IT 00-2
Tax Type: Income Tax
Issue: Net Operating Loss (General)

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

THE DEPARTMENT OF REVENUE	)	Docket No.	94-IT-0000
OF THE STATE OF ILLINOIS	)	FEIN	00-0000000
v.	)	Tax Years Ending	12/88-12/91
"ABC OIL COMPANY"., et al.	)	John E. White,	
Taxpayer.	)	Administrative Law Judge	

RECOMMENDATION FOR DISPOSITION

Appearances: Fred Ackerson appeared for "ABC Oil Co."; James Dickett appeared for the Department of Revenue.

Synopsis:

This matter involves, *inter alia*, Notices of Deficiency ("NODs") the Illinois Department of Revenue ("Department") issued to "ABC Oil Co." ("ABC" or "taxpayer") and affiliated companies regarding "ABC"'s 1988 through 1991 tax years. "ABC" protested those NODs, and requested hearings thereon. Prior to hearing, the parties settled most of the issues challenged in "ABC's" protest.

The matter proceeded to hearing to decide whether the Department properly computed the application of net operating loss carry forwards to 1990, and whether "ABC" was subject to the Department's proposed assessment of a penalty pursuant to § 1005 of the IITA for its 1991 tax year. At hearing, the parties submitted a stipulation of facts, and offered certain documents into evidence pursuant to stipulation. I include in this recommendation findings of fact and conclusions of law. I recommend that both issues be resolved in favor of "ABC".

Findings of Fact:

Summary of Tax Returns - Audits, Notices of Deficiency, Protests and Subsequent Events

1. Taxpayers filed timely Illinois corporate income tax returns for each of the years in the audit period.

2. For 1988 and 1989, taxpayers filed combined returns pursuant to Section 304(e) of the Illinois Income Tax Act ("IITA") as six distinct unitary business groups, for the following companies and their affiliates:

   (a) "ABC" Oil Company" & affiliates;
   (b) "Subsidiary #1" and affiliates;
   (c) "Subsidiary #2" and affiliates;
   (d) "Subsidiary #3" (f/k/a "" Corporation) and affiliates
   (e) "Subsidiary #4" and affiliates; and
   (f) "Subsidiary #5" and affiliates (which was required to file as a separate unitary group because it was engaged in providing transportation services as required by 35 **ILCS** 5/1501(a)(27)).

   Stip. ¶ 3. Each of the unitary groups described in (a) through (e) filed a combined return and made the election described in Section 502(e) of the IITA. Stip. ¶ 3.

3. Following the Department's audit of taxpayers' 1988 and 1989 returns, the Department issued Notices of Deficiency to these taxpayers, dated September 27, 1994. The Department concluded that taxpayers should have filed combined returns as three unitary business groups, consisting of:

   (a) "ABC Oil Company" and affiliates; "Subsidiary #1" and affiliates; "Subsidiary #2" and affiliates; "Subsidiary #3" (f/k/a "" Corporation) and affiliates; "Subsidiary #4" and affiliates (referred to herein as the "main group");
   (b) "Subsidiary #6". for the period 1/l/88 to 4/19/88, when this company was sold, which taxpayers had included in the group that included "Subsidiary #1"; and

(c) "Subsidiary #5" and affiliates (which was required to file as a separate unitary group, because it was engaged in providing transportation services, by 35 **ILCS** 5/1501(a)(27)).

Stip. ¶ 4.

4. Taxpayers filed Protests and Requests for Administrative Hearing for 1988 and 1989 on November 22,1994. Taxpayers did not protest the Department's determination that the Taxpayers should have filed combined returns as three unitary business groups. Taxpayers also filed timely refund claims for 1988 and 1989 by filing amended returns on Form IL-1120-X in the amounts of $280,706 for 1988 and $245,573 for 1989 (such returns were filed by "Subsidiary #4" and "Subsidiary #3" (formerly "" Corporation). Taxpayers also filed Petitions for Alternative Apportionment under § 304(f) of the IITA at the time of filing their Protests. Stip. ¶ 5.

5. For 1990 and 1991, taxpayers filed seven distinct unitary group returns for the following companies:

(a) "ABC Oil Company" and affiliates;
(b) "Subsidiary #1" and affiliates;
(c) "Subsidiary #2" and affiliates (for the period 1/l/90 to 7/17/90, at which time "Subsidiary #2" and its affiliates were sold);
(d) "Subsidiary #3" (f/k/a "" Corporation) and affiliates;
(e) "Subsidiary #4" and affiliates;
(f) "Subsidiary #7" and affiliates; and
(g) "Subsidiary #5" and affiliates (which was required to file as a separate unitary group because it was engaged in providing transportation services as required by 35 **ILCS** 5/1501(a)(27)).

Each of the unitary groups described in (a) through (f) filed a combined return by making the election described in § 502(e) of the IITA. Stip. ¶ 6.

6. The Department audited the 1990 and 1991 returns of the taxpayers and issued Notices of Deficiency to "Subsidiary #5" on September 15, 1995, and to the other

taxpayers on December 8, 1995. The Department concluded that taxpayers should have filed combined returns as two unitary business groups, consisting of:

(a) "ABC Oil Company" and affiliates; "Subsidiary #1" and affiliates; "Subsidiary #2" and affiliates; "Subsidiary #3" (f/k/a "" Corporation) and affiliates; "Subsidiary #4" and affiliates; and Subsidiary #7 and affiliates (also referred to herein as the "main group"); and

(b) "Subsidiary #5" and affiliates (which was required to file as a separate unitary group, because it was engaged in providing transportation services, by 35 **ILCS** 5/1501(a)(27)).

Stip. ¶ 7.

