

IT 09-14

Tax Type: Income Tax

Issue: Net Operating Loss (General)

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

THE DEPARTMENT OF REVENUE)	Docket No.	00-IT-0000
OF THE STATE OF ILLINOIS)	FEIN	00-0000000
v.)	Tax Years	8/31/04, 8/31/05
ABC, INC.,)	John E. White,	
Taxpayer)	Administrative Law Judge	

RECOMMENDATION FOR DISPOSITION

Appearances: Anna Johnson, ABC, Inc., appeared for ABC, Inc.;
Ralph Bassett, Special Assistant Attorney General,
appeared for the Illinois Department of Revenue.

Synopsis:

This matter involves a protest ABC, Inc. (ABC or Taxpayer) filed to contest the Notice of Deficiency (NOD) the Illinois Department of Revenue (Department) issued to it to propose to assess Illinois income and replacement income tax regarding Taxpayer's 2004 and 2005 tax years ending, respectively, on August 31 of 2004 and 2005. The tax proposed is based on the Department's determination that that Taxpayer was not entitled to the Illinois net loss deduction Taxpayer claimed on each of its 2004 and 2005 Illinois income tax returns.

In lieu of hearing, the parties submitted a stipulated record and filed briefs regarding the issue. After considering the stipulated record and the parties' arguments, I am including in the recommendation findings of fact and conclusions of law. I recommend that the Director finalize the NOD as issued, pursuant to statute.

Findings of Fact:

1. Taxpayer is a Delaware corporation with its principal place of business in Massachusetts. Stip. ¶ 1.
2. Taxpayer is taxed as a cooperative by the federal government under Subchapter T, Cooperatives and Their Patrons, of the Internal Revenue Code (IRC or Code). Stip. ¶ 2; Stip. Exs. 8, 10, 12, 3, 6 (copies of ABC's federal income tax returns (federal returns) for tax years ending on August 31 of, respectively, 2001, 2002, 2003, 2004, and 2005).¹
3. For federal tax purposes, the return Taxpayer files is a form 990-C, Farmers' Cooperative Association Income Tax Return. Stip. Exs. 3, 6, 8, 10, 12. For each year, Taxpayer attaches to its Form 990-C a Form 8817, Allocation of Patronage and Nonpatronage Income and Deductions. Stip. Exs. 3, 6, 8, 10, 12.
4. Taxpayer timely filed its federal returns for tax years ending on August 31 of 2001, 2002, 2003, 2004, and 2005. Stip. ¶¶ 8, 10, 12, 3, 6.
5. Taxpayer also timely filed its Illinois returns for the same tax years. Stip. ¶¶ 9, 11, 13, 4, 7.
6. Taxpayer attached an NOL schedule to its 2004 federal return. Stip. ¶ 3; Stip. Ex. 3.
7. The Department made certain internal alterations to the Taxpayer's Form IL-1120 for the tax year ending August 31, 2004. Stip. ¶ 5; Stip. Ex. 5 (copy of 2004 Illinois return that was received by the Department, and which contains handwritten entries on it that were made by Department employees when reviewing it).
8. Taxpayer reported the following amounts of patronage and non-patronage income (losses) on line 29 of its federal 8817 forms for 2001 through 2005, and the following

¹ In this recommendation, I refer to the returns admitted into evidence by the year in which Taxpayer's particular tax year ended, notwithstanding the fact that the preprinted federal and Illinois tax forms filed by Taxpayer reflect, for example, that Taxpayer's 2004 federal and Illinois returns were reported on "2003" forms. Stip. Exs. 3 (copy of ABC's 2004 federal return), 4 (copy of ABC's 2004 Illinois return).

amounts of taxable income before and after applying any available federal net operating loss and special deductions for such years, on lines 28 and 30 of its federal 990-C forms:

Year	Taxable Patronage Income (Loss), line 29(a) of 8817	Taxable Non-patronage Income (Loss) line 29(b) of 8817	Taxable Income (Loss) Before NOL & Special Deductions, line 28 of 990-C	Taxable Income (Loss), line 30 of 990-C
2001	0	(9,744,635)	31,006,596	(9,744,635)
2002	2,955,547	(11,781,550)	9,619,139	(8,826,003)
2003	13,775,832	(2,839,319)	48,436,513	13,775,832
2004	(5,490,353)	0	(3,527,895)	(5,490,353)
2005	(12,283,709)	735,400	(10,597,025)	735,400

Stip. Exs. 8, 10, 12, 3, 6.

9. On its Illinois returns for tax years 2001 through 2005, Taxpayer attached a memorandum which provided, in part:

DATE: []
 TO: State Department of Revenue
 FROM: Jane Doe
 SUBJECT: Net Operating Losses — ABC, Inc. []

ABC Inc. is a Farmer's Cooperative and as such, files a Federal Form 990C. This memo is attached to all 8/31/[] State Income Tax returns to explain the unique income structure of a cooperative and, therefore, unique "utilization" of net operating losses.

A cooperative has two types of income: Patronage and Non-patronage. The two types of income must be stand-alone and therefore, losses from patronage cannot offset income from non-patronage and losses from non-patronage cannot offset income from patronage.

Stip. Exs. 9, 11, 13, 4, 7.

10. In the memo Taxpayer attached to its 2001 Illinois return, in the section indicated by asterisks in finding of fact number 9, Taxpayer made the following additional statements.

