ILLINOIS INDEPENDENT
TAX TRIBUNAL

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| MCGRATH IMPORTS, INC., | ) | |
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| Petitioner, | ) | |
| v. | ) | No. 16 TT 133 |
| | ) | Judge Brian F. Barov |
| | ) | |
| ILLINOIS DEPARTMENT OF REVENUE, | ) | |
| | ) | |
| | ) | |
| Respondent. | ) | |

DEPARTMENT'S ANSWER TO PETITION

Respondent, the Illinois Department of Revenue (the "Department"), by and through its attorney, Lisa Madigan, Illinois Attorney General, for its Answer to the Petition (the "Petition"), hereby states as follows:

STATEMENT OF JURISDICTION

1. McGrath brings this petition pursuant to the Illinois Independent Tax Tribunal Act of 2012. 35 ILCS 1010 et seq.

ANSWER: The Department admits the allegations contained in paragraph 1.

2. This Tribunal has jurisdiction because this matter involves two Notices of Tax Liability issued by the Department on May 9, 2016 with respect to tax alleged to be due

in each Notice of Tax Liability in excess of $15,000, exclusive of interest. 35 ILCS 1010/1-45.

ANSWER: The Department admits the allegations contained in paragraph 2.

## INTRODUCTION

3. Petitioner owns and operates two auto dealers franchises under the names Audi Morton Grove and McGrath Acura of Morton Grove. Its operations include the sale of new and used vehicles, retail parts, and a service department. As explained in detail below, Petitioner was audited by the Illinois Department of Revenue and disputes multiple findings contained in the Notices of Tax Liability (described below) that were issued upon conclusion of the Department's audit (the "Audit"). In support of its position, Petitioner will provide information that was either not readily available at the time of the audit or was misinterpreted by the Audit Division.

ANSWER: The Department admits that Petitioner owns and operates two auto dealer franchises and that its operations include the sale of new and used vehicles, parts and service but denies that it misinterpreted any information taxpayer provided in the course of its audit. Otherwise, the remaining allegation concerning Petitioner's intention to provide information is not a material allegations of fact and as such does not require an answer pursuant to Tribunal Rule 86 Ill.Adm.Code §5000.310(b).

## BACKGROUND, PROCEDURAL HISTORY AND RELEVANT FACTS

4. Petitioner is an Illinois corporation, whose corporate address is 9105 Waukegan Road, Morton Grove, IL 60053. Petitioner's Taxpayer ID number is 1864-7898. Petitioner's telephone number is (847) 470-2300.

ANSWER: The Department admits the allegations contained in paragraph 4.

5. On May 9, 2016, the Department issued to McGrath a statutory Notice of Tax Liability, Letter ID: CNXXXXX566421923, for Form EDA-556, Sales Tax Transaction Audit Report, in the amount of $1,092,338.66 for the reporting period of October 1, 2006 through June 30, 2009 (the "Amnesty Period Assessment"). A copy of this assessment is attached as Exhibit A.

ANSWER: The Department admits the existence, force and effect, at all relevant times of the document attached to the Petition as Exhibit A and referred to in Paragraph 5 and state that such document speaks for itself.

6. The Amnesty Period Assessment was comprised of $559,063.00 in Tax; $223,625.00 in Late Payment Penalty; and $309,650.66 in Interest.

ANSWER: The Department admits the existence, force and effect, at all relevant times of the document attached to the Petition as Exhibit A and referred to in Paragraph 6 and state that such document speaks for itself.

7. On May 9, 2016, the Department also issued to McGrath a second statutory Notice of Tax Liability, Letter ID: CNXXX1856X626X80, for Form EDA-556, Sales Tax Transaction Audit Report in the amount of $333,203.92 for the reporting period of July 1, 2009 through December 31, 2010 (the "Post-Amnesty Period Assessment"). A copy of this assessment is attached as Exhibit B.

ANSWER: The Department admits the existence, force and effect, at all relevant times of the document attached to the Petition as Exhibit B and referred to in Paragraph 7 and state that such document speaks for itself.

8. The Post-Amnesty Period Assessment was comprised of $244,047.00 in Tax; $48,810.00 in Late Payment Penalty; and $40,346.92 in Interest.

ANSWER: The Department admits the existence, force and effect, at all relevant times of the document attached to the Petition as Exhibit B and referred to in Paragraph 8 and state that such document speaks for itself.

9. The Amnesty Period Assessment and the Post-Amnesty Period Assessment shall be referred to collectively herein as the "Assessment."

