IT 03-2
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 OF THE STATE OF ILLINOIS	**Docket No. 02-IT-0000** **FEIN: 00-0000000** **Tax yr.: 1995**
v.	
ABC REINSURANCE CO., Taxpayer	**Charles E. McClellan** **Administrative Law Judge**

ORDER ON DEPARTMENT'S MOTION FOR SUMMARY JUDGMENT AND TAXPAYERS' CROSS MOTION FOR SUMMARY JUDGMENT

Appearances: Deborah H. Mayer, Special Assistant Attorney General, for the Department of Revenue; Damon N, Vocke, of Lord, Bissell & Brook for the taxpayer.

This matter comes on for the Department's Motion for Summary Judgment and the taxpayers' Cross-motion for Summary Judgment. The parties agree that there is no genuine issue of material fact.

Background:

On April 23, 2002, taxpayer filed a form IL-1120-X, Amended Corporation Income and Replacement Tax Return, to carry back a net loss incurred in 1998[1] to the year 1995. The Department denied the claim in a form LTR-353 Notice of Claim Status on May 13, 2002.

[1] Taxpayer files its income tax returns on a calendar year basis.

The Department's denial is based on its assertion that Section 207(a)(1) of the Illinois Income Tax Act[2] limits the taxpayer's loss carryback to the two-year carryback period set forth Section 172 of the Internal Revenue Code ("IRC")[3], for the year 1998. The taxpayer asserts that its operating loss deductions are governed by IRC § 810, which provides a three-year loss carryback period for life insurance companies.

Following my review of the record, I conclude that the Department's determination is correct. The appropriate carryback period for taxpayer's loss in this case is the two-year period prior to 1998, the year the loss was incurred.

Analysis:

Summary judgment is appropriate where there is no genuine issue of material fact and a movant is entitled to judgment as a matter of law. *Eidson v. Audrey's