

IT 97-8  
Tax Type: INCOME TAX  
Issue: Throwback Sales (General)  
Reversionary Sales  
Reasonable Cause Asserted on Application of Penalties

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

---

---

THE DEPARTMENT OF REVENUE	)	
OF THE STATE OF ILLINOIS,	)	No.
Petitioner	)	
	)	
v.	)	FEIN:
	)	
TAXPAYER, INC.,	)	
Taxpayer	)	Administrative Law Judge
	)	Linda K. Cliffel
	)	

---

---

RECOMMENDATION FOR DISPOSITION

**APPEARANCES:** H. Randolph Williams for TAXPAYER; Thomas P. Jacobsen, Special Assistant Attorney General, for the Illinois Department of Revenue.

**SYNOPSIS:**

On January 6, 1995 the Illinois Department of Revenue ("Department") issued a Notice of Deficiency to TAXPAYER ("TAXPAYER" or "taxpayer") for the years ended 10/31/88, 10/31/89 and 10/31/90 for additional tax and penalties of \$25,090. This Notice was protested by the taxpayer on March 6, 1995. On January 31, 1996 the Department of Revenue issued a Notice of Deficiency for the years ended October 31, 1991 and October 31, 1992 for additional tax and penalties of \$24,290. This Notice was protested on March 29, 1996. These causes have been consolidated for hearing.

The issue herein is whether sales made by TAXPAYER to customers in states in which TAXPAYER neither files returns nor pays tax were properly "thrown back" to Illinois and included in the numerator of the sales factor pursuant to §304(a)(3)(B)(ii) of the Illinois Income Tax Act<sup>1</sup>, when the sales were shipped from taxpayer's supplier in Illinois.

In addition, taxpayer has protested the Department's imposition of Section 1005 penalties. 35 ILCS §1005.

On consideration of these matters, it is recommended that these sales be included in the sales numerator of TAXPAYER, and the Section 1005 penalties be abated.

**FINDINGS OF FACT:**

1. TAXPAYER (formerly known as MARKETING, Inc.<sup>2</sup>) is a wholly owned subsidiary of FOODS Foods Corporation<sup>3</sup> ("FOODS"). (Dept Ex. No. 3)
2. TAXPAYER's corporate headquarters is in TAXPAYER, Iowa. (Tr. p. 81) TAXPAYER has sales offices throughout the United States, including one in Chicago. (Tr. p. 89) Taxpayer's Chicago office's sales area is limited to Illinois. (Tr. p. 100)
3. TAXPAYER was formed by FOODS and Foods, Inc. (""). FOODS was involved in a strike which required it to seek out other sources of pork for its products. FOODS looked to , one of its competitors, who also produced pork products. At the same time, was looking to expand its market. Most of 's sales were in a three-state area,

---

<sup>1</sup> 35 ILCS §5/304(a)(3)(B)(ii).

<sup>2</sup> The corporate name was changed from MARKETING. to TAXPAYER, Inc. in 1993 (Tr. p. 81). To minimize confusion, the taxpayer will be referred to as TAXPAYER throughout.

<sup>3</sup> Formerly known as FOODS & Company.

Illinois, Iowa and Wisconsin, whereas FOODS had a national marketing and distribution structure. was able to produce its products more cheaply than FOODS and FOODS had a stronger marketing program. In order to utilize both companies strengths, they formed TAXPAYER. (Tr. pp. 84-85, 95)

4. FOODS, and TAXPAYER entered into a Marketing and Distribution Agreement ("Agreement") on July 26, 1985. The Agreement governed, *inter alia*, the manner in which TAXPAYER operated with . (Dept. Ex. No. 7, Tr. pp. 40-41)

5. Article II of the Agreement provides that TAXPAYER will be the sole and exclusive distributor for 's products. (Dept. Ex. No. 7)

6. has no ownership interest in TAXPAYER. (Tr. p. 84)

7. Article III of the Agreement provides that TAXPAYER will sell products at a price determined by Article XI of the Agreement. TAXPAYER is to arrange for shipping and distribution of products from 's producing plant or storage facility. TAXPAYER is to consult with regarding 's costs and methods of production and make such recommendations as necessary to modify the cost and quality characteristics of 's products to meet market requirements. (Dept. Ex. No. 7)

