

ST 08-9

Tax Type: Sales Tax

Issue: Responsible Corporate Officer – Failure to File or Pay Tax

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

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

v.

JOHN DOE

Taxpayer

**Docket # 06-ST-0000
IBT # 0000-0000
NPL # 0000-000-00-0
NPL # 0000-000-00-0
NOD # 0000-000-00-0
NPL # 0000-000-00-0
NPL # 0000-000-00-0
NOD # 0000-000-00-0**

RECOMMENDATION FOR DISPOSITION

Appearances: Kent Steinkamp, Special Assistant Attorney General, for the Department of Revenue of the State of Illinois; Jim R. Reid of Reid Law Office for John Doe

Synopsis:

The Department of Revenue (“Department”) issued Notices of Penalty Liability (“NPLs”) and Notices of Deficiency (“NODs”) to John Doe (“taxpayer” or “Doe”) pursuant to section 3-7 of the Uniform Penalty and Interest Act (“UPIA”) (35 ILCS 735/3-7) and section 1002(d) of the Income Tax Act (35 ILCS 5/1002(d)). The NPLs and NODs allege that the taxpayer was an officer or employee of ABC, LLC f/k/a ABC Food Services, LLC (“corporation”) who was responsible for willfully failing to pay the corporation's retailers' occupation taxes (“ROT”) and Illinois income withholding taxes for various months from April 2004 through July 2006. The taxpayer timely protested

the NPLs and NODs, and an evidentiary hearing was held. After reviewing the record, it is recommended that a portion of the liability be dismissed and the remaining amount be affirmed.

Findings of Fact:

1. The corporation was in the business of operating various franchises of XYZ's International, Inc. under the franchise name of "XYZ's Inc.." (Dept. Ex. #2, pp. 2, 4)
2. The taxpayer owned a 20% interest in the corporation. Joe Blow ("Blow") owned a 70% interest, and Blow's son Jim ("Jim") owned 10%. The taxpayer's initial investment in the corporation was \$100,000. (Dept. Ex. #2 p. 3, Ex. #4; Tr. pp. 41, 49)
3. The taxpayer was the president of the corporation through July 2005. (Dept. Ex. #2; Resp. Ex. #32; Tr. p. 10)
4. Through July 31, 2005, the taxpayer oversaw the daily operations of the restaurants and the clerical staff in the office. (Dept. Ex. #2, p. 4; Ex. #4, p. 1; Tr. pp. 12-13)
5. The clerical staff who reported to the taxpayer while he was president included the controller, accounts payable person, payroll person, and accounting clerk. (Tr. p. 15)
6. The taxpayer attended most of the corporate business meetings that were held during 2004 and 2005. (Dept. Ex. #2, p. 6)
7. The corporation had two disbursement accounts during the times in question: one at U.S. Bank and the other at First Bank. (Dept. Ex. #2, p. 4)
8. The taxpayer had signature authority on the First Bank account. (Dept. Ex. #2, p. 5; Tr. p. 20)
9. The taxpayer spoke with Blow almost daily to discuss the bills that were owed and which creditors would be paid. Each morning Jane Doe ("Jane Doe"), who

was the corporation's controller at the time, emailed to Blow and Doe a list of expenses that needed to be paid on that day, week, or within the next few weeks. Doe would then call Blow to go over the expenses. Blow was usually available for disbursement discussions by cellular telephone or electronic mail. If Blow did not answer the call, sometimes Blow's assistant, Ms. Smith, would return the call. (Dept. Ex. #2, p. 7; Tr. pp. 17-18, 24)

