**IT 03-3**
**Tax Type: Income Tax**
**Issue: Throwback Sales (General)**

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

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| **THE DEPARTMENT OF REVENUE OF THE STATE OF ILLINOIS** | No. 01-IT-0000 |
| | FEIN: 00-0000000 |
| v. | TYE 5/31/91, 5/31/92, 5/31/93 |
| **ABC, INCORPORATED, Taxpayer** | **Ted Sherrod Administrative Law Judge** |

## RECOMMENDATION FOR DISPOSITION

**Appearances:** Special Assistant Attorney General Deborah Mayer on behalf of the Illinois Department of Revenue; Donald Brown, Esq., on behalf of ABC, Incorporated.

**Synopsis:**

This matter is before this administrative tribunal as the result of a timely protest by ABC, Incorporated (hereinafter "ABC" or "taxpayer") of the Department's denial of the taxpayer's refund claims for the tax years ended 5/31/91, 5/31/92 and 5/31/93. The taxpayer timely filed a combined Illinois income tax return for each of these years. Upon examination of the taxpayer's combined returns, the Department issued a notice of deficiency against the taxpayer for these years, which the taxpayer timely protested. Subsequently, the taxpayer withdrew its protest, paid the taxes assessed and filed amended IL-1120-X returns seeking a refund of the taxes paid. Upon the Department's denial of the taxpayer's refund claims, the taxpayer filed a protest and requested a hearing. Prior to the convening of a hearing, the taxpayer and the Department agreed that this case should be decided based upon a stipulation of facts and memorandums of law submitted by both parties in lieu of an evidentiary hearing.

The Department and the taxpayer have entered into a settlement agreement pursuant to which the Department has agreed to grant a partial refund of taxes claimed in the taxpayer's refund claims with respect to proceeds from the draw down of a letter of credit classified as business income.[1] Accordingly, the sole issue to be determined in this case is whether sales originating in Illinois can properly be thrown back to Illinois for inclusion in the numerator of the sales factor where the taxpayer is not taxable in the destination state under 35 **ILCS** 5/304(a)(3)(B). Upon a review of the record including memorandums of law submitted by the parties, it is recommended that this issue be resolved in favor of the Department.

**<u>Findings of Fact:</u>**

**1.** ABC, Incorporated (hereinafter "ABC") is a Delaware corporation qualified to do business and doing business in Illinois.[2] Taxpayer Brief p. 1; Dept. Brief p. 2.

**2.** XYZ Corporation (hereinafter "XYZ"), a company engaged in business in Illinois, is a member of a group of corporations affiliated through common ownership, which includes ABC. XYZ, ABC and other similarly affiliated companies are members of a unitary business group (hereinafter the "ABC group"), which is engaged in the

[1] The Department has agreed to refund 30% of tax paid on proceeds from the draw down of a letter of credit classified as business income; the taxpayer has agreed that 70% of these proceeds are taxable. Stipulation of Facts in Lieu of Hearing.

[2] Unless otherwise noted, findings of fact apply to the tax years ended May 31, 1991, May 31, 1992 and May 31, 1993.

business of selling tangible personal property and related activities. Taxpayer Brief pp.1, 3; Dept. Brief pp. 2, 3, 5; Stipulation of Facts, ABC and XYZ's Filing History by State (hereinafter "Stip. Filing History") pp. 2, 3, 4, 5.

**3.** ABC is subject to tax in Illinois, and files returns in this State. Taxpayer Brief p. 1; Dept. Brief p. 2.

**4.** For the years at issue, the members of the ABC group filed their Illinois returns on a combined basis and elected to be treated as one taxpayer pursuant to Section 502(e) of the Illinois Income Tax Act, 35 **ILCS** 5/502(e). Taxpayer Brief p. 1; Dept. Brief p. 2.

**5.** XYZ ships products from Illinois to customers located in states in which it does not file returns and pay taxes based on net income. While XYZ does not file returns and pay tax in these states, ABC, a member of the ABC group, is subject to tax and pays tax in all of these states that impose income taxes. Taxpayer Brief pp. 2, 3; Dept. Brief pp. 2, 3.

**6.** The Department determined that for the year ended May 31, 1991, XYZ made sales of $208,846,499 to purchasers in states and foreign countries where it did not file returns or pay tax; in its amended return for this tax year, ABC agreed that $8,507,612 of such sales were properly included in the numerator of the sales factor of the ABC group's Illinois apportionment formula, but disputed the throw back to this state of $200,338,887 of sales. Stip. Filing History p. 6; Dept. Brief p. 4.