8. TAXPAYER is responsible for collecting its accounts receivable as well as 's accounts receivable which were outstanding prior to the effective date of the Agreement. (Dept. Ex. No. 7)

9. An amendment ("Amendment") was made to the Agreement on August 28, 1987. The Amendment changed Article VII of the Agreement to read: "MKT [TAXPAYER] will purchase and sell PRODUCTS produced by pursuant to production schedules provided for in Article VI. will

sell such PRODUCTS to MKT on a delivered to MKT's customers basis."  
(Dept. Ex. No. 8)

10. Vice President and Controller of TAXPAYER during the audit period, testified that the Amendment merely conformed the Agreement to what had been the understanding of the parties from the beginning. (Tr. p. 114) WITNESS also testified that bore the risk of loss or damage until it was delivered to the purchaser's location and title passed to TAXPAYER. (Tr. pp. 116-117)

11. TAXPAYER reimburses for all services performed under the Agreement (Dept. Ex. No. 7).

12. TAXPAYER and share evenly in all profits generated by TAXPAYER. (Tr. pp. 115-116; Dept. Ex. No. 11)

13. has two processing plants: one in Rochelle, Illinois and one in TAXPAYER, Iowa. The TAXPAYER plant produces a full line of deli products, ham products, sausage products and bacon products. The Rochelle plant concentrates on producing bacon and sausage items. (Tr. pp. 104-105)

14. TAXPAYER rents its office space from which owns the building. occupies part of the same building. (Tr. p. 92)

15. TAXPAYER has no employees of its own. Instead, its personnel consists of employees who are loaned from either FOODS or . Approximately 14 FOODS employees and 130 employees were on loan to TAXPAYER during this period. TAXPAYER reimburses FOODS and , respectively, for their compensation and benefits. While on loan, all of the FOODS employees act solely on TAXPAYER's behalf, but some of the employees have dual functions with TAXPAYER and . (Tr. pp. 90-92) employees are used in the areas of sales, credit, traffic

and sales administration. (Dept. Ex. No. 7) FOODS employees are used in the areas of accounting, cost accounting, quality control, and marketing. (Dept. Ex. No. 7)

16. When orders are made, TAXPAYER marketing representatives enter the orders into the computer system. (Tr. pp. 50-51) One main frame computer is used by both TAXPAYER and . Both companies have access to some of the information on the computer, but is unable to access all of TAXPAYER's information and likewise, TAXPAYER is unable to access all of 's information. (Tr. pp. 51-52)

17. product managers review orders on the computer screen in TAXPAYER and recap them to gear their production capacity to fill the orders. The production managers provide this information to the production people in either plant by means of the computer. (Tr. pp. 102-103)

18. TAXPAYER groups the orders by geographic area for shipment. A handwritten traffic sheet shows a suggested list of trucks and what orders are to be on each truck. The traffic sheet is given to and used as a guideline for loading the trucks. is supposed to follow the traffic sheet to the best of its ability, but the availability of the product or the availability of the trucks may change it. (Tr. pp. 53-54)

19. For orders produced in Rochelle, an traffic employee reviews the orders and makes sure trucks are available to ship the products the day before shipment. (Tr. p. 106)

20. 's shipping crew load the trucks. They pull a manifest off of the computer system which gives them a list of products to be loaded on the truck and the customer's name. The shipping crew physically

pulls the product and puts it on the truck. When the truck is loaded, 's shipping people note how many boxes or pounds of each product are being placed on the truck. That information is given to the billing department in TAXPAYER by means of the computer, which then issues the invoice. (Tr. pp. 57, 106-107)

21. 's billing department prepares the bills of lading for shipments out of the Rochelle plant. TAXPAYER's billing department prepares the bills of lading for shipments out of the TAXPAYER plant. (Tr. p. 55)

22. The customer has the option of having the invoice shipped with the product or mailed to them. For shipments originating at the Rochelle plant where the invoice is to go along with the shipment, the invoice is printed in Rochelle. Invoices that are mailed to the customer are printed in TAXPAYER. (Tr. pp. 108-109)

23. TAXPAYER's sales people in the field can check by computer whether the products ordered are put on the truck. (Tr. p. 55) In some circumstances, if knows the production scheduling won't allow them to produce products that a customer ordered, they will notify TAXPAYER that they can't fill the order. (Tr. pp. 58-59)