7. "Subsidiary #5" filed a Protest and Request for Administrative Hearing for 1990 and 1991 on November 13, 1995. The remaining taxpayers filed their Protest and Request for Administrative Hearing for 1990 and 1991 on February 6, 1996. Taxpayers did not protest the Department's determination that they should have filed combined returns as two unitary business groups. Taxpayers also filed Petitions for Alternative Apportionment under § 304(f) of the IITA at the time of filing their Protests. Stip. ¶ 8.

8. Subsequent to the issuance of the Notices of Deficiency, Taxpayers completed a federal income tax audit of taxable years prior to 1988, which resulted in changes reported to the Department pursuant to § 506(b) of the IITA, 35 **ILCS** 5/506(b). These federal changes affected the amount of Illinois NOLs arising in pre-1988 years which could be carried by the taxpayers in "ABC's main group to 1988 and subsequent years. Stip. ¶ 9.

9. The Department recomputed the deficiencies asserted against taxpayers in "ABC's main group, by: (i) taking into account the concession of various issues of the parties, (ii) taking into account the federal income tax changes for 1982-1987 which affected net operating loss carry forwards to the audit period; and (iii)

applying the net operating loss carry forwards of the main group to 1990 and 1991. The results of these computations with respect to the main group are that:

(a) no deficiencies remain for any corporations in "ABC's" main group with respect to 1988, 1989 or 1990; and

(b) a deficiency of $587,785 (not including statutory interest and penalties) is asserted by the Department against the main group, after application of net operating loss carry forwards but without the application of any net operating loss carry backs from subsequent years. Taking into account the application of a net operating loss carryback from 1993, the amount of the 1991 deficiency is $418,690.

Stip. ¶ 10; *see also* Schedule EDA-25, Exhibit 1 to Stipulation of Fact.

Issues Resolved by Agreement

10. On December 1, 1998, "Subsidiary #5" executed a Form IL-870 for the years 1988 through 1991. "Subsidiary #5" paid the full amount of tax shown to be due on that Form IL-870, plus statutory interest. The parties agree that ""Subsidiary #5" overpaid the interest due with respect to these amounts by $2,346 and is due a refund of such amount. Accordingly, there is no remaining controversy with respect to "Subsidiary #5" for any of the years in the audit period. Stip. ¶ 11; Form IL-870.

11. The Department has withdrawn the NOD issued to XXXXX, Inc. for 1988. Stip. ¶ 12.

12. The Department has withdrawn the penalties and interest proposed in the NODs issued to the members of the main group for tax years 1988 and 1989. Stip. ¶ 13.

13. The Department has agreed to grant the refund claims filed by taxpayers for 1988 and 1989, together with statutory interest thereon. Stip. ¶ 14.

14. Taxpayers withdrew their Petitions for Alternative Apportionment under § 304(f) of the IITA with respect to all years and all taxpayers at issue. Stip. ¶ 15.

Issues Remaining for Hearing

15. Taxpayers waived all other issues set forth in their protests and in the Pre-Hearing Conference Order in this matter dated November 11, 1998, except for the following two issues:

    (a) Net Operating Loss Carry Forwards. Whether the Department properly computed the application of net operating loss carry forwards to 1990, and in particular whether the Department properly computed the amount of such net operating loss carry forwards which should be assigned to "Subsidiary #2" when it was sold from the main group on July 17, 1990.

    (b) Penalties/Reasonable Cause Exception for 1991. Whether reasonable cause exists to abate the § 1005 penalties the Department proposed to assess against Taxpayers for 1991.

    Stip. ¶ 16.

Facts with Respect to the Computation of Net Operating Losses

16. The main group's taxable year ended on December 31. Department Ex. 1, pp. 6, 55 (NODs issued, respectively, to "ABC Oil" Group for 1989, and for 1990 and 1991).

17. The main group incurred Illinois net operating losses of $81,030,218 in 1986 and $21,013,475 in 1988. The amount of the main group's 1986 INOL available to carry forward to the 1990 taxable year was $32,477,897. The amount of the main group's 1988 INOL available to carry forward to the 1990 taxable year was $19,252,677. "Subsidiary #2's" allocable share of these INOLs was 91.92% of the 1986 INOL and 82.72% of the 1988 INOL. These INOL figures take into account the adjustments of the 1982-1987 years as a result of a federal income tax audit reported pursuant to 35 **ILCS** 5/506(b), and the allocation of a portion of the

net operating loss carry forward to "Anonymous" Co., which ceased to be a member of "ABC's main group as of December 31, 1989. Stip. ¶ 17.

18. The Department determined that "Subsidiary #7" should be included in the main group's unitary business group beginning with the 1990 taxable year. Taxpayers agreed. "Subsidiary #7" incurred Illinois net operating losses prior to 1990, which were available to be carried forward to 1990, in the amount of $7,200,304. Stip. ¶ 18.

19. "Subsidiary #2" and certain of its affiliates were sold to an unrelated party on July 17, 1990, and ceased to be members of the main group's unitary business group on that date. As a result, the Illinois taxable income of the main group for 1990 was determined by the Department to take into account the fact that "Subsidiary #2" was a member of the group for only part of 1990. The Department determined that the main group's Illinois taxable income was $29,404,789 for the period from January 1, 1990 to July 17, 1990, and $10,734,688 for the period from July 18, 1990 to December 31, 1990. Stip. ¶ 19.[1]

20. The Department applied the Illinois net operating loss carry forward of the main group to the 1990 year by treating the 1990 year as two separate segments and by determining the amount of the INOLs which would be allocated to "Subsidiary #2" (and therefore would leave the main group) as of the close of the first

