

IT 98-3

Tax Type: INCOME TAX

Issue: Financial Organization(s) (General)

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

XYZ COMPANY, successor in interest)	
To ABC CORPORATION)	FEIN #
)	FEIN #
Taxpayer)	
)	Docket #
v.)	Track #
)	
THE DEPARTMENT OF REVENUE)	Barbara S. Rowe
OF THE STATE OF ILLINOIS)	Administrative Law Judge

RECOMMENDATION FOR DISPOSITION

Appearances: Philip H. Hamilton, Farrell Law Firm, P.C. for XYZ COMPANY successor in interest to ABC CORPORATION taxpayer; Charles Hickman, Special Assistant Attorney General, for the Illinois Department of Revenue.

Synopsis:

The Illinois Department of Revenue (the "Department") issued a notice of denial of refund of Illinois Income taxes on July 7, 1995 to ABC CORPORATION (the "Taxpayer") in the amount of \$121,342.00. The basis of the denial was that the refund claims by the taxpayer for overpayment of Income Tax for interest or dividend income from Missouri Held Securities should not be excluded from the numerator calculation for the applicable years. The taxpayer timely protested the denial and requested a hearing in the matter. At the hearing, it was established that the interest and dividend income from Missouri Held Securities were allocable to

Illinois pursuant to the Illinois Income Tax Act and should be included in the numerator calculations for the applicable years. It is therefore recommended that this matter be resolved in favor of the Department.

Findings of Fact:

1. The *prima facie* case of the Department, consisting of the Notice of Denial of Claim for Refund, was established by the admission into evidence of Dept. Ex. No. 1. (Tr. p. 4)

2. The taxpayer is an Illinois corporation located at FICTITIOUS ADDRESS, Illinois. Its federal identification number is XX-XXXXXX. (Dept. Ex. No. 6 - Stip. 1)

3. The taxpayer is a "bank holding company" (205 **ILCS** 10/2(b)) within the meaning of the Illinois Bank Holding Company Act of 1957 found at 205 **ILCS** 10/1 *et seq.* The taxpayer is the owner of 30,000 shares of the FICTITIOUS BANK. There were 30,000 shares of outstanding stock of the FICTITIOUS BANK during the years 1991, 1992, and 1993. (Dept. Ex. No. 6 - Stip 6 and corresponding Ex. No. 8)

4. The taxpayer is a "financial organization" (35 **ILCS** 5/1501(a)(8)) within the meaning of the Illinois Income Tax Act found at 35 **ILCS** 5/35 *et seq.* (Dept. Ex. No. 6 - Stip. 7)

5. The taxpayer is the owner of certain investment securities located at: the Boatman's National Bank of FICTITIOUS CITY; , a brokerage house; and the Federal Reserve Bank of FICTITIOUS CITY, all located in Missouri. The investment securities are defined as "Missouri Held Securities" for the purposes of this matter. (Dept. Ex. No. 6 - Stip. 8 and corresponding Ex. No. 14)

6. The Missouri Held Securities fall into the following categories:

- (a) Interest income on Security Investments, defined as interest earned from Federal National Mortgage Association ("FNMA") and Student Loan Marketing Association ("SLMA") investments;
- (b) Interest income on Federal Funds sold, defined as interest earned from short-term lending of funds available at a Federal Reserve bank to other financial institutions;

- (c) Interest income: U.S. Agencies, defined as interest earned from indirect government obligations, such as Federal Home Loan Banks, Federal Farm Credit Banks, and Student Loan Marketing Association, notes;
- (d) Interest income on Municipal Securities, defined as interest earned on obligations of state and local governments;
- (e) Interest or dividend income on Corporate Securities, defined as interest or dividends earned from various publicly traded corporate securities. (Dept. Ex. No. 6 - Stip. 9)

7. The taxpayer filed form IL-1120 for the calendar year ending December 31, 1991, on or about March 16, 1992. The taxpayer then filed two amended returns for that year. The final return requested a refund in the amount of \$18,602.00. The Department denied the requested refund in full. (Dept. Ex. No. 6 - Stips. 2 & 3 and corresponding Ex. Nos. 1-3)

8. The taxpayer filed form IL-1120 for the calendar year ending December 31, 1992, on or about March 15, 1993. The taxpayer subsequently filed an amended return for that year. The amended return requested a refund in the amount of \$57,713.00. The Department allowed \$44.00 of the claimed refund amount. (Dept. Ex. No. 6 - Stip. 4 and corresponding Ex. Nos. 4 & 5)