24. For large shipments to an individual customer, arranges for an over-the-road carrier to make the delivery directly to the customer. pays for the shipping and is reimbursed by TAXPAYER. (Tr. pp. 70, 106)

25. For smaller shipments going to several customers in a general geographic area, TAXPAYER contracts with a drayman to furnish delivery to the individual customers. (Tr. pp. 68-69)

26. During this period, TAXPAYER invoices bore the name Foods, Inc. along with TAXPAYER. (Dept. Ex. No. 9) WITNESS testified that the reason TAXPAYER used invoices with 's name was that had a surplus of invoice forms. (Tr. p. 110)

27. TAXPAYER handles all customer complaints relating to shipping. (Tr. p. 121)

28. bills TAXPAYER weekly for services performed by it, equipment used by TAXPAYER, and for freight charges incurred by it. (Tr. p. 71, Dept. Ex. No. 11)

29. WITNESS testified that while he was Vice President and Controller of TAXPAYER he had daily communications with people and was on several committees for : Employee Relations Committee, which established the rules governing the employees of regarding things such as holidays; salary administration program for ; Cost Accounting Committee; Data Processing Committee. (Tr. pp. 93-94)

30. Under Article X of the Agreement, TAXPAYER and have full access to their respective books and records. (Dept. Ex. No 7)

31. Article XXI of the Agreement recites that the parties agree that they are independent contractors, and that "there is no joint venture, partnership or other such relationship."

32. TAXPAYER files Illinois income tax returns which only include sales made to Illinois customers in the numerator of the sales factor. (Tr. p. 32)

33. Taxpayer did not present any evidence that it was taxable in the states from which the Department has "thrown back" sales.<sup>4</sup>

---

<sup>4</sup> In fact, taxpayer was precluded from submitting any tax returns or evidence of tax payments which related to whether taxpayer was

34. Taxpayer did not dispute the calculation of the sales which were shipped from the Rochelle, Illinois plant.

**CONCLUSIONS OF LAW:**

Throwback Sales

For Illinois income tax purposes, the business activity of a corporate taxpayer in Illinois is measured by the property, payroll and sales in the State as compared to these factors everywhere. 35 **ILCS** §5/304. The primary issue in this case is an apportionment issue: whether sales made by TAXPAYER to customers in states in which TAXPAYER neither files returns nor pays tax should be thrown back to Illinois and included in the numerator of the sales factor.

TAXPAYER is a marketer of meat products. It is the exclusive distributor of 's products, and is its sole supplier. has processing plants in Rochelle, Illinois and TAXPAYER, Iowa. TAXPAYER is headquartered in Iowa with sales offices throughout the United States. One office is located in Chicago, and its sales territory is limited to the state of Illinois. TAXPAYER files Illinois income tax returns which include only the sales to customers located in Illinois in the sales numerator. The sales at issue in this case are sales which are shipped from 's Rochelle plant to states in which TAXPAYER is not taxable.

---

taxable in the states identified in the discovery requests which were not previously provided to Department's counsel pursuant to an Order entered by this ALJ on October 2, 1996 as a result of Department's Motion for Sanctions or Other Relief.

Generally speaking, sales are located in the destination state for apportionment purposes. Section 304(a)(3)(B)(ii) of the Illinois Income Tax Act provides an exception to the general rule by what is commonly referred to as the throwback rule:

(B) Sales of tangible personal property are in this State if:

...

(ii) The property is shipped from an office, store, warehouse, factory or other place of storage in this State and either the purchaser is the United States government or the person is not taxable in the state of the purchaser....

35 ILCS 5/304(a)(3)(B)(ii).

That is, where the taxpayer is not subject to tax in the destination state, sales are "thrown back" to the state of origination.

The purpose of the throwback rule is to ensure that 100% of sales will be assigned to some state so that there is neither a gap nor overlap in taxing income. See GTE Automatic Electric v. Allphin, 68 Ill. 2d 326 (1977); Dover Corp. v. Department of Revenue, 271 Ill. App. 3d 700 (1st Dist. 1995).

