 7 (in the facts section of its brief, ABC Corporation concedes that “[t]he Department did not receive sales invoices because ABC Corporation had none.”). All of the regularly kept books and records that were admitted into evidence were records showing ABC Corporation’s purchases from XYZ, and some of its other payments to XYZ. Taxpayer Exs. 1, 4-6. But those purchase records do not identify the amount of receipts ABC Corporation realized from the business activities it engaged in with such equipment purchases.

Nor do the general statements contained in Taxpayer Exhibits 2 and 3 constitute competent evidence of the amount of receipts — whether taxable or not — that ABC Corporation realized from making any types of sales during the audit period. For example, Taxpayer Exhibit 2 provides that 60% of ABC Corporation’s Illinois XXX Network sales involved ABC Corporation’s sale of equipment to customers. Taxpayer Ex. 2. But no documents were admitted which identify the total amount of gross receipts that ABC Corporation realized from its Illinois XXX Network sales. Nor does the record include documentary evidence sufficient to corroborate ABC Corporation’s written assertion that 40% of the unknown amount of gross receipts from its Illinois XXX Network sales during 2003 was derived from selling services, only, to customers. *Id.* And, of course, nothing within Taxpayer Exhibit 3 even touches upon the receipts ABC Corporation realized during the audit period from selling equipment and services related to AAA Company. *See* Taxpayer Ex. 2, p. 2. In sum, Taxpayer cannot even document the amount of its daily sales during the audit period, let alone how much of those receipts might not be subject to ROT.

Next, Taxpayer claims that the Department's audit methods were arbitrary and unreasonable. Taxpayer's Brief, p. 11. I cannot agree. There is no dispute that ABC Corporation filed returns throughout the audit period. Department Ex. 4 (reflecting amounts of receipts reported on Taxpayer's filed returns during the audit period); Taxpayer Ex. 2, p. 1 (identifying first periods for which ABC Corporation filed Illinois sales tax returns); Tr. p. 56 (John Doe). Nor is there any dispute that ABC Corporation made taxable sales of equipment it sold to customers at retail, for which ABC Corporation collected tax from customers, and which sales it reported on the returns it filed during the audit period. Tr. pp. 56, 59 (John Doe); *see also* Taxpayer Exs. 2-3. When the Department conducted an audit of Taxpayer for periods for which ABC Corporation filed returns, ABC Corporation was unable to produce the books and records required to be kept by persons engaged in the occupations of making retail sales, or of being a serviceman. 35 ILCS 120/7; 35 ILCS 115/12; Department Ex. 1, pp. 4-6.

The Department, thereafter, used a mark-up method to estimate receipts that were subject to ROT. Department Ex. 1, pp. 4-6. That method has often been used to estimate what a given taxpayer might expect to realize by selling the goods it purchases for resale at retail. *See, e.g. Mel-Park Drugs, Inc.*, 218 Ill. App. 3d at 216, 577 N.E.2d at 1286 (citing cases in which the Department estimated a taxpayer's gross receipts using a mark-up method). This general method of estimating sales receipts has long been used by the Department, and has been repeatedly upheld. *Mel-Park Drugs, Inc.*, 218 Ill. App. 3d at 216, 577 N.E.2d at 1286.

ABC Corporation's real argument, I suspect, is not with the Department's audit methods, but with the Department's ultimate audit conclusion that ABC Corporation had not supported its claim that most of the receipts it realized during the audit period were derived from its sales of services, only. Under the circumstances, however, that ultimate conclusion is also reasonable.

The Illinois General Assembly has assigned to taxpayers the statutory burden of showing that certain receipts were not subject to either ROT or SOT. 35 ILCS 120/7; 35 ILCS 115/12. It may well be true that ABC Corporation realized considerable receipts from selling services, only, to customers. But it has failed to offer documentary evidence which clearly shows the specific amounts of such receipts, and the non-taxable nature of the transactions that gave rise to such receipts. Similarly, it may well be true that ABC Corporation had entered into a written agreement with XXX Network and XYZ which provided that some or all of the digital television equipment ABC Corporation obtained from XYZ, and paid for, did not actually belong to ABC Corporation. But no such writing was admitted as evidence at hearing, and Illinois law presumes that ABC Corporation owned the equipment it purchased from XYZ, once XYZ delivered physical possession of such goods to ABC Corporation. 810 ILCS 5/2-401(2); Sprague, 195 Ill. App. 3d at 801-02, 552 N.E.2d at 438.

Conclusion:

I recommend that the Director finalize the NTLs as issued, with penalties and interest to accrue pursuant to statute.

March 24, 2011

John E. White

Administrative Law Judge