IT 08-12
Tax Type: Income Tax
Issue: Net Operating Loss Carryback

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

THE DEPARTMENT OF REVENUE OF THE STATE OF ILLINOIS	**No. 06-IT-0000**
	FEIN 00-0000000
v.	**Tax Year 1999**
ABC CORPORATION AND AFFILIATED COMPANIES,	**Ted Sherrod**
Taxpayer	**Administrative Law Judge**

RECOMMENDATION FOR DISPOSITION

Synopsis:

Appearances: Special Assistant Attorneys General Rick Walton and Brian Fliflet on behalf of the Illinois Department of Revenue; William Goldman, Thomas Donohoe, Keith Staats and J. Page Scully of McDermott, Will & Emery, on behalf of ABC and Affiliated Companies.

Synopsis:

This matter involves a Notice of Denial the Illinois Department of Revenue ("Department") issued to ABC Corporation and Affiliated Companies on February 2, 2006. ABC and Affiliated Companies ("taxpayer") timely protested this Notice of Denial and requested a hearing thereon. Subsequently, on June 5, 2007, the taxpayer filed an Amended Protest and Request for Hearing pursuant to 86 Ill. Admin. Code, ch. I, section

200.120(c). In its protest and amended protest, the taxpayer requested that this tribunal decide whether the Department properly computed the application of a 2002 net capital loss of the XYZ Communications, Inc. unitary group which included the taxpayer as a carryback to the taxpayer's short tax period beginning October 9, 1999 and ending December 31, 1999.

Prior to the scheduled hearing in this matter, the Department and the taxpayer submitted agreed stipulations of fact, and exhibits, and agreed that this case should be decided on the basis of these documents, testimony presented by expert witnesses and briefs submitted by the parties. A hearing to receive testimony from expert witnesses was held on April 24, 2008 and April 25, 2008 at which John Doe, a former Director of the Illinois Department of Revenue, testified on behalf of the taxpayer and Paul Castleton, the Department's Deputy General Counsel-Income Tax, testified on behalf of the Department. Following a review of the record of these hearing proceedings and the documents of record, it is recommended that this matter be resolved in favor of the Department. In support of this recommendation, I make the following findings of fact and conclusions of law.

Findings of Fact:

I. General

1. ABC Inc., f/k/a XYZ Communications Inc. ("XYZ"), a Delaware corporation with its principal place of business in Anywhere, Texas, is the parent of an

affiliated group of companies that are primarily engaged in the business of providing telecommunications services. Stipulation of Facts ("Stip.") ¶ 1.[1]

2. In November 2005, XYZ acquired the stock of ABC Corp. Immediately following the acquisition, XYZ changed its name to ABC Inc. This Recommendation for Disposition ("recommendation") will refer to ABC Inc. as XYZ because that was the name of the corporation during the short tax period beginning October 9, 1999 and ending December 31, 1999, the tax period at issue. Stip. ¶ 2.

3. XYZ filed federal consolidated income tax returns with entities with which it was affiliated. XYZ and its affiliates comprise the XYZ Consolidated Group. XYZ also filed Illinois combined returns with entities with which it was engaged in a unitary business. XYZ and its unitary business members comprise the XYZ Unitary Group. Stip. ¶ 3; [Stip. Exhibit 5 (Complete listing of members of the XYZ Consolidated Group during the 1999 tax year); Stip. Exhibit 30 (Complete listing of members of the XYZ unitary group for the 1999 tax year)].

4. ABC Group, Inc., f/k/a ABC Corporation ("ABC"), a subsidiary of XYZ, is also a Delaware corporation with its principal place of business in Anywhere, Texas. ABC changed its name to XYZ Group, Inc. on September 15, 2004 and was renamed again to ABC Group, Inc. on March 14, 2006 after XYZ acquired ABC Corp. This recommendation will refer to ABC Group, Inc. as ABC because that was the name of the corporation during 1999. Stip. ¶ 4.

5. ABC was created as a holding company in 1984 in connection with the ABC divestiture and held the stock of: Illinois System Company; Indiana System

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[1] Except as indicated by brackets, all Findings of Fact are *verbatim* recitations of stipulations as agreed to by the parties.

Company, Inc.; Michigan System Company; The Ohio System Company; and Wisconsin System, Inc. Stip. ¶ 5.

6. ABC also owned all of the stock of ABC Communications, Inc., a wireless company that operated cellular networks in many of the major cities in the Midwest. Stip. ¶ 6.

7. Prior to October 8, 1999, ABC, as the common parent, filed federal consolidated income tax returns with the members of the ABC Consolidated Group. ABC also filed Illinois combined returns with the members of the ABC Unitary Group. Stip. ¶ 7.

II. XYZ's Acquisition of ABC

8. On October 8, 1999, XYZ acquired all of the stock of ABC in exchange for newly issued XYZ stock (the "Acquisition"). Stip. ¶ 8.

9. At the time of the Acquisition, both XYZ and ABC were engaged in the business of providing telecommunications services, with ABC providing such services principally in Illinois, Indiana, Michigan, Ohio, and Wisconsin and XYZ providing such services principally in other parts of the country. Stip. ¶ 9.

10. However, with respect to wireless telecommunications services, XYZ and ABC were direct competitors as two wireless telecommunications providers in the Chicago, Illinois and St. Louis, Missouri markets. Stip. ¶ 10.

11. On October 9, 1999, the day after XYZ acquired the stock of ABC, ABC sold its overlapping wireless assets in the Chicago and St. Louis markets. This sale arose directly from XYZ's decision to acquire ABC and consolidate the telecommunications operations of the two entities. Stip. ¶ 11.

12. As a result of its sale of overlapping wireless assets, ABC reported a capital gain of $2,703,844,546 and a recapture gain of $115,360,874 under section 1245 of the Internal Revenue Code. [With respect to the capital gain, see Stip. Exhibit 25, Statements 914, 915, 921, 922, and 923 of the 1999 XYZ Consolidated Group's federal income tax return. With respect to the recapture gain, see Gain from Form 4797, line 31, and Statements 1072, 1073, 1078, and 1079 of the 1999 XYZ Consolidated Group's federal income tax return (Stip. Exhibit 26)]. In total, ABC reported a gain of $2,819,205,420 related to this sale of assets. The capital gain was business income. Stip. ¶ 12.

III. ABC's Original Federal and Illinois Income Tax Returns for 1999

13. Both XYZ and ABC were calendar year taxpayers prior to the Acquisition. Stip. ¶ 13.

14. As a result of the Acquisition, ABC and the members of the ABC Consolidated Group became members of the XYZ Consolidated Group for federal income tax purposes. As a consequence, the federal Consolidated Return Regulations required ABC's income for 1999 to be allocated between two federal consolidated income tax returns. Treas. Reg. §1.1502-76(b)(l)(i). ABC's income for the short tax period of January 1, 1999 through October 8, 1999 (the "pre-Acquisition short tax period") was included in the final consolidated return of the ABC Consolidated Group. ABC's income for the short tax period of October 9, 1999 through December 31, 1999 (the "post-Acquisition short tax period"), the tax period at issue, was included in the 1999 consolidated income tax return of the XYZ Consolidated Group. Stip. ¶ 14.

15. As a consequence of its two short tax periods for 1999 for federal income tax purposes, ABC also filed two short tax period returns for Illinois income tax purposes. 35 **ILCS** 5/401. Stip. ¶ 15.

16. For Illinois income tax purposes, ABC and XYZ were not engaged in a unitary business together in either short tax period of the 1999 tax year. Stip. ¶ 16.

17. ABC filed Illinois combined income tax returns for the ABC Unitary Group for the pre-Acquisition and post-Acquisition short tax periods. Therefore, ABC was not included in the XYZ Unitary Group for the pre-Acquisition short tax period and the post-Acquisition short tax period. [See Stip. Exhibits 1 and 2]. Stip. ¶ 17.

18. ABC made a ratable allocation election pursuant to Treasury Regulation section 1.1502-76(b)(2)(ii). As a consequence of this election, for both federal and Illinois income tax purposes, ABC's taxable income (other than extraordinary items) for the 1999 calendar year was divided between the pre-Acquisition short tax period and the post-Acquisition short tax period based on the ratio of the number of days in each short tax period (281 days in the pre-Acquisition period and 84 days in the post-Acquisition period). ABC recognized the extraordinary items of income in the periods in which they occurred. [See Stip. Exhibits 3 and 4]. Stip. ¶ 18.

19. The $2,703,844,546 capital gain from the sale of ABC's overlapping wireless assets was allocated entirely to the 1999 post-Acquisition short tax period because the capital gain is considered an extraordinary item for income tax purposes. Accordingly, the entire capital gain was reported on the 1999 XYZ consolidated federal income tax return. [See Stip. Exhibit 5 (Schedule D from the XYZ Consolidated Group's federal income tax return)]. Stip. ¶ 19.

20. For Illinois income tax purposes, the entire capital gain was apportionable business income and was reported on the ABC combined return for the post-Acquisition short tax period because it was an extraordinary item that occurred after XYZ's acquisition of ABC. See Stip. Exhibit 2 (Copy of the Illinois combined income tax return with the relevant supporting schedule). Stip. ¶ 20.

21. ABC also reported a capital loss of $1,017,885,434 from the sale of its Series C preferred stock of ABC Management Corporation ("AMC") in December 1999. This capital loss also was apportionable business income and was allocated in its entirety to the post-Acquisition short tax period. Stip. Exhibit 27 (Schedule showing the ABC Unitary Group members that reported a capital loss from the sale of ABC's Series C preferred stock of AMC on Schedule D [at Stip. Exhibit 5]of the XYZ Consolidated Group's 1999 federal income tax return). Stip. ¶ 21.

22. When ABC combined its various capital gains and losses, ABC reported a net capital gain of $1,582,653,052 for the post-Acquisition short tax period. The net capital gain reflected the capital gain from the sale of the overlapping wireless assets, the capital loss from the sale of the AMC preferred stock, and certain other capital gains and losses. Stip. ¶ 22; [Stip. Exhibit 2 (See page 10, line 8, column E)].

23. On its post-Acquisition short tax period Illinois return, ABC reported $1,658,196,136 of federal taxable income before its NOL deduction, which included the portion of ABC's ordinary federal taxable income for the entire 1999 calendar year that had been ratably allocated to the 84 days in the post-Acquisition short tax period and the $1,582,653,052 net capital gain arising from extraordinary items in that short tax period. Exhibit 2 [See page 10, line 30, column E of Exhibit 2]. Stip. ¶ 23.

IV. Transactions During 2000-2002

24. On January 1, 2000, ABC and XYZ became engaged in a unitary business together. Accordingly, ABC and its subsidiaries became members of the XYZ Unitary Group. The XYZ Unitary Group, including the former ABC Unitary Group, filed single combined Illinois income tax returns for the 2000-2002 tax years. [Stip. Exhibit 6 (Copy of the Schedule UB, Part 1, section B detail for 2002, which provides the listing of members of the unitary group)]. Stip. ¶ 24.