ABC, Inc. had patronage losses starting in year ending 8/31/96 and continued to incur losses through 8/31/99. Patronage income in years ending 8/31/00 and 8/31/01 were offset by net operating losses carried forward from prior years.

In year ending 8/31/01, ABC, Inc. had a non-patronage net operating loss. This loss will be carried forward to future years, when it will offset non-patronage income.

Attached is a detailed schedule of net operating losses and carry forwards for both patronage and non-patronage income.

Stip. Ex. 9. As part of the memo Taxpayer attached to its 2001 Illinois return, Taxpayer included schedules detailing amounts that it was reporting as being state non-patronage and/or patronage losses. *Id.*

11. In the memo Taxpayer attached to its 2002 Illinois return, in the section indicated by asterisks in finding of fact number 9, Taxpayer made the following additional statements.

ABC, Inc. had patronage losses starting in year ending 8/31/96 and continued to incur losses through 8/31/99. Patronage income in years ending 8/31/00, 8/31/01, and partial 8/31/02 were offset by net operating losses carried forward from prior years.

In the years ending 8/31/01 and 8/31/02, ABC, Inc. had [] non-patronage net operating losses. These losses will be carried forward to future years, when they will offset non-patronage income.

Attached is a detailed schedule of net operating losses and carry forwards for both patronage and non-patronage income.

Stip. Ex. 11. As part of the memo Taxpayer attached to its 2002 Illinois return, Taxpayer included schedules detailing amounts that it was reporting as being state non-patronage and/or patronage losses. *Id.*

12. In the memo Taxpayer attached to its 2003 Illinois return, in the section indicated by asterisks in finding of fact number 9, Taxpayer made the following additional statements:

ABC, Inc. had patronage losses starting in year ending 8/31/96 and continued to incur losses through 8/31/99. Patronage income in years ending 8/31/00, 8/31/01, and partial 8/31/02 were offset by net operating losses carried forward from prior years. 8/31/03 taxable income reported to the state is patronage taxable income.

In years ending 8/31/01, 8/31/02, and 8/31/03 ABC, Inc. had [] non-patronage net operating losses. These losses will be carried forward to future years, when they will offset non-patronage income.

Attached is a detailed schedule of net operating losses and carry forwards for non-patronage income.

Stip. Ex. 13. As part of the memo Taxpayer attached to its 2003 Illinois return, Taxpayer included schedules detailing amounts that it was reporting as being state non-patronage and/or patronage losses. *Id.*

13. Taxpayer also attached to its 2003 Illinois return a Schedule UB/NLD Unitary Illinois form, Part III of which provided as follows:

	A	B	C	D	E	F	G	H	I
	FEIN	Loss Year month / year	Illinois net loss available	Illinois net loss previously used	Remainder of Illinois net loss	Base income allocable to Illinois	Illinois [NLD]	Base income after NLD	Remaining NLD
* 1	04-1215610	8/2001	390,165		390,165				390,165
*	04-1215610	8/2002	384,797		384,797				384,797
*	04-1215610	8/2003	105,691		105,691				105,691
	* non-patronage loss carryforward								
2	Totals		880,653	0	880,653	0	0	0	880,653

Stip. Ex. 13.

14. In the memo Taxpayer attached to its 2004 Illinois return, in the section indicated by asterisks in finding of fact number 9, Taxpayer made the following additional statements:

ABC, Inc. had a patronage loss in the current year ending 8/31/04.

In years ending 8/31/01, 8/31/02, and 8/31/03 ABC, Inc. had [] non-patronage net operating losses. These losses will be used to offset non-patronage income in FY04 when filing a consolidated state return. For separate states — ABC, Inc. only incurred a non-patronage loss in current year ending 8/31/04 which will be carried forward to future years, when it will offset non-patronage income.

Attached is a detailed schedule of net operating losses and carry forwards for patronage and non-patronage income.

Stip. Ex. 4. As part of the memo Taxpayer attached to its 2004 Illinois return, Taxpayer included schedules detailing amounts that it was reporting as being state non-patronage and/or patronage losses. *Id.*

15. Taxpayer also attached to its 2004 Illinois return a Schedule UB/NLD Unitary Illinois form, Part III of which provided as follows:

	A	B	C	D	E	F	G	H	I
	FEIN	Loss Year month / year	Illinois net loss available	Illinois net loss previously used	Remainder of Illinois net loss	Base income allocable to Illinois	Illinois net loss deduction	Base income after NLD	Remaining NLD
1		08/2001	390,165		390,165				390,165
	04-1215610	08/2002	384,797		384,797				384,797
	04-1215610	08/2003	105,691		105,691				105,691
	04-1215610	08/2004	190,082		190,082				190,082
08/2001 — 08/2003 Non-patronage NOL									
08/2004 Patronage NOL									
2	Totals		1,070,735		1,070,735	256,218	256,218	0	814,517

Stip. Ex. 4.

16. In the memo Taxpayer attached to its 2005 Illinois return, in the section indicated by asterisks in finding of fact number 9, Taxpayer made the following additional statements:

ABC, Inc. had a patronage loss in the current year ending 8/31/05 and prior year 8/31/04 — these losses will be carried forward to future years.

In years ending 8/31/01, 8/31/02, and 8/31/03 ABC, Inc. had [] non-patronage net operating losses. These losses will be used to offset non-patronage income in FY05 when filing a consolidated state return. For separate states — ABC, Inc. only incurred a non-patronage loss in year ending 8/31/04 which will be applied against current year non-patronage income (where permitted).