ANSWER: The Department admits the allegations contained in paragraph 9.

10. Petitioner disputes numerous aspects of the alleged taxable portion of the Assessment based on items erroneously included (both factually and legally) on the respective Global Taxable Exceptions Reports as taxable items. In addition, Petitioner disputes the applicability of the double penalty and double interest imposed in the Amnesty Period Assessment as more fully explained below.

ANSWER: Paragraph 10 is not a material allegation of fact but a recitation of the alleged error's in the Department's Notices of Tax Liability and as such do not require an answer pursuant to Tribunal Rule 86 Ill.Adm.Code §5000.310(b). To the extent an answer is required, the Department denies the allegations as legal conclusions not material allegations of fact.

11. Petitioner timely petitioned the Informal Conference Board ("ICB"), a Hearing was held with the Conferees, and on March 22, 2016, ICB issued an Action Decision granting in part and denying in part, Petitioner's request for Audit Adjustments (the "Action Decision"). The Action Decision however lacked specificity and merely provided, "Audit is to finalize this case using the figures as revised during the Informal Conference Board

process." Further, "The Audit Bureau is instructed to conclude and process the audit in a manner consistent with this decision."

ANSWER: The Department admits that Petitioner filed a timely petition with the ICB and further admits the existence, force and effect, at all relevant times of the Action Decision referred to in Paragraph 11 and state that such document speaks for itself. The Department is prohibited from admitting or denying the remaining allegations of Paragraph 11 as they pertain to actions taken and/or matters before the ICB, which matters and/or actions are confidential. See 86 Ill.Adm.Code § 215.120(e).

12. Taxpayer never received a copy of the ICB's aforementioned instructions to the Audit Bureau, and thus has only been able to surmise such changes to the Department's Audit Report.

ANSWER: Paragraph 12 is not a material allegation of fact and as such does not require an answer pursuant to Tribunal Rule 86 Ill.Adm.Code §5000.310(b).

ERROR 1 IMPROPER SAMPLING METHOD OF TRADE-INS

13. The Department did not employ a proper sampling methodology with respect to traded-in vehicles and thus, this sampling cannot be entitled to any presumption of correctness. The auditor used a methodology of reviewing the "top 200 deals" for Honda lease trade-ins (associated with the Acura dealership), top 200 VW lease trade-ins (associated with the Audi dealership) and top 200 non-lease trade-ins spanning both dealerships. The "top 200" referred to the 200 deals with the *largest* trade-in deductions for each respective population.

ANSWER: The Department admits that it used a “top 200” sampling methodology but otherwise denies such methodology was not proper as a legal conclusion and not a material allegation of fact.

14. Unlike statistical sampling (for which the representativeness of the sample can be calculated) or block sampling (where the selected period presumably contains a representative array of transactions that are similar to the transactions in the other reporting periods within the audit period), the "top 200" methodology does *not* and cannot provide any assurance that the transactions sampled were *representative* of the entire population. In fact, it is *more likely* that this *sample will not be representative* of the entire population because the deals with higher trade-ins are a larger dollar amount of proposed errors, and such transactions more likely to contain errors than the lower trade value transactions. This is borne out by the auditor's findings. The larger trade-in deductions are far more likely to have multiple trade-ins, application of advance trade credits, combinations of advance trade credits and third party trade credits, which, if found to be in error, would have had a much larger effect on the error rate than a randomized sample of invoices. Thus, the "Top 200" transactions reviewed are qualitatively different from the clear majority of the transactions in the population and do *not* provide any type of reliable basis as a representative sample to project across the population. In addition, any missing documentation such as missing trade titles or drive away permits would produce an outsized result based on the sampling methodology.

ANSWER: The Department denies the allegations contained in paragraph 14. The Department further affirmatively states that its audit methodology of selecting the top 200 transactions was necessary due to Petitioner's unwillingness or refusal to provide or extensive delay in providing the requested records, despite repeated requests to do so.

15. Notably, this sampling methodology is different than that used in a prior audit of the Petitioner. In the prior audit of the Petitioner, the Department used a combination of random and statistical sampling of smaller transactions and a detailed, non-projected sample of the largest transactions. Further, for the audit of the subsequent period initiated by the same auditor, a combination of random sampling and detailed analysis of the largest transactions is being used again rather than the suspect "Top 200" methodology used in this Audit currently being protested. To illustrate, the average trade-in deduction for the Top 200 samples used were $44,708 (Honda Top 200/Acura store), $43,329 (VW Top 200/Audi store) and $39,586 (Top 200 non-lease trades, both stores). These figures compare with an average trade-in deduction across all trades of $24,406. Almost 84% of the trade in deductions for the Audit Period were less than $20,000.