25. In 2002, the XYZ Consolidated Group, which included the former ABC Consolidated Group, reported a $3,800,859,083 net capital loss for federal income tax purposes as a result of sales of capital assets. [Stip. Exhibit 7 (Copy of Schedule D of the 2002 XYZ Consolidated Group's income tax return (Form 1120), showing the members that reported capital gains or losses in 2002)]. Stip. ¶ 25.

V. Carryback of the 2002 Capital Loss

26. For federal income tax purposes, the XYZ Consolidated Group carried $1,582,653,052 of the 2002 reported net capital loss back to the XYZ 1999 federal consolidated return and utilized the loss to offset $1,582,653,052 of reported net capital gain attributable to the sales by the former members of the ABC Consolidated Group. [See Stip. Exhibit 8 (Copies of the relevant pages of the federal corporate application for tentative refund (Federal Form 1139), which was filed on March 19, 2003)]. Stip. ¶ 26.

27. For Illinois income tax purposes, the 2002 XYZ Unitary Group, which included the former ABC Unitary Group, reported a net capital loss of $3,634,691,714 for the 2002 tax year. All of this net capital loss reported by the 2002 XYZ Unitary Group for the 2002 tax year was apportionable business income and was available for

carryback to the ABC Unitary Group's post-Acquisition short tax period and the XYZ Unitary Group's 1999 tax year. [See Stip. Exhibit 9 (Copy of the relevant pages of the XYZ Unitary Group's 2002 Illinois income tax return) and Stip. Exhibit 10 (Modified Schedule D of the 2002 XYZ Consolidated Group's federal income tax return (Form 1120) showing the members of the XYZ Unitary Group that reported capital gains or losses on the XYZ Consolidated Group's federal income tax return)]. Stip. ¶ 27.

28. Initially, XYZ allocated the 2002 net capital loss of the XYZ Unitary Group to the former members of the ABC Unitary Group based on the ratio of the former members' 2002 Illinois gross receipts to the XYZ Unitary Group's combined Illinois gross receipts. Stip. ¶ 28.

29. This allocation method resulted in $3,455,508,863 or 95.0702% of the XYZ Unitary Group's 2002 net capital loss being allocated to former members of the ABC Unitary Group. Stip. ¶ 29.

30. On June 20, 2003, ABC filed its first amended Illinois income tax return for the 1999 post-Acquisition short tax period and carried back and offset $1,531,365,848 of the XYZ Unitary Group's 2002 net capital loss against $1,531,365,848 of the net capital gain reported on the ABC Unitary Group's original Illinois income tax return for the post-Acquisition short tax period, a period in which ABC was not engaged in a unitary business with the XYZ Unitary Group. [See Stip. Exhibit 11, Statement 1 (Copy of the first amended Illinois return)]. Stip. ¶ 30.

31. The first amended Illinois return claimed an Illinois income tax refund of $38,204,008 for the post-Acquisition short tax period. Stip. ¶ 31.

VI. Federal Audit Adjustments

32. After ABC filed its first amended Illinois income tax return to carryback $1,531,365,848 of 2002 net capital loss to the post-Acquisition short tax period, the Internal Revenue Service ("IRS") proposed audit adjustments with respect to ABC's two short tax periods in 1999. Stip. ¶ 32.

33. One of the proposed IRS audit adjustments was the proposed disallowance of the entire $1,017,885,434 capital losses reported on XYZ's 1999 federal consolidated income tax return from ABC's sale of preferred stock of AMC as described in Stip. ¶ 21. Stip. ¶ 33.

34. On March 17, 2004, the IRS issued a statutory Notice of Deficiency ("NOD") to XYZ disallowing the entire $1,017,885,434 capital loss as well as other adjustments. [See Stip. Exhibit 12 (Copy of the relevant pages of the NOD)]. Stip. ¶ 34.

35. On November 30, 2005, ABC and the IRS entered into a Closing Agreement that finalized the treatment of the capital gains and losses in ABC's 1999 post-Acquisition short tax period. In the Closing Agreement, the IRS and ABC agreed to the allowance of $254,471,359 of the claimed capital loss from the sale of preferred stock of AMC in December 1999. [See Stip. Exhibit 13 (Copy of the Closing Agreement)]. Stip. ¶ 35.

VII. Illinois Developments

36. ABC submitted two amnesty payments to the Illinois Department of Revenue (the "Department") on November 17, 2003 in order to satisfy the Illinois income tax liabilities that might have resulted from anticipated IRS audit adjustments. Stip. ¶ 36.

37. ABC submitted an amnesty payment of $33,405,602 that was designated for the pre-Acquisition short tax period of January 1, 1999 through October 8, 1999. Stip. ¶ 37.

38. ABC also submitted an amnesty payment of $497,915 that was designated for the post-Acquisition short tax period of October 9, 1999 through December 31, 1999. Stip. ¶ 38.

39. The Department conducted a limited scope audit of ABC's first amended Illinois income tax return, dated June 30, 2003, for the post –Acquisition short tax period to determine the portion of the 2002 net capital loss incurred by the XYZ Unitary Group that the ABC Unitary Group could carryback to its separate unitary return filed for the post-Acquisition short tax period. [See Stip. Exhibit 28 (Auditor's Comments Section, dated March 11, 2004)]. Stip. ¶ 39.

40. On March 11, 2004, following the Department's limited scope audit, the Department issued a Form EDA-125, Notice of Proposed Claim Denial. [See Stip. Exhibit 14 (Copy of this Notice of Proposed Claim Denial, along with Form IL-870, EDA-25, and Audit Schedule I-A)]. Stip. ¶ 40.

41. On audit, the auditor verified that the 2002 XYZ Unitary Group's net capital loss was $3,634,691,714 for the 2002 tax year, as reported on XYZ's Statement 24, Schedule D. See Stip. Exhibit 10. The auditor agreed that the following adjustments to the XYZ Consolidated Group's 2002 capital loss were appropriate:

a) Reduction of the XYZ Consolidated Group's 2002 capital loss by $13,370,889, which represents the combined capital losses incurred by AMI VCOM1 ($13,237,180) and AMI VCOM3 ($133,709), both of which were not engaged in a unitary business with XYZ during the 2002 tax year. [See Stip. Exhibit 29 (Audit Schedule I-A), and Stip. Exhibit 28 (Auditor's Comments Section, p. 3)].

b) Reduction of the XYZ Consolidated Group's capital loss by $152,796,480, which represents the combined capital losses incurred by ABC International ($143,939,685) and XYZ International ($8,856,795), both of which were "80/20 companies" under 35 ILCS 5/1501(a)(27) and were therefore excluded from the 2002 XYZ Unitary Group. [See Stip. Exhibit 29 (Audit Schedule I-A) and Stip. Exhibit 28 (Auditor's Comments Section, p. 3)].

Stip. ¶ 41.

42. After removing the capital losses of the members of the XYZ Consolidated Group that were properly excluded from the XYZ Unitary Group, the 2002 XYZ Unitary Group's total capital loss was $3,634,963,272 ("TCL"), its capital gain was $271,558, and its net capital loss was $3,634,691,714 ("NCL"). [See Stip. Exhibit 29 (Audit Schedule I-A)]. Stip. ¶ 42.

43. The auditor allocated a pro rata share of the 2002 XYZ Unitary Group's NCL to each member of the XYZ Unitary Group that reported a capital loss on Schedule D of the 2002 XYZ Consolidated Group's federal income tax return. [See Stip. Exhibit 28, Auditor's Comments Section, p. 3]. The portion of the 2002 NCL that was allocated by the auditor to each member was determined by a formula that consisted of the NCL multiplied by the ratio of the individual member's reported capital loss on Schedule D to the TCL of the 2002 XYZ Unitary Group (NCL multiplied by (individual capital

loss/TCL)). It is the Department's position that this computation yields the portion of the NCL that was available for a specific member to carry back or carry forward. Stip. ¶ 43.

44. The auditor used the formula described above in Stip. ¶ 43 to allocate the NCL to the members of the 2002 XYZ Unitary Group as shown on the Audit Schedule I-A (third column). [See Stip. Exhibit 29 (Audit Schedule I-A)] . Stip. ¶ 44.

45. From among the members that were allocated a portion of the 2002 NCL, the auditor identified the companies that were members of the ABC Unitary Group during the 1999 post-Acquisition short tax period. The auditor concluded that members of the 2002 XYZ Unitary Group that were not members of the 1999 ABC Unitary Group were ineligible to carryback the losses to the ABC Unitary Group's post-Acquisition short tax period. [See Stip. Exhibit 28 (Auditor's Comments Section, p. 3)]. Stip. ¶ 45.

46. The auditor determined that ABC and XYZ Venture Capital (f/k/a ABC Development) were the only two companies that were allocated pro rata shares of the 2002 NCL and were members of the ABC Unitary Group during the post-Acquisition short tax period. [See Stip. Exhibit 28 (Auditor's Comments Section, p. 4)]. Stip. ¶ 46.

47. The auditor determined that the ABC Unitary Group was entitled to carryback $83,920,965 of the 2002 NCL, which represents the combined capital losses reported by ABC ($35,277,654) and XYZ Venture Capital ($48,643,311) on Schedule D of the 2002 XYZ Consolidated Group's income tax return, to the 1999 post-Acquisition short tax period. [See Stip. Exhibit 28 (Auditor's Comments Section, p. 4)]. Stip. ¶ 47.

48. In the March 11, 2004 Notice of Proposed Claim Denial, the auditor asserted that ABC was only entitled to an Illinois income tax refund of $1,969,436, plus

interest, for the post-Acquisition short tax period. The remaining $36,234,572 of the claimed refund was denied. Stip. Exhibit 14 (Copy of the auditor's work papers contained in Notice of Proposed Claim Denial). In calculating this refund amount, the auditor allocated the 2002 capital loss of the XYZ Unitary Group among the members of the Group using the separate accounting method of the federal Consolidated Return Regulations. Stip. ¶ 48.

49. ABC considered the IRS's proposed disallowance in the March 17, 2004 NOD of the entire $1,017,885,434 capital loss, as described in Stip. ¶ 34, a "federal change" within the meaning of Illinois Income Tax Act Section 506(b). Stip. ¶ 49.

50. In October 2004, ABC filed its fifth amended Illinois return for the post-Acquisition short tax period, which increased ABC's base income by the amount of the tentatively disallowed $1,017,885,434 capital loss. Stip. ¶ 50.