Attached is a detailed schedule of net operating losses and carry forwards for patronage and non-patronage income.

Stip. Ex. 7. As part of the memo Taxpayer attached to its 2005 Illinois return, Taxpayer included schedules detailing amounts that it was reporting as being state non-patronage and/or patronage losses. *Id.*

17. Taxpayer also attached to its 2005 Illinois return a Schedule UB/NLD Unitary Illinois form, Part III of which provided as follows:

	A	B	C	D	E	F	G	H	I
	FEIN	Loss Year month / year	Illinois net loss available	Illinois net loss previ-	Remainder of Illinois net loss	Base income allocable	Illinois net loss deduc-	Base income after	Remaining NLD

			ously used		to Illinois	tion	NLD		
1		08/2001	390,165		390,165	256,218	256,218	0	133,947
	04-1215610	08/2002	384,797		384,797	140,406	140,406	0	244,391
	04-1215610	08/2003	105,691		105,691				105,691
	04-1215610	08/2004	190,082		190,082				190,082
2	Totals		1,070,735		1,070,735	396,624	396,624	0	674,111

Stip. Ex. 4.

18. Taxpayer's 2001 Illinois return contains the following entries within Part 1, where a taxpayer is asked to calculate its Illinois base income:

1	Write your federal taxable income before FNOLD from the worksheet		1	<u>25,248,126</u>
2	Additions (See specific instructions for Part I.)			
a	State, municipal, and other interest income excluded in arriving at Line 1 above	2a		
b	Illinois income and replacement tax deducted in arriving at Line 1 above	2b	<u>5,666</u>	
c	Other additions (specify: <u>Non-Patronage loss addback</u>)	2c	<u>9,744,635</u>	
3	Add Lines 2a through 2c. This is the total of your additions.		3	<u>9,750,301</u>
4	Add Lines 1 and 3. This is your total income.		4	<u>34,998,427</u>
5	Subtractions (See specific instructions for Part I.)			
a	Interest income from U.S. Treasury and other exempt federal obligations	5a		
b	Enterprise zone or foreign trade zone/sub-zone dividends from Schedule 1299-B	5b		
c	Enterprise zone contributions from Schedule 1299-B	5c		
d	Enterprise zone or high impact business interest from Schedule 1299-B	5d		
e	Contributions to certain job training projects (See specific instructions for Part I.)	5e		
f	Other subtractions (specify: _____)	5f		
g	Federal NOL carryforward from tax years ending prior to 12/31/86 (Attach Sch. NL-5g.)	5g		
6	Add Lines 5a through 5f. This is the total of your subtractions.		6	<u>0</u>
7	Subtract Line 6 from Line 4. This is your base income or loss. If your base income or loss is derived solely inside Illinois, write this amount on Part IV, Line 1. If your base income or loss is derived inside and outside Illinois, write this amount on Part III, Line 1.		7	<u>34,998,427</u>

Stip. Ex. 9, p. 1 (Taxpayer completed the entry on the specification part of line 2c).

19. In Part III of its 2001 Illinois return, Taxpayer reported that its Illinois apportionment factor was 0.040039, and that \$1,401,302 of its \$34,998,427 base income was allocable to Illinois. Stip. Ex. 13, p. 2, Part III, lines 5c, 6 and 9. In Part IV of its

2001 Illinois return, Taxpayer reported having net income in the amount of \$625,093.

Id., Part IV, line 7.

20. Taxpayer's 2002 Illinois return contains the following entries within Part 1:

1	Write your federal taxable income before FNOLD from the worksheet	1	<u>9,619,135</u>
2	Additions (See specific instructions for Part I.)		
	a State, municipal, and other interest income excluded in arriving at Line 1 above	2a	<u> </u>
	b Illinois income and replacement tax deducted in arriving at Line 1 above	2b	<u>142,903</u>
	c Other additions (specify: <u>See stmt 1</u>)	2c	<u>13,431,167</u>
3	Add Lines 2a through 2c. This is the total of your additions.	3	<u>13,574,070</u>
4	Add Lines 1 and 3. This is your total income.	4	<u>23,193,205</u>
5	Subtractions (See specific instructions for Part I.)		
	a Interest income from U.S. Treasury and other exempt federal obligations	5a	<u> </u>
	b Enterprise zone or foreign trade zone/sub-zone dividends from Schedule 1299-B	5b	<u> </u>
	c Enterprise zone contributions from Schedule 1299-B	5c	<u> </u>
	d Enterprise zone or high impact business interest from Schedule 1299-B	5d	<u> </u>
	e Contributions to certain job training projects (See specific instructions for Part I.)	5e	<u> </u>
	f Other subtractions (specify: <u> </u>)	5f	<u> </u>
6	Add Lines 5a through 5f. This is the total of your subtractions.	6	<u>0</u>
7	Subtract Line 6 from Line 4. This is your base income or loss. If your base income or loss is derived solely inside Illinois, write this amount on Part IV, Line 1. If your base income or loss is derived inside and outside Illinois, write this amount on Part III, Line 1.	7	<u>23,193,205</u>

Stip. Ex. 11, p. 1 (Taxpayer completed the entry on the specification part of line 2c).

21. In Part III of its 2002 Illinois return, Taxpayer reported that its Illinois apportionment factor was 0.032661, and that \$757,513 of its \$23,193,205 base income was allocable to Illinois. Stip. Ex. 13, p. 2, Part III, lines 5c, 6 and 9. In Part IV of its 2002 Illinois return, Taxpayer reported having net income in the amount of \$757,480. *Id.*, Part IV, line 7.