[1] There is a conflict between the parties' stipulation of fact and exhibit one to that stipulation, regarding the date on which "Subsidiary #2" was sold. The stipulation reflects that "ABC" sold "Subsidiary #2"on July 17, 1990 and the exhibit uses a sale date of July 19, 1990. *Compare* Stip. ¶ 19 *with* Stip. Ex. 1, pp. 2-3. For purposes of this recommendation, I have relied on the parties' stipulation of fact.

segment on July 17, 1990. The results of this application of the INOL carry forwards is as follows:

Illinois Taxable Income 1/l/90 to 7/19/90	29,404,789
Use of 1986 main group INOL	29,404,789
1986 Main Group INOL Remaining	3,073,108
1986 INOL Allocated to "Sub #2" (91.92%)	2,831,425
1986 INOL Available to Carry Forward	241,682
1988 Main Group INOL Remaining	19,252,677
1988 INOL Allocated to "Sub #2" (82.72%)	15,925,388
1988 INOL Available to Carry Forward	3,327,289
Illinois Taxable Income 7/20/90 to 12/31/90	10,734,688
Use of 1986 Main Group INOL	241,682
Use of 1988 Main Group INOL	3,327,289
Use of "Sub #7" INOL	7,165,717
Purina INOL Available to Carry Forward to 1991	$ 60,219

Stip. ¶ 20.

21. Taxpayers dispute the Department's method of applying the INOL carry forwards to 1990 as shown above. Taxpayers believe that the INOL carry forwards to 1990 must be applied to the entire 1990 taxable year prior to the determination of what part of the remaining INOLs are allocable to "Subsidiary #2". Taxpayer's method of applying the INOLs to 1990 is shown in the following table:

Main Group's 1990 Illinois Taxable Income	40,139,477
Use of 1986 main group INOL	32,477,897
Use of 1988 main group INOL	7,661,580
1988 Main Group INOL Remaining	11,497,134
1988 INOL Allocated to "Sub #2" (82.72%)	9,451,794
1988 INOL Available to Carry Forward to 1991	2,045,340
Purina INOL Available to Carry Forward to 1991	7,200,304

The result of taxpayers' proposed application of the INOLs to 1990 is that a total of $9,245,644 of INOLs are available to be carried forward to the 1991 taxable

year of the main group, which would entirely eliminate the deficiency for the 1991 taxable year. Stip. ¶ 21.

Facts with Respect to the Section 1005 Penalty

22. The Department proposed to assess a penalty pursuant to Section 1005 of the IITA regarding taxpayers' 1991 tax year. The amount of this penalty is $197,003. Stip. ¶ 22.

23. The adjustments made by the Department to "ABC Oil Company's" tax returns included the inclusion of income and apportionment factors attributable to partnerships in which Taxpayer owned an interest. Taxpayers excluded the income and apportionment factors attributable to the "ZZ Top Partnership" based upon their belief that the income of that partnership should be apportioned using the rules set forth in Section 305 of the Income Tax Act. 35 **ILCS** 5/305. Stip. ¶ 23.

24. At the time it filed its Illinois income tax returns for audit period, taxpayers were aware that the Department adopted rule 3700(d) (*now* 86 Ill. Admin. Code § 100.3380(c)) in 1987, and "ABC" knew of the rule's history, including the objection filed by the Joint Committee on Administrative Rules (hereinafter "JCAR") before the rule was adopted. Stip. ¶ 24.

25. The taxpayers were advised by counsel at the law firm of X Law Firm, that in their opinion rule 3700(d) was in conflict with the statute and was invalid. Stip. ¶ 24.

Conclusions of Law:

Issue 1. Application of the NOL Carry Forwards

This issue involves how Illinois net operating losses ("INOLs") from tax years 1986 and 1988, which were largely attributable to one of the main subsidiaries in "ABC's main group, "Subsidiary #2" ("Sub #2"), should be carried forward to tax year 1990. The dispute arose after "ABC" sold "Sub #2" and certain affiliated companies to an unrelated company in July 1990, following which those companies ceased being members of "ABC's main group's unitary business group. *See* 35 **ILCS** 5/1501(a)(27) (definition of "unitary business group" requires that members be "related through common ownership").

Since there had been a change in the composition of the unitary business group during 1990, the Department split "ABC's main group's 1990 tax year into two separate return periods, with the dividing line being July 17, 1990, the date following which the group's composition changed. Stip. ¶ 20. The Department determined that "ABC's main group's Illinois taxable income for 1990 was $40,139,477, of which $29,404,789 was earned between 1/1/90 through 7/17/90, and $10,734,688 for the period from 7/18/90 through 12/31/90. Stip. ¶ 19. While "ABC" does not dispute the Department's determination of the percentage of the INOL allocable to "Sub #2" (*see* Stip. ¶¶ 17, 21), it does challenge the Department's fundamental decision to treat "ABC's" main group as having two separate return periods, and its further decision to apply the INOL carry forwards to a short taxable year having an end date of July 17, 1990, instead of to the group's taxable year ending 12/31/90. Stip. ¶ 21; "ABC's" Brief, pp. 15-18.

The *prima facie* correctness of the Department's determinations was established when the Department introduced the NODs into evidence at hearing, under the certification of the Director. 35 **ILCS** 5/904. Thereafter, the burden shifted to "ABC" to

prove that the Department's application of the INOLs at issue here was in error. Balla v. Department of Revenue, 96 Ill. App. 3d 293, 295, 421 N.E.2d 236, 238 (1st Dist. 1981).

"ABC" asserts that the Department's creation of a short taxable year for "ABC's Oil group, and its further application of the INOLs to that short year instead of to the group's actual taxable year, violates § 207 of the IITA, and was caused by the Department's erroneous reading of certain Department income tax regulations. In response, the Department defends its application of the INOLs here by asserting that it is authorized by Department income tax rules 100.2350, 100.3320(f) and 100.5270(f). Department's Post-Hearing Brief ("Department's Brief"), p. 2. Each of those rules, therefore, will be reviewed to determine whether they authorize the Department's manner of applying the INOLs in this case.

