

IT 96-9
Tax Type:
Issue:

INCOME TAX
Apportionment: One Factor/Three Factor Application
1005 Penalty (Reasonable Cause Issue)

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

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

RECOMMENDATION FOR DISPOSITION

APPEARANCES: ATTORNEY, FOR TAXPAYER; WENDY PAUL, SPECIAL ASSISTANT ATTORNEY GENERAL, FOR THE ILLINOIS DEPARTMENT OF REVENUE.

SYNOPSIS:

THIS CASE INVOLVES TAXPAYER ("TAXPAYER" OR "TAXPAYER"), AN ILLINOIS CORPORATION, THAT FILES A COMBINED RETURN WITH ITS WHOLLY-OWNED SUBSIDIARY, CORPORATION ("CORPORATION"). CORPORATION IS A NEW JERSEY CORPORATION WHICH HAS ALL OF ITS ACTIVITIES IN NEW JERSEY. ON OCTOBER 9, 1990, THE DEPARTMENT OF REVENUE ISSUED AN ASSESSMENT FOR INCOME TAX AGAINST THE TAXPAYER FOR THE YEARS ENDED OCTOBER 31, 1986 AND JUNE 30, 1987 IN THE AMOUNT OF \$7,754, INCLUSIVE OF SECTION 1005 PENALTIES.

THIS MATTER COMES ON BEFORE THE OFFICE OF ADMINISTRATIVE HEARINGS PURSUANT TO THE TAXPAYER'S TIMELY PROTEST TO THE NOTICES OF DEFICIENCY DATED NOVEMBER 13, 1990. THE FOLLOWING ISSUES ARE PRESENTED:

1. DID THE DEPARTMENT ERR IN ELIMINATING INTERCOMPANY SALES FROM THE DENOMINATOR OF THE SALES FACTOR FOR SALES FROM CORPORATION TO TAXPAYER WHERE EXCLUDING INTERCOMPANY SALES INCREASED TAXPAYER'S OVERALL STATE TAX BURDEN; AND

2. IF IT IS DETERMINED THAT THE DEFICIENCY ASSESSED AGAINST THE TAXPAYER IS CORRECT, SHOULD THE SECTION 1005 PENALTY BE ABATED DUE TO REASONABLE CAUSE.

A HEARING WAS HELD AND EVIDENCE WAS TAKEN BY WAY OF TESTIMONY REGARDING THE ISSUES. ON CONSIDERATION OF THESE MATTERS, IT IS RECOMMENDED THAT THESE ISSUES BE RESOLVED IN FAVOR OF THE DEPARTMENT.

FINDINGS OF FACT:

1. TAXPAYER ("TAXPAYER"), AN ILLINOIS CORPORATION LOCATED IN CHICAGO, IS THE PARENT COMPANY OF CORPORATION ("CORPORATION"), A NEW JERSEY CORPORATION LOCATED IN NEW JERSEY. FOR THE TAXABLE YEARS ENDING OCTOBER 31, 1986 AND JUNE 30, 1987, TAXPAYER AND CORPORATION FILED AN ILLINOIS COMBINED RETURN. (DEPT. EX. NO. 2; TR. P. 6).

2. BOTH COMPANIES FILED SEPARATE COMPANY RETURNS IN NEW JERSEY AND GEORGIA, AND ALSO FILED UNITARY RETURNS IN CALIFORNIA AND NEW YORK. (DEPT. EX. NO. 2).

3. TAXPAYER AND CORPORATION FILED A CONSOLIDATED FEDERAL INCOME TAX RETURN. (DEPT. EX. NO. 2).

4. CORPORATION MANUFACTURES LIGHTING FIXTURES, AND ALL OF THEIR SALES ARE TO THE PARENT COMPANY, TAXPAYER, WHICH IS THE DISTRIBUTOR. (TR. P. 10).

5. TAXPAYER ELIMINATED THE PROFIT ON INTERCOMPANY SALES FROM INCOME IN THE COMBINED ILLINOIS RETURN WHICH WAS FILED FOR THE TAX YEARS ENDED OCTOBER 31, 1986 AND JUNE 30, 1987. (DEPT. EX. NO. 8, 9; TR. P. 12)

6. WHEN FILING ITS ILLINOIS COMBINED RETURN FOR THE YEARS ENDING OCTOBER 31, 1986 AND JUNE 30, 1987, TAXPAYER INCLUDED INTERCOMPANY SALES IN ITS SALES FACTOR. (TR. PP. 27-28).