51. Prior to the filing of ABC's fifth amended Illinois return for the post-Acquisition short tax period, ABC had filed its second amended return on or about October 14, 2003, a third amended return on or about November 8, 2003, and a fourth amended return on or about April 13, 2004. The second amended return related to a claim of an additional training expense credit and slightly lower apportionment factors, while the third and fourth amended returns reported IRS adjustments increasing ABC's federal taxable income. [See Stip. Exhibit 15, 16 and 17 (Copies of the relevant pages of the second, third, and fourth amended Illinois returns, respectively)]. Stip. ¶ 51.

52. The fifth amended return increased ABC's federal taxable income for the post-Acquisition short tax period by $1,031,798,081 and computed a tax underpayment of $24,213,974, payment of which was made with the filing of the fifth amended return.

[See Stip. Exhibit 18 (Copy of the relevant pages of the fifth amended return, attached as Exhibit 18. See Line 1, Columns A, B, and C of the return)]. Stip. ¶ 52.

53. On May 6, 2004, ABC filed a Request for Informal Conference Board ("ICB") review of the March 11, 2004 Notice of Proposed Claim Denial. [See Stip. Exhibit 19 (Copy of the Request for ICB review)]. Stip. ¶ 53.

54. On August 30, 2005, the ICB issued an Action Decision that did not modify the Department's proposed partial denial of ABC's refund claim. Stip. ¶ 54.

55. Accordingly, on February 2, 2006, the Department issued its Notice of Denial to ABC allowing $1,969,436 and disallowing $36,234,572 of ABC's refund claim. This Notice of Denial is the basis of the March 31, 2006 Protest and this appeal. Stip. ¶ 55.

56. On February 24, 2006, the Department issued ABC a second Form EDA-125, Notice of Proposed Claim Denial, which addressed the second, third, and fourth amended Illinois returns that ABC filed with respect to the pre-Acquisition short tax period, and the third, fourth, and fifth amended Illinois returns that ABC had filed with respect to the post-Acquisition short tax period. [See Stip. Exhibit 20 (Copy of EDA-125, Notice of Proposed Claim Denial including the Department's work papers)]. Stip. ¶ 56.

57. The Department's work papers for the pre-Acquisition short tax period took into account (i) certain federal IRS adjustments, and (ii) the $33,405,602 amnesty payment that ABC made for the pre-Acquisition short tax period and determined that ABC overpaid its Illinois income tax liability for that short tax period by $29,720,286. Stip. ¶ 57.

58. The Department's work papers for the post-Acquisition short tax period included (i) the $1,031,798,081 increase in ABC's federal taxable income as a result of the proposed disallowance by the IRS of the entire capital loss from ABC's sale of the preferred stock of AMC in December 1999, and (ii) the $497,915 amnesty payment that ABC made for the post-Acquisition short tax period. The work papers do not reflect the Closing Agreement with the IRS dated November 30, 2005 and described in Stip. ¶ 35, which allowed $254,471,359 of the capital loss. Stip. ¶ 58.

59. As a result of the adjustments included in and excluded from the Department's work papers of February 24, 2006, the work papers show an underpayment of $23,810,155 for the post-Acquisition short tax period. Stip. ¶ 59.

60. Based upon a netting of the proposed underpayment for the post-Acquisition short tax period against the proposed overpayment for the pre-Acquisition short tax period, the Department proposed to allow a net refund of $5,910,131 with respect to the six ABC amended returns that were the subject of the February 24, 2006 Notice of Proposed Claim Denial. Stip. ¶ 60.

61. Due to the November 30, 2005 Closing Agreement between ABC and the IRS, both ABC's fifth amended Illinois return for the post-Acquisition short tax period and the Department's February 24, 2006 Notice of Proposed Claim Denial overstated ABC's net capital gain for the post-Acquisition short tax period. The correct net capital gain for the post-Acquisition short tax period is $2,346,067,127, which reflects the agreed adjustment to the capital loss from the sale of the AMC stock. Stip. ¶ 61.

62. On March 31, 2006, ABC filed amended Illinois income tax returns to report additional federal changes to its taxable income for the 1997, 1998, and 1999 tax

years. [See Stip. Exhibits 21 and 22 (Copies of the relevant pages of the amended Illinois returns for the 1999 pre-Acquisition short tax period and the post-Acquisition short tax period)]. These amended returns included the sixth amended return for the post-Acquisition period and the fifth amended return for the pre-Acquisition period. Stip. ¶ 62.

63. The 2002 capital loss carryback shown on the sixth amended return for the post-Acquisition period and the fifth amended return for the pre-Acquisition period offset ABC's entire $2,346,067,125 capital gain on the post-Acquisition short tax period return. Stip. ¶ 63.

64. The two March 31, 2006 amended Illinois returns claim a total refund of $70,846,976 of tax, plus interest for the two 1999 short tax periods - $36,615,684 of tax for the post-Acquisition short tax period and $34,231,292 of tax for the pre-Acquisition short tax period. Stip. ¶ 64.

VIII. Revised Claim

65. ABC has now revised its claim for the 1999 post-Acquisition short tax period. The claim is reduced because ABC has reduced the portion of the 2002 net capital loss of the XYZ Unitary Group that should be allocated to the former members of the ABC Unitary Group. As described in Stip. ¶¶ 28 and 29 above, XYZ initially allocated $3,455,508,863 or 95.0702% of the net capital loss to the former members of the ABC Unitary Group. ABC now claims that the percentage is 28.2903%. In calculating this percentage, ABC allocated the 2002 net capital loss of the XYZ Unitary Group to the former members of the ABC Unitary Group based on the ratio of the former

members' 2002 total gross receipts to the XYZ Unitary Group's combined total gross receipts. Stip. ¶ 65.

66. This results in 28.2903% of the 2002 XYZ Unitary Group's total gross receipts being attributable to the former members of the 1999 ABC Unitary Group. [See Stip. Exhibit 23 (Schedule showing the 2002 XYZ Unitary Group's gross receipts and the gross receipts of the former members of the 1999 ABC Unitary Group)]. Stip. ¶ 66.

67. The parties agree that 28.2903% is the appropriate percentage if the Court adopts XYZ's legal position that the 2002 net capital loss of the XYZ Unitary group should be allocated among the members using ABC's unitary method. The parties also agree, taking into account federal and Illinois audit adjustments and all tax payments to Illinois, that this allocation percentage results in: (i) a capital loss carryback from 2002 to the post-Acquisition short tax period of $1,028,264,669, which ABCs not fully offset the $2,346,067,125 of capital gain; and (ii) a final Illinois tax liability for that period of $34,731,988. [See Stip. Exhibit 23 (Work papers showing the computation of these numbers)]. Stip. ¶ 67.

68. The parties further agree that, if the Court adopts the Department's allocation method, $83,920,965 of the 2002 XYZ Unitary Group's capital loss should be carried back to the post-Acquisition short tax period return of the ABC Unitary Group. The parties also agree, taking into account federal and Illinois audit adjustments and all tax payments to Illinois, that this capital loss carryback results in a final Illinois tax liability for that period of $56,959,584. Stip. ¶ 68.

<u>Conclusions of Law:</u>

Background

The issue presented in this case is whether a 2002 net capital loss attributable to the activities of a unitary business group which included XYZ Communications, Inc. ("XYZ") and its subsidiaries and ABC Corp. ("ABC") and its subsidiaries, (the "XYZ Group"), should be carried back to a tax year preceding the formation of this unitary business group by allocating the capital loss *pro rata* among all entities that were XYZ Group members in 2002. Specifically, the Department has refused to allow ABC and its affiliated companies (the "taxpayer") to carry back a net capital loss incurred by the XYZ Group in 2002 so as to offset the taxpayer's entire 1999 capital gain on a sale of assets precipitated by the taxpayer's acquisition by XYZ in that year. The dispute arose as a consequence of a sale by the taxpayer of its assets used in the provision of wireless communication services in 1999 which generated a capital gain of $2,703,844,546. This sale was necessitated by the acquisition of all of the taxpayer's stock by XYZ on October 8, 1999.

At the time of this acquisition, XYZ and the taxpayer had been direct competitors as wireless telecommunications providers in the Chicago, Illinois and St. Louis, Missouri markets. Stip. ¶ 10. Once XYZ acquired the stock of the taxpayer, the resulting group of companies had overlapping wireless assets. Stip. ¶¶ 9 – 11. Consequently, the taxpayer sold its overlapping wireless assets on October 9, 1999, the day after its acquisition by XYZ. Stip. ¶ 11. As a result of this sale, the taxpayer reported a capital gain of $2,703,844,506 from the sale of its wireless assets. Stip. ¶ 12. All of this capital gain was apportionable business income for Illinois income tax purposes. *Id*.

XYZ and its subsidiaries, along with the taxpayer were included in a single federal consolidated return after the taxpayer was acquired by XYZ. Stip. ¶ 3; Stip. Exhibit 5. In 2002, this XYZ consolidated group, which included the taxpayer, reported a $3,800,859,083 net capital loss for federal income tax purposes. Stip. ¶ 25. The XYZ consolidated group carried $1,582,653,052 of the 2002 reported net capital loss back to the XYZ 1999 federal consolidated income tax return and utilized the loss to offset $1,582,653,052 of reported net capital gain attributable to the sale of overlapping wireless assets in 1999. Stip. ¶ 26.

On June 20, 2003, the taxpayer amended its Illinois combined income tax return for the 1999 post-Acquisition short tax period following its acquisition by XYZ in that year in order to carryback a portion of the XYZ Group's 2002 net capital loss to the 1999 post-Acquisition short period. Stip. ¶ 30. Initially, XYZ allocated the 2002 net capital loss among the members of the XYZ Group on the ratio of the group members' 2002 Illinois gross receipts to the XYZ Group's combined Illinois gross receipts. Stip. ¶ 28. This allocation method resulted in over 95% of the 2002 net capital loss being allocated to the former members of the taxpayer, ABC and its affiliates, which had reported income in 1999 as a unitary business group. Stip. ¶ 29. Based on this method, the taxpayer carried back and offset $1,531,365,848 of the 2002 net capital loss against the net capital gain reported on the taxpayer's original Illinois combined return for the post-acquisition short period. Stip. ¶¶ 28 – 30. The amended Illinois return claimed an Illinois income tax refund of $38,204,008 for the post-acquisition short tax period. Stip. ¶ 31

The Department disallowed the allocation of the XYZ capital loss using the gross receipts method proposed by the taxpayer, finding that this method of allocation was contrary to the method prescribed by the Department's rules and regulations. Stip. ¶¶ 39 – 44; Stip. Exhibits 28, 29 (Auditor's Schedule 1-A). It determined that the method authorized by the Department's rules required the allocation of capital loss only among members of the XYZ Group having losses. *Id.* Accordingly, the Department allocated the 2002 XYZ Group net capital loss only to those members of the XYZ Group that reported a capital loss on Schedule D of the XYZ Group's consolidated federal income tax return. *Id.* Pursuant to the Department's audit determination, of 10 members of the XYZ Group that were former members of the taxpayer's unitary business group prior to its acquisition by XYZ, only two qualified for allocation of any portion of the XYZ Group's capital loss. Stip. ¶ 47. Consequently, only $83,920,965 or 2.3089% of the XYZ Group's net capital loss was allocated to the taxpayer. *Id.*

The taxpayer subsequently filed an amended protest and request for hearing on May 31, 2007, in which the taxpayer revised its methodology for allocating the 2002 net capital loss among the members of the 2002 XYZ Group and reduced its claim. Stip. ¶¶ 65, 66. Under the taxpayer's revised methodology, the 2002 net capital loss was allocated among the members of the 2002 XYZ Group based on the ratio of the members' 2002 total gross receipts to the XYZ Group's combined total gross receipts. Stip. ¶ 65. This resulted in 28.2903% of the 2002 XYZ Group's total gross receipts being attributable to the taxpayer. Stip. ¶ 66, Stip. Exhibit 23. Thus, the taxpayer's allocation method resulted in a capital loss carryback of $1,028,264,669 (or 28.2903% of the 2002 net capital loss) to the post-acquisition short tax period (Stip. ¶ 67)).