> **Section 100.5270. Computation of Combined Income and Tax**
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> * * * *
>
> f) Part-year members
>
> 1) General rule. **If a corporation** becomes a member of a unitary business group after the beginning of the combined return year or **ceases to be a member of the unitary business group during the combined return year, two tax returns will be affected for that taxable year**. The combined return shall include the separate company items of such corporation for the part of the year it was a member of the unitary business group. **Separate company items of a part-year member for any portion of its taxable year prior to the date it joins or after the date it leaves the unitary business group shall either be reported in a short-year separate return filed by such part-year member (if it is subject to Illinois income tax during that period) or included in any combined return filed on behalf of a unitary business group to which such part-year member belongs during that portion of the year.**
>
> 2) Accounting. The part-year member shall use either Method 1 or Method 2 (described in Section 100.5265(b) of this Part) to determine its separate company

> items for the portion of the year before it becomes a member and the portion of the year after it becomes a member of the combined group.

86 Ill. Admin. Code § 100.5270(f) (1987) (emphasis added).

A complete reading of the first paragraph shows that, within the context of this dispute, the "two returns [that] will be affected" for such a taxable year refers to (1) the return to be filed by or on behalf of the member (e.g., by the designated member of a unitary business group that has made a § 502(e) election) for the period during which it was a member of the group, and (2) the short period separate return to be filed by or on behalf of the member for the period after it left the unitary group. Thus, under both federal and state law, it is *the exiting member* that has the responsibility to see to it that two returns are filed regarding its two distinct reporting periods for the year in which it changed ownership. 35 **ILCS** 5/401; 26 C.F.R. § 1.1502-76(b)(2), (d) (1991).[2] The

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[2] In 1991, Treasury regulation § 1.1502-76 provided, in pertinent part:

> Taxable year of members of group.
>
> * * * *
>
> (b) Income to be included in returns for taxable year.
>
> (1) Inclusion of income in consolidated return. **The consolidated return of a group must include the income of the common parent for that corporation's entire taxable year** (excluding any portion of such taxable year for which its income is properly included in the consolidated return of another group) **and**, except as provided in subparagraph (5) of this paragraph, **the income of each subsidiary for the portion of such taxable year during which it was a member of the group.**
>
> * * * *
>
> (2) Separate return for period not included in a consolidated group. **If the consolidated return of a group properly includes the income of a corporation for only a portion of such corporation's taxable year** (determined without regard to a change of its taxable year under paragraph (a) of this section), **then the income for the portion of such taxable year not included in the consolidated return must be included in a separate return (or if such corporation is a member of another group which files a consolidated return for such corporation for such portion of such year, then in such**

unitary group from which a member exits in mid-year, however, is not required to assume two separate taxable years unless the group itself affects a change in its federal taxable year. *See* 35 **ILCS** 5/401.

The next rule cited by the Department is income tax rule 100.3320. That rule provides, in pertinent part:

> **Section 100.3320. Business Income of Persons Other Than Residents (IITA Section 304) -- Apportionment**
> (a) In general. If the business activity in respect to any trade or business of a person occurs both within and without this state, and if by reason of such business activity such person is taxable in another state, the portion of the net income arising from such trade or business which is derived from sources within Illinois shall be determined by apportionment in accordance with these regulations.
> * * * *
> (f) Unitary business group: changes in membership and the treatment of part-year members.
> (1) Scope. Whenever the membership of a unitary business group (as defined in IITA Section 1501(a)(28) as amended by Public Act 82-1029 applicable to all taxable years ending on or after December 13, 1982; and as defined previously by 86 Ill. Adm. Code 100.3010) is altered during the common accounting period for combined apportionment computation (see paragraph 3 of subsection (b) of this section), the members of the group must compute their liabilities in accordance with this paragraph (6). A unitary business group's membership may be altered by the entry of a new member or by the departure of an old member, such entry or departure ordinarily resulting from stock transactions which create or destroy the common ownership relative to the corporation entering or leaving the group.
> (2) General rule. **If a corporation** becomes a

> **consolidated return).**
> * * * *
> (d) Taxable year of less than 12 months. Any period of less than 12 months for which either a separate return or a consolidated return is filed under the provisions of this section shall be considered as a separate taxable year.

26 C.F.R. § 1.1502-76 (1991) (emphasis added).

member of a group during the group's common accounting period or **loses its status as a member during the group's common accounting period, then other members of the group, in computing their liabilities, must take into account the property, payroll, sales and income data of the part-year member for the portion of the common accounting period that it was a member of the group**. Likewise, the corporation which is a part-year member of a group must make a dual computation to arrive at its liability:

(A) its business income attributable to the portion of its year that it was a member of a group must be combined with the business income which other members of the group had for that same part year and must be apportioned to Illinois on a combined apportionment basis, and

(B) its business income attributable to the portion of its year in which it was not a member of a group must be apportioned to Illinois on the basis of its own Illinois property, payroll, and sales for that part year as respective fractions of its own total property, payroll, and sales for that part year.