**7.** The Department determined that for the year ended May 31, 1992, XYZ made sales of $172,304,373 to purchasers in states and foreign countries where it did not file tax returns or pay tax. In its amended return for this year, ABC agreed that $3,985,321 of such sales were properly included in the numerator of the sales factor of the ABC group's Illinois apportionment formula, but disputed the throw back to this state of $168,319,052 of sales. Stip. Filing History p. 6; Dept. Brief p. 4.

**8.** The Department determined that for the year ended May 31, 1993, XYZ made sales of $168,153,892 to purchasers in states and foreign countries where it did not file tax returns or pay tax. In its amended return for this year, ABC agreed that $7,259,384 of such sales were properly included in the numerator of the sales factor of the ABC group's Illinois apportionment formula but disputed the throw back to this state of $160,894,508 of sales. Stip. Filing History p. 6; Dept. Brief p. 4.

**9.** ABC filed income tax returns as a separate company and paid taxes in the following states to which XYZ shipped products from Illinois for all or a portion of the tax years ending May 31, 1991, May 31, 1992 and May 31, 1993: Alabama, Connecticut, Delaware, Kentucky, Louisiana, Maine (for tax years ended 5/31/91 and 5/31/92), Maryland, Massachusetts, New Hampshire, New Jersey, New Mexico, New York, North Carolina, Rhode Island, Tennessee, Vermont, Virginia, West Virginia and Wisconsin. In addition to filing a separate return, ABC also paid franchise tax in New Mexico. Stip. Filing History pp. 1, 2, 4, 5, 6.

**10.** ABC filed "water's edge" or "worldwide" combined income tax returns in Maine (for tax year ended May 31, 1993 only), Minnesota, Montana, North Dakota and Utah. ABC included XYZ and other commonly owned affiliates in these returns, but XYZ's property, payroll and sales were not included in the numerators of the apportionment formulas used in these states to assign income to each state. Stip. Filing History pp. 2, 3, 4, 5.

**11.** ABC filed nexus consolidated returns[3] in Mississippi and South Carolina. XYZ was not a member of the nexus consolidated group in either of these states. Stip. Filing History pp. 3, 5.

**12.** Neither ABC nor XYZ filed returns in Nevada, South Dakota or Wyoming; none of these states has a corporate income tax. The Department determined that sales by XYZ to customers in these states should be thrown back to Illinois and included in the numerator of the ABC group's apportionment formula pursuant to section 304(a)(3)(B) of the Illinois Income Tax Act, 35 **ILCS** 5/304(a)(3)(B). Stip. Filing History pp. 3, 5, 6.

**13.** ABC filed annual sales, use and withholding tax returns in Michigan for tax years ended 5/31/91, 5/31/92 and 5/31/93, but did not file a Single Business Tax (hereinafter "SBT") return.[4] XYZ filed an SBT return in Michigan on a separate company basis for the tax year ending 5/31/93, but did not file an SBT return for the tax years ending 5/31/91 and 5/31/92. Stip. Filing History p. 2.

**14.** On April 26, 1996, the Department issued a Notice of Deficiency to the ABC group for the tax years ended 5/31/91, 5/31/92 and 5/31/93 with respect to the states to which the Department determined throwback sales should be calculated. This included each of the states in which ABC filed returns on a separate company basis, combined returns or consolidated returns, and states to which XYZ ships products that do not impose an income tax. The Department also determined that throwback

[3] A nexus consolidated group includes the members of the federal consolidated group for federal income tax purposes that have nexus with the taxing state. Stip. Filing History p. 3; Miss. Code Ann. § 27-7-37; S.C. Code Ann. § 12-6-5020(B).

[4] All foreign corporations that have taxable business activity in Michigan and have nexus with this state are subject to the Michigan Single Business Tax. See Mich. Comp. Laws Ann. § 208.31.

sales should be calculated for Michigan, which imposes a Single Business Tax rather than an income tax. The taxpayer timely protested the Department's determination on June 21, 1996, but withdrew this protest and paid the entire tax assessed on January 20, 1999. Taxpayer Brief p. 1; Dept. Brief p. 3.