7. WHEN INTERCOMPANY SALES WERE ELIMINATED FROM THE SALES FACTOR BY THE DEPARTMENT, TAXPAYER WAS TAXED ON 115% OF ITS INCOME, VERSUS 107% WHEN INTERCOMPANY SALES WERE INCLUDED, FOR AN INCREASE OF TAX LIABILITY OF 10% IN 1986 AND 18% IN 1987. (TR. PP. 13-15).

CONCLUSIONS OF LAW:

ISSUE #1

THE PRIMARY ISSUE PRESENTED HERE IS THE PROPER APPORTIONMENT FORMULA TO BE USED BY THE TAXPAYER. THE TAXPAYER DOES NOT CONTEST THAT IT IS A UNITARY BUSINESS NOR THAT THE FILING OF A COMBINED RETURN IS PROPER. TAXPAYER OBJECTS TO THE EXCLUSION OF INTERCOMPANY SALES BETWEEN CORPORATION AND TAXPAYER FROM THE DENOMINATOR OF THE SALES FACTOR.

THIS CASE HINGES ON THE INTERPRETATION OF REGULATION SECTION 100.3320(D)¹. THIS REGULATION PROVIDES:

UNITARY BUSINESS INCOME; ELIMINATIONS; INTERCOMPANY TRANSACTIONS. ELIMINATION OF INCOME AND DEDUCTION ITEMS ARISING FROM TRANSACTIONS BETWEEN MEMBERS OF THE GROUP MUST BE DONE WHENEVER NECESSARY TO AVOID DISTORTION OF THE GROUP'S INCOME, THE DENOMINATORS USED BY ALL MEMBERS OF THE GROUP IN CALCULATING APPORTIONMENT FACTORS, OR THE NUMERATORS USED BY ANY PARTICULAR MEMBER OF THE GROUP IN CALCULATING ITS APPORTIONMENT FACTORS.

§6 ADMIN. CODE, CH. I, SEC. 100.3320(D).

TAXPAYER MAINTAINS THAT IT SHOULD INCLUDE INTERCOMPANY SALES IN THE DENOMINATOR OF THE SALES FACTOR IN THOSE STATES WHERE IT FILES UNITARY RETURNS IN ORDER TO AVOID DISTORTION. BY INCLUDING INTERCOMPANY SALES, TAXPAYER IS TAXED ON 107% OF ITS INCOME BY ALL JURISDICTIONS, VERSUS 115% OF INCOME IF INTERCOMPANY SALES ARE EXCLUDED. TAXPAYER ARGUES THAT SINCE THE EXCLUSION OF INTERCOMPANY SALES RESULTS IN AN OVERALL HIGHER STATE TAX BURDEN, THE DEPARTMENT CANNOT MANDATE THE ELIMINATION OF INTERCOMPANY SALES. I DISAGREE.

IN THE CASE AT HAND WE ARE DEALING WITH ELIMINATING INTERCOMPANY SALES FROM THE SALES FACTOR OF A UNITARY GROUP. CORPORATION'S SALES ARE ALL TO THE PARENT, TAXPAYER, AND THEN THE SAME PRODUCT IS SOLD TO THIRD PARTIES BY TAXPAYER. IF THE INTERCOMPANY SALES WERE INCLUDED IN THE SALES FACTOR, SALES OF THE SAME PRODUCT WOULD BE INCLUDED TWICE. IF CORPORATION WERE A DIVISION OF TAXPAYER, WHERE ONE COMPANY BOTH MANUFACTURED AND DISTRIBUTED THE LIGHT FIXTURES, THE PAYROLL AND PROPERTY OF THE MANUFACTURING DIVISION WOULD BE LOCATED IN NEW JERSEY, AND THE SALES FACTOR WOULD CONSIST ONLY OF SALES MADE TO THIRD PARTIES. A UNITARY

¹ Formerly Section 100.3510(d).