Taxpayer relies on the terms of its Marketing and Distribution Agreement with FOODS and to determine the state of origin. By amendment, the Agreement provides that will sell the product to TAXPAYER on a "delivered to MKT's [TAXPAYER's] customers basis." Taxpayer argues that the title to the goods does not pass to TAXPAYER until the product reaches the customer, at which point title is then passed from TAXPAYER to the customer. Taxpayer concludes that the sale occurs on the customer's dock, wholly outside of Illinois, and cannot be included in Illinois sales.

By the plain language of the statute, sales are thrown back if "[t]he property is shipped from an office, store, warehouse, factory or other place of storage in this State." §304(a)(3)(B)(ii) by its terms does not require that the taxpayer itself ship the product from its own Illinois facility or that the taxpayer takes title or possession of the product in Illinois. All of the sales at issue are shipped from the plant in Illinois.

In GTE Automatic Electric, Inc. v. Allphin, 68 Ill. 2d 326 (1977), the taxpayer's supplier shipped tangible personal property from supplier's inventory in Illinois to the purchaser in a state in which the taxpayer was not taxable, that is, a "drop shipment."<sup>5</sup> The Illinois Supreme Court held that "drop shipment" sales were within the language of §304(a)(3)(B)(ii). Although in this case it is argued that TAXPAYER takes title before the purchaser takes delivery, the property is shipped from Illinois, and therefore, the result is the same. Whether title passes FOB 's dock or the customer's dock is immaterial.

In New WITNESSer Magazine, Inc. v. Department of Revenue, 187 Ill. App. 3d 931 (1st Dist. 1989), the appellate court considered a similar fact situation. The New WITNESSer is headquartered in New WITNESS and has a branch office in Illinois for soliciting advertising. Some of the magazines were sold to Illinois consumers through newsstand or subscription sales. The magazine is printed in Illinois and shipped from the printer to wholesalers in various parts of the country pursuant to the instruction of an independent

---

<sup>5</sup> GTE involved two types of sales: the drop shipment sales described above and sales which were both shipped from and delivered to states in which the taxpayer was not taxable.

contractor who sells the magazines. While the New WITNESSer included the sales of the magazines sold to consumers in Illinois in its Illinois sales numerator, the Department included the sales of magazines shipped from Illinois to states in which the New WITNESSer wasn't taxable. The court affirmed the circuit court, stating that the New WITNESSer contracted with the printer not only for the printing of the magazine but also for the shipping of the magazine, and therefore, the finding that the magazines were "shipped from an office, store, warehouse, factory or other place of storage in [Illinois]" is not against the manifest weight of the evidence.

The facts in TAXPAYER are substantially the same. TAXPAYER has contracted with to produce the meat products for sale. TAXPAYER specifies who is to receive shipment and schedules the deliveries. TAXPAYER monitors the shipments to ensure that the product is available and that it will be shipped timely. TAXPAYER pays for all of 's costs. TAXPAYER has established nexus with Illinois through its sales office which makes sales to Illinois purchasers. According to New WITNESSer, it is not required that the office, store, warehouse, factory, or other place of storage from where the product is shipped belong to the taxpayer, or that the title to the property passes to the taxpayer in Illinois, and since TAXPAYER has contracted with for the shipping of the product, TAXPAYER's sales shipped from the Rochelle plant should be included in Illinois' sales factor.

The designation by the taxpayer of where title passes cannot control the determination of state of origin.<sup>6</sup> To hold otherwise

---

<sup>6</sup> It is not clear where title passes by the terms of taxpayer's own document. Taxpayer cites the Illinois Commercial Code for the proposition that absent express terms as to where title passes from

would render the throwback rule a nullity, since anytime a taxpayer sought to avoid the throwback rule, it would merely take title FOB the customer's dock. That is, if where title passes controls the determination of the state of origin, taxpayer would not be taxable in either the destination state or the state of origin, since they would be one and the same. This would result in "nowhere sales" which is contrary to the purpose of apportionment. Dover Corp. v. Department of Revenue, 271 Ill. App. 3d 700 (1st Dist. 1995). The Illinois Supreme Court found that the intent of the General Assembly in enacting the throwback rule was to apportion income in such a manner that there is neither overlap nor gap in taxing the income of a multistate business. GTE Automatic Electric, Inc. v. Allphin, 68 Ill. 2d 326 (1977). The Department's inclusion of the sales at issue in the numerator of TAXPAYER's sales factor is consistent, therefore, with the plain language of the statute and the legislative intent as articulated by the Illinois Supreme Court in GTE. *Id.*

Taxpayer makes several constitutional arguments. Taxpayer contends that the Department's actions violate both the Due Process Clause<sup>7</sup> and the Commerce Clause<sup>8</sup> of the U. S. Constitution.