22. Taxpayer's 2003 Illinois return contains the following entries within Part 1:

1	Write your federal taxable income before FNOLD from the worksheet	1	<u>10,936,513</u>
2	Additions (See specific instructions for Part I.)		
	a State, municipal, and other interest income excluded in arriving at Line 1 above	2a	<u> </u>
	b Illinois income and replacement tax deducted in arriving at Line 1 above	2b	<u>60,000</u>
	c Other additions (specify: <u>non-pat loss add back/bonus depreciation</u>)	2c	<u>9,342,027</u>
3	Add Lines 2a through 2c. This is the total of your additions	3	<u>9,402,027</u>
4	Add Lines 1 and 3. This is your total income	4	<u>20,338,540</u>
5	Subtractions (See specific instructions for Part I.)		

a	Interest income from U.S. Treasury and other exempt federal obligations	5a	_____	
b	Enterprise zone or foreign trade zone/sub-zone dividends from Schedule 1299-B	5b	_____	
c	Enterprise zone contributions from Schedule 1299-B	5c	_____	
d	Enterprise zone or high impact business interest from Schedule 1299-B	5d	_____	
e	Contributions to certain job training projects (See specific instructions for Part I.)	5e	_____	
f	Other subtractions (specify: _____)	5f	_____	
6	Add Lines 5a through 5f. This is the total of your subtractions.			6 _____ 0
7	Subtract Line 6 from Line 4. This is your base income or loss. If your base income or loss is derived solely inside Illinois, write this amount on Part IV, Line 1. If your base income or loss is derived inside and outside Illinois, write this amount on Part III, Line 1.			7 _____ 20,338,540

Stip. Ex. 13, p. 1(Taxpayer completed the entry on the specification part of line 2c).

23. In Part III of its 2003 Illinois return, Taxpayer reported that its Illinois apportionment factor was 0.037224, and that \$757,082 of its \$20,338,540 base income was allocable to Illinois. Stip. Ex. 13, p. 2, Part III, lines 5c, 6 and 9. In Part IV of its 2003 Illinois return, Taxpayer reported having net income in the amount of \$757,045. *Id.*, Part IV, line 7.

24. Taxpayer's 2004 Illinois return contains the following entries within Part 1:

1	Write your federal taxable income before FNOLD from the worksheet			1 _____ - 3,527,895
2	Additions (See specific instructions for Part I.)			
a	State, municipal, and other interest income excluded in arriving at Line 1 above	2a	_____	
b	Illinois income and replacement tax deducted in arriving at Line 1 above	2b	_____ 80,000	
c	Other additions (specify: <u>Includes "special depreciation" 1342173</u> Patronage NOL)	2c	_____ 15,996,388	
3	Add Lines 2a through 2c. This is the total of your additions.			3 _____ 16,076,388
4	Add Lines 1 and 3. This is your total income.			4 _____ 12,548,493
5	Subtractions (See specific instructions for Part I.)			
a	Interest income from U.S. Treasury and other exempt federal obligations	5a	_____	
b	Enterprise zone or foreign trade zone/sub-zone dividends from Schedule 1299-B	5b	_____	
c	Enterprise zone contributions from Schedule 1299-B	5c	_____	
d	Enterprise zone or high impact business interest from Schedule 1299-B	5d	_____	
e	Contributions to certain job training projects (See specific instructions for Part I.)	5e	_____	
f	Other subtractions (specify: _____)	5f	_____ 5,147,835	
6	Add Lines 5a through 5f. This is the total of your subtractions.			6 _____ 5,147,835
7	Subtract Line 6 from Line 4. This is your base income or loss. If your base income or loss is derived solely inside Illinois, write this amount on Part IV, Line 1. If your base income or loss is derived inside and outside Illinois, write this amount on Part III, Line 1.			7 _____ 7,400,658

28. On June 2, 2008, the Department issued the NOD to Taxpayer regarding tax years ending on August 31 of 2004 and 2005. Stip. ¶ 14; Stip. Ex. 1 (copy of NOD). The deficiency was based solely on the Department's disallowance of the Illinois net loss deduction Taxpayer claimed on each of its 2004 and 2005 Illinois returns. *Id.*
29. On July 18, 2008, Taxpayer filed a Protest to the NOD. Stip. ¶ 15; Stip. Ex. 2 (copy of Protest).

Conclusions of Law:

Section 904(a) of the Illinois Income Tax Act (IITA) provides that “[t]he findings of the Department [in a NOD] shall be prima facie correct and shall be prima facie evidence of the correctness of the amount of tax and penalties due.” 35 ILCS 5/904(a). Thus, when the parties offered the NOD as a stipulated exhibit, that NOD constituted prima facie proof that Taxpayer was not entitled to the Illinois net loss deduction for the years at issue. 35 ILCS 5/904(a)-(b); Balla v. Department of Revenue, 96 Ill. App. 3d 293, 296, 421 N.E.2d 236, 238 (1st Dist. 1981). The Department's prima facie case is a rebuttable presumption. See Branson v. Department of Revenue, 168 Ill. 2d 247, 260, 659 N.E.2d 961, 968 (1995). After the Department introduces its prima facie case, the burden shifts to the taxpayer to establish that the Department's determinations are not correct. *Id.*; Mel-Park Drugs, Inc. v. Department of Revenue, 218 Ill. App. 3d 203, 217, 577 N.E.2d 1278, 1287 (1st Dist. 1991) (“To overcome the Department's prima facie case, a taxpayer must present more than its testimony denying the accuracy of the assessments, but must present sufficient documentary support for its assertions.”).