RETURN IS DESIGNED TO ARRIVE AT THE SAME RESULT SINCE THE ENTIRE BUSINESS ENTERPRISE IS VIEWED AS A SINGLE ECONOMIC UNIT. THUS, WHEN FILING AS A UNITARY GROUP, IT IS NECESSARY TO ELIMINATE INTERCOMPANY TRANSACTIONS IN ORDER TO ACCURATELY MEASURE THE SALES ACTIVITY OF THE GROUP.

OTHER STATES REFLECT ILLINOIS' POSITION. BOTH CALIFORNIA AND NEW YORK, THE OTHER STATES WHERE TAXPAYER FILES A UNITARY RETURNS, REQUIRE THE ELIMINATION OF INTERCOMPANY SALES FROM THE SALES FACTOR OF COMBINED RETURNS. SEE SECTION 1190, CALIFORNIA UDITPA MANUAL (1984)²; SECTION 4-4.7, NY CORP. FRANCHISE TAX REGULATIONS³. ALSO, SECTION 1717 OF THE MULTISTATE TAX COMMISSION'S AUDIT PROCEDURE MANUAL, CORPORATE INCOME TAX (1987) STATES,

INTERCOMPANY ELIMINATIONS -- 1717.1. IN GENERAL, REVENUES FROM INTERAFFILIATE SALES BETWEEN MEMBERS OF A COMBINED GROUP OF CORPORATIONS CONDUCTING A UNITARY BUSINESS ARE TO BE ELIMINATED FROM THE SALES FACTOR. THIS AVOIDS A DUPLICATION IN THE FACTOR AMOUNTS. IF CORPORATION A SELLS GOODS TO CORPORATION B AT \$90 AND B SELLS TO OUTSIDERS AT \$100, ONLY THE \$100 ENTERS THE TOTAL SALES FACTOR; THE \$90 IS ELIMINATED AS AN INTERAFFILIATE SALE... ONLY INTERCOMPANY REVENUES BETWEEN CORPORATIONS THAT ARE UNITARY ARE ELIMINATED. THUS, NONUNITARY INTERDIVISIONAL SALES WITHIN A CORPORATION AND SALES BETWEEN NON-UNITARY ENTITIES ARE NOT ELIMINATED. THE SALES FACTOR INCLUDES ONLY SALES TO PURCHASERS OUTSIDE THE UNITARY GROUP. (EMPHASIS ADDED)

WHEN THE REGULATION SECTION 100.3320(D) REFERS TO "DISTORTION," IT IS DISTORTION OF THE COMBINED GROUP'S INCOME AND HOW THE INCOME IS ATTRIBUTED TO THE STATE OF ILLINOIS. THE PROPER ANALYSIS HERE IS NOT WHAT PERCENTAGE

² "Sales Factor -- The sales factor for a combined unitary group is comprised of total gross receipts less intercompany gross receipts."

³ "The receipts factor on a combined report is computed as though the corporations in the report were one corporation. All intercorporate business receipts are eliminated in computing the combined business receipts factor. Intercorporate receipts are receipts by any corporation included in the combined report from any other corporation included in the combined report."

OF TAXPAYER'S INCOME IS TAXED THROUGHOUT THE UNITED STATES, BUT WHETHER ILLINOIS' METHOD FAIRLY REFLECTS TAXPAYER'S ACTIVITY WITHIN THE STATE. THE SUPREME COURT ENUMERATED THE REQUIREMENTS FOR FAIRNESS OF AN APPORTIONMENT METHODOLOGY IN CONTAINER CORP. OF AMERICA V. FRANCHISE TAX BOARD, 463 U.S. 159 (1983):