* * * *

(4) Accounting. A corporation which is a part-year member of a group (or which is a member of one group for part of the year and a second group for the remainder of the year) may attribute business income to the different portions of its taxable year by prorating its business income for the entire taxable year on the basis of the number of months falling within the respective periods: For instance, in the examples of subparagraph (B), Corporation D could attribute 5/l2ths of its total business income for 1984 to the period January 1 through May 31, 1984 and 7/l2ths to the period June 1 through December 31, 1984. Alternatively, a corporation that is a member of a unitary business group for part of the year or a corporation that is a member of two different groups during its taxable year may divide its business income for the taxable year into revenue and expense elements and allocate those elements between the respective periods on the basis of generally accepted accounting principles applied as though those periods were separate and distinct for financial reporting purposes. However, the part-year member divides its business income between the respective portions of its taxable year, all other corporations with which it is

> related for combined apportionment purposes for the taxable year shall be required, in computing their liabilities, to use the same method in accounting for the respective portions of the taxable year.

86 Ill. Admin. Code § 100.3320 (1984) (emphasis added).

What rule 3320(f)(2) requires is that when a member leaves a unitary group in the middle of the group's taxable year, the remaining members of the group, when computing their liabilities, take into account the property, payroll, sales and income data of the part-year member for the portion of the common accounting period that it was a member of the group. 86 Ill. Admin. Code § 100.3320(f)(2). However, that rule says nothing about requiring the remaining members of the group to change each of their taxable years, or their collective taxable year, simply because a member left the group. Nor does that rule have anything to say about how an INOL should be carried over to a taxable year during which a member has left the group.

Finally, the Department asserts that one of the examples in rule 100.2150 directly supports its application of the INOLs here. That rule provides, in pertinent part:

> **Section 100.2350. Illinois Net Losses and Illinois Net Loss Deductions for Losses Occurring On or After December 31, 1986, of Corporations that are Members of a Unitary Business Group: Changes in Membership**
>
> * * * *
>
> (c) Carryover and Carryback of Combined Net Losses to Separate Return Years
>
> (1) This subsection applies to unitary members that have made an election to file a combined return under IITA Section 502(f). If a combined Illinois net loss (as defined in Section 100.5270(b)(3) of this Part) can be carried under the principles of Section 172(b) to a separate return year of a corporation (or could have been so carried if such corporation were in existence) which was a member of a unitary business group in the year in which such loss arose, then the portion of such combined Illinois net loss attributable to such corporation (as determined under subsection (c)(3)

below) shall be assigned to such corporation and shall be an Illinois net loss carryover or carryback to such separate return year; accordingly, such portion shall not be included in the combined Illinois net loss carryovers or carrybacks to the equivalent combined return year. Thus, for example, if a member filed a separate return for the third year preceding a combined return year in which a combined Illinois net loss was sustained and if any portion of such loss is assigned to such member for such separate return year, such portion may not be carried back by the group to its third year preceding such combined return year.

* * * *

(4) Examples. The provisions of this subsection (c) may be illustrated by the following examples:

* * * *

(C) Example 3:

(i) Corporation P was formed on January 1, 1986. P filed a separate return for the calendar year 1986. On March 15, 1987, P formed Corporation S. P and S filed a combined return for 1987. On January 1, 1988, P purchased all the stock of Corporation T, which had been formed in 1987 and had filed a separate return for its taxable year ending December 31, 1987.

(ii) P, S, and T join in the filing of a combined return for 1988, which return reflects a combined Illinois net loss of $11,000. $2,000 of such combined net loss is attributable to P, $3,000 to S, and $6,000 to T. Such attribution of the combined net loss was made on the basis of the separate net losses of each member as determined under paragraph (3) of this subsection (c).

(iii) $5,000 of the 1988 combined Illinois net loss can be carried back to P's separate return for 1986. Such amount is the portion of the combined net loss attributable to P and S. Even though S was not in existence in 1986, the portion attributable to S can be carried back to P's separate return year, since S (unlike T) was a member of the group immediately after its organization. The 1988 combined net loss can be carried back against the group's income in 1987 except to the extent (i.e., $6,000) that it is apportioned to T for its 1987 separate return year and to the extent that it was absorbed in P's 1986 separate return year. The portion of the 1988 combined net loss attributable to T

($6,000) is a net loss carryback to its 1987 separate return.

(D) Example 4:

(i) Assume the same facts as in Example 3. Assume further that on June 15, 1989, P sells all the stock of T to an outsider, that P and S file a combined return for 1989 (which includes the income of T for the period January 1 through June 15), and that T files a separate return for the period June 16 through December 31, 1989.

(ii) The 1988 combined Illinois net loss, to the extent not absorbed in prior years, must first be carried to the short period ending June 15, 1989. Any portion of the $6,000 amount attributable to T which is not absorbed in T's 1987 separate return year or in the short combined period ending June 15, 1989, shall then be carried to T's separate short return year ending December 31, 1989.

86 Ill. Admin. Code § 100.2350(c) (1987) (emphasis added).

The Department contends that example 4 in rule 2350(c)(4)(D) "is directly on point …." *See* Department's Post-Hearing Brief, p. 2. To the extent that it is directly on point, however, it does not support the manner in which the Department applied the INOLs here. *See* Stip. ¶ 20. While the text of the rule uses the phrase, "the short period" and "the short period ending [when the member left the combined group]", what cannot be disputed is the fact that generally, only the corporation that ceases to be a member of a consolidated group — and not the group itself — is required to file returns (or cause to have them filed) regarding two separate taxable years following a mid-taxable year change of ownership. *Compare* 26 C.F.R. § 1.1502-76(b)(2) (1991) *with* 86 Ill. Admin. Code § 100.5270(f)(1). The evidence clearly shows that "ABC's" main group's taxable year, for federal and for Illinois tax reporting purposes, ended on December 31 for each of the audited years. Department Ex. 1, pp. 6, 55 (NODs issued, respectively, for 1989, and for 1990 and 1991).