9. The taxpayer filed form IL-1120 for the calendar year ending December 31, 1993, on or about March 15, 1994. The taxpayer then filed an amended return requesting a refund in the amount of \$45,248.00. The Department allowed \$177.00 of the claimed refund amount. (Dept. Ex. No. 6 - Stip. 5 and corresponding Ex. Nos. 6 & 7)

10. In 1991, the taxpayer received income from Missouri held securities as follows:

Interest income on securities investments	\$ 110,392.00
Interest income on Federal funds sold	\$ 294,786.00
Interest income: U.S. agencies	\$ 624,405.00
Interest income on municipal securities	\$1,174,113.00
Interest and dividend income on corporate securities	\$ 689,557.00

(Dept. Ex. No. 6 - Stip. 10)

11. In 1992, the taxpayer received income from Missouri held securities as follows:

Interest income on Federal funds sold	\$ 87,675.00
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Interest income: U.S. agencies	\$ 727,409.00
Interest income on municipal securities	\$1,340,364.00
Interest and dividend income on corporate securities	\$ 566,346.00

(Dept. Ex. No. 6 - Stip. 11)

12. In the year 1993, the taxpayer received income from Missouri held securities as follows:

Interest income on Federal funds sold	\$ 148,516.00
Interest income: U.S. agencies	\$ 86,873.00
Interest income on municipal securities	\$ 533,121.00
Interest and dividend income on corporate securities	\$ 453,095.00

(Dept. Ex. No. 6 - Stip. 12)

13. The taxpayer submitted a computation of gross receipts for 1991, 1992, and 1993. Illinois source and non-Illinois source [income] was shown on the computation for the taxable years in question. (Dept. Ex. No. 6 - Stip. 13; Group Ex. No. 10)

14. The NATIONAL BANK OF FICTITIOUS CITY, and the Federal Reserve Bank of FICTITIOUS CITY, FICTITIOUS CITY Branch (*see* finding of fact No. 5) credited the taxpayer's accounts at the places of business maintained by NATIONAL BANK OF FICTITIOUS CITY, and the Federal Reserve Bank of FICTITIOUS CITY, in Missouri, for the amounts of interest and dividend income that the taxpayer received in Missouri. (Dept. Ex. No. 6 - Stip. 14)

15. The Missouri Held Securities are titled in the name of FICTITIOUS BANK, an Illinois chartered bank. FICTITIOUS BANK is a subsidiary of the taxpayer. The Missouri Held Securities are managed by the investment committee of FICTITIOUS BANK, located at Illinois 62002. (Dept. Ex. No. 6 - Stip. 15)

16. Taxpayer filed Missouri corporate income tax returns and paid Missouri corporate income tax for the tax years ending December 31, 1992, and December 31, 1993, for the business, which it transacted within Missouri for those tax years. No Missouri return was filed for the year ending December 31, 1991. (Dept. Ex. No. 6 - Stip. 16; Group Ex. No. 9)

17. For 1991, if income from Missouri Held Securities is excluded from the numerator referenced in Ill. Rev. Stat. Ch. 120, ¶3-304¹(c)(1)(A)-(E), it will have the following effects on the taxpayer's return:

Net income	(\$262,551)
Income tax	(12,603)
Total income tax	(12,603)
Credit for replacement tax paid	(565)
Total credits	(565)
Net income tax	(12,038)
Net replacement tax	(6,564)
Total net income and replacement tax	(18,602)
Refund	\$18,602
(Dept. Ex. No. 6 - Stip. 20)	

18. For 1992, if income from Missouri Held Securities is excluded from the numerator referenced in Ill. Rev. Stat. Ch. 120, ¶3-304(c)(1)(A)-(E), it will have the following effects on the taxpayer's return:

Net income	(\$815,370)
Income tax	(39,089)
Total income tax	(39,089)
Credit for replacement tax paid	(1,735)
Total credits	(1,735)
Net income tax	(37,354)
Net replacement tax	(20,359)
Total net income and replacement tax	(57,713)
Refund	\$57,713
(Dept. Ex. No. 6 - Stip. 21)	

19. For 1993, if income from Missouri Held Securities is excluded from the numerator referenced in Ill. Rev. Stat. Ch. 120, ¶3-304(c)(1)(A)-(E), it will have the following effects on the taxpayer's return:

Net income	(\$638,292)
Income tax	(30,638)
Total income tax	(30,638)

¹. That section of the statutes is currently found at 35 ILCS 5/304.