**15.** On January 11, 2000 the taxpayer filed Illinois corporate income tax amended returns for tax years ended 5/31/91, 5/31/92 and 5/31/93 seeking a refund of a portion of the taxes paid on January 20, 1999 with respect to sales for which the Department determined that throwback sales should be calculated. The Department issued a notice of denial denying all of these claims on April 13, 2001 and the taxpayer timely protested these refund claim denials on June 12, 2001. Taxpayer Brief p. 2; Dept. Brief p. 3; Stipulation of Facts in Lieu of Hearing; Stip. Filing History p. 6.

**Conclusions of Law:**

The issue presented in this case is whether the Department erred in denying refund claims wherein the taxpayer challenged the inclusion of certain sales of XYZ Corporation, a member of the ABC unitary business group (hereinafter "ABC group") in the computation of the group's 1991, 1992 and 1993 Illinois income tax. The resolution of this issue entails the construction of 35 **ILCS** 5/304(a)(3)(B), the state's so-called "throwback rule." The throwback rule applies when a corporation sells products from Illinois in a state that does not have sufficient contact to subject the corporation to taxation in that state. Pursuant to this rule, sales into such states are "thrown back" to Illinois for purposes of determining the numerator of the corporation's Illinois income tax apportionment formula, or the unitary group's combined apportionment formula, if the corporation is a member of a unitary business group. 86 Ill. Admin. Code § 100.5270(b)(1)(A), (B). The throwback rule is designed to eliminate sales that cannot be assigned to any state (so-called "nowhere" sales) by assigning such sales to Illinois, the originating state. Dover Corp. v. Department of Revenue, 271 Ill. App. 3d 700, 708 (1st Dist. 1995). The clear purpose of this rule is to reduce the possibility of income escaping taxation by any state. *Id*.

During the tax periods in controversy, XYZ was engaged in business in Illinois as one of several affiliated corporations comprising the ABC unitary business group. The federal taxable income, property, payroll and sales of the members of this group were included in a combined report filed by ABC, as required by 35 **ILCS** 5/304(e). Of the members of the unitary group, both ABC and XYZ were taxpayers and filed tax returns in Illinois. In addition to sales that are unquestionably attributable to Illinois, XYZ sold goods in a number of states in which it was not taxable individually, but in which an affiliated member of ABC's unitary business group was taxable. The Department concluded that those sales should be thrown back to Illinois and included in the apportionment formula as Illinois sales.

After the Department issued its assessment for the audit years 1991 through 1993, ABC filed a protest challenging the assessment, but later withdrew its protest and paid the tax assessed. Subsequently, on January 11, 2000, the taxpayer filed refund claims seeking a refund of tax attributable to XYZ's 1991 through 1993 throw back sales. The Department's denial of these claims is the subject of this proceeding.

Illinois assesses corporate income tax pursuant to the Illinois Income Tax Act (hereinafter "IITA"), 35 **ILCS** 5/101 *et seq*. The apportionment provisions of the IITA are based on the Uniform Division of Income for Tax Purposes Act (hereinafter "UDITPA"). Hartmarx Corp. and Subsidiaries v. Bower, 309 Ill. App. 3d 959, 964, 965 (1st Dist. 1999). UDITPA was promulgated by the National Conference of Commissioners on Uniform State Laws and approved at their 66th Annual Conference in July, 1957. Hellerstein & Hellerstein, State Taxation Cases and Materials, 4th Ed., 1978 at p. 480. This measure is designed to permit states to equitably apportion the income of a multistate corporation in accordance with the distribution of the corporation's property, payroll and sales. *Id*. Absent such apportionment procedures, Illinois would tax the entire federal taxable income of a multistate unitary business in violation of the United States Constitution. ASARCO v. Idaho State Tax Commission, 458 U.S. 307 (1982).

The UDITPA apportionment formula produces a percentage of multistate corporate income that can constitutionally be taxed in Illinois. Because each state is at liberty to tax and apportion income as it chooses, subject only to constitutional limits, UDITPA involves no mandatory consideration of the aggregate taxes imposed by the various states. Nonetheless, in theory, if every state employed UDITA's apportionment scheme, gaps and overlaps in the apportionment of income would be eliminated and a multistate corporation would, in the aggregate, pay taxes on no more than 100 percent of its income. GTE Automatic Electric v. Allphin, 68 Ill. 2d 326, 335, 336 (1977).