The *prima facie* correctness of the Department's determination was established through the inclusion in the record of the Department's Notice of Denial denying the taxpayer's refund claim in the amount of $36,234,572. Department Ex. 1; See 35 **ILCS** 5/904(a). Thereafter, the burden shifted to the taxpayer to prove that the Department's denial of a portion of the taxpayer's net capital loss carryback at issue in this case was in error. Balla v. Department of Revenue, 96 Ill. App. 3d 293, 295 (1st Dist. 1981).

Taxpayer's Section 304(e) Argument

The taxpayer asserts that the Department's disallowance of a capital loss carry back of the XYZ Group's net capital loss for 2002 allocated *pro rata* among all members of the XYZ group to offset a portion of the taxpayer's capital gain in 1999 is barred by section 304(e) of the Illinois Income Tax Act ("IITA"), 35 **ILCS** 5/304(e). Section 304(e) provides as follows:

> Combined apportionment. Where 2 or more persons are engaged in a unitary business as described in subsection (a)(27) of Section 1501, a part of which is conducted in this State by one or more members of the group, the business income attributable to this State by any such member or members shall be apportioned by means of the combined apportionment method.[2]
> 35 **ILCS** 5/304(e) ("section 304(e)")

Section 304(e) requires that taxpayers engaged in a multi-corporate unitary business as described in 35 **ILCS** 5/1501(a)(27), a part of which is conducted in Illinois by one or more members of a unitary business group must apportion their income to Illinois using "the combined apportionment method." *Id*; see also 86 Ill. Admin. Code, ch. I, section 100.3380(d)(1). The taxpayer contends that its proposed method of allocating the XYZ

[2] 35 **ILCS** 5/1501(a)(27) provides in relevant part as follows: "Unitary business group. The term "unitary business group" means a group of persons related through common ownership whose business activities are integrated with, dependent upon and contribute to each other."

Group's 2002 net capital loss to the taxpayer is based on the combined apportionment method, that the Department's alternative method of allocation is not, and that, therefore, the taxpayer's allocation method is mandated by section 304(e). Taxpayer's Post-Trial Brief ("Taxpayer's Brief") pp. 11 – 34.

As a threshold matter, the parties disagree on whether or not the taxpayer's method of allocating capital net loss is permitted by the Department's rules and regulations. The Department contends that the method of allocation applicable in this case is the method of allocation applicable to the carry back and carry forward of net capital losses prescribed in the Federal consolidated return regulations pursuant to 86 Ill. Admin. Code, ch. I, section 100.5270(a). This regulation provides, in relevant part, as follows:

> **a) Determination of base income.** The combined base income shall be determined by first computing the combined group's combined taxable income and then modifying this amount by the combined group's combined Illinois addition and subtraction modification amounts.
>
> **1) Combined net income.** The designated agent will determine combined base income by treating all members of the unitary business group (including ineligible members) as if they constituted a federal consolidated group and by applying the federal regulations for determining consolidated taxable income, except that the separate return limitation year provisions and the limitations on consolidated life and non-life companies in Treasury Reg. Section 1.1502-47 shall not apply. …
>
> Example 1. Corporations A and B properly make an election under IITA Section 502(e), or are properly required to file a combined return under Section 502(e). On a separate return basis, A's federal taxable income would be a loss of ($500). This amount ABCs not include an excess capital loss of $75 pursuant to Internal Revenue Code Section 1211(a). B's federal taxable income is $1,000 of which $100 is a capital gain. As a result of applying Treasury Reg. Section 1.1502-

> 11 and Section 1.1502-22 (26 CFR 1.1502-22), the combined federal taxable income for A and B is $425.
>
> 86 Ill. Admin. Code, Ch. I, Section 100.5270(a)

As is evident from the foregoing, the Illinois income tax regulations clearly require a taxpayer to apply the federal consolidated return regulations in determining the manner in which to account for a capital loss for state tax purposes.

As noted by the Department:

> The federal consolidated return regulations incorporated by the Department's regulations make express provision for instances when a net capital loss, incurred by a consolidated group, can be carried over to years in which membership of the group changed. In particular, Treas. Reg. §1.1502-22(b)(3) provides that the group's loss must be allocated among the members, and thereafter each member is entitled to carry the loss to a year in which it filed a separate return or was a member of a different consolidated return. Specifically, Treas. Reg. §1.1502-22(b)(3) states:
>
> > If any consolidated net capital loss that is attributable to a member may be carried to a separate return year under the principles of Sec. 1.1502-21(b)(2), the amount of the consolidated net capital loss attributable to the member is apportioned and carried to the separate return year (apportioned loss).
>
> Treas. Reg. §1.1502-21(b)(2) referred to in Reg. 86 Ill. Adm. Code §100.5270 contains the provisions for allocating a consolidated net operating loss among members of a group in order to allow each member to carry its share of the loss to its separate or consolidated returns in a carryover period. Treas. Reg. §1.1502-21(b)(2)(iv)(B) provides:
>
> > The percentage of the [consolidated net operating loss] attributable to a member shall equal the separate net operating loss of the member for the year of the loss divided by the sum of the separate net operating losses for that year of all members having such losses. For this purpose, the separate net operating loss of a member is determined by computing the [consolidated net operating loss] by reference to only to the member's items of income, gain, deduction, and loss, including the member's losses and deductions actually absorbed by the group in the taxable year (whether or not absorbed by the member).

> These provisions allocate consolidated net operating losses and consolidated net capital losses among the members of a consolidated group based on the losses reported by each member on its own books and records (i.e., the member's separate-return loss).
>
> Department's "brief in support of the Department's *prima facie* case" ("Department's Brief") pp. 16, 17.[3]

However, the taxpayer argues that the mandate that the allocation method for allocating a capital loss prescribed in the Federal consolidated return regulations be used for state tax purposes has been superseded by 86 Ill. Admin. Code, ch. I, section 100.2350(c). Taxpayer's Brief pp. 23 – 27. This regulation provides, in relevant part, as follows:

> Carryover and Carryback of Combined Net Losses to Separate Return Years
>
> 1) This subsection applies to unitary members that have made an election to file a combined return under IITA Section 502(f). If a combined Illinois net loss (as defined in Section 100.5270(b)(3) of this Part) can be carried under the principles of Section 172(b) to a separate return year of a corporation (or could have been so carried if such corporation were in existence) which was a member of a unitary business group in the year in which such loss arose, then the portion of such combined Illinois net loss attributable to such corporation (as determined under subsection (c)(3) below) shall be assigned to such corporation and shall be an Illinois net loss carryover or carryback to such separate return year; accordingly, such portion shall not be included in the combined Ilinois net loss carryovers or carrybacks to the equivalent combined return year. Thus, for example, if a member filed a separate return for the third year preceding a combined return year in which a combined Illinois net loss was sustained and if any portion of such loss is assigned to such member for such separate return year, such portion may not be carried back by the group to its third year preceding such combined return year.
> 2) Nonassignment to certain members not in existence. Notwithstanding subsection (c)(1), the portion of a combined Illinois net loss attributable to a member shall not be assigned to a prior separate return year for which such member was not in existence and shall be included in the combined Illinois net loss carrybacks to the equivalent combined return year of the group (or,

[3] The Department submitted only one brief in this case, which was not titled. However, the first line of its brief states that this document is the Department's "brief in support of the Department's *prima facie* case."

if such equivalent year is a separate return year, then to such separate return year), provided that such member was a member of the unitary business group immediately after its organization.

3) Portion of combined Illinois net loss attributable to a member. The portion of a combined Illinois net loss attributable to a member of a group is an amount equal to the combined Illinois net loss of the group multiplied by a fraction, the numerator of which is what would have been the separate Illinois net loss of such corporation had a combined return not been filed, and the denominator of which is the sum of what would have been the separate Illinois net losses of all members of the group in such year having such losses. The separate Illinois net loss of a member of the group shall be determined pursuant to Sections 100.2320 and 100.2340 above.
86 Ill. Admin. Code, ch. I, section 100.2350(c)

The taxpayer argues that this regulation incorporates the unitary business principle into the methodology for allocating loss and therefore provides a basis for the method of allocation the taxpayer seeks to employ. Specifically, the taxpayer argues as follows:

> Thus, the revised method recognizes, consistent with the unitary business principle, that the net loss is the loss of the group operating as a single economic enterprise and that all of the members contribute to the group's net loss. Similarly, the revised method ABCs not rely on separate-company accounting as shown on the federal return. Rather, the net loss is allocated based on each member's Illinois factor. This revised approach thereby implements the combined apportionment method for apportioning a unitary group's income to Illinois.
> Taxpayer's Brief p. 26.

In support of this claim, the taxpayer argues that the example indicated in rule 86 Ill. Admin. Code, ch. I, section 100.2340(a) ("section 100.2340(a)"), referenced in rule 86 Ill. Admin. Code, ch. I, section 2350(c) ("section 100.2350(c)") provides for the allocation of loss among members of the unitary business group in the manner the taxpayer advocates. Specifically, the taxpayer notes the following:

Section 100.2350(c) provides for the “Carryover and Carryback of Combined Net Losses to Separate Return Years.” 86 Ill. Admin. Code § 100.2350(c). When a unitary group files a combined return, as the XYZ Unitary Business Group did in 2002, section 100.2350(c) provides that, if “a combined Illinois net loss … can be carried … to a separate return year of a … member of the unitary business group … then the portion of such combined Illinois net loss attributable to such [member] … shall be an Illinois net loss carryover or caryback to such separate return year.” 86 Ill. Admin. Code § 2350(c)(1). The issue then becomes how to determine the “portion …attributable to such [member] … under subsection (c)(3).” Subsection 100.2350(c)(3) provides:

> 3) Portion of combined Illinois net loss attributable to a member. The portion of a combined Illinois net loss attributable to a member of a group is an amount equal to the combined Illinois net loss of the group multiplied by a faction, the numerator of which is what would have been the separate Illinois net loss of such corporation had a combined return not been filed, and the denominator of which is the sum of what would have been the separate Illinois net losses of all members of the group in such year having such losses. The separate Illinois net loss of a member of the group shall be determined pursuant to Sections 100.2320 and 100.2340 above.