ANSWER: The Department denies the allegations contained in paragraph 15. The Department further affirmatively states that its audit methodology of selecting the top 200 transactions was necessary due to Petitioner's unwillingness or refusal to provide or extensive delay in providing the requested records, despite repeated requests to do so.

16. The Auditor did not use a standard, reliable projection method to accurately project potential errors in the sample, and such method deviated from prior and subsequent methodologies used by the same Auditor.

ANSWER: The Department denies the allegations contained in paragraph 16. The Department further affirmatively states that its audit methodology of selecting the top 200 transactions was necessary due to Petitioner's unwillingness

or refusal to provide or extensive delay in providing the requested records, despite repeated requests to do so.

17. Consequently, this sampling method must be deemed *void and invalid* and the Department cannot be entitled to any presumption of correctness.

ANSWER: Although paragraph 17 is not an allegation of material fact but a legal conclusion, the Department denies the allegations/legal conclusions contained in paragraph 17.

## ERROR 2 IMPROPER DENIAL OF CERTAIN TRADE-INS

18. The Department challenged certain trade-in transactions as errors in the Audit Report because the title may not have been available at the time of Audit or the Auditor otherwise required further substantiation that the purchaser was the owner of the traded-in vehicle.

ANSWER: The Department admits the allegations contained in paragraph 18.

19. Copies of such titles have been ordered and Petitioner will provide such documentation prior to a hearing.

ANSWER: Paragraph 19 is not a material allegation of fact but a statement of Petitioner's intention to provide certain documentation and as such does not require an answer pursuant to Tribunal Rule 86 Ill.Adm.Code §5000.310(b).

## ERROR 3 IMPROPER TAXATION OF SALES TO EXEMPT OUT OF STATE BUYERS

20. The Department improperly subjected retailer's occupation (sales) tax ("Sales Tax" or "ROT") on the sales of certain vehicles sold to exempt out-of-state purchases. These

transactions include sales of vehicles which are clearly in international or interstate commerce.

ANSWER: Although paragraph 20 is not an allegation of material fact but a legal conclusion, the Department denies the allegations/legal conclusions contained in paragraph 20.

21. Illinois Sales Tax is not imposed upon the sale of a motor vehicle in this State even though the motor vehicle is delivered in this State, if the motor vehicle is sold to a nonresident, the motor vehicle is not to be titled in this State, and either a drive-away permit for purposes of transporting the motor vehicle to a destination outside of Illinois is issued to the motor vehicle as provided in Section 3-603 of the Illinois Vehicle Code [ 625 ILCS 5/3-603], or the nonresident purchaser has non-Illinois vehicle registration plates to transfer to the motor vehicle upon transporting the vehicle outside of Illinois. The issuance of the drive-away permit or having the out-of-state registration plates to be transferred is prima facie evidence that the motor vehicle will not be titled in this State. *See e.g.,* 35 ILCS 120/2-5(25) and 86 IL Admin.Code §130.605(b).

ANSWER: The Department admits the existence, force and effect, at all relevant times of the statute and regulation set forth or referred to in paragraph 21 and state that such statutory and regulatory provisions speak for themselves.

22. The documentation required to be retained by the dealer under 86 Il. Admin. Code 130.605(b) changed during the audit period. The auditor appears to have applied the standard and requirements which went into effect July 1, 2008, to all such out-of-state transactions in the audit, including those from October 2006 through June 2008. The

Department must evaluate transactions based on the law in effect at the time the transactions occurred.

ANSWER: Although paragraph 22 is not an allegation of material fact but a legal conclusion, the Department denies the allegations/legal conclusions contained in paragraph 22.

23. Petitioner will provide evidence to reflect the exemption of such vehicle transactions, including, but not limited to, evidence of proper taxation for out-of-state reciprocal and non-reciprocal sales.

ANSWER: Paragraph 23 is not a material allegation of fact but a statement of Petitioner's intention to provide evidence and as such does not require an answer pursuant to Tribunal Rule 86 Ill.Adm.Code §5000.310(b).

## ERROR 4 IMPROPER TAXATION OF REBATES AND INCENTIVES

24. The Department improperly subjected certain automobile manufacturer rebates or incentives to Illinois ROT. Automobile manufacturer rebates, incentives and hold-backs are *not* subject to Illinois Sales Tax if the amounts paid by the manufacturer to the dealership are not conditioned upon the retail sale of a specific vehicle. *See e.g.,* Ill. Admin Code§ 130.2125(f).