Credit for replacement tax paid	(1,347)
Total credits	(1,347)
Net income tax	(29,291)
Net replacement tax	(15,957)
Total net income and replacement tax	(45,248)
Refund (Dept. Ex. No. 6 - Stip. 22)	\$45,248

Conclusions of Law:

The Illinois Income Tax Act requires that business income of persons other than residents of this state shall be allocated to this State if such person's business income is derived solely from this State. *See* Ill. Rev. Stat. ch. 120. para. 3-304 *et seq.* The applicable statutory provisions at issue for the periods in question are as follows:

In 1991, the Illinois Income Tax Act, at Ill. Rev. Stat. ch. 120, para. 3-304 (c) provided:

Financial organizations. (1) In general. Business income of a financial organization shall be apportioned to this State by multiplying such income by a fraction, the numerator of which is its business income from sources within this State, and the denominator of which is its business income from all sources. For the purposes of this subsection, the business income of a financial organization from sources within this State is the sum of the amounts referred to in subparagraphs (A) through (E) following, but excluding the adjusted income of an international banking facility as determined in paragraph (2):

(A) Fees, commissions or other compensation for financial services rendered within this State;

(B) Gross profits from trading in stocks, bonds or other securities managed within this State;

(C) Interest and dividends received within this State;

(D) Interest charged to customers at places of business maintained within this State for carrying debit balances of margin accounts, without deduction of any costs incurred in carrying such accounts; and

(E) Any other gross income resulting from the operation as a financial organization within this State. In computing the amounts referred to in paragraphs (A) through (E) of this subsection, any amount received by a member

of an affiliated group (determined under Section 1504(a) of the Internal Revenue Code [26 U.S.C.A. § 1504] but without reference to whether any such corporation is an "includable corporation" under Section 1504(b) of the Internal Revenue Code) from another member of such group shall be included only to the extent such amount exceeds expenses of the recipient directly related thereto.

For 1992 and 1993, business income of a financial organization was apportioned pursuant to the formula found at 35 ILCS 5/304(c)(1)(A)-(E) which provided:

Financial organizations. (1) In general. Business income of a financial organization shall be apportioned to this State by multiplying such income by a fraction, the numerator of which is its business income from sources within this State, and the denominator of which is its business income from all sources. For the purposes of this subsection, the business income of a financial organization from sources within this State is the sum of the amounts referred to in subparagraphs (A) through (E) following, but excluding the adjusted income of an international banking facility as determined in paragraph (2):

(A) Fees, commissions or other compensation for financial services rendered within this State;

(B) Gross profits from trading in stocks, bonds or other securities managed within this State;

(C) Dividends, and interest from Illinois customers, which are received within this State;

(D) Interest charged to customers at places of business maintained within this State for carrying debit balances of margin accounts, without deduction of any costs incurred in carrying such accounts; and

(E) Any other gross income resulting from the operation as a financial organization within this State. In computing the amounts referred to in paragraphs (A) through (E) of this subsection, any amount received by a member of an affiliated group (determined under Section 1504(a) of the Internal Revenue Code [26 U.S.C.A. § 1504] but without reference to whether any such corporation is an "includable corporation" under Section 1504(b) of the Internal Revenue Code) from another member of such group shall be included only to the extent such amount exceeds expenses of the recipient directly related thereto.

The Department asserts that any income of a financial organization which is not apportioned pursuant to the above statutes may be allocated to this State pursuant to the provisions found in Section 304 (f) [Ill Rev. Stat. ch. 120, para. 3-304(f)²] which states:

Alternative allocation. If the allocation and apportionment provisions of subsections (a) through (e) do not fairly represent the extent of a person's business activity in this State, the person may petition for, or the Director may require, in respect of all or any part of the person's business activity, if reasonable:

- (1) Separate accounting;
- (2) The exclusion of any one or more factors;
- (3) The inclusion of one or more additional factors which will fairly represent the person's business activities in this State; or
- (4) The employment of any other method to effectuate an equitable allocation and apportionment of the person's business income.

The interpretation of the statutory language above creates several issues in this matter. All involve the method of apportioning business income of a financial organization for the purposes of computing Illinois corporate income tax.