THE FIRST, AND AGAIN OBVIOUS, COMPONENT OF FAIRNESS IN AN APPORTIONMENT FORMULA IS WHAT MIGHT BE CALLED INTERNAL CONSISTENCY - THAT IS, THE FORMULA MUST BE SUCH THAT, IF APPLIED BY EVERY JURISDICTION, IT WOULD RESULT IN NO MORE THAN ALL OF THE UNITARY BUSINESS INCOME BEING TAXED. THE SECOND AND MORE DIFFICULT REQUIREMENT IS WHAT MIGHT BE CALLED EXTERNAL CONSISTENCY - THE FACTOR OR FACTORS USED IN THE APPORTIONMENT FORMULA MUST ACTUALLY REFLECT A REASONABLE SENSE OF HOW INCOME IS GENERATED. THE CONSTITUTION DOES NOT "INVALIDAT[E] AN APPORTIONMENT FORMULA WHENEVER IT MAY RESULT IN TAXATION OF SOME INCOME THAT DID NOT HAVE ITS SOURCE IN THE TAXING STATE...." MOORMAN MFG. CO. [V. BAIR], 437 U.S. [267], 272, 98 S.CT. AT 2344 [(1978)] (EMPHASIS ADDED). SEE UNDERWOOD TYPEWRITER CO. [V. CHAMBERLAIN], 254 U.S. [113], 120-121, 41 S.CT., AT 46-47 [(1920)]. NEVERTHELESS, WE WILL STRIKE DOWN THE APPLICATION OF AN APPORTIONMENT FORMULA IF THE TAXPAYER CAN PROVE BY 'CLEAR AND COGENT EVIDENCE' THAT THE INCOME ATTRIBUTED TO THE STATE IS IN FACT 'OUT OF ALL APPROPRIATE PROPORTIONS TO THE BUSINESS TRANSACTED...IN THAT STATE,' HANS REES' SONS, INC. [V. NORTH CAROLINA EX REL. MAXWELL], 283 U.S. [123], 135, 51 S. CT. AT 389 [(1931)] OR HAS 'LED TO A GROSSLY DISTORTED RESULT,' NORFOLK AND WESTERN RR V. STATE TAX COMMISSION, 390 U.S. 317, 326, 88 S.CT. 995, 1001, 19 L.ED.2D 1201 (1968)." MOORMAN MFG. CO., SUPRA, 437 U.S., AT 274, 98 S.CT., AT 2345.

463 U.S. AT 170.

TAXPAYER RELIES ON GTE AUTOMATIC ELECTRIC V. ALLPHIN, 68 ILL.2D 326, 369 N.E.2D 841 (1977), FOR THE PROPOSITION THAT NO MORE THAN 100% OF THE COMBINED GROUP'S INCOME MAY BE SUBJECT TO TAX BY THE VARIOUS STATES. TAXPAYER'S RELIANCE ON GTE IS MISPLACED. THE COURT IN GTE STATED "[T]HE

PURPOSE OF THE UNIFORM ACT⁴ AND ARTICLE 3 OF THE ILLINOIS ACT IS TO ASSURE THAT 100%, AND NO MORE OR NO LESS, OF THE BUSINESS INCOME OF A CORPORATION DOING MULTISTATE BUSINESS IS TAXED BY THE STATES HAVING JURISDICTION TO TAX IT." 68 ILL. 2D AT 335. THE COURT HAS MERELY STATED THE GOAL OF FORMULARY APPORTIONMENT. IF ALL THE STATES ADOPTED THE UNIFORM ACT (UDITPA), THEN NO MORE THAN 100 PERCENT OF A TAXPAYER'S INCOME WOULD BE TAXED. IN FACT, IF ALL OF THE JURISDICTIONS WHERE TAXPAYER IS SUBJECT TO TAX EMPLOYED THE SAME METHODOLOGY USED BY THE DEPARTMENT, THE RESULT WOULD BE THAT EXACTLY 100% OF TAXPAYER'S INCOME IS SUBJECT TO TAX.

TAXPAYER'S PROBLEM IS THAT IT ALSO FILES TAX RETURNS IN NEW JERSEY WHICH DOES NOT ALLOW COMBINED REPORTING. SINCE NEW JERSEY DOES NOT ALLOW UNITARY FILING, ALL INCOME OF BOTH COMPANIES ARE SUBJECT TO TAX: 100% OF CORPORATION'S INCOME INCLUDING INTERCOMPANY PROFITS (WHICH ARE ELIMINATED IN A UNITARY RETURN), AND A PERCENTAGE OF TAXPAYER'S INCOME ACCORDING TO ITS APPORTIONMENT FACTORS IN NEW JERSEY. AS A RESULT, MORE THAN 100 PERCENT OF TAXPAYER'S INCOME IS SUBJECT TO TAX IN THE VARIOUS JURISDICTIONS IN WHICH IT DOES BUSINESS.