ANSWER: The Department denies that it improperly subjected certain automobile manufacturer rebates or incentives to taxation but otherwise admits the existence, force and effect, at all relevant times of the regulation set forth or referred to in paragraph 24 and state such regulation speaks for itself.

25. Petitioner will provide evidence to reflect the proper exemption from taxation of such rebates and incentives.

ANSWER: Paragraph 25 is not a material allegation of fact but a statement of Petitioner's intention to provide evidence and as such does not require an answer pursuant to Tribunal Rule 86 Ill.Adm.Code §5000.310(b).

## ERROR 5 – IMPROPER DISALLOWANCE OF ADVANCE TRADE-IN CREDITS

26. The Department improperly disallowed advance trade-in credits allegedly involving different leasing trusts of the same respective automotive manufacturer (i.e., Honda Vehicle Trust vs. Honda Lease Trust and VW Credit versus Audi Financial). These transactions are also commonly known as the "Cab West" or "Van Drunen Ford" issue. It appears that ICB made some audit adjustments related to Honda Vehicle Trust (HVT) owned vehicles consistent Petitioner's protest, but there was no accounting of where these adjustments have been applied, and it is not clear that similarly situated deals involving Volkswagen Credit leases have likewise been addressed. The Department must provide an accounting. Overall however, it was improper to deny use of these advance trade-in credits, and thus, these amounts should not be included as taxable events in the Global Exceptions Report. Consequently, the total amount of the Assessment must be reduced accordingly.

ANSWER: To the extent paragraph 26 contains legal conclusions and not allegations of material facts, those legal conclusions are denied. The Department further affirmatively states that its audit file, which will be provided in total to Petitioner' counsel, provides or contains the necessary accounting of the adjustment referenced in Paragraph 26.

## ERROR 6 – IMPROPRER DISALLOWANCE OF ADVANCE TRADE-IN CREDITS COMBINED WITH THIRD PARTY TRADE-INS

27. The Department improperly disallowed Petitioner's use of certain advanced trade credits in combination with third party trade-in credits in the same transaction. The Auditor, without statutory authority, *arbitrarily and capriciously* disallowed the lower dollar trade-in credit. Petitioner is entitled to combine both types of credits and thus, such disallowance must be reversed and the assessment must be revised accordingly. We disagree with the Auditor's position that 86 IL. Admin Code 130.455 precludes combination of third party trades and advanced trades which are recorded as a single sale transaction. Further, such treatment serves no policy purpose as the vehicles accepted in trade are then subjected to sales tax on a higher retail amount when sold to a retail customer, a result consistent with trades the Department considers "allowable."

> ANSWER: To the extent paragraph 27 contains legal conclusions and not allegations of material facts, those legal conclusions are denied. Otherwise, the Department admits the existence, force and effect, at all relevant times of the regulation set forth or referred to in paragraph 27 and state such regulation speaks for itself.

28. Ill. Admin Code § 130.425 provides that "selling price" shall *not* include "the value of or credit given for traded-in tangible personal property where the item traded-in is a like kind and character as that which is being sold." *See also,* Ill. Admin Code § 130.455 (same and discussion generally regarding multiple trade-in and combined transactions). At a minimum, the Taxpayer should be allowed to use advance trade-in credits against other vehicle transactions with sales tax liability rather than forfeiting the trade-in deduction entirely.

ANSWER: To the extent paragraph 28 contains legal conclusions and not allegations of material facts, those legal conclusions are denied. Otherwise, the Department admits the existence, force and effect, at all relevant times of the regulations set forth or referred to in paragraph 28 and state such regulations speak for themselves.

## ERROR 7 – IMPROPER TAXATION OF VIN ETCHING SERVICES

29. The Department improperly subjected VIN etching services to ROT. VIN etching is a process by which the vehicle's VIN is marked on glass surfaces by removing the upper layer of the glass in the etching process. No tangible personal property is transferred pursuant to this service. The customer has the option of buying or not buying this service and it is available from other service providers. In addition, the charge is separately stated on the sales order.

ANSWER: Although paragraph 29 is not an allegation of material fact but a legal conclusion, the Department denies the allegations/legal conclusions contained in paragraph 29.

30. As no tangible personal property is transferred and this service is separately stated, it cannot be subject to ROT and must be removed from the tax base for calculating Retailers Occupation Tax on each respective vehicle.