10. When Blow was unavailable, the taxpayer approved payments to vendors, utility providers, attorneys and other creditors when the payments were necessary to keep the restaurants operating. The taxpayer approved payments when Blow could not be found and/or when he failed to respond to requests from the accounts payable clerk for authorization of payments. (Dept. Ex. #2, p. 7, Ex. #4, p. 2, #12, 13; Tr. p. 78)
11. The taxpayer was generally aware that various expenses were not being paid during the term of his employment, and he was aware that the Department was not being paid. (Dept. Ex. #2, pp. 7-8, Ex. #4, p. 2, #15; Tr. p. 21)
12. On December 20, 2004, Blow sent an email to Jane Doe and asked her to confirm that all future deposits at U.S. Bank were under his direct control. Jane Doe responded, with a copy to Doe, stating that certain commitments that week would not clear without the funds from that account. One of the commitments was to the Department for sales taxes for \$29,558. Blow responded by stating he would not write checks until the outstanding checks cleared. (Resp. Ex. #22)¹
13. On December 21, 2004, Blow sent an email to Jane Doe stating he was shocked that \$70,000 of checks were cut out of the U.S. Bank account. He stated that all authority was revoked and all control was vested in him over the U.S. Bank

¹ Taxpayer's exhibit #8 is the same as his exhibit #23, and both are included in exhibit #22. Exhibit #16 is also included in #22. Other duplicate exhibits include the following: #9 is the same as #17, #6 is the same as #20, #7 is the same as #21, #11 is the same as #29, #10 is the same as #30, and #12 is the same as #31.

account. Jane Doe responded, with a copy to Doe, stating “This was the account that we talked about using as the ‘Paid out’ account. Both you and John Doe [taxpayer] signed the signature card. John Doe is aware of everything that was paid from this account. I have called XXXX and told her the account is ‘under your control’.” (Resp. Ex. #9)

14. On January 5, 2005, Doe responded to an email from Jane Doe that was also sent to Blow, and Jim. Jane Doe’s email listed expenses, and Doe’s response stated the amount being deposited in the corporation’s accounts was not enough to cover expenses. He referred to expenses that needed to be paid and stated, “We also need to send ILL the \$100k we committed to do. In return, they’ll postpone the proceedings until February.” (Resp. Ex. #25; Tr. pp. 26-27)
15. On January 7, 2005, Doe sent an email to Blow and Jim stating he needed their help with cash because the corporation did not have the funds to pay a number of its expenses. The email lists some of the expenses, and Doe stated he expected at least a \$55k shortfall each week. (Resp. Ex. #19)
16. On January 13, 2005, the Department issued NPL number 2005-011-11-N to the taxpayer that proposed a total penalty liability of \$836,427.70, including tax, interest, and penalty, for failure to pay ROT for the following months: April 2004 through October 2004. (Dept. Ex. #1).
17. On January 18, 2005, Doe sent an email to Blow, Jane Doe, and Jim with the subject “Tax Accounts.” The email stated “If taxes are going to be paid out of the Lemay account we need to get together so everyone knows what needs to be paid and when.” On January 25, 2005, Jane Doe forwarded the email to Ms. Smith, with a copy to Doe, stating she did not see a check for sales taxes on the list of checks that were signed. On January 25, 2005, Doe responded to the email, with a copy to Blow, stating “We need to meet immediately in order to ensure that

these tax payments are given priority. Are you available tomorrow?” (Resp. Ex. #26; Tr. p. 14)