86 Ill. Admin. Code § 2350(c). Section 100.2340(a) provides that, if a combined return is not filed (but the combined apportionment method is used), the Illinois net loss of the unitary group “will be apportioned among all members of the group based on each member’s apportionment factors in Illinois compared to their combined apportionment factors everywhere.” 86 Ill. Admin. Code § 100.2340(a). The key point is that the “separate Illinois net loss” of a member is an apportioned share of the unitary group’s combined Illinois net loss determined using the combined apportionment method required by section 304(e). It is not the same as the separate-company loss for federal income tax purposes. And not filing a combined return for a unitary group is not the same as apportioning income to Illinois on a separate-company basis as was done before the enactment of section 304(e).

The following example, which is provided in section 100.2340(a), illustrates this point: Corporation A and Corporation B constitute a unitary business group, and there is no nonbusiness income or loss.

	Corp. A	Corp. B	Combined

Base Income/≤Loss≥	$200	≤$1,200≥	≤$1,000≥
Business Income/≤Loss≥			≤$1,000≥
Apport. % (sep. Ill./comb. Everywhere)	10%	40%	
Apport. % (comb. Ill./comb. Everywhere)			50%
Apportioned Income//≤Loss≥	≤$100≥	≤$400≥	≤$500≥
Base Income/≤≥	≤$100≥	≤$400≥	≤$500≥

86 Ill. Admin. Code § 100.2340(a). If, in applying the apportionment method, a combined return is not filed, the ratio of Corp. A's Illinois apportionment factors to the group's combined factors everywhere is 10% and 10% of the group's combined loss of $1,000 is $100. Thus, Corp. A's separate Illinois net loss is $100. Similarly, Corp. B's ratio is 40% and Corp. B's separate Illinois net loss is $400.

These "separate Illinois net losses" are then plugged into the allocation formula set forth in section 100.2350(c)(3) to allocate the combined Illinois net loss among members for carryback purposes. In this example, application of the section 100.2350(c)(3) formula results in Corp. A being allocated $100 of the group's $500 combined Illinois net loss for carryback purposes ($500 multiplied by the ratio of $100/$500). Corp. A is allocated this share of the combined Illinois net loss notwithstanding the fact that, according to the chart in the example, Corp. A reported a $200 gain, rather than a loss, for federal income tax purposes. Nonetheless, Corp. A is allocated a share of the combined net loss because the combined apportionment method disregards the amount that unitary group members report on a separate-company basis for federal income tax purposes.

It is important to stress that the "separate Illinois net loss" of a member, as determined under section 100.2340(a), is determined in accordance with the unitary business principle and the combined apportionment method used for unitary groups that file combined returns. Although the term "separate" is used, it is not based on the separate-company losses reported on a federal income tax return. To the contrary, as provided for in section 100.2340, it is a pro rata share of the unitary group's overall combined Illinois net loss. Every

> member that has an Illinois factor, regardless of its separate-company income or loss, has a "separate Illinois net loss."
> Taxpayer's Brief pp. 23 – 26.

The Department ABCs not agree with this contention. Department's Brief p. 27 ("The methodology used by the taxpayer has no basis in law or in the theory underlying the unitary computation of income."). Moreover, it argues, even if the taxpayer was correct, the allocation procedure for carrying back net operating losses to separate return years under regulation section 100.2350(c) is essentially the same as the allocation method prescribed in the Federal consolidated return regulations, which is the method the Department employed to arrive at its determination of net loss carryback the taxpayer is entitled to.

The Department presents the correct legal position. As noted above, section 100.2350(c) provides, in relevant part, as follows:

> Portion of combined Illinois net loss attributable to a member. The portion of a combined Illinois net loss attributable to a member of a group is an amount equal to the combined Illinois net loss of the group multiplied by a fraction, <u>the numerator of which is what would have been the separate Illinois net loss of such corporation had a combined return not been filed, and the denominator of which is the sum of what would have been the separate Illinois net losses of all members of the group in such year having such losses.</u> The separate Illinois net loss of a member of the group shall be determined pursuant to Sections 100.2320 and 100.2340 above. (emphasis added)

Pursuant to this regulation, the portion of a combined Illinois net loss attributable to a member of a unitary business group is an amount equal to the combined net loss of the group multiplied by a fraction, the numerator of which is what would have been the separate Illinois net loss of such corporation had a combined return not been filed, and the denominator of which is the sum of what would have been the separate Illinois net losses of all members of the group in such year having such losses.

Under the taxpayer's method each member of the unitary business group would be allocated a pro rata share of loss whether or not the member incurred a loss on a separate basis in the loss year. This methodology clearly is inconsistent with the methodology outlined in regulation section 100.2350(c) noted above, which allocates loss exclusively to members of the unitary business group in the loss year that had losses on a separate entity basis. Consequently, the taxpayer's method is neither consistent with nor supported by the method for prorating and carrying back loss set forth at regulation section 100.2350(c).

The taxpayer claims that its position is supported by the example at section 100.2340(a). Section 2340(a) provides, in part, as follows:

> IITA Section 502(f) allows corporations (other than Subchapter S corporations) that are members of the same unitary business group to elect to be treated as one taxpayer for certain purposes including the filing of returns (combined returns) and the determination of the group's tax liability. Consequently, if an election under Section 502(f) is in effect, any Illinois net loss and Illinois net loss deduction of the unitary business group shall be determined separately on the facts shown on the separate corporate returns of each member of the group. In general, the Section 502(f) election will not affect total amount of net loss or net loss deduction that is available, but it may affect how quickly the loss is absorbed. In general, if an election is in effect, net losses are absorbed more quickly. The rules for determining a net loss or net loss deduction set forth in Sections 100.2310 through 100.2330 apply in the same manner whether or not such an election is in effect. If business income of a unitary business group results in a loss, the amount of that loss will be the same whether or not a combined return is filed. If a combined return is not filed, any such loss will be apportioned among members of the group based on each member's apportionment factors in Illinois compared to their combined apportionment factors everywhere. This is illustrated by the following Example:

Assume that Corporation A and B constitute a unitary business group and there is no nonbusiness income or loss. Under the facts given below, if A and B file separate returns in 1986, using combined apportionment, A will have an Illinois net loss of $100 and B will have an Illinois net loss of $400, and if a combined return is filed, the group will report a combined Illinois net loss of $500.

	Corp. A	Corp. B	Combined
Base Income/≤Loss≥	$200	≤$1,200≥	≤$1,000≥
Business Income/≤Loss≥			≤$1,000≥
Apport. % (sep. Ill./comb. Everywhere)	10%	40%	
Apport. % (comb. Ill./comb. Everywhere)			50%
Apportioned Income//≤Loss≥	≤$100≥	≤$400≥	≤$500≥
Base Income/≤≥	≤$100≥	≤$400≥	≤$500≥

The taxpayer's claim that its position is supported by the example at section 100.2340(a) must be rejected because this example addresses a situation in which a combined return is filed. See section 100.2340(a) ("A will have a net loss of $100 and B will have an Illinois net loss of $400, and <u>if a combined return is filed</u>, the group will report a combined Illinois net loss of $500." emphasis added). Pursuant to regulation section 100.2350(c) the allocation of net loss prescribed by this section is to be determined based upon the separate Illinois net loss of members of a unitary business group "had a combined return <u>not</u> been filed." (emphasis added).

The inapplicability of the regulatory example relied on by the taxpayer in determining the allocation of net loss pursuant to section 100.2350(c) is made clear by developments subsequent to the promulgation of section 100.2340 which became effective on October 16, 1987. In describing the evolution of combined reporting in Illinois, John Doe, a former Director of the Illinois Department of Revenue, who testified on the taxpayer's behalf in this matter, stated the following:

> A: During this period of time, we were just learning about the unitary business principle, and how to apply it. We didn't have any experience. Certainly other states had experience, but we had none. So we were in the learning process. And initially, we took the position that even though Illinois had adopted the unitary approach to apportionment of income of a unitary group, we still had interpreted that each member ot the unitary group had to file its separate return but apportion the income on a unitary basis.
>
> Well, the taxpayer community … had lots of experience in other states reacted to that and said: That's crazy. That's not how other states approach the filing of the unitary return. They allow for the filing of a single return in a unitary business group. And we said: Well, that makes some sense. But we don't think our law necessarily provides for that, because there was another provision of the law that prohibited the filing of a consolidated return. So we didn't think we had the power to just do it.
>
> So we were convinced by the taxpayer community that we should permit it. So we recommended statutory change to the Governor for consideration to submit to the General Assembly, to allow for the filing of a single return by the unitary business group. And that was ultimately incorporated in Section 502(f) of that proposed legislation to the Governor's office. They approved it. We submitted it to the General Assembly. And it was ultimately adopted.
>
> Q: Is that now Section 502(e)?
>
> A: It is now Section 502(e). It has not been modified since that initial enactment.
>
> Again, we were going through this learning process about how to apply the combined methodology in Illinois. And later we decided that the first version of 502(e) really did not incorporate the spirit or intent of treating the unitary group as the taxpayer, it still had this reference to separate company liability of each member.
>
> Well, that was contrary to the whole concept of unitary apportionment of a – and treating the unitary group as a taxpayer.
>
> So then we proposed another amendment to more incorporate the concept of the unitary group in Illinois law. And that was to say, forget about the separate liability of each of the members; the liability is the liability of the group – the unitary group, not of individual

> members of the group. Because the concept of individual member liability was just foreign to the concept of combined apportionment of unitary business group.
>
> So we made another recommendation for an amendment to 502(f) at the time, now (e) to say, you know, it's the liability of the group rather than a separate – the summation of the liability of each of the members.
>
> I think that just reflects that we were learning. We didn't –
>
> We responded to issues as they came to our attention as we learned. And as taxpayers or different parties brought issues to our attention, we said, you know, you're right, we need to get guidance, we need to get clarification in the law.
>
> And we were regularly, during the period of '82, '86, '87, making recommended changes to more incorporate the spirit and intent of the unitary business principle in Illinois law.
>
> Q: Are there any changes to 502?
>
> A: Oh, there have been since. Now – 502(e) provides "require."
>
> So a taxpayer that is a unitary – A unitary group is required to file a single return. And that was, again, more – partly for administrative simplicity as well, both for the taxpayer and the Department.
>
> We were having unitary groups of 50 members, all of them filing separate returns. And that was kind of ludicrous. So we got to the point of saying we are not even going to permit it anymore, we are requiring it. So it was just a summation of learning what the tax process around combined apportionment of a unitary business group should be.
>
> Transcript of Hearing April 24, 2008 ("Tr.") pp. 95 – 99.