ANSWER: Although paragraph 30 is not an allegation of material fact but a legal conclusion, the Department denies the allegations/legal conclusions contained in paragraph 30.

## ERROR 8 – IMPROPER TAXATION OF VEHICLES NOT OWNED OR SOLD BY McGRATH IMPORTS

31. The Department improperly included vehicles in it Global Taxable Exceptions report which were *not* sold by the Taxpayer to its customers. Specifically, these sales

include *courtesy deliveries* for Volkswagen Corporate sales to employees for which the Petitioner merely acted as the delivering dealer- not the retailer, as well as vehicles that were sold to Audi as Audi loaners by a different dealer and entered into Central Vehicle Registration (CVS) by employees of Petitioner. Petitioner will provide documentation previously provided to the Auditor documenting and supporting this assertion.

ANSWER: Although paragraph 31 is not an allegation of material fact but a legal conclusion, the Department denies the allegations/legal conclusions contained in paragraph 31.

## ERROR 9 – IMPROPER IMPOSTION OF AMNESTY DOUBLE PENALTY AND INTEREST

32. Petitioner respectfully requests that any Amnesty double penalty and double interest imposed with respect to the Amnesty Period Assessment be abated to single penalty and single interest (subject to Petitioner's request for complete abatement of penalty for reasonable cause as discussed further below).

ANSWER: Paragraph 32 is not a material allegation of fact but Petitioner's request for an abatement of amnesty penalty and interest and as such does not require an answer pursuant to Tribunal Rule 86 Ill.Adm.Code §5000.310(b).

33. Petitioner was effectively *precluded* from participating in the State's Amnesty Program due to the requirement that amnesty payments must have been made on amended returns (in this case Forms ST-556-X). Notably, *each* vehicle transaction *requires its own tax return* (i.e., a ST-556), which is unlike a monthly ST-1, and there was insufficient information during the limited Amnesty window to determine which transactions, if any, were in error at the time of the Amnesty Program. Additionally, the

Department did not permit the Petitioner to make an estimated good-faith payment since it had to be tied to a specific vehicle tax return. And even if such good faith estimated payment could have been permitted, there was substantial risk leading up to the issuance of the final Amnesty regulations that any overpayment would have been forfeited rather than refunded or applied to other dealership liabilities.

ANSWER: The Department denies the allegations contained in paragraph 33.

34. Consequently, Petitioner was effectively denied the ability to participate in the Amnesty program and respectfully requests that it does not get penalized for its inability to participate in this program by the imposition of double penalties and double interest.

ANSWER: The Department denies the allegations contained in paragraph 34.

35. Petitioner respectfully requests complete abatement penalty for reasonable cause, in the event any tax is due. Petitioner reasonably relied upon its then outside accountant during the Audit Period at issue. Petitioner has since replaced its accountant with a national accounting firm with specific auto dealer industry knowledge and has engaged in numerous steps to remedy prior issues and improve both compliance and documentary evidence. For example, Petitioner, among other things: (1) commissioned a study of its procedures with recommendations to employ on a going forward basis, (2) invested in training to improve current and prospective compliance, and (3) Petitioner hired an independent third-party company to digitize its records to improve both record retention and accessibility of such information.

ANSWER: The Department denies the allegations contained in paragraph 35.

36. Petitioner respectfully reserves the right, to the extent permitted by statute, regulation or practice, to amend, supplement and/or revise this Petition at any time.

ANSWER: Paragraph 36 is not a material allegation of fact and as such does not require an answer pursuant to Tribunal Rule 86 Ill.Adm.Code §5000.310(b).

WHEREFORE, the Department prays:

A) That Judgment be entered against the Petitioner and in favor of the Department as to all Petitioner's allegations of Error in this matter;
B) That the Department's Notices of Tax Liability be determined to be correct;
C) That this Tribunal grant such other additional relief it deems just and proper.

Respectfully Submitted,

LISA MADIGAN
Illinois Attorney General

By _____
Michael Coveny,
Assistant Attorney General

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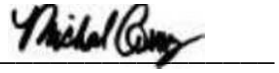
## CERTIFICATE OF SERVICE

I, Michael Coveny, an attorney for the Illinois Department of Revenue, state that I served a copy of the attached Department's Answer to Petitioner's Petition upon:

David C. Blum
Akerman LLP
71 South Wacker Drive
46th Floor
Chicago, IL 60606

By attachment to email to david.blum@akerman.com on September 14, 2016



Michael Coveny,
Assistant Attorney General