The use of formula apportionment to determine taxable income is problematic where a multistate corporation has sales in one state but has no property or payroll there. Public Law 86-272, 15 U.S.C. §§ 381 through 384 (hereinafter "P.L. 86-272"), a federal statutory provision enacted in 1959, prevents a state from taxing a corporation that has, as its only contact with the state, the solicitation of sales. Pursuant to UDITPA's throwback rule, UDITPA reassigns those sales that occur in states in which the taxpayer is not taxable to the originating state. Because the Illinois Income Tax Act is based on UDITPA, this concept has been incorporated into the IITA at 35 **ILCS** 5/304(a)(3)(B).

As originally enacted, UDITPA, and comparable Illinois income tax apportionment provisions, dealt only with a single corporate taxpayer engaged in multistate business. However, in 1982, Illinois adopted a statutory requirement that affiliated corporations engaged in a unitary business file a combined report listing the aggregate, and by company, federal taxable income, property, payroll and sales. See P.A. 82-1029, Laws 1982, eff. Dec. 15, 1982. The aggregate income on the combined report is apportioned in accordance with the state's UDITPA based provisions and each corporate taxpayer pays tax on its Illinois share of income. As a result of the 1982 amendments to the IITA, the state's UDITPA based provisions became applicable to a taxpayer and its affiliates, giving rise to the controversy presented in this case.

During the audit years in question, Illinois' share of the ABC group's income was determined pursuant to 35 **ILCS** 5/304 using the following computation:

> (B)y multiplying the income by a fraction, the numerator of which is the sum of the property factor (if any), the payroll factor (if any) and 200% of the sales factor (if any), and the denominator of which is 4 reduced by the number of factors other than the sales factor which have a denominator of zero and by an additional 2 if the sales factor has a denominator of zero.

The sales factor is defined as follows:

> (A) The sales factor is a fraction, the numerator of which is the total sales of the person in this State during the taxable year, and the

> denominator of which is the total sales of the person everywhere during the taxable year.
> 35 **ILCS** 5/304(a)(3)(A)

Similar provisions define the property and payroll factors of the IITA. See 35 **ILCS** 5/304(a)(1), 35 **ILCS** 5/304(a)(2). The apportionment formula derived is then multiplied by the federal taxable income of the entire unitary business group to determine income that can properly be taxed by Illinois.

In determining the sales factor numerator, section 304(a)(3)(B), 35 **ILCS** 5/304(a)(3)(B), the state's throwback rule, provides that a taxpayer's sales are attributed to Illinois if "(T)he property is shipped from an office, store, warehouse, factory or other place of storage in this State and … the person is not taxable in the state of the purchaser." (emphasis added) ABC implicitly argues that the term "person" as used in the throwback rule must, after the adoption of combined reporting, be construed to refer to ABC and its unitary affiliates included in ABC's combined return, including XYZ. Under this construction of Illinois law, XYZ's sales could not be thrown back to Illinois because ABC and other affiliates in the ABC group are taxable in the destination states. Taxpayer Brief pp. 3, 4, 5, 6; Taxpayer Reply Brief pp. 2, 3, 4, 5. The taxpayer urges this tribunal to deduct such sales from the Illinois sales of the ABC group for purposes of apportioning federal taxable income. Taxpayer Brief p. 7.

The taxpayer's argument is based in part upon section 502(e) of the IITA, 35 **ILCS** 5/502(e), which allows a unitary group to elect to be treated as a single taxpayer. Taxpayer Brief pp. 4, 5, 6. This section provides in part as follows:

> (e) For taxable years ending on or after December 31, 1985, and before December 31, 1993, taxpayers that are corporations (other than Subchapter S corporations) having the same taxable year and that are members of the same unitary business group may elect to be treated as

> <u>one taxpayer</u> for purposes of any original return, amended return which includes the same taxpayers of the unitary group which joined in the election to file the original return, extension, claim for refund, assessment, collection and payment and determination of the group's tax liability under this Act. This subsection (e) does not permit the election to be made for some, but not all, of the purposes enumerated above. For taxable years ending on or after December 31, 1987, corporate members (other than Subchapter S corporations) of the same unitary business group making this subsection (e) election are not required to have the same taxable year. (emphasis added)

The taxpayer reasons that if, as both parties agree[5], section 502(e) of the IITA includes all members of a unitary business group in defining the "taxpayer" for purposes of procedurally reporting combined income, then the word "person" as used in the throwback rule must also include the unitary business group. Taxpayer Brief pp. 4, 5, 6. In support of this claim, it notes that sales can be thrown back to Illinois under sec. 304(a)(3)(B) only if "the taxpayer" is not taxable in the destination state under IITA section 303(f), 35 **ILCS** 5/303(f). Taxpayer Brief pp. 4, 5, 6, 7. It argues that the term "taxpayer" used in IITA section 502(e) necessarily refers to the same entity (the unitary business group) when used in section 303(f). <u>*Id*</u>. This position, however, is without any support in the Illinois statutes, regulations or case law.