18. On February 2, 2005, Doe sent an email to the accounts payable clerk with a copy to Jane Doe. The subject was “Illinois Department of Revenue,” and the email stated “Cut 20 \$5,000 checks made payable to Illinois Department of Revenue.” Jane Doe responded by asking “how are these going to clear?” (Resp. Ex. #27; Tr. pp. 27-28)
19. On February 23, 2005, Jane Doe sent an email to Doe regarding bank statements. In the email she stated “Starting in February, all of the stores at U.S. Bank are depositing in to the ABC Management² account at U.S. Bank. I do not have access to this account.” (Resp. Ex. #28)
20. On March 2, 2005, Jane Doe sent an email to Doe, Blow, and Jim, the subject of which was “IL Dept of Rev.” In it she stated “I want to remind all of you that we do not have the funds to cover any of the \$100,000 checks that were sent to IL DOR.” Blow responded by stating he told Doe to put funds in the account to cover it. (Resp. Ex. #11)
21. On March 3, 2005, Doe sent an email to Blow, Jane Doe, and Jim, the subject of which was “Ill. Dept. of Revenue,” and in it he stated “There seems to be some miscommunication. I wasn’t told to segregate \$50k a day to cover these checks. Even if I had been told, there isn’t \$50k available to do it. We need to discuss, ASAP as these checks will probably be presented today.” (Resp. Ex. #12)
22. On July 31, 2005, Doe left the employment of the corporation. (Dept. Ex. #2; Resp. Ex. #32; Tr. p. 10)

² ABC Management, LLC was owned and managed by Blow. It is a separate company from ABC Food Services, LLC, which was the previous name of ABC, LLC. Doe never owned any interest in ABC Management, LLC. (Dept. Ex. #4, p. 4)

23. On October 4, 2005, the Department issued NPL number 0000-000-00-0 to the taxpayer that proposed a total penalty liability of \$579,534.87, including tax, interest, and penalty, for failure to pay ROT for the following months: November 2004 through June 2005. (Dept. Ex. #1).
24. On October 4, 2005, the Department issued NOD number 0000-000-00-0 to the taxpayer that proposed a total penalty liability of \$77,528.04, including tax, interest, and penalty, for failure to pay withholding taxes for the second and third quarters of 2004. (Dept. Ex. #1).
25. On May 12, 2006, the Department issued NPL number 0000-000-00-0 to the taxpayer that proposed a total penalty liability of \$275,268.76, including tax, interest, and penalty, for failure to pay ROT for the following months: July 2005, August 2005, November 2005, January 2006, and February 2006. (Dept. Ex. #1).
26. On December 22, 2006, the Department issued NPL number 0000-000-00-0 to the taxpayer that proposed a total penalty liability of \$518,935.41, including tax, interest, and penalty, for failure to pay ROT for the following months: May 2005, March 2006 through July 2006. (Dept. Ex. #1).
27. On December 22, 2006, the Department issued NOD number 0000-000-00-0 to the taxpayer that proposed a total penalty liability of \$34,445.26, including tax, interest, and penalty, for failure to pay withholding taxes for the first and second quarters of 2006.
28. All the NPLs and NODs were admitted into evidence under the certificate of the Director of the Department. (Dept. Ex. #1).

Conclusions of Law:

Section 1002(d) of the Income Tax Act provides as follows:

Willful failure to collect and pay over tax. Any person required to collect, truthfully account for, and pay over the tax imposed by this Act who willfully fails to collect such tax or truthfully account for and pay over such tax or willfully attempts in any manner to evade or defeat the tax or

the payment thereof, shall, in addition to other penalties provided by law, be liable for the penalty imposed by Section 3-7 of the Uniform Penalty and Interest Act. 35 ILCS 5/1002(d).

Section 3-7 of the Uniform Penalty and Interest Act provides in part as follows:

Any officer or employee of any taxpayer subject to the provisions of a tax Act administered by the Department who has the control, supervision or responsibility of filing returns and making payment of the amount of any trust tax imposed in accordance with that Act and who wilfully fails to file the return or make the payment to the Department or wilfully 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 taxpayer including interest and penalties thereon; 35 ILCS 735/3-7(a).

An officer or employee of a corporation may therefore be personally liable for the corporation's taxes if (1) the individual had the control, supervision or responsibility of filing the returns and paying the taxes, and (2) the individual willfully failed to perform these duties.