As is clear from the foregoing, under current law, if A and B determine income using the combined apportionment method, they could no longer "elect" not to be combined but would, after 1993, be required to file a combined return pursuant to section 502(e) of the IITA. Specifically, section 502(e) provides, in relevant part, as follows:

> For taxable years ending on or after December 31, 1993, taxpayers that are corporations (other than Subchapter S corporations) and that are members of the same unitary business group shall be treated as one taxpayer for purposes of any original return, amended return which includes the same taxpayers of the unitary business group which joined in the filing of the original return, extension, claim for refund,

> assessment, collection and payment and determination of the group's tax liability under the Act.
> 35 **ILCS** 5/502(e)

Accordingly, the amount determined by A and B in this example in regulation section 100.2340(a) would, under current law, be separate entity income computed where a combined return <u>is required to be filed</u>. This computation is at odds with the procedure required by the net loss allocation provisions of section 2350(c) which require the use of separate entity net loss computed as if a combined return had <u>not</u> been filed.

More importantly, even if regulation section 100.2350(c) could be read as endorsing the methodology the taxpayer seeks to employ, this regulation could not be relied upon as a legal basis for the taxpayer's claim because it only addresses the allocation of <u>net operating losses</u> as determined for Illinois income tax purposes pursuant to 86 Ill. Admin. Code, ch. I, sections 100.2310 – 100.2330.[4] At issue in this case is not the allocation of net operating losses, or Illinois net losses, but rather the manner in which <u>net capital losses</u> are to be allocated for carryback purposes. The only Illinois tax regulation that addresses this issue is 86 Ill. Admin. Code, ch. I, section 100.5270(c) which incorporates Treas. Reg. § 1.1502-22(b)(3) of the consolidated return regulations, a provision that expressly addresses the issue concerning the allocation of net capital loss carrybacks presented in this case.

Nor do I find persuasive the taxpayer's argument that Treas. Reg. 1.1502-22(b)(3), adopted by reference as the methodology to allocate net capital losses in

[4] With respect to net operating loss carrybacks, individuals are entitled to the net operating loss deductions allowed for federal income tax purposes because there is no provision in section 203 of the IITA, 35 **ILCS** 5/203, that requires them to add back net operating loss deductions. This is in contrast to the provisions in Section 203 that require all other taxpayers to add back any federal net operating loss deductions they have taken. For corporations and other non-individual taxpayers, Section 207 of the IITA, 35 **ILCS** 5/207, then provides for a separate computation and carryover of Illinois net losses.

Illinois, is sufficiently ambiguous as to any specific methodology to be employed in allocating loss so as to not preclude the employment of the allocation method the taxpayer seeks to utilize in this case. This line of argument is spelled out as part of the taxpayer's claim that its methodology is in accord with regulation 86 Ill. Admin. Code, ch. I, section 100.5270(a) ("section 100.5270(a)"). Specifically, the taxpayer makes the following contentions:

> The Department's reliance on section 100.5270(a)(1) is misplaced. ABC's method of allocating the 2002 Net Capital Loss among members of the XYZ Unitary Group is perfectly in accord with section 100.5270(a)(1). Indeed, as discussed below, section 100.5270 contains provisions that recognize and implement the unitary business principle.
>
> For purposes of determining the combined net income of a unitary group, section 100.5270(a)(1) provides:
>
>> The designated agent will determine combined base income treating all members of the unitary business group (including ineligible members) as if they constituted a federal consolidated group and by applying the federal regulations for determining consolidated taxable income … [.]
>
> 86 Ill. Admin. Code § 100.5270(a)(1). Apparently, the Department interprets this provision as requiring the application of the method in the federal consolidated return regulations for allocating consolidated net capital losses among the members of a consolidated group for carryback purposes. Neither section 100.5270(a)(1) nor the federal consolidated return regulations, however, supports the use of the Department's allocation method in allocating the 2002 Net Capital Loss of the XYZ Unitary Group.
>
> Treasury Regulation section 1.1502-22 of the federal consolidated return regulations governs the treatment of capital gains and losses of consolidated groups. In addressing carryovers and carrybacks of consolidated net capital losses to years in which group members file separate returns, the Regulation provides:
>
>> If any consolidated net capital loss that is attributable to a member may be carried to a separate return year under the principles of section 1.1502-21(b)(2), the amount of the

consolidated net capital loss that is attributable to the member is apportioned and carried to the separate return year (apportioned loss).

Treas. Reg. § 1.1502(b)(3). Treasury Regulation section 1.1502-21(b)(2) governs carryovers and carrybacks of federal consolidated net operating losses to separate return years. Thus, the portion of the federal consolidated return regulations specifically governing the carryover and carryback of capital losses to separate return years ABCs not contain its own rules for doing this. Instead, that provision directs taxpayers to follow the "principles" of the provision governing the carryover and carryback of net operating losses to separate return years. There is no separate, stand-alone provision in the consolidated return regulations that specifically prescribes the method to be used with respect to consolidated capital losses.

Thus, even assuming, as the Department ABCs, that section 100.5270(a)(1) of the Illinois Administrative Code follows the approach of the federal consolidated return regulations, that approach requires the adoption of ABC's method. The approach of the federal consolidated return regulations, insofar as the carryback of net capital losses to separate return years is correct, is to follow the "principles" of the provisions governing the carryback of net operating losses. As applied in Illinois, this approach results in the allocation of the 2002 Net Capital Loss in a manner consistent with the treatment of combined Illinois net losses.
Taxpayer's Brief pp. 35 - 37.

The taxpayer's position is not supported by federal income tax regulations governing the calculation of net capital loss carrybacks and carryovers. For purposes of calculating the amount of net capital losses to be carried over or back to separate return years, the federal regulations expressly state that the amount of net capital loss attributable to a member of the group is determined "under the principles of §1.1502-21(b)(2)" applicable to the allocation of net operating losses. See 26 C.F.R. §1.1502-22(b)(2). Treas. Reg. §1.1502-21(b)(2) provides as follows:

(2) Carryovers and carrybacks of CNOLs [Consolidated Net Operating Losses] to separate return years –(i) In general. If any

> CNOL that is attributable to a member may be carried to a separate return year of the member, the amount of CNOL that is attributable to the member is apportioned to the member (apportioned loss) and carried to the separate return year. If carried back to a separate return year, the apportioned loss may not be carried back to an equivalent, earlier, consolidated return year of the group, if carried over to a separate return year, the apportioned loss may not be carried over to an equivalent, or later, consolidated return year of the group.

The method for determining the amount of consolidated net operating loss ("CNOL") that is attributable to a member of the consolidated group is set forth in Treas. Reg. §1.1502-21(b)(2)(iv) which states, in relevant part, as follows:

> …[T]he percentage of the CNOL attributable to a member shall equal the separate net operating loss of the member for the year of the loss divided by the sum of the separate net operating losses for that year of all members having such losses. For this purpose, the separate net operating loss of a member is determined by computing the CNOL by reference to only the member's items of income, gain, deduction, and loss, including the member's losses and deductions actually absorbed by the group in the taxable year (whether or not absorbed by the member).

This is the only "principle" enunciated in federal consolidated return regulations for allocating a net capital loss or net operating loss to a member of the consolidated group for purposes of determining net capital loss and net operating loss carrybacks to separate return years.

Neither Treas. Reg. 1.1502.21 nor Treas. Reg. 1.1502.22 in any way alludes to or implies that the use of a methodology that is in any way similar to that used by the taxpayer in this case, is in any way authorized or sanctioned as a proper method for determining the carryback of consolidated net capital losses or consolidated net operating losses to separate return years. Nor do these regulations in any way suggest that any alternative to the allocation procedures they precisely spell out is permitted.

Consequently, the methodology prescribed by these regulations for allocating net capital losses is the exclusive method of allocation that these federal regulations authorize taxpayers to employ for such purposes. For this reason, I must reject the taxpayer's claim that the federal consolidated return regulations, governing the allocation of net capital loss for purposes of determining carrybacks, authorize or permit the use of the method of allocation the taxpayer seeks to employ in this case.

For the reasons enumerated above, I find that the taxpayer's proposed method for allocating net capital losses to the taxpayer is not authorized by the Department's income tax rules and regulations. Moreover, section 304(e), which the taxpayer claims is the statutory basis for its contentions, contains no language authorizing or even addressing, the allocation of capital losses to members of a unitary business group for purposes of determining net capital loss carrybacks. Accordingly, I conclude that the taxpayer has failed to establish any statutory or regulatory basis for the method of allocation it seeks to employ.

This conclusion is significant to the proper disposition of this matter because the Illinois Supreme Court has stated that "[t]he granting of a deduction for net operating losses is a privilege created by statute as a matter of legislative grace", and that, as a consequence "the taxpayer is not entitled to [this] deduction unless clearly authorized by statute and the burden is on the taxpayer to show he is entitled to the deduction claimed." See Bodine Electric v. Allphin, 81 Ill. 2d 502, 513 - 14 (1980) (quoting Bodine Electric Co. v. Allphin, 70 Ill. App. 3d 844, 850 (1st Dist. 1979)). See also United States v. Olympic Radio & Television, Inc., 349 U.S. 232 (1955). The taxpayer's failure to establish a statutory or regulatory basis for the method of allocation it seeks to employ leads me to conclude that the taxpayer has not met its required burden of proof in this case.

In the alternative, the taxpayer argues that irrespective of the validity of the Department's interpretation of its rules and regulations, the Department cannot apply its methodology to allocate loss to the taxpayer without violating section 304(e)'s mandate to apportion income of an Illinois taxpayer that is a member of a multicorporate unitary business group using the "combined apportionment method." Specifically, the taxpayer argues as follows:

> …[T]he Department's proposed method clearly is not the combined apportionment method required by section 304(e) of the IITA. Nor ABCs the Department's method treat the members of a unitary group as one taxpayer, as required by section 502(e) of the IITA. Instead the Department's method uses the capital losses separately reported by members on Schedule D for federal income tax purposes as the basis for allocating the 2002 Net Capital Loss among the members for carryback purposes. As discussed above, this method violates the unitary business principle, and, as such, is wholly inconsistent with the combined apportionment method.
> Taxpayer's Brief p. 40.

The *gravaman* of the taxpayer's claim is that the allocation of net loss pursuant to Federal consolidated return regulations is not authorized by Illinois law, which the taxpayer reads to require the consistent application of the unitary business principle where the taxpayer is a member of a multicorporate unitary business group. The unspoken premise of this contention is that the IITA mandates that all aspects of such taxpayers' income and apportionment be determined using the combined apportionment method rather than the separate accounting method. A review of the procedure for determining the net income of taxpayers properly includable in a unitary business group reveals the fallacy of this proposition.