The business income of persons other than residents is allocated to the State of Illinois pursuant to the language found at 35 **ILCS** 5/304. The taxpayer argues that the plain language of the statute mandates that "interest and dividends received without the State should be excluded from the computation of "business income from sources within this State" or conversely that the interest and dividends from the Missouri Held Securities were not from Illinois customers. The taxpayer also asserts that the income from the Missouri Held Securities is not "gross profits from trading in stocks, bonds or other securities." The Department disagrees.

Both the taxpayer and Department are correct that the primary rule in construing statutes is to ascertain and give effect to the intention of the legislature, City of Chicago v. Cross City Disposal, Inc., 200 Ill.App.3d 520 (1st. Dist. 1990). At the third reading of House Bill 1429, on

². The statutory language was identical in 1992 and 1993. The applicable statutory cites for those years are Ill Rev. Stat. ch. 120, para. 3-304(f) and 35 **ILCS** 5/3-304(f).

May 16, 1991, Representative Keane explained what was the attempt of the legislation regarding interest and dividends. He stated:

This bill proposes to make the following changes in regard to that portion of a financial organization's business income where it involves interest and dividends. Interest and dividends from Illinois...from Illinois customers received within Illinois shall meet...will be considered interest and dividends. Interest charged to customers within Illinois, without deduction of any cost incurred thereon. In other words, this financial organization business income is taxable to the extent that interest and dividends were accounted for as received from Illinois customers regardless of the source or sources outside of Illinois from which payments were made.... State of Illinois 87th General Assembly, H.R. Transcription Debate, G13, p. 132.

I do not find the argument of the taxpayer convincing that just because the interest and dividend income in question was earned through investments in Missouri, the income is not attributable to Illinois. The Missouri Held Securities are titled in the name of an Illinois chartered bank located in Illinois. The Missouri Held Securities are managed by the investment committee of that same bank in Illinois. The income that purchased the Missouri Held Securities is presumed to be from applicant's Illinois customer's deposits.

The taxpayer did not file a Missouri return in 1991 and therefore did not pay any Missouri taxes on the income in question. There was no assertion by the taxpayer that Missouri tax was paid on the income in question for the 1992 and 1993 taxable years. The Illinois courts have found that it is the intention of the legislature to allocate and apportion the business income from the multi-state operations of a corporation with other states having jurisdiction to tax such income, in such a manner that there is neither overlap nor gap in taxing all of such income derived from the multi-state business. GTE Automatic Electric v. Allpin, 68 Ill.2d 326 (1977) In addition, including in the numerator of the Illinois sales factor, used in apportioning income among states of sales in states where the taxpayer is subject to income tax, but where the taxpayer has not filed a tax return and paid the tax, does not violate the commerce clause. Any risk of double taxation is created by the taxpayer's own conduct in failing to file tax returns and pay taxes in other states. Dover Corp. v. Department of Revenue, 271 Ill.App.3d 700 (1st. Dist.

1995; leave to appeal denied; rehearing denied). There is no risk of double taxation on the amounts at issue because the taxpayer did not pay taxes to Missouri on the interest and dividend income from the Missouri Held Securities for the taxable years at issue.

As the taxpayer states in its brief, another settled principle of statutory construction is that the specific controls over the general. People v. Singleton, 103 Ill.2d 339 (1984) Because 35 **ILCS** 5/304(c)(1)(A)-(E) specifically deals with the allocation of income of a financial organization to Illinois, I find that it is the appropriate portion of the statutes to address the issue of whether the interest and dividend income received from investments of the Missouri Held Securities should be included in the numerator referenced in Ill. Rev. Stat. Ch. 120, ¶3-304(c)(1)(A)-(E).

As mentioned before, it is the legislative intent to allocate and apportion the business income from the multi-state operations of a corporation with other states having jurisdiction to tax such income, in such a manner that 100% of such income is taxed. I therefore find that the taxpayer's interest and dividend income is allocable to the state of Illinois and includable in the numerator referenced in Ill. Rev. Stat. Ch. 120, ¶3-304(c)(1)(A)-(E).

Because I have found that this income is allocable to Illinois pursuant to Ill. Rev. Stat. Ch. 120, ¶3-304(c)(1)(A)-(E), it is unnecessary to address the Department's alternative arguments.

Based on the reasoning above, I recommend that the portions of the denials of claim issued by the Department to the above referenced taxpayer for the 1991, 1992, and 1993 tax years be upheld in their entirety.

Respectfully Submitted,

Barbara S. Rowe
Administrative Law Judge
May 11, 1998