Under section 3-7, the Department's certified record relating to the penalty liability constitutes *prima facie* proof of the correctness of the penalty due.³ See Branson v. Department of Revenue, 168 Ill. 2d 247, 260 (1995). Once the Department presents its *prima facie* case, the burden shifts to the taxpayer to establish that one or more of the elements of the penalty are lacking, i.e., that the person charged was not a responsible corporate officer or employee, or that the person's actions were not willful. *Id.* at 261. In order to overcome the Department's *prima facie* case, the allegedly responsible person must present more than his or her testimony denying the accuracy of the Department's assessment. See Sprague v. Johnson, 195 Ill. App. 3d 798, 804 (4th Dist. 1990); Elkay Manufacturing Company v. Sweet, 202 Ill. App. 3d 466, 472 (1st Dist. 1990); A. R.

³ The relevant portion of section 3-7 provides as follows: "The Department shall determine a penalty due under this Section according to its best judgment and information, and that determination shall be prima facie correct and shall be prima facie evidence of a penalty due under this Section. Proof of that determination by the Department shall be made at any hearing before it or in any legal proceeding by reproduced copy or computer printout of the Department's record relating thereto in the name of the Department under the certificate of the Director of Revenue. * * * That 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 or penalty due." 35 ILCS 735/3-7(a).

Barnes & Co. v. Department of Revenue, 173 Ill. App. 3d 826, 833-34 (1st Dist. 1988); Vitale v. Department of Revenue, 118 Ill. App. 3d 210, 213 (3rd Dist. 1983). The person must present evidence that is consistent, probable, and identified with the respondent's books and records to support the claim. *Id.*

In the present case, the Department's *prima facie* case was established when the Department's certified record relating to the penalty liabilities was admitted into evidence. In response, Doe contends that Blow was the managing member and CEO of the corporation, and Blow controlled the company. According to Doe, Blow made all the disbursement decisions, and Doe had to contact Blow almost daily to ask him which creditors should be paid because there was not enough money in the bank account to pay the expenses. Doe testified that during the middle of 2003, Blow began having some of the restaurants deposit their daily receipts into an account that was solely controlled by Blow. By 2005, approximately 19 of their 42 restaurants were depositing their receipts into that account, including five of the highest volume restaurants. (Tr. pp. 16-19) This left less money available to pay the corporation's bills. Doe stated that Blow used much of the corporation's income for his personal expenses, and the amount of money Blow took out of the business "was always the problem." (Tr. p. 22) Doe claims that he only signed checks that Blow told him to sign, and if he wrote a check without Blow's approval, Blow would stop payment on it.

For guidance in determining whether a person is responsible under section 3-7 the Illinois Supreme Court has referred to cases interpreting section 6672 of the Internal Revenue Code (26 U.S.C. §6672).⁴ See Branson, at 254-56; Department of Revenue v. Heartland Investments, Inc., 106 Ill. 2d 19, 29-30 (1985). These cases state that the critical factor in determining responsibility is whether the person had significant control

⁴ This section imposes personal liability on corporate officers who willfully fail to collect, account for, or pay over employees' social security and Federal income withholding taxes.

over the corporation's finances.⁵ See Purdy Co. of Illinois v. United States, 814 F. 2d 1183, 1186 (7th Cir. 1987). Significant control does not mean having exclusive or absolute control over the disbursement of funds or having the final say over whether taxes or bills are paid. Thomas v. U.S., 41 F. 3d 1109, 1113 (7th Cir. 1994). The concept of responsibility focuses on whether the person could have impeded the flow of business to the extent necessary to prevent the corporation from squandering the taxes. *Id.* More than one person can be a responsible person under this penalty provision. *Id.* Responsibility is generally found in high corporate officials who have control over the corporation's business affairs and who participate in decisions concerning the payment of creditors and the dispersal of funds. Monday v. United States, 421 F. 2d 1210, 1214-1215 (7th Cir. 1970), cert. den. 400 U.S. 821.