Since Taxpayer's arguments are premised upon the unique characteristics and taxation of cooperatives, it will be helpful to review the structure of cooperatives in general, and how nonexempt cooperatives are taxed federally. One particularly good

overview of both is contained in a United States Tax Court case cited by both parties, Buckeye Countrymark, Inc. v. Commissioner, 103 T.C. 547 (1994), and which provides, in part:

*An Overview of the Taxation of
Nonexempt Cooperatives Under Subchapter T*

*** In general, a cooperative is a type of business organization that operates at cost for the mutual benefit of its patrons. It is characterized: (1) By the fact that the capital contributed to the cooperative is subordinated to the rights of the members of the cooperative both as regards control over the cooperative enterprise and as regards ownership of the pecuniary benefits arising therefrom; (2) by the fact that the cooperative is democratically controlled by its members; and (3) by the fact that the net earnings of the cooperative enterprise (i.e., excess of operating revenues derived from business with patrons over the costs incurred in generating those revenues) are vested in the cooperative's patrons and are returned or allocated to each patron in proportion to the patron's participation in producing those net earnings. See *Puget Sound Plywood, Inc. v. Commissioner*, 44 T.C. 305, 308-309 (1965).

For Federal income tax purposes, cooperatives are distinguished from other business organizations by the fact that they are eligible for certain special deductions set forth in subchapter T. See *Illinois Grain Corp. v. Commissioner*, 87 T.C. 435, 449 (1986). For discussions of the history of subchapter T, see *Farm Serv. Co-op v. Commissioner*, 619 F.2d 718, 722-726 (8th Cir.1980), revg. and remanding 70 T.C. 145 (1978); *St. Louis Bank for Co-ops v. United States*, 224 Ct.Cl. 289, 624 F.2d 1041, 1043-1045 (Ct.Cl.1980); *Independent Co-op Milk Producers Association v. Commissioner*, 76 T.C. 1001, 1012-1014 (1981); *Farmers Co-op Co. v. Birmingham*, 86 F.Supp. 201 (N.D.Iowa 1949).

Subchapter T applies to exempt farmers' cooperatives described in section 521 and "any corporation operating on a cooperative basis". Sec. 1381(a). The first of the special deductions provided by subchapter T, section 1382(b), permits all cooperatives that are covered thereunder to deduct "patronage dividends", defined in section 1388(a), and "per-unit retain allocations", defined in section 1388(f). In general, a patronage dividend is an amount that is allocated or paid to a patron out of the net earnings of the cooperative from business done with or for its patrons and that is based upon the quantity or value of business done with or for the patron, under a preexisting obligation to pay such amount. Sec. 1388(a). A per-unit retain allocation is an amount allocated or paid to a patron with respect to products marketed for the patron that is fixed without regard to the net earnings of the cooperative. Sec. 1388(f).

In effect, every cooperative, subject to subchapter T, whether an exempt or a nonexempt cooperative, is entitled to deduct patronage income to the extent that it pays or allocates such income to its patrons as a patronage dividend. Sec. 1382(b). Thus, patronage income is subject to tax only once, at the cooperative level or the patron level, depending upon

whether the cooperative distributes such income to its patrons. This treatment reflects the notion that the cooperative is merely an agent for its patrons and that the money returned to patrons as patronage dividends in fact always belonged to them. *Farm Serv. Co-op v. Commissioner*, 619 F.2d at 722; see *Des Moines County Farm Serv. Co. v. United States*, 324 F.Supp. 1216, 1219 (S.D.Iowa 1971), *affd. per curiam* 448 F.2d 776 (8th Cir.1971). Patronage dividends are considered rebates on purchases or deferred payments on sales, allocated or distributed pursuant to a preexisting obligation of the cooperative, and, as such, do not constitute taxable income to the cooperative. *Farmers Co-op Co. v. Birmingham*, 86 F.Supp. at 213-214.

The treatment of nonpatronage income, on the other hand, differs depending upon whether it is earned by an exempt or a nonexempt cooperative. In the case of a nonexempt cooperative, nonpatronage income is fully taxable to the cooperative whether or not distributed and, if the cooperative distributes nonpatronage income to its patrons, it is again taxed to the patrons. *Farm Serv. Co-op v. Commissioner*, *supra* at 723. In the case of an exempt cooperative, nonpatronage income, like patronage income, is taxed only once, either at the cooperative level or at the patron level, depending on whether the cooperative distributes the income to its patrons. Sec. 1382(c)(2).

Because of the differences in the tax treatment of patronage income and nonpatronage income, and because of the differences between the treatment of exempt and nonexempt cooperatives, subchapter T requires nonexempt cooperatives to separate patronage from nonpatronage income in computing taxable income. *St. Louis Bank for Co-ops v. United States*, 624 F.2d at 1044-1045; *Farm Serv. Co-op v. Commissioner*, *supra* at 723; *Certified Grocers of Cal., Ltd. v. Commissioner*, 88 T.C. 238, 246 (1987). This is a fundamental principle of subchapter T.