The record shows that the ABC group made the statutory election prescribed by 35 **ILCS** 5/502(e) in each of the tax years at issue in this case. Since this section treats the unitary business group as a single entity or "person", the taxpayer argues that not treating the unitary business group as a "person" under 35 **ILCS** 5/304(a)(3)(B), contradicts the plain meaning of section 502(e). <u>*Id.*</u>

[5] See Dept. Brief p. 15.

Absent other statutory provisions contained in the IITA, it might be logical to treat the term "taxpayer" when used in 35 **ILCS** 5/303(f) as having the same meaning as it does when used in 35 **ILCS** 5/502(e). Doing so would effectively construe the term "person" when used in 35 **ILCS** 5/304(a)(3)(B) to mean the unitary business group since the throwback rule only applies if a "taxpayer" or "person" is not taxable in another state. See 86 Ill. Admin. Code § 100.3200(a) (applying 35 **ILCS** 5/303(f) in determining the sales factor under 35 **ILCS** 5/304). However, as pointed out in the Department's brief (pp. 14, 15), the taxpayer's argument ignores the fact that the IITA expressly defines the term "unitary business group" as follows:

> Unitary business group. The term "unitary business group" means a <u>group of persons</u> related through common ownership whose business activities are integrated with, dependent upon and contribute to each other. (emphasis added)
> 35 **ILCS** 5/1501(a)(27)

To construe the term "person" as used in section 304(a)(3)(B) of the IITA to mean the unitary business group would contradict the plain meaning of IITA section 1501(a)(27), 35 **ILCS** 5/1501(a)(27). Moreover, the taxpayer's argument would effectively base the meaning of the term "person" as used in section 304(a)(3)(B) upon whether or not the taxpayer elected to be treated as a single taxpayer for filing purposes under 35 **ILCS** 5/502(e). Yet nothing in the IITA suggests that the legislature intended for the term "person" as used in section 304(a)(3)(B) and in other provisions of the IITA[6] to have more than one meaning.

The taxpayer's position is also completely at odds with the Department's regulatory scheme governing the application of section 304(a)(3)(B). This is significant

[6]See 35 **ILCS** 5/304(a)(1), 35 **ILCS** 5/304(a)(2) and 35 **ILCS** 5/304(a)(3)(A).

because, in interpreting the meaning of Illinois statutes governing the determination of apportionable business income, the Illinois courts look for guidance to regulations promulgated by the Department. Texaco-Cities Service Pipeline Co. v. Department of Revenue, 182 Ill. 2d 262, 272 (1998). The Illinois Supreme Court has recognized that such regulations, "although not binding" are "entitled to substantial deference." *Id*.

The instant case involves the application of the throwback rule to a unitary business group. XYZ, a member of the group, ships products from Illinois to states in which it is not taxable, although ABC, and other members of the ABC group are. The Department has thrown back these sales to Illinois. The application of the throwback rule in this manner is often referred to as the "Joyce rule" in reference to a California administrative decision, Appeal of Joyce, Inc., Cal. SBE, No. 66-SBE-070, 11/23/66. Joyce involved a unitary business consisting of an Ohio parent and a California subsidiary. The Ohio corporation had no nexus with the State of California. In determining the tax liability of the unitary group, the California Franchise Tax Board included the California property, payroll and sales of both corporations in the numerators of the factors used to apportion income to this state. The taxpayer protested the inclusion, in the numerator of the sales factor, sales made by a corporation over which the Franchise Tax Board had no taxing jurisdiction. The State Board of Equalization (hereinafter "SBE") agreed with the taxpayer and ruled that a corporation which is immune from tax pursuant to P.L. 86-272 cannot be taxed even though it is a member of a combined unitary group.

In 1990, the SBE issued a decision in Appeal of Finnigan Corp., Cal. SBE, No. 88-SBE-022-A, 1/24/90. In that decision, the SBE effectively overruled Joyce, and held that out-of-state sales made by a member of a unitary business group should not be thrown back where another member of the group was taxable in the destination state. Subsequently, in Appeal of Huffy Corp., Cal SBE, No. 99-SBE-005, 4/22/99, the State Board of Equalization rejected the rule established in Finnigan in favor of its old taxing rule established in Joyce.