As noted in Atlantic Richfield Company v. State of Alaska, 705 P. 2d 418 (1985), there are essentially three basic methods by which the income of a multistate enterprise can be divided among the states that are constitutionally permitted to tax the enterprises' income: separate accounting, specific allocation by situs and formula apportionment. The court in this case, outlines the parameters of each of these methods as follows:

> 1. *Separate Accounting*
> Separate accounting attempts to carve out of the taxpayer's overall business the income derived from sources within a single state, and by accounting analysis, to determine the profits attributable to that portion of the business. [Citing J. Hellerstein, State Taxation: Corporate Income and Franchise Taxes ¶ 8.3, at 323-327 (1983)]. Income within the state is determined without reference to the success or failure of the taxpayer's activities in other states. [Citing P. Hartman, Federal Limitations on State and Local Taxation ¶ 9.17, at 522 (1981)]. …
>
> 2. *Specific Allocation by Situs*
> Specific allocation by situs refers to the method of dividing a tax measure (in whole or in part) by tracing particular property, receipts, or income to their source state, and attributing the item *in its entirety* to that state. [Citing J. Hellerstein, *supra*, note 7, ¶ 8.4, at 328)]. … The specific allocation method has been used commonly with "non-business" income such as income from dividends, patent and copyright royalties, and gains or losses from the sale of capital assets. …
>
> 3. *Formula Apportionment*
> Formula apportionment is the method commonly used to divide the income of a unitary business among various jurisdictions in which the business operates. The formula method, "unlike separate accounting, ABCs not purport to identify the precise geographical source of a corporation's profits; rather, it is employed as a rough approximation of a corporation's income that is reasonably related to the activities conducted within the taxing State." [Citing Moorman Mfg. v. Bair, 437 U.S. 267, 273 (1978)]. The formula method assumes that the total income of a business enterprise results from certain income producing factors – typically property, payroll and sales. The value of the corporation's property, payroll and sales within the taxing state is compared with the value of these factors outside of the taxing state.

> The resulting ratio is then multiplied by the total apportionable net income worldwide of the multi-state corporation. [Citing P. Hartman, *supra*, note 8, § 9.18, at 523-524].
> Atlantic Richfield, *supra* at 422 – 23.

The taxpayer equates the methodology prescribed by the IITA, as pertains to taxpayers that are members of a multicorporate unitary business enterprise, with the formula apportionment method of apportioning and determining income taxable in a given state. Taxpayer's Brief pp. 10, 19, 20. Conversely, it equates the determination of the separate taxable income of a member of a unitary business group for federal and state income tax purposes with separate accounting. *Id*.[5] After comparing the methods used by the Department to determine the taxpayer's income, it concludes that the formula apportionment method is the only methodology the Illinois Income Tax Act authorizes to determine the income of a unitary combined group of corporations. However, in doing so, the taxpayer ignores the IITA's clear distinction between the method for determining income subject to apportionment and the method to be used to apportion such income once it has been determined.

Under the Illinois Income Tax Act, a tax measured by net income is imposed on every corporation for each taxable year ending after July 31, 1969. 35 **ILCS** 5/201(a). The tax is exacted on the privilege of earning or receiving income in or as a resident of this State. *Id*. Net income is that portion of the taxpayer's base income for such taxable year that is allocable to this State. 35 **ILCS** 5/202. A corporation's base income is equal to the corporation's taxable income for the taxable year for Federal income tax purposes,

[5] While the commonly understood meaning of separate accounting as described in Atlantic Richfield, *supra,* (i.e. as a method for sourcing income to a single geographical source) differs from "separate-company accounting" as used by the taxpayer to refer to sourcing income to a single entity, the taxpayer's discussion in its brief indicates that it is using commonly understood "separate accounting" and "separate-company accounting" to mean the same thing. See Taxpayer's Brief pp. 10, 19, 20.

subject to certain adjustments prescribed by the Act. 35 **ILCS** 5/203(b), 35 **ILCS** 5/203(e). Taxable income is determined as if a corporate taxpayer that has been included in a consolidated Federal income tax return had filed a separate return for federal income tax purposes for the taxable year and each preceding taxable year for which it was a member of a federal affiliated group of corporations filing a consolidated return. Specifically, 35 **ILCS** 5/203(e)(2)(E) of the IITA provides as follows:

> In the case of a corporation which is a member of an affiliated group of corporations filing a consolidated income tax return for the taxable year for federal income tax purposes, taxable income [is] determined as if such corporation had filed a separate return for federal income tax purposes for the taxable year and each preceding taxable year for which it was a member of an affiliated group.
> 35 **ILCS** 5/203(e)(2)(E) ("Section 203(e)(2)(E)")

Consistent with this dictate, Parts II and III of Schedule UB for Form IL-1120 (2002)[6] require the designated agent to separately list federal and Illinois tax attributes for each member of a combined filing group. Lines 12 through 27 of Part II require federal business expense deductions to be listed separately for each member – and whether a federal deduction is allowable is a substantive question that must be answered on a separate basis for each individual member. See Treas. Reg. §§ 1.1502-11(a)(1) - 12 (requiring the federal income tax laws to be applied on a separate basis to each member of a federal consolidated group). Likewise, Line 8 of Part III requires nonbusiness income or loss to be listed separately for each member. In sum, the determination of the income of a unitary business group begins with a determination of net income on a separate entity basis.

[6] The Schedule UB is a form that must be filed by a unitary business group with its IL-1120 "to determine the amount of its unitary business income that is attributable to Illinois." See Schedule UB Instructions, p. 1 (General Information).

In short, the analysis of each taxpayer's taxable income, whether or not a member of a unitary business group, begins with a determination of its separate federal taxable income. This is true because sections 203(b), and 203(e) of the IITA clearly provide that Illinois base income is an amount equal to the taxpayer's separately determined taxable income (as modified by Illinois statute).

As a consequence of section 203(e)(2)(E), a corporation is required to utilize separate accounting rather than formulary apportionment in determining its net income. Consistent with the mandate of section 203(e)(2)(E) to utilize separate accounting in determining a taxpayer's net income, the Department has adopted rules and regulations designed to conform the determination of each separate corporation's separate income for Illinois income tax purposes with its determination of income pursuant to the statutes, rules and regulations governing the determination of separate entity federal taxable income pursuant to the Internal Revenue Code. As noted by the Department:

> The adoption and incorporation of the methodology contained in the federal consolidated return regulations is the appropriate methodology for allocating a net capital loss of a combined group to the group's members. The methodology set forth in the federal consolidated return regulations is the method required by the Department's regulations. The Department's regulations adopt the methodology contained in the federal consolidated return regulations, which allocate a net capital loss to each loss member in proportion to each member's separate return net capital loss as a percentage of the sum of all net capital losses. 86 Ill. Adm. Code §100.5270(a) and Treas. Reg. §1.1502-21(b)(2). In the current case, the Department allocated the 2002 Net Capital Loss in the manner prescribed by the federal consolidated return regulations, which is incorporated in the Department's regulations. Accordingly, the Department used the correct methodology to allocate the 2002 Capital Loss to the former members of the ABC Unitary Group.
>
> The separate-return loss methodology provided for in the federal consolidated return regulations provides an orderly and consistent

> method in which taxpayers can prepare, and thereafter file their federal and Illinois corporate income tax returns. For federal tax purposes, a taxpayer allocates a consolidated net capital loss to the members of the group based on the members' separate return losses. Treas. Reg. §1.1502-21(b)(2). Subsequently, the taxpayer computes its federal taxable income, which is the starting point for computing the taxpayer's Illinois income tax liability. 35 **ILCS** 5/203(b)(1). If a taxpayer uses the same methodology to allocate a net capital loss amount its members for federal and Illinois tax purposes, its federal taxable income computed for federal tax purposes will be the same as its federal taxable income for Illinois tax purposes.
>
> In contrast, if ABC allocates the 2002 Net Capital Loss in accordance with the methodology in the federal consolidated return regulations (which is the method required by the Department's regulation) for federal tax purposes but uses another methodology (such as ABC's separate Illinois apportionment factor method) to allocate the 2002 Net Capital Loss for Illinois tax purposes, ABC will have two different amounts for federal taxable income, one for federal purposes and one for Illinois tax purposes.

Department's Brief pp. 23, 24.

In sum, as discussed above, a corporation whose taxable income is included in a consolidated federal return is required to recompute its federal taxable income on a separate accounting or separate return basis to arrive at its state base income pursuant to section 203 of the IITA. It is only after the determination of net income on a separate entity basis has been made that combined income is determined. See Schedule UB Instructions, pp. 2, 3. This is done by combining the separate income and loss of each entity, determined separately, to arrive at the income of the unitary business group. *Id*.

Thus, not only is the use of separate accounting to determine the separate taxable income of each entity includable in a multicorporate unitary business group authorized by the IITA, it is in fact required by section 203(e)(2)(E) of this Act. Section 203(e)(2)(E) sets forth separate accounting as the only authorized mechanism to determine the separate entity income of each taxpayer that is includable in the multicorporate unitary business group. It is only after this separate accounting determination has been made, the separate incomes combined, and losses of members of the unitary business group with losses offset against the income of members with income, that the mandate of section 304(e) comes into play. Given the foregoing, I find that the unspoken premise of the taxpayer's argument that every aspect of the determination of income taxable in Illinois derived by a member of a multicorporate unitary business group must be determined using formulary apportionment, to be incorrect.

Contrary to the taxpayer's claim, the use of separate accounting is expressly authorized and required to determine the net income of all Illinois corporate taxpayers, whether or not members of a unitary business group, by section 203 of the IITA. Since separate accounting is authorized and required by Illinois law in determining each taxpayer's net income, the use of a separate accounting methodology to determine the net income of the taxpayer for 1999, as the Department has done in this case, is not outside the bounds of Illinois law. Consequently, I find to be without merit taxpayer's claim that the separate accounting methodology utilized by the Department to allocate the net capital loss of the taxpayer for purposes of determining the amount of the taxpayer's net capital loss carryback is not authorized by the IITA.

Validity of 86 Ill. Admin. Code, ch. I, Section 100.5270(a)

The taxpayer, at page 39 of its brief, makes the following argument: "Alternatively, if the Department's interpretation of section 100.5270(a)(1) were upheld, the regulation would be invalid." The Department contends that the validity of this regulation is beyond the scope of the issue agreed to by the parties to be adjudicated in this matter in the pre-trial order they agreed to have entered in this case. Department's Brief p. 31. The pre-trial order entered in this matter describes the issue to be decided as follows:

> The issue in this case is how, for Illinois income tax purposes, the 2002 net capital loss of the XYZ Communications Inc. unitary group (the "XYZ Unitary Group"), which included the former members of the ABC Unitary Group, should be allocated among the members of the XYZ Unitary Group for purposes of determining the portion of the 2002 net capital loss that the former members of the ABC Unitary Group can carryback to offset the net capital gains reported in tax periods in which they were not members of the XYZ Unitary Group.