The evidence in this case supports a finding that Doe was a responsible person under section 3-7. He made an initial investment of \$100,000 and had a 20% ownership interest in the corporation. He was also the president of the corporation until he left in July 2005. Although he testified that Blow solely controlled the company, Doe was active in the day-to-day management of the company. He oversaw the daily operations of the restaurants and the clerical staff, which included the controller and accounts payable clerk. Doe testified that near the end of 2004 and into 2005, Blow rarely visited the office, and Doe communicated with him by phone or email. Doe also attended most of the corporate business meetings that were held during 2004 and 2005.

In addition, Doe had signature authority on at least one of the two disbursement accounts. He admitted that pursuant to bank records, he had authority to sign checks from the First Bank account. Although he testified that this was the only account for which he had signature authority, the email sent by Jane Doe on December 21, 2004 to

⁵ Other indicia of responsibility include the following: (1) holding corporate office; (2) owning stock in the company; (3) serving on the board of directors; and (4) possessing authority to sign checks. U. S. v. Kim, 111 F. 3d 1351, 1362-63 (7th Cir. 1997).

Blow, with a copy to Doe, stated that Doe signed the signature card for the U.S. Bank account. Nothing indicates Doe did not remain an authorized signatory while he was working for the corporation.

Furthermore, Doe spoke with Blow almost daily to discuss the bills that were owed and which creditors would be paid. Doe testified that because the corporation did not have sufficient funds to cover expenses, each morning Jane Doe emailed a list of expenses that needed to be paid to Blow and Doe. Doe would then call Blow and ask him what to do because someone was not going to be paid.

In Thomas, *supra*, the court declined to hold that the penalty would be precluded if the taxpayer presented evidence that his check-writing authority was limited by a superior. Thomas, at 1115. The court stated that signing checks only at the direction of one's superior does not automatically make one a responsible person. *Id.* Nevertheless, writing checks to creditors in preference to the government at the direction of a superior does not allow a taxpayer to avoid the penalty. *Id.* The court noted in Thomas that the taxpayer eventually quit, but he departed only after he had seen on a weekly basis for three months that his superior would not pay the withholding taxes. Thomas, at 1116. The court noted the taxpayer simply waited too long to quit to shield himself from liability as a matter of law. *Id.*

In the present case, Doe cannot avoid liability by claiming he wrote checks only at the direction of Blow. The corporation's cash shortfalls apparently began in 2003, when Blow started putting some of the restaurant deposits into a personal account. (Tr. pp. 16-17) Instead of paying the subsequent ROT and income withholding taxes, the corporation applied its funds to pay its operating expenses. Doe was aware of the failure to pay the Department the taxes that were owed. While Doe was still working for the corporation, he received the first NPL that was issued to him in January 2005. Doe could have impeded the functioning of the corporation by refusing to sign checks and refusing

to let the corporation continue to operate until the corporation paid the taxes it had collected from its customers and withheld from the wages of its employees.

Although Doe contends that Blow would stop payment on a check that was written without Blow's approval, the only time that Doe testified this actually happened was the week before he left the corporation.⁶ (Tr. pp. 20-21) Doe did not provide evidence substantiating that Blow previously or regularly stopped payment on checks that were written without his authorization, and Doe has not established that Blow actually prevented him from exercising his authority to sign checks. He also has not shown that the accounts payable clerk refused to draw checks except at Blow's direction, or that the bank refused to honor checks with only Doe's signature.

Moreover, Doe actually wrote checks without Blow's authority when Blow was unavailable. He admitted that he would sign checks to keep the business operating. Doe testified that one time he and Jane Doe allowed restaurants to shut down because the utilities had not been paid, and they could not contact Blow. After that happened, Blow told Doe that if he ever allowed a restaurant to close again by not paying the utility bill, Blow was going to fire people. (Tr. pp. 24-25) At that point, Doe made sure the utilities were paid to avoid closing a restaurant.