Illinois has consistently rejected the now discarded Finnigan holding and followed the Joyce rule. According to 86 Ill. Admin. Code § 100.5270(b)(1)(A) and (B), sales made by corporations which are not taxable in Illinois due to P.L. 86-272 are not to be included in the numerator of the sales factor of a unitary business group. The same regulation also treats the issue of throwback sales for members of a unitary business group. Examples 1 and 2, under subdivision (b)(1)(A) and (B) of this regulation provide as follows:

> Example 1:
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> i) Corporations A, B, and C constitute a unitary business group. Corporations A and B are eligible to make the election under IITA Section 502(e) for tax years ending before December 31, 1993. However, under Public Law 86-272, Corporation C is not taxable in Illinois.
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> ii) Based on these facts, if the election to be treated as one taxpayer is made, the combined Illinois sales factor must be determined by dividing the combined group's total combined Illinois sales (that is, excluding any sales of Corporation C shipped to purchasers in Illinois) by the total combined sales of the unitary business group everywhere. If the same facts are applied to a tax year ending on or after December 31, 1993, the same result will occur in the mandatory combined return situation. …
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> Example 2:
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> i) Same facts as in Example 1, except these additional facts also exist. Under Public Law 86-272, Corporations B and C are taxable in South Carolina, but corporation A is not.
>
> ii) Based on these facts, if the election to be treated as one taxpayer is made, or the taxpayers are required to be treated as one

> taxpayer, the combined Illinois sales factor must be determined by dividing the combined group's total Illinois sales (including any sales of Corporation A shipped to purchasers in South Carolina from any place of storage in Illinois, i.e., throwback sales) by the total sales of the unitary business group everywhere.

Under this regulation, where corporations A and B are part of a unitary group and subject to tax in Illinois, and Corporation A is not subject to tax in the destination state, but Corporation B is, the combined Illinois sales factor includes Corporation A's destination state sales. The regulation clearly provides that the sales of corporation A are to be thrown back to Illinois.

Significantly, the Illinois courts have endorsed the Department's decision to follow the Joyce rule on at least three occasions. In Dover Corp., *supra*, the taxpayers were members of a unitary business group filing in Illinois. They argued that the entire unitary group is the "taxpayer" and therefore, a tax payment by any member of the group meant that the taxpayer was taxable in the destination state for purposes of section 304(a)(3)(B). The court looked to GTE Automatic Electric, Inc. v. Allphin, 68 Ill. 2d 326, 335 (1977) where the Illinois Supreme Court stated that the purpose of apportionment is to have 100% of the taxpayer's income taxable by the states having jurisdiction to do so. The Dover court held that treating a unitary group as one taxpayer for purposes of the throwback rule would defeat the purpose of Illinois' UDITPA based throwback sales provisions to assure that 100% of a taxpayer's business income is subject to taxation. Dover at 708.

The court followed its precedent in Dover when the identical issue was presented in Beatrice Companies, Inc. v. Whitley, 292 Ill. App. 3d 532 (1st Dist. 1997). As in

Dover, the taxpayers in Beatrice were members of a unitary business group filing in Illinois. As they had in Dover, the taxpayers argued that the entire unitary group constituted the "taxpayer" and therefore, a tax payment by any member of the group in the destination state rendered the entire group immune from any throw- back to Illinois. After considering 35 **ILCS** 304(a)(3)(B)(ii) and 35 **ILCS** 1501(a)(27), the Appellate Court concluded that construing, as the taxpayer proposed, the term "person" used in the throwback rule to refer to the unitary business group would be manifestly incompatible with the General Assembly's intent. Beatrice at 536, 537. Accordingly, the court held that sales shipped from Illinois by a member of a unitary business group to purchasers located in states where group members paid tax but the shipper did not should be thrown back to Illinois.