The Due Process Clause imposes two restrictions on the power of a state to tax income generated by a multistate business. First, there must be a minimal connection between the activities of the multistate business and the taxing state, and second, the income

---

seller to buyer, title passes to the buyer when seller completes performance by the delivery of goods, 810 **ILCS** 5/2-407(2), and therefore, that title passes to TAXPAYER at the taxpayer's dock.

<sup>7</sup> U.S. Constitution, Amendment XIV, §1.

<sup>8</sup> U.S. Constitution, Article I, §8, cl. 3.

attributed to the state must be rationally related to those activities. Moorman Manufacturing Co. v. Bair, 437 U.S. 267 (1978).

Whether TAXPAYER has nexus with Illinois is not at issue here. The parties agree that there is sufficient connection between the activities of the taxpayer and Illinois to subject it to tax, and in fact, TAXPAYER has voluntarily filed Illinois income tax returns and paid Illinois income tax. Taxpayer contends, however, that there must be nexus with the individual sales which the Department seeks to throw back.<sup>9</sup> Taxpayer is suggesting a method akin to separate accounting, even though it is well settled that the three-factor formula is a constitutionally acceptable method of calculating the proportion of a taxpayer's business activity in a given state. Container Corp. v. Franchise Tax Board, 463 U.S. 159 (1983); Moorman Manufacturing Co. v. Bair, 437 U.S. 267 (1978) (formulary apportionment does 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). Thus, it is not necessary to examine each sale so long as there is a rational relationship between taxpayer's activities in Illinois and the income apportioned to the State. No evidence was presented by the taxpayer to support the proposition that the State's application of the

---

<sup>9</sup> The taxpayer cites private letter rulings 90-0200 (August 2, 1990) and 91-0340 (December 26, 1991) in its brief to bolster its argument that the State's application of the throwback rule is unconstitutional. Both letter rulings deal with establishing sufficient nexus to subject a taxpayer to the taxing jurisdiction of the State, and therefore do not apply to the case at hand where nexus to tax has been established, and merely apportionment is at issue.

throwback rule here has unreasonably allocated extraterritorial income to Illinois.

Assuming, *arguendo*, that taxpayer is correct that there must be a showing of business activity in Illinois for every sale that is thrown back, the operations of and TAXPAYER are so interrelated that 's actions can be attributed to TAXPAYER. All of 's product is sold to TAXPAYER. TAXPAYER's only supplier is . TAXPAYER's employees are all loaned from either FOODS or . employees are responsible for the sales activity of TAXPAYER. remains responsible for their salary structure, their benefits, and pension. TAXPAYER and share the same computer system, so that employees of TAXPAYER can access information and vice versa.

Further, production managers review orders that were entered by TAXPAYER employees in the computer system and gear their production capacity to fill the orders. TAXPAYER employees can check whether the products that they had ordered are being shipped by means of the same computer system.

In addition, TAXPAYER organizes orders by geographic area and prepares traffic sheets which indicate what products should be shipped on which truck. The traffic sheet is a guideline and attempts to follow it as much as possible although the availability of either the product or the trucks might alter it.

Also, TAXPAYER's invoices bear the name Foods, Inc. in addition to TAXPAYER. TAXPAYER rents its offices from in the same building that offices are located. TAXPAYER acted as 's agent in collecting old accounts receivable. Although arranges for over-the-road carriers for large shipments, where small shipments are sent to a

general geographic area, TAXPAYER hires draymen to provide delivery to the individual customers.

Finally, TAXPAYER reimburses for all expenses relating to the product. It was the intention of the parties to the Agreement that would be a "zero profit company," and TAXPAYER and would then split equally all profits relating to TAXPAYER's marketing efforts. Thus, TAXPAYER and are engaged in a joint undertaking for mutual profit. As such, the actions of are sufficient to provide nexus for the sales made by TAXPAYER which originate at the Rochelle plant.