Since the validity of the Section 100.5270(a) is neither an enumerated issue in this matter, nor a necessary consequence of the agreed upon issue in this matter, I decline to address the taxpayer's contention that this regulation is invalid.[7] It should be noted, moreover, that, in Department of Corrections v. Illinois Civil Service Commission, 187 Ill. App. 3d 304 (1st Dist. 1989), the court states the following:

> Rules adopted by an administrative agency pursuant to statutory authority have the force of law and the administrative agency is bound by the rules. *Id.*at 308.

Accordingly, even if the validity of Section 100.5270(a) were properly before this tribunal in the instant case, I would have no authority to declare this duly promulgated regulation *ultra vires* or otherwise invalid.

Taxpayer's Section 304(f) Argument

The taxpayer also contends, that the application of the Department's methodology for allocating net capital losses for purposes of determining the amount of XYZ net

[7] Nor was the validity of Regulation Section 100.5270(a) raised as an issue in the taxpayer's protest filed March 26, 2006 or in the taxpayer's amended protest filed June 5, 2007.

capital loss that can be carried back to offset the taxpayer's 1999 net capital gain, frustrates the purpose of combined reporting, which is to determine the income tax base of in-state taxpayers by viewing such taxpayers as part of a unitary business. Taxpayer's Brief pp. 41 – 43; Taxpayer's Reply Brief pp. 23 – 24. As a consequence, it argues, the Department's methodology grossly distorts the extent of the taxpayer's business activity in Illinois and improperly apportions the taxpayer's income to this state. Taxpayer's Brief pp. 41 – 43. To correct this distortion the taxpayer offers that it is entitled to utilize an alternative method of apportionment pursuant to section 304(f) of the IITA. ***Id.***[8]

Section 304(f) provides that, if the allocation and apportionment provisions of subsections (a) through (e) or (h) "do not fairly represent the extent of a person's business activity in this State, the person may petition for, or the Department may require, in respect of all or any part of the person's business activity in this State," the use of an alternative method "to effectuate an allocation and apportionment of the person's business income." 35 **ILCS** 5/304(f). The regulations interpreting section 304(f) provide that an alternative apportionment method is appropriate "if the application of the statutory formula will lead to a grossly distorted result in a particular case." 86 Ill. Admin. Code, ch. I, section 100.3390 ("section 100.3390")(c). The person seeking to utilize an alternative apportionment method has the burden of proving "by clear and cogent evidence that the statutory formula results in the taxation of extraterritorial values and operates unreasonably and arbitrarily in attributing to Illinois a percentage of income which is out of all proportion to the business transacted in the State." ***Id.***

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[8] While section 304(f) was not enumerated as an issue in the pre-trial order entered in this case, this issue was raised in the taxpayer's amended protest filed June 5, 2007.

Section 100.3390 spells out the procedure that must be followed in order to petition for section 304(f) relief, stating, in relevant part as follows:

> (d) Filing procedure
>
> A petition for alternative apportionment must be clearly labeled "Petition for Alternative Apportionment" and supported by sufficient facts and information to allow the Director to determine whether the taxpayer has met the burden of proof required under subsection (b) above. A petition will be summarily rejected if the sole basis for support rests on the fact than an alternative method reaches a different apportionment percentage than the statutory formula. Petitions must be submitted to:
>
> Illinois Department of Revenue
>
> Legal Services Bureau/ Income Tax
>
> 101 W. Jefferson Street
>
> Springfield, IL 62794-9001
>
> e) Timely Filed Petitions
>
> A taxpayer petition for use of a separate accounting method or any other alternative apportionment method will not be considered by the Director unless such petition has been timely filed. A taxpayer who petitions the Director for an alternative apportionment formula ABCs so subject to the Department's right to verify, by audit of the taxpayer's return and supporting books and records within the applicable statute of limitations, the facts submitted as the basis of the petition. A petition for alternative allocation or apportionment is timely filed if the petition is filed:
>
> 1) 120 days prior to the due date of the tax return (including extensions) for which permission to use such alternative method is sought. A taxpayer who ABCs not petition more than 120 days prior to the due date of the original return must file the return and pay tax according to the statutorily approved allocation or apportionment method.
>
> 2) as an attachment to a return amending an original return which was filed using the statutory allocation and apportionment rules. A taxpayer who has not filed a petition for alternative apportionment under subsection (e)(1) above, or whose subsection (e)(1) petition has been rejected, may thereafter file such petition with an amended return and the Department will consider the petition along with any other issues raised in the

> claim for refund pursuant to the procedures set forth at Section 100.9110 of this Part.
>
> 3) as part of a protest to a notice of deficiency issued as a result of the audit of the taxpayer's return and supporting books and records; provided that the audit adjustments being protested result in the need for the petition for alternative apportionment.

The record in this case ABCs not reflect that the taxpayer ever filed a petition for section 304(f) relief in accordance with any of the requirements of section 100.3390 noted above. Consequently, the taxpayer has failed to show that it has complied with any of the procedural requirements for obtaining relief pursuant to this provision.

Even if the taxpayer had correctly presented the section 304(f) issue, its arguments for relief pursuant to this provision are legally flawed. The Illinois and federal courts have placed a heavy burden of proof on taxpayers seeking to challenge the validity of state apportionment schemes. Citizens Utilities Co. v. Department of Revenue, 111 Ill. 2d 32, 52 (1986); Butler Brothers v. McColgan, 315 U.S. 501, 507 (1942) ("[O]ne who attacks a formula of apportionment carries a distinct burden of showing by 'clear and cogent evidence' that it results in extraterritorial values being taxed …"). To prevail, the taxpayer must show that "in any aspect of the evidence its income attributable" to the taxing State was "out of all appropriate proportion to the business transacted in the State." *Id*. One way of meeting this burden is by showing that the apportionment scheme results in the imposition of tax on income arising from business conducted beyond the borders of the state. Hans Rees' Sons, Inc. v. North Carolina, 283 U.S. 123 (1931). In that case, the United States Supreme Court found that the state's apportionment scheme produced an apportionment of income to North Carolina "out of all appropriate proportion" to the taxpayer's activities in the taxing state. *Id.* at 135.

Consistent with the foregoing line of authority, the Illinois appellate court, in Rockwood Holding Co. v. Department of Revenue, 312 Ill. App. 3d 1120 (1st Dist. 2000), upheld a trial court's determination that section 304(f) "only pertains to situations where the general statutory formulae for 'allocation and apportionment' fail to fairly represent the true extent of a taxpayer's activities within Illinois." *Id.* at 1126. In the instant case, the taxpayer has failed to produce any evidence that the application of the Department's methodology results in the attribution of the taxpayer's income to Illinois in a manner that is out of all proportion to the taxpayer's business activities in this state. Indeed, the Department contends that the facts support the exact opposite conclusion, i.e. that the taxpayer's method would allocate loss to the taxpayer in a manner that ABCs not reflect the taxpayer's actual contribution to the XYZ Group's loss during 2002. The Department notes the following:

> Further, the methodology that XYZ used to allocate the 2002 Net Capital Loss to ABC should be rejected because it is contrary to the methodology expressly required by the Department's regulations and would allocate a disproportionate share of the 2002 Net Capital Loss to Illinois. The net capital loss at issue in this matter arose in tax year 2002. (Stip. ¶25). The ABC Group and the XYZ Unitary Group were not engaged in a unitary business enterprise with each other until January 1, 2000. (Stip. ¶24). XYZ was not required to file a coporate income tax return in Illinois for tax year 1999. (Stip. ¶¶8 – 9). Members of the ABC Unitary Group were the only members of the 2002 XYZ Unitary Group that reported Illinois gross receipts in tax year 1999. (Stip. Exs. 6, 9, 11, 15, 16, 17, 18, 21 and 22). Yet, XYZ attempts to allocate its losses to Illinois using ABC as a conduit. XYZ

> Communications, by itself, accounted for over $3.2 million[9] of the total $3,800,859,083 net capital loss that the XYZ Consolidated Group reported on the 2002 XYZ Consolidated tax return. (Stip. Ex. 29). XYZ's proposed methodology would allocate to Illinois losses out of all proportion to XYZ's business activities conducted in Illinois during tax year 1999.
>
> Department's Brief, pp. 30-31.

In lieu of evidence sufficient to meet its statutory burden, the taxpayer merely contends that inherent flaws in the methodology used to allocate the XYZ Group's 2002 loss to the taxpayer results in the attribution of far more income to Illinois than the methodology the taxpayer has proposed. However, the courts have held that a showing that an application of an apportionment or allocation method other than the method required by the state results in a lower amount of income being subject to taxation is of no legal significance. In Citizens Utilities, *supra*, the Illinois Supreme Court held that a taxpayer must prove distortion by clear and cogent evidence, and that this burden cannot be met by reliance upon bare percentages alone. *Id.* at 52 - 53.

For the foregoing reasons, I find that, even if the taxpayer had properly petitioned for section 304(f) relief, the record ABCs not support the taxpayer's claim to such relief in the instant case. Consequently, I find that the taxpayer's request to employ its alternative apportionment method pursuant to section 304(f) must be denied.

Taxpayer's Constitutional Argument

Finally, the taxpayer further contends that "[I]f the Department's [m]ethodology were [u]pheld under the Illinois Income Tax Act, [t]hen the [s]tatute [w]ould [v]iolate the

[9] The Department's brief incorrectly states that XYZ Communications accounted for "over 3.2 million" of the total $3,800,859,083 net capital loss that the XYZ Consolidated Group reported in 2002. However, a review of the record indicates that this amount is actually over $3.2 billion. See Stip. Exhibit 29.

Due Process Clause of the United States Constitution." Taxpayer's Brief p. 44. The resolution of this issue must necessarily consider the constitutionality of a statute. It is a settled tenet of administrative law jurisprudence that administrative agencies must presume the constitutionality of the statutes they interpret, and thus have no power to determine the type of constitutional issue the taxpayer has presented. Texaco-Cities Service Pipeline Co. v. McGaw, 182 Ill. 2d 262, 278 (1988), (citing Moore v. City of East Cleveland, 431 U.S. 494 (1977)). Accordingly, I have no authority to adjudicate the constitutionality of the Illinois Income Tax Act, the issue the taxpayer has raised by virtue of its constitutional claims.

WHEREFORE, for the reasons stated above, it is my recommendation that the Department's partial denial of the taxpayer's claim for refund for the tax year 1999 be upheld.

Ted Sherrod
Administrative Law Judge

Date: November 22, 2008