Doe bears the burden of proving his lack of responsibility, and he has failed to meet that burden. The evidence supports a finding that Doe was a responsible officer who had significant control and authority over the corporation's finances even though he did not always exercise that authority. Blow may have been a difficult person to work with, but this does not allow Doe to escape responsibility. As the court stated in Thomas, *supra*, the evidence does not indicate a lack of responsibility; rather, it highlights a lack of reasonable diligence with respect to his duties for the corporation. *Id.*

⁶ Doe testified that prior to leaving for a one-week vacation, he received authority from Blow to write a check to the IRS and another check for a royalty payment to XYZ's. While Doe was gone, Blow stopped payment on the checks. When Doe returned and was told what Blow had done, Doe quit working for the corporation. (Tr. pp. 20-21, 37-38)

The evidence also supports a finding that Doe's failure to pay the taxes was willful. Cases define "willful" as involving intentional, knowing and voluntary acts or, alternatively, reckless disregard for obvious known risks. See Branson at 254-56; Heartland at 29-30. Willful conduct does not require bad purpose or intent to defraud the government. Branson at 255; Heartland at 30. Willfulness may be established by showing that the responsible person (1) clearly ought to have known that (2) there was a grave risk that the taxes were not being paid and (3) the person was in a position to find out for certain very easily. Wright v. United States, 809 F. 2d 425, 427 (7th Cir. 1987). Furthermore, whether the person in question willfully failed to pay the taxes is an issue of fact to be determined on the basis of the evidence in each particular case. Heartland at 30; Department of Revenue v. Joseph Bublick & Sons, Inc., 68 Ill. 2d 568, 577 (1977). Courts have found that giving preferential treatment to other creditors rather than paying the corporation's taxes constitutes willful behavior. See Heartland at 29-30.

Doe has again failed to meet his burden of proving his lack of willfulness. He said the corporation "never had sufficient funds to cover the expenses that we incurred," so he contacted Blow almost daily to ask him what to do because someone was not going to be paid. (Tr. p. 17) He knew the corporation was not timely paying its bills, and he was aware the Department was not being paid. (Tr. p. 21) Doe received his first NPL while he was still working for the corporation. Although he was aware of the unpaid tax liabilities, he allowed other creditors to be paid instead of the Department. He admitted that when Blow was unavailable, Doe approved payments to vendors, utility providers, and attorneys when the payments were necessary to keep the restaurants operating. Other creditors were preferred over the Department. Although Doe claims Blow would have stopped payment on the check if he had tried to pay the Department, Doe did not provide evidence to substantiate this. Doe referred to two checks for which Blow stopped payment after Blow had authorized Doe to write the checks (Tr. p. 34), but these two checks may have been the ones that caused Doe to quit. Without substantiating evidence

that Blow stopped payment on checks sent to the Department, it cannot be found that Doe did not willfully fail to pay the taxes.

Nevertheless, the evidence supports a finding that Doe left the employment of the corporation effective July 31, 2005. Because he resigned on that date, he has successfully rebutted the presumption of responsibility and willfulness for the assessments that became due after July 31, 2005. The portions of the NPLs and NODs that include assessments that became due after July 31, 2005 must be dismissed.

Recommendation

For the foregoing reasons, it is recommended that the Notices of Penalty Liability and Notice of Deficiency that include assessments that became due before July 31, 2005 be upheld. It is recommended that NOD number 0000-000-00-0 be dismissed because it covers withholding taxes for the first and second quarters of 2006. It is also recommended that the portion of NPL number 0000-000-00-0 that covers March 2006 through July 2006 be dismissed, and the portion of NPL number 0000-000-00-0 that covers August 2005, November 2005, January 2006, and February 2006 be dismissed.⁷

Linda Olivero
Administrative Law Judge

Enter: June 11, 2008

⁷ The portion of NPL number 0000-000-00-0 that covers July 2005 should be upheld because the corporation was required to make quarter monthly payments for that liability in July 2005 pursuant to 35 ILCS 120/3.