In effect, subchapter T requires nonexempt cooperatives to separate income and deductions into two categories or baskets, one for patronage income and deductions and one for nonpatronage income and deductions. Subchapter T limits the deduction for patronage dividends to the net income in the first basket, the net patronage income for the taxable year, and in the case of a nonexempt cooperative, subchapter T prohibits the cooperative from computing a patronage dividend with respect to any income in the second basket, nonpatronage income. Secs. 1382(b), 1388(a). We note that the Code expressly permits cooperatives to combine patronage income or loss from different "allocation units", but, in that event, it must provide its patrons with certain information in a written notice. Sec. 1388(j).

Subchapter T prohibits a nonexempt cooperative from increasing the net income in the patronage basket by treating nonpatronage income as patronage income, e.g., *Land O'Lakes, Inc. v. United States*, 514 F.2d 134, 141 (8th Cir.1975), or by treating patronage expenses as nonpatronage expenses, see *Certified Grocers of Cal., Ltd. v. Commissioner*, *supra* at 245-257. Subchapter T also prohibits the netting of patronage losses against nonpatronage income. E.g., *Farm Serv. Co-op v. Commissioner*, *supra*; *Certified Grocers of Cal., Ltd. v. Commissioner*, *supra* at 250. For example, a nonexempt cooperative can file a consolidated return under section 1501 with one or more noncooperative corporations but net

patronage losses cannot be used to offset nonpatronage income in the consolidated return. *Certified Grocers of Cal., Ltd. v. Commissioner, supra* at 250-251. The nonexempt cooperative must separate patronage and nonpatronage income and loss, and the consolidated return can only combine the cooperative's nonpatronage income or loss with the income or loss of other members of the same affiliated group of corporations that are not cooperatives. *Id.* at 251.

Similarly, a nonexempt cooperative is entitled to deduct net operating losses pursuant to section 172, but it cannot carry net patronage losses over or back under section 172 to offset net nonpatronage income from a different year. See *Farm Serv. Co-op v. Commissioner, supra* at 728; *Ford-Iroquois FS, Inc. v. Commissioner*, 74 T.C. 1213, 1221 (1980); *Associated Milk Producers, Inc. v. Commissioner*, 68 T.C. 729 (1977). Otherwise, the special deductions which are reserved by subchapter T only for patronage income could be taken against nonpatronage income in violation of subchapter T. See *Certified Grocers of Cal., Ltd. v. Commissioner, supra* at 250.

Buckeye Countrymark, Inc. v. Commissioner, 103 T.C. 547, 555-60 (1994).

Issue and Arguments

The parties identify the issue in slightly different ways. Taxpayer writes that the “sole issue is whether [it] properly deducted non-patronage losses created in 8/31/2001, 8/31/2002 and 8/31/2003 when determining [its] taxable income on Form IL-1120 for the tax years ending 8/31/2004 and 8/31/2005.” Taxpayer’s Rebuttal to and Request for Reassessment of the Department’s Notice of Deficiency for Net Loss Deduction in Lieu of Hearing (Taxpayer’s Brief), p. 1. The Department, in turn, writes that the issue is “whether Taxpayer properly carried forward and deducted non-patronage losses created in tax years ending August 31, 2001, 2002 and 2003 when determining [its] base income on Form IL-1120 for the tax years ending August 31, 2004 and 2005. Department of Revenue’s Post Hearing Brief (Department’s Brief), p. 4.

The better statement of the issue, however, is slightly different than as described by either party. A brief review of the statutory terms “net income,” “base income,” and “taxable income,” helps to explain why.

The IITA imposes “a tax measured by net income ... on every

individual, corporation, trust and estate for each taxable year ending after July 31, 1969 on the privilege of earning or receiving income in or as a resident of [Illinois]." 35 ILCS 5/201(a). Section 202 defines "net income," generally, as "that portion of his base income for such year which is allocable to this State under the provisions of Article 3, less the standard exemption allowed by Section 204 and the deduction allowed by Section 207." 35 ILCS 5/202.

Section 203 defines both the terms "base income" and "taxable income." 35 ILCS 5/203. For a corporation, "base income" means the person's taxable income (35 ILCS 5/203(b)(1)), as modified by adding certain amounts (called addition modifications) to the person's taxable income, and as further modified by subtracting other amounts (called subtraction modifications) from that sum. 35 ILCS 5/203(b)(2).

Section 203(e) defines "taxable income" generally to mean "the amount of ... taxable income properly reportable for federal income tax purposes for the taxable year under the provisions of the Internal Revenue Code [the Code]." 35 ILCS 5/203(e)(1). The legislative intent underlying § 203(e) is to provide a fixed and easily ascertainable starting point for taxpayers – as well as for the Department – when attempting to determine a person's correct Illinois income tax liability. Bodine Electric Co. v. Allphin, 81 Ill. 2d 502, 510, 512, 410 N.E.2d 828, 832-33 (1980); Hollinger International, Inc. v. Bower, 363 Ill. App. 3d 313, 316, 841 N.E.2d 447, 451 (1st Dist. 2005).

Section 203(e)(2) provides special rules that more specifically define the meaning of "taxable income properly reportable for federal income tax purposes" for certain types of entities. 35 ILCS 5/203(e)(2). One of those special rules is for cooperatives, and it defines a cooperative's taxable income properly reportable for federal income tax purposes to mean "the taxable income of such organization determined in accordance with the provisions of Section 1381 through

1388 of the ... Code.” 35 ILCS 5/203(e)(2)(F). Finally, the applicable Illinois return form instructs a corporation to begin the calculation of its base income by “writ[ing] your federal taxable income before FNOLD [federal net operating loss deduction] ...” Stip. Exs. 4, 7, 9, 11, 13 (p. 1, Part I, line 1 of each return).