The other constitutional limitation to a state's taxing authority is imposed by the Commerce Clause. Complete Auto Transit, Inc. v. Brady, 430 U.S. 274 (1977), imposes a four-step test on whether an out-of-state corporation's activities in interstate commerce may be subject to state taxation without violating the Commerce Clause: 1) the activity sought to be taxed has sufficient nexus with the State; 2) the tax does not discriminate against interstate commerce; 3) the tax is fairly apportioned; and 4) the tax is related to services provided by the State.

As discussed above, not only does TAXPAYER voluntarily file income tax returns in Illinois indicating nexus, but its joint activities with in Illinois are sufficient to meet the nexus requirements. To successfully attack the State's apportionment scheme under the Commerce Clause, the taxpayer must show that the imposition of tax duplicates the imposition of tax by another state. GTE Automatic Electric, Inc. v. Allphin, 68 Ill. 2d 326 (1977); Dover Corp. v. Department of Revenue, 271 Ill. App. 3d 700 (1st Dist. 1995); Moorman Manufacturing Co. v. Bair, 437 U.S. 267 (1978). In

GTE, the Illinois Supreme Court rejected the taxpayer's claim that the throwback rule was unconstitutional under the Commerce Clause, stating that "[i]t is only those out-of-State...sales in which plaintiff is not taxable either in the State of origin or destination that are being assigned to Illinois, and this obviously cannot result in double taxation." 68 Ill.2d at 341. Logically, the inclusion of these sales by the State of Illinois in the sales numerator cannot be duplicative since they are only being thrown back by reason of the fact that they are not being taxed in the destination state. Furthermore, there is nothing in the record to suggest that any other state is seeking to include these sales in the apportionment factor thereby subjecting the same income to tax.

Both parties have argued in their briefs that the other party did not properly raise an argument for alternative apportionment pursuant to §304(f)<sup>10</sup>. I agree that §304(f) is not at issue, and therefore, it is unnecessary to examine the requirements of §304(f) here.

Based upon the above, in my opinion the throwback sales were properly included in the numerator of taxpayer's sales factor.

### Penalties

Regarding the imposition of the Section 1005 penalties, taxpayer has requested an abatement of Section 1005 penalties due to reasonable cause. Section 1005 of the Illinois Income Tax Act provides that:

---

<sup>10</sup> 35 ILCS 5/304(f), formerly codified at §304(e).

...If any amount of tax required to be shown on a return prescribed by this Act is not paid on or before the date required for filing such return (determined without regard to any extension of time to file), a penalty shall be imposed at the rate of 6% per annum upon the tax underpayment unless it is shown that such failure is due to reasonable cause. This penalty shall be in addition to any other penalty determined under this Act...

Under federal case law, "reasonable cause" includes taking a good faith position on a tax return. See I.R.C. Section 6664(c). In general, if there is an honest difference in opinion between the taxpayer and the IRS regarding the correct amount of tax, no penalty is imposed. As a result, no penalty is imposed due to a deficiency arising from a good faith tax return position with regard to law or facts. See, Ireland v. Commissioner, 39 T.C. 978 (1987); Webble v. Commissioner, 54 T.C.M. 281 (1987); Balsamo v. Commissioner, 54 T.C.M. 608 (1987).

In the audit cycle prior to that at issue, an administrative recommendation was finalized which found that the Department properly included throwback sales in MARKETING's (TAXPAYER's) sales numerator. In that recommendation, the Administrative Law Judge refused to give effect to the Amendment to the Agreement since the Amendment was executed after the audit period. In my opinion, the Agreement is not controlling regarding the issue of whether these sales were properly thrown back. However, it was not unreasonable for the taxpayer to have believed that the throwback issue would be decided differently subsequent to the Amendment on the basis of the decision in the prior case involving the same taxpayer. Based on the above, taxpayer has offered reasonable cause to abate the Section 1005 penalty.

WHEREFORE, for the reasons stated above, it is my recommendation that the Notice of Deficiency should be finalized as to the throwback sales issue, but that the taxpayer has offered sufficient evidence of reasonable cause to abate the Section 1005 penalties.

Date:

---

Linda K. Cliffler  
Administrative Law Judge