The specific terms of an agency's regulation should be read in context with the statute the rule was adopted to interpret. *See, e.g.,* Du-Mont Ventilating Co. v. Department of Revenue, 73 Ill. 2d 243, 248, 383 N.E.2d 197, 200 (1978). In its brief, the Department truncates the text of example 4, and argues that the rule requires that the losses first be applied "to the short period." Department's Post-Hearing Brief, p. 2. In this case, however, the concept the words "short period" refers to is the *reporting period* during which a corporation shared common ownership with other members of a unitary group. For the exiting member, that reporting period ended on the date it left the group. *See* 26 C.F.R. §§ 1.1502-76(b)(2), 1.1502-79(a)(1)(ii). But for the remaining members of the unitary group, that period consists of the group's taxable year and not a completely new, short taxable year that was not used by the group for federal tax purposes. *See* 86 Ill. Admin Code § 100.5270(f)(1). Properly understood within the context of § 207 of the IITA, the proposition example 4 illustrates is that, before any INOL may be carried forward to the Illinois income tax return "Sub #2" is required to cause to have filed regarding the period beginning July 18, 1990 (i.e., the first day of its new ownership), that loss must first be applied to the taxable year during which "Sub #2" was a member of "ABC's" main group.

In effect, the Department's reading of rule 2350 recharacterizes example 4 from one that illustrates the limited manner by which an INOL may be carried forward and applied to the *exiting member's* subsequent short taxable year (i.e., only those amounts remaining unused after application to the group's taxable year), into one that requires an application of an INOL to the taxable year *of the group from which the member exited* in a manner that is much more limited than under § 172 of the Code. The Department's

reading of example 4 limits the application of the carry forward by requiring the group to pretend that it actually had two separate taxable years in 1990 — one for the period during which the group shared common ownership with the exiting member, and the second taxable year beginning after the exiting member left the group. *See* Stip. ¶ 20.

Section 401 of the IITA requires taxpayers to use the same taxable years for Illinois reporting purposes as for federal purposes. 35 **ILCS** 5/401. In Consolidated Rail Corp. v. Department of Revenue, the Illinois appellate court recently construed § 401 of the IITA with the following holding, "we read section 401(a) to mean that, when one files a federal return for a certain period, the taxpayer's Illinois return must be filed for a period that is consistent with any designations made pursuant to federal law." Consolidated Rail Corp. v. Department of Revenue, 293 Ill. App. 3d 555, 563 (1st Dist. 1997). The Department has never disputed that "ABC's" main group's 1990 taxable year ended on December 31, and that the group used that taxable year on its federal returns. *See* Department Ex. 1, pp. 6, 55. Reading example 4 of rule 2350 to require the remaining members of "ABC's" main group to use a taxable year for Illinois reporting purposes that is different from the taxable year used for federal taxable purposes, in the manner the Department has attempted here (*see* Stip. ¶ 20), directly contravenes § 401 of the IITA.

In contrast, reading example 4 of rule 2350 to allow application of the INOLs in the manner urged by "ABC" respects § 401 of the IITA. It has the added benefit of being consistent with § 207 of the IITA, which provides:

> Net Losses. (a) If after applying all of the modifications provided for in paragraph (2) of Section 203(b), paragraph (2) of Section 203(c) and paragraph (2) of Section 203(d) and the allocation and apportionment provisions of Article 3 of this Act, the taxpayer's net income results in a loss, such loss shall be allowed as a carryover or

> carryback deduction in the manner allowed under Section 172 of the Internal Revenue Code.
>
> (b) Any loss determined under subsection (a) of this Section must be carried back or carried forward in the same manner for purposes of subsections (a) and (b) of Section 201 of this Act as for purposes of subsections (c) and (d) of Section 201 of this Act.

35 **ILCS** 5/207.

"ABC" asserts that, since § 207 of the IITA provides that losses "shall be allowed … in the same manner allowed under § 172 …", the Department is required to first apply the losses to the group's taxable year, because that is the way the losses would be applied under federal rules where a corporation left a federal consolidated group in mid-taxable year. In its brief, "ABC" accurately describes how losses are carried forward for federal purposes. Taxpayer's Post Hearing Brief, pp. 12-18. Specifically, section 172 of the Code provides, in pertinent part:

> (2) Amount of carrybacks and carryovers.
>
> The entire amount of the net operating loss for any taxable year (hereinafter in this section referred to as the "loss year") shall be carried to the earliest of the taxable years to which (by reason of paragraph (1)) such loss may be carried. The portion of such loss which shall be carried to each of the other taxable years shall be the excess, if any, of the amount of such loss over the sum of the taxable income for each of the prior taxable years to which such loss may be carried. * * * *
>
> * * * *
>
> [(h)(5)](A) Regulations. The Secretary shall prescribe such regulations to carry out the purposes of this subsection, including regulations … for applying this subsection … in cases where a taxpayer becomes, or ceases to be, a member of an affiliated group filing a consolidated return under section 1501 ….

26 U.S.C § 172(b)(2), (h)(5)(A) (1991).

Treasury regulations in effect, as well as revenue rulings issued prior to the tax

years at issue confirm that, where a member ceases being a member of a federal consolidated group during the middle of the group's taxable year, a loss carry forward attributable to the exiting member from a prior year is first applied to the group's taxable year, and then to the separate short taxable year of the exiting corporation, which would begin on the date following the date the corporation exited the consolidated group. *See* 26 C.F.R. §§ 1.172-1, 1.172-4; Rev. Rul. 61-224 (attached as an exhibit to "ABC's Brief); "ABC's Brief, pp. 13-15. The pertinent Treasury regulation in effect during the years at issue,

§ 1.1502-79,[3] provided:

> **Separate Return Years.**
> (a)(1) In general. (i) If a consolidated net operating loss can be carried under the principles of section 172(b) and paragraph (b) of § 1.1502-21 to a separate return year of a corporation (or could have been so carried if such corporation were in existence) which was a member in the year in which such loss arose, then the portion of the consolidated net operating loss attributable to such corporation (as determined under subparagraph (3) of this paragraph) shall be apportioned to such corporation (and any successor to such corporation in a transaction to which section 381(a) applies) and shall be a net operating loss carryover or carryback to such separate return year; accordingly, such portion shall not be included in the consolidated net operating loss carryovers or carrybacks to the equivalent consolidated return year. Thus, for example, if a member filed a separate return for the third year preceding a consolidated return year in which a consolidated net operating loss was sustained and if any portion of such loss is apportioned to such member for such separate return year, such portion may not be carried back by the group to its third year preceding such consolidated

[3] In its brief, "ABC" cited to rule § 1.1502-21T (temporary), instead of to federal rule § 1.1502-79. "ABC's" Brief, p. 16. That rule is not applicable because, by its own terms, it was not in effect during the years at issue. 26 C.F.R. § 1.1502-21T(g) ("Effective date - (1) In general. This section generally applies to consolidated return years beginning on or after January 1, 1997."). "ABC's" error does not affect the substance of its argument, however, because the regulation that was in effect also supports "ABC's" fundamental proposition.

return year.

(ii) If a corporation ceases to be a member during a consolidated return year, any consolidated net operating loss carryover from a prior taxable year must first be carried to such consolidated return year, notwithstanding that all or a portion of the consolidated net operating loss giving rise to the carryover is attributable to the corporation which ceases to be a member. To the extent not absorbed in such consolidated return year, the portion of the consolidated net operating loss attributable to the corporation ceasing to be a member shall then be carried to such corporation's first separate return year.

* * * *

(4) Examples. The provisions of this paragraph may be illustrated by the following examples:

Example (1). (i) Corporation P was formed on January 1, 1966. P filed a separate return for the calendar year 1966. On March 15, 1967, P formed corporation S. P and S filed a consolidated return for 1967. On January 1, 1968, P purchased all the stock of corporation T, which had been formed in 1967 and had filed a separate return for its taxable year ending December 31, 1967.

(ii) P, S, and T join in the filing of a consolidated return for 1968, which return reflects a consolidated net operating loss of $11,000. $2,000 of such consolidated net operating loss is attributable to P, $3,000 to S, and $6,000 to T. Such apportionment of the consolidated net operating loss was made on the basis of the separate net operating losses of each member as determined under subparagraph (3) of this paragraph.

(iii) $5,000 of the 1968 consolidated net operating loss can be carried back to P's separate return for 1966. Such amount is the portion of the consolidated net operating loss attributable to P and S. Even though S was not in existence in 1966, the portion attributable to S can be carried back to P's separate return year, since S (unlike T) was a member of the group immediately after its organization. The 1968 consolidated net operating loss can be carried back against the group's income in 1967 except to the extent (i.e., $6,000) that it is apportioned to T for its 1967 separate return year and to the extent that it was absorbed in P's 1966 separate return year. The portion of the 1968 consolidated net operating loss attributable to T ($6,000) is a net operating loss carryback to its 1967 separate return.

> Example (2). (i) Assume the same facts as in example (1). Assume further that on June 15, 1969, P sells all the stock of T to an outsider, that P and S file a consolidated return for 1969 (which includes the income of T for the period January 1, through June 15), and that T files a separate return for the period June 16 through December 31, 1969.
>
> **(ii) The 1968 consolidated net operating loss, to the extent not absorbed in prior years, must first be carried to the consolidated return year 1969. Any portion of the $6,000 amount attributable to T which is not absorbed in T's 1967 separate return year or in the 1969 consolidated return year shall then be carried to T's separate return year ending December 31, 1969.**
>
> * * * *

26 C.F.R. § 1.1502-79 (emphasis added).

The symmetry between the text of federal rule § 1.1502-79 and the text of Illinois income tax rule 2350 strongly suggests that the Illinois rule was based on the federal rule, and the fact that rule 2350 was adopted with other rules to interpret and administer § 207 of the IITA only confirms that conclusion. *See* 11 Ill. Reg. 17782, 17784, 17786 (Oct. 30, 1987).[4] Section 207 of the IITA specifically provides that, for Illinois purposes, "loss[es] shall be allowed as a carryover or carryback deduction in the manner allowed under Section 172 of the Internal Revenue Code." 35 **ILCS** 5/207(a). Within § 172 of the Code, Congress specifically authorized the Secretary of the Treasury to issue regulations applying § 172 to "cases where a taxpayer … ceases to be, a member of an affiliated group filing a consolidated return under section 1501 …." 26 U.S.C. § 172(h)(5)(A) (1990). Federal rule § 1.1502-79 describes how loss carry forwards shall be applied

[4] Rule 2350 was originally numbered 100.2565. 11 Ill. Reg. 17782, 17799-17805 (Department's Notice of Adopted Amendments as published in vol. 11, issue 44 of the Illinois Register). The purpose for new regulation sections 100.2560 through 100.2565 was to "provide rules for the calculation of Illinois net losses and Illinois net loss deductions pursuant to Section 207 of the [IITA] …." 11 Ill. Reg. at 17784 (¶ 15); *see also id*. at 17786 (list of new regulations underlined).

pursuant to § 172 in a situation such as the one presented here. *See* Stip. ¶ 19; 26 C.F.R. § 1.1502-79(a)(1)(ii),[5] (d)(Example 2(ii)). The symmetry between federal rule § 1.1502-79 and Department rule 2350 further supports the conclusion that example 4 of the Illinois regulation should be understood to require that the INOLs at issue here must first be applied to the full taxable year of "ABC's" main group. *See* 26 U.S.C § 172(b)(2). That taxable year ended on December 31st and not on July 17th. Department Ex. 1, pp. 6, 55.