AS A RESULT OF THE DEPARTMENT'S EXCLUSION OF THE INTERCOMPANY SALES FROM THE SALES FACTOR, TAXPAYER HAS EXPERIENCED AN INCREASE IN ITS ILLINOIS TAX LIABILITY OF 10% IN 1986 AND 18% IN 1987. IN CONTAINER, THE SUPREME COURT HELD A 14% INCREASE IN TAX TO BE "WITHIN THE SUBSTANTIAL MARGIN OF ERROR INHERENT IN ANY METHOD OF ATTRIBUTING INCOME AMONG THE COMPONENTS OF A UNITARY BUSINESS." ID. AT 185. SEE ALSO, CITIZENS UTILITIES CO. V. DEPT. OF REVENUE, 111 ILL. 2D (1986), (COURT UPHELD A 213% INCREASE IN TAX LIABILITY); FILTERTEK, INC. V. DEPT. OF REVENUE, 186 ILL. APP. 3D 208 (2ND DIST. 1989), (COURT UPHELD INCREASES OF 561% AND 807% TO INCOME IN ILLINOIS); NEW

⁴ Reference is to Uniform Division of Income for Tax Purposes Act ("UDI TPA").

YORKER MAGAZINE V. DEPT. OF REVENUE, 187 ILL. APP. 3D 931 (1ST DIST. 1989), (COURT UPHELD TAXES ON 120% OF ITS COMBINED CIRCULATION AND ADVERTISING REVENUES AND 128% OF ITS ADVERTISING REVENUES).

ULTIMATELY, THE ISSUE IS NOT A MATHEMATICAL TEST OF WHAT PERCENTAGE OF INCOME BEING TAXED IS ACCEPTABLE, OR BY HOW MUCH DOES TAXPAYER'S LIABILITY INCREASE. THE RELEVANT ANALYSIS IS WHETHER THE METHODOLOGY EMPLOYED BY THE STATE OF ILLINOIS FAIRLY APPORTIONS TAXPAYER'S INCOME TO THE STATE OF ILLINOIS BASED UPON ITS ACTIVITY IN THE STATE.

NO EVIDENCE HAS BEEN INTRODUCED BY TAXPAYER WHICH WOULD INDICATE THAT THE STATE'S METHOD OF APPORTIONMENT TAXES EXTRATERRITORIAL VALUES. TAXPAYER HAS FAILED TO REBUT THE PRIMA FACIE CORRECTNESS OF THE DEPARTMENT'S PROPOSED ASSESSMENT.

ISSUE #2

TAXPAYER HAS REQUESTED THAT IN THE EVENT THAT THE DEPARTMENT'S POSITION IS UPHELD REGARDING THE ELIMINATION OF INTERCOMPANY SALES THAT THE SECTION 1005 PENALTIES SHOULD BE ABATED DUE TO REASONABLE CAUSE. I DISAGREE.

TAXPAYER HAS MANIPULATED THE APPORTIONMENT FACTORS TO ARTIFICIALLY REDUCE THE AMOUNT OF TAX IT PAYS TO THE STATE OF ILLINOIS. ELIMINATION OF INTERCOMPANY TRANSACTIONS IS THE NORM WHEN FILING COMBINED OR CONSOLIDATED RETURNS IN ORDER TO AVOID DUPLICATION. *see* AUDIT PROCEDURE MANUAL, CORPORATE INCOME TAX, SECTION 1717, MULTISTATE TAX COMMISSION (1987) SUPRA. IN ADDITION, IT SHOULD BE NOTED THAT TAXPAYER DID ELIMINATE INTERCOMPANY SALES WHEN CALCULATING TAXABLE INCOME.

TAXPAYER PRESENTED NO EVIDENCE REGARDING HOW THE APPORTIONMENT FORMULA AS APPLIED BY THE DEPARTMENT RESULTED IN ALLOCATING INCOME TO ILLINOIS THAT WAS OUT OF PROPORTION TO TAXPAYER'S ACTIVITY IN THIS STATE. THEREFORE, I FIND THAT TAXPAYER DID NOT SHOW REASONABLE CAUSE FOR ITS UNDERPAYMENT OF TAX, SO THAT THE SECTION 1005 PENALTIES STAND.

WHEREFORE, FOR THE REASONS STATED ABOVE, IT IS MY RECOMMENDATION THAT THE NOTICE OF DEFICIENCY SHOULD BE FINALIZED IN ITS ENTIRETY.

DATE:

LINDA K. CLIFFEL
ADMINISTRATIVE LAW JUDGE