After reviewing the statutory definitions, it is clear that the Illinois General Assembly intended the deduction authorized by IITA § 207 to be one that is to be subtracted from that portion of a corporation’s base income that is allocable to Illinois, when calculating the corporation’s net income for a given year. 35 ILCS 5/202, 203. Therefore, the better statement of the issue is whether IITA § 207 authorizes Taxpayer, a non-exempt cooperative, to deduct from the portion of its base income that is allocable to Illinois some portion of its non-patronage losses which it incurred and determined, federally, during prior years, when computing its Illinois net income during a subsequent year.

Taxpayer asserts that, under federal law, it is entitled to carry forward a non-patronage loss and use that loss as a deduction against non-patronage income in subsequent years. Taxpayer’s Brief, pp. 4-5 (*citing* IRS Revenue Ruling 74-377); Taxpayer’s Response to Department’s Post Hearing Brief and in Further Support of its Request for Reassessment of the Notice of Deficiency for Net Loss Deduction (Taxpayer’s Reply), pp. 3-4. Taxpayer argues that Illinois law requires cooperatives filing Illinois returns to comply with Subchapter T of the Code. Taxpayer’s Brief, p. 3 (*citing* 35 ILCS 5/203(e)(2)(F)). Taxpayer explains that the face of its federal form 990-C creates an anomaly in that the return combines both patronage and non-patronage earnings, whereas under Subchapter T of the Code, cooperatives are prohibited from combining patronage and non-patronage income in computing net income. *Id.* (*citing* Buckeye Countrymark, Inc. v. Commissioner, 103 T.C. 547 (1994); Certified Grocers of

California, Ltd. v. Commissioner, 88 T.C. 15 (1987); Farm Service Cooperative v. Commissioner, 619 F. 2d 718 (8th Cir. 1980)). Taxpayer reasons that its federal form 8817 resolves the anomaly for federal tax purposes, but complains that the anomaly is exacerbated at the state level because it must use state return forms that are not specifically created for cooperatives. Taxpayer asserts that, for Illinois reporting purposes, the anomaly is resolved by line 2c (Part I) of the Illinois return, which, Taxpayer asserts, requires it to add back any current year patronage or non-patronage loss when calculating base income. Taxpayer’s Brief, p. 4.

The Department presents two arguments in support of its NOD. First, it asserts that Taxpayer has cited no federal authority that gives a cooperative association the option of either applying net non-patronage losses against patronage income, or carrying such a loss to another tax year. Department’s Brief, pp. 7, 9. Second, the Department argues that each of the Illinois returns Taxpayer filed regarding 2001 through 2003 reported a positive net income after Taxpayer made its Illinois apportionment calculations. *Id.*, pp. 8-9 (*citing* Stip. Exs. 9, 11, 13 (Part VI, lines 1 of each Illinois return); 35 ILCS 5/207).² Thus, the Department’s argument concludes, under the plain

² When describing the facts relevant to this argument, the Department repeatedly expressed ignorance as to why Taxpayer added back its current-year patronage or non-patronage losses when calculating its Illinois base income for tax years 2001 through 2003. Department’s Brief, pp. 2-3 (the Department writes, “for some unexplained reason,” before describing Taxpayer’s addition of such losses when calculating Illinois base income for the particular years). This repeated expression of ignorance implies — but does not directly assert — that Taxpayer’s add back of such loss amounts is not required. The Department later argues that, even if Taxpayer’s reporting position was correct (that is, even if Taxpayer correctly added back such loss amounts when calculating Illinois base income), there would still have been no losses reported on its 2001 through 2003 Illinois returns that would be available to carry forward to 2004 and 2005. *Id.*, p. 8. While the Department’s latter assertion is mathematically correct, if Taxpayer was *not* required by Illinois law to add back its patronage and/or non-patronage losses when calculating its Illinois base income for its 2001 through 2003 tax years, its Illinois base income would have been significantly less than as reported on the returns filed for those years. Stip. Exs. 9, 11, 13 (p. 1, Part I of each return). And if it was not required to add back such losses for 2004 and 2005, the years at issue, its base income would be less than zero for each such year. Stip. Exs. 4, 7 (p. 1, Part I of each return).

This matter, however, does not involve any determination by the Department regarding the correctness of Taxpayer’s addition modifications reported on line 2c of its 2001 through 2005

language of IITA § 207, Taxpayer had no Illinois net losses during 2001 through 2003 that it could carry forward to 2004 and 2005. *Id.*, pp. 8-9.

Analysis

Based on the evidence, I consider the Department's second argument to be determinative of the issue. Under the express text of IITA § 207, Taxpayer did not incur any *Illinois* net losses during 2001 through 2003 that are available to carry forward to 2004 and 2005.

During the tax years at issue, 2004 and 2005, § 207 provided:

§ 207. Net Losses.

(a) If after applying all of the modifications provided for in paragraph (2) of Section 203(b), paragraph (2) of Section 203(c) and paragraph (2) of Section 203(d) and the allocation and apportionment provisions of Article 3 of this Act, the taxpayer's net income results in a loss;

(1) for any taxable year ending prior to December 31, 1999, such loss shall be allowed as a carryover or carryback deduction in the manner allowed under Section 172 of the Internal Revenue Code;

(2) for any taxable year ending on or after December 31, 1999 and prior to December 31, 2003, such loss shall be allowed as a carryback to each of the 2 taxable years preceding the taxable year of such loss and shall be a net operating carryover to each of the 20 taxable years following the taxable year of such loss; and

(3) for any taxable year ending on or after December 31, 2003, such loss shall be allowed as a net operating carryover to each of the 12 taxable years following the taxable year of such loss.

(a-5) Election to relinquish carryback and order of application of losses.

(A) For losses incurred in tax years ending prior to December 31, 2003, the taxpayer may elect to relinquish the entire carryback period with respect to such loss. Such election shall be made in the form and manner prescribed by the Department and shall be made by the due date (including extensions of time) for filing the taxpayer's return for the taxable year in which such loss is incurred, and such election, once made, shall be irrevocable.

returns. *Id.* Further, the parties have not briefed this particular issue, so neither side has attempted to identify which of the statutory addition modifications enumerated in § 203(b)(2) require a corporation that is a non-exempt farmers cooperative to add back to the amount of its federal taxable income (before FNOLD) any current year's patronage and/or non-patronage losses when calculating its Illinois base income. Therefore, this recommendation advances no conclusions regarding the correctness of Taxpayer's reporting of patronage or non-patronage losses on Part 1, line 2c, of its 2001 through 2005 Illinois returns.

(B) The entire amount of such loss shall be carried to the earliest taxable year to which such loss may be carried. The amount of such loss which shall be carried to each of the other taxable years shall be the excess, if any, of the amount of such loss over the sum of the deductions for carryback or carryover of such loss allowable for each of the prior taxable years to which such loss may be carried.

(b) Any loss determined under subsection (a) of this Section must be carried back or carried forward in the same manner for purposes of subsections (a) and (b) of Section 201 of this Act as for purposes of subsections (c) and (d) of Section 201 of this Act.

35 ILCS 5/207 (2003).

During 2001 through 2003, the text of § 207(a) was identical to the amended version in effect during 2004 and 2005. Thus, during all of the years pertinent to this dispute, § 207(a) had always identically described how to determine whether one had an Illinois net loss for a given tax year. 35 ILCS 5/207(a). While the remaining subsections of that statute were amended between 2001 and now, those other subsections have always described, for example: the manner in which an Illinois net loss for a given year could be used as a deduction to reduce net income the taxpayer realized during a prior and/or future year; as well as other limitations regarding the use of such a net loss. But those amendments to other subsections of IITA 207 did not affect the procedures the Illinois General Assembly described in §§ 202 and 207(a) to determine whether a person, in fact, had a net loss — or net income — for a given year. 35 ILCS 5/202, 207(a).

Taxpayer's Illinois returns for 2001 through 2003 did not report a loss — and by that I mean a number that is less than zero — on Part IV of its 2001 through 2003 returns. Stip. Exs. 9, 11, 13 (pp. 1-2, Part IV, line 1 each return). Regarding this point, I note that Taxpayer checked the boxes next to Part IV, line 1 of its 2002 and 2003 Illinois returns, to indicate that the amounts of \$757,513 and \$757,082 were losses, and that it was electing to carry such amounts forward. Stip. Exs. 11, 13 (p. 2, Part IV, line 1a of each return). Also, Taxpayer checked the box next to Part IV, line 1 of its 2001 Illinois return, to indicate that it was electing to forego the Illinois NLD carryback. Stip. Ex. 9, p. 2, Part

IV, line 1a. However, it is also clear from Parts 1, III and V of those same returns that the amounts Taxpayer reported on Part IV, line 1 were positive numbers, and thus, were not losses. Stip. Exs. 9, 11, 13 (pp. 1-2, Parts I, III and V of each return). In Part IV of its 2001 through 2003 Illinois returns, Taxpayer reported having net income in the respective amounts of \$625,093, \$757,480, and \$757,045. Stip. Exs. 9, 11, 13 (p. 2, Part IV, line 7 of each return). The Illinois General Assembly has described what an Illinois net loss is for a given year (35 ILCS 5/207(a)), and, under the plain and clear terms of that statute, Taxpayer did not incur any Illinois net losses during 2001 through 2003. Stip. Exs. 9, 11, 13 (pp. 1-2, Parts I, III-V of each return).

The Illinois Supreme Court has noted 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 “the taxpayer is not entitled to a deduction unless clearly allowed by statute and the burden is on the taxpayer to show he is entitled to the deduction claimed.” Bodine Electric Co., 81 Ill. 2d at 512-13, 410 N.E.2d at 833 (quoting and noting agreement with the appellate court’s decision in the matter being reviewed). Similarly, just because a taxpayer is entitled to deduct a net loss for federal tax purposes does not mean that it has any inherent authority to the same type or measure of such a deduction for purposes of Illinois income tax law. *Id.* at 510-11, 410 N.E.2d at 831-32.

In this respect, the Department’s first argument, that Taxpayer has not cited to any federal authority to show that it is entitled to carry forward non-patronage net losses incurred during one year to subsequent years, is wholly irrelevant. That Taxpayer may have been authorized under federal law to carry forward non-patronage losses incurred during 2001 through 2003 and apply them as a deduction against its non-patronage income earned during 2004 and 2005, simply does not affect whether it had an *Illinois* net loss during each of its tax years 2001 through 2003.

Conclusion

I recommend that the Department finalize the NOD as issued, with interest to accrue pursuant to statute.

November 17, 2009
Date

John E. White, Administrative Law Judge