Based on the evidence and stipulations of fact offered at hearing, I conclude that the losses cannot be applied in the manner the Department has attempted here. The Department's application of the losses, in effect, created a new short taxable year for "ABC's" main group, despite the fact that that group did not use such a short taxable year for federal tax purposes. Stip. ¶ 20; Department Ex. 1, pp. 6, 55; 35 **ILCS** 5/401(a); Consolidated Rail Corp. v. Department of Revenue, 293 Ill. App. 3d at 563. Therefore, I recommend that the losses be applied as urged by "ABC".

Issue 2. Should the § 1005 Penalty Proposed Be Assessed:

This issue involves whether "ABC's" main group had reasonable cause to justify an abatement of the § 1005 penalty proposed for "ABC's" failure to pay the amount of tax required to be shown on the Illinois combined tax returns it filed regarding tax year 1991. *See* Stip. ¶ 22. "ABC" did not accurately report the amount of tax required to be

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[5] Under the Code, where a wholly owned subsidiary is sold (as opposed to being liquidated) during a taxable year — which is what both parties stipulated is what occurred here, *see* Stip. ¶ 19 — the corporation that is sold cannot be considered a member of the parent's federal consolidated group following the date on which the transaction took place. *See* 26 U.S.C. § 1501 (1991); Rev. Rul. 61-224 (attached as an exhibit to "ABC's" Brief). Similarly, under Illinois law, such a corporation can no longer be considered a member of a single unitary business group. 35 **ILCS** 5/1501(a)(27).

shown due on those returns, in part, because "ABC" did not follow the directions provided by a regulation the Department adopted in 1987, and published at 86 Ill. Admin. Code

§ 100.3700(d) (1987) (*now codified at* 86 Ill. Admin. Code § 100.3380(c)) (hereinafter, "rule 3700(d)"). *See* Stip. ¶¶ 23-24.

The recommended resolution to the first issue, however, renders this second issue moot. Specifically, the parties' stipulation of facts reveals that, after the Department issued the NODs in this matter, the Internal Revenue Service ("IRS") completed an audit of taxpayer's business regarding earlier tax years. Stip. ¶ 9. The parties agree that "ABC" timely filed Illinois amended returns to notify the Department of those changes pursuant to § 506(b) of the IITA, which changes increased the amount of net operating losses arising from prior taxable years that were available to be carried forward by "ABC's" main group to the tax years at issue here. Stip. ¶ 9. After "ABC" filed those amended returns, the Department recomputed the deficiencies in the NODs it had previously issued by taking into account, *inter alia*, the increased amount of loss carry forwards available to be used by "ABC". Stip. ¶ 10. It must be recalled that those prior year loss carry forwards were determined by the IRS, after "ABC" apparently made errors on its original federal (and therefore, on its Illinois combined) tax returns. *See* Stip. ¶¶ 9-10, 17; 35 **ILCS** 5/506(b). Finally, the Department stipulated that, if taxpayers' proposed application of the INOLs to 1990 were correct, the net losses available to be carried forward to "ABC's" main group's 1991 taxable year would entirely eliminate the deficiency proposed for that year. *See* Stip. ¶ 21; *see also id*. ¶¶ 9-10, 17-18.

In other words, since "ABC's" earlier errors on prior year returns were corrected

by the IRS and timely reported by "ABC" to Illinois, no additional tax was required to be shown due on the main group's 1991 Illinois combined return. Stip. ¶¶ 10, 21. Because of those available loss carry forwards, "ABC" did not underpay the amount of tax required to be shown due on its 1991 Illinois combined returns. Therefore, the § 1005 penalty proposed should not be assessed against "ABC".[6]

Conclusion:

After considering all the facts and circumstances here, I conclude that, consistent with §§ 207 and 401 of the IITA, the main group's available 1986 and 1988 INOL carry forwards (*see* Stip. ¶ 17) should be applied to "ABC's" main group's 1990 taxable year, which ended on December 31, 1990, as urged by "ABC". Stip. ¶ 21. Therefore, I recommend that the Director revise the NOD issued regarding the main group's 1990 and 1991 taxable years to take into account the carry forwards as described in the parties' stipulation ¶ 21. Additionally, the record shows that, because of those available loss carry forwards — which, both parties agree, were timely reported on Illinois returns filed pursuant to § 506(b) of the IITA, *see* Stip. ¶¶ 8-9 — "ABC" did not underpay its proper Illinois income tax liability for 1991. *See* 35 **ILCS** 5/1005. Therefore, I recommend that the Director revise the NOD to eliminate the § 1005 penalty proposed for that year.

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6 This conclusion should not be understood to mean that "ABC" has established that it acted with ordinary business care and prudence when it filed its 1991 return on which it knowingly disregarded a properly adopted administrative regulation it knew had been in effect for over four years. *See* Stip. ¶ 24. A taxpayer's knowing and willful decision to disregard a properly adopted regulation is an act that completely militates against a finding that the appropriate "reasonable cause" standard has been met. *See* Kroger v. Department of Revenue, 284 Ill. App. 3d 473, 484 (1st Dist. 1996). Rather, the conclusion is based on the facts of record which show that, despite "ABC's" intentional conduct, "ABC's" prior losses available to be carried forward from prior tax years were timely reported to Illinois by "ABC" and, when such losses are properly taken into account, completely eliminate the amount of tax that would have been required to be shown due on "ABC's" main group's 1991 Illinois combined return had it heeded rule 3700(d). Stip. ¶¶ 9-10, 17-18, 21.

1/6/00
Date

John E. White