The identical fact pattern presented in the instant case was presented in Hartmarx Corporation, *supra*. As in the case in chief, in Hartmarx the taxpayer elected to be treated as a single taxpayer under section 502(e) of the IITA. The taxpayer sought to distinguish the court's earlier decisions in Dover and Beatrice, arguing that the enactment of section 502(e) subsequent to the years in controversy in those cases, requires the treatment of the unitary business group as a single "taxpayer" for purposes of the throwback rule. Hartmarx at 966. In affirming the Department's position, the court, citing Beatrice, found that the taxpayer's construction of the section 502(e) would undermine the legislative intent in adopting UDITPA based provisions to apportion income so that there is neither an overlap nor a gap in taxation. Hartmarx at 967, 968. Rejecting the taxpayer's argument to the contrary, it found no evidence that the income from thrown back sales the taxpayer sought to have removed from its Illinois sales factor numerator were included in income taxable in any of the destination states. Hartmarx at 968. As a result, it determined, construing the throwback rule in the manner advocated by the taxpayer would completely undermine the purposes of the throwback rule by creating sales that could not be assigned to any state, potentially resulting in the apportionment of less than 100% of the taxpayer's income. Hartmarx at 967, 968. Since the purpose of the throwback rule is to prevent tax avoidance of this type, the court found that the Department's interpretation of the throwback rule fully comported with the legislative purpose of section 304(a)(3)(B). *Id.*

The reasoning followed by the Illinois appellate courts in Dover, Beatrice and Hartmarx fully supports the Department's denial of the taxpayer's refund claims in this case. Moreover, as noted above, P.L. 86-272 provides protection to companies by restricting the ability of states to impose taxes based on the *de minis* nature of their contacts with the state. If this tribunal were to follow the taxpayer's reasoning, and consider the unitary group as one person for apportionment purposes, sales of a member company having insufficient contacts to be taxable under P.L. 86-272, could be included in the numerator of the state's sales factor. As a result, the member would have income apportionable to Illinois and would be taxed in this state. In effect, the nexus of one company alone would be sufficient to subject all members of the unitary business group to taxation. Such a construction of the IITA would undermine the protection afforded by P.L. 86-272 and therefore is of questionable validity under the supremacy clause of the United States Constitution.[7] In Re Joyce, *supra*.

[7]Pursuant to Article VI of the United States Constitution, the so-called supremacy clause, the federal income tax law is supreme and state income tax laws must yield to the federal law. McCullough v. Maryland, 17 U.S. 316 (1819); Ward v. Maryland, 79 U.S. 418 (1870); Wheeling, Parkersburg and Cincinnati Transportation Co. v. City of Wheeling, 99 U.S. 273 (1878).

86 Ill. Admin. Code § 100.5270(b)(1)(A) and (B), applying the Joyce rule, was promulgated more than 15 years ago. Hartmarx at 966.[8] The appellate court's opinions upholding the Department's application of the Joyce rule date from 1995. Dover, *supra*. The General Assembly has convened in regular session numerous times since the Department's construction of the Illinois throwback rule in this manner was adopted and confirmed by the courts. As noted by the Department in its brief, had the Department's regulations and the case law overlooked or misconceived the legislature's intent, the legislature would surely have rectified this situation by now. Dept. brief at p. 9 (citing Southwestern Bell Mobile Systems, Inc. v. Department of Revenue, 314 Ill. App. 3d 583, 589 (1st Dist. 2000)). The legislature's continued inaction in the face of the Department's decision to apply the Joyce rule, particularly given repeated affirmation of this rule by the courts, fully supports the Department's claim that the Department's interpretation comports with the legislative intent of the state's throwback rule.

For the reasons indicated above, I find that the Department's decision to throw back XYZ sales to Illinois from states where a member or members of the ABC group were taxable, but XYZ was not, is fully supported by the statutory language, the Department's regulations and Illinois case law. The facts presented in this case indicate that the Department has also thrown back sales from states where neither XYZ nor ABC or any of its affiliates have been taxed. Stip. Filing History pp. 3, 5, 6. In the states of Nevada, South Dakota and Wyoming, no income tax has been imposed because none of

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[8] 86 Ill. Admin. Code § 100.5270 was adopted effective November 3, 1986.

these states have enacted income tax statutes.[9] Section 303(f) of the IITA, 35 **ILCS** 5/303(f), provides guidance with respect to this situation, stating that "(A) taxpayer is taxable in another state if … (T)hat state has jurisdiction to subject the taxpayer to a net income tax regardless of whether, in fact, the state does or does not." The plain language of section 303(f) supports the conclusion that a taxpayer is "taxable" in a destination state that has not enacted an income tax when the destination state has jurisdiction to impose a tax, whether or not tax is actually imposed. 86 Ill. Admin. Code § 100.3200(a) confirms this conclusion, providing in pertinent part as follows:

> (A) taxpayer claiming to be taxable in another state under the tests set forth in … (35 **ILCS** 5/303(f)(1)) … must establish, not only that under the laws of such state he is subject to one of the specified taxes, but that he, in fact, pays such tax. If a taxpayer is subject to one of the taxes specified in … (35 **ILCS** 5/303(f)(1)) … but does not, in fact, pay such tax, such taxpayer may not claim to be taxable in the state imposing such tax under the test set forth in … (35 **ILCS** 5/303(f)(2)) … . <u>On the other hand, if a taxpayer is not subject in a given state to any of the taxes specified in … (35 **ILCS** 5/303(f)(1)) … but such taxpayer establishes that his activities in such state are such as to give the state jurisdiction to subject him to a net income tax, then under the test set forth in … (35 **ILCS** 5/303(f)(2)) … the taxpayer is taxable in such state, nothwithstanding the fact such state has not enacted legislation subjecting him to such tax</u>. In the case of any state other than a foreign country or political subdivision thereof, the determination of whether such state has jurisdiction to subject the taxpayer to a net income tax will be determined under the Constitution and statutes of the United States. Such a state does not have jurisdiction to subject the taxpayer to a net income tax if it is prohibited from imposing such a tax by reason of the provisions of Public Law 86-272, 15 U.S.C. Sections 381-385. In the case of any foreign country or political subdivision thereof, the determination of whether such state has jurisdiction to subject the taxpayer to a net income tax will be

[9] While Michigan also does not impose an income tax, it does impose a Single Business Tax (hereinafter "SBT") which is based in part on net income. See Mich. Comp. Laws Ann. § 208.31; Mich. Comp. Laws Ann. § 208.9; Mich. Comp. Laws Ann. § 208.3(3). The Department has, in effect, treated the SBT as the equivalent of a state income or franchise tax under 35 **ILCS** 5/303(f)(1) and did not throw back XYZ sales from Michigan in 1993, when XYZ paid an SBT in this state. Stip. Filing History p. 2. Consistent with this classification of the SBT, the Department has properly thrown back sales from Michigan in 1991 and 1992, since XYZ failed to show that it paid tax in this state in these years. 86 Ill. Admin. Code § 100.3200(a); <u>Dover</u>, *supra*.

> determined as if the foreign country or political subdivision were a state of the United States or political subdivision thereof. (emphasis added)

The Appellate Court has concluded that this regulation properly implements section 304(a)(3)(B) of the IITA, in accordance with that statutory provision's legislative intent. Dover at 708.

The record does not indicate whether XYZ's contacts with Nevada, Wyoming and South Dakota were sufficient for any of these states to exercise jurisdiction over XYZ without violating P.L. 86-272. It was incumbent upon the taxpayer to make such a showing since, under 35 **ILCS** 5/904(a), the Department's finding that these sales were properly thrown back to Illinois is presumed correct. In order to rebut this presumption in favor of taxability, the taxpayer must prove that the Department's determination was in error. *Id*; Balla v. Department of Revenue, 96 Ill. App. 3d 293, 295 (1st Dist. 1981). To overcome the Department's prima facie case, the taxpayer must present consistent and probable evidence identified with its books and records. Jefferson Ice Co. v. Johnson, 139 Ill. App. 3d 626, 632 (1st Dist. 1985); Central Furniture Mart v. Johnson, 157 Ill. App. 3d 907 (1st Dist. 1987). However the record in this case, which consists of a stipulation of facts agreed to by both parties, contains no evidence that XYZ's activities in these states were sufficient contacts for these states to impose tax on XYZ without violating P.L. 86-272. Since the taxpayer has failed to demonstrate that XYZ's contacts with Nevada, South Dakota and Wyoming were sufficient to allow these states to impose tax, it didn't prove that XYZ met the tests under 35 **ILCS** 5/303(f) (as implemented by 86 Ill. Admin. Code § 100.3200(a)) for avoiding throw back. Accordingly, the taxpayer has failed to rebut the Department's prima facie case.

As noted above, the parties have entered into a settlement agreement pursuant to which the Department has agreed to refund 30% of the tax paid on proceeds from the draw down of a letter of credit classified by the Department as business income.

**WHEREFORE,** for the reasons stated above, it is my recommendation that the Department's denial of the taxpayer's refund claims for the tax years ended 5/31/91, 5/31/92 and 5/31/93 be modified in accordance with the settlement agreement entered into by the parties, and, as amended, be upheld.

Ted Sherrod
Administrative Law Judge

Date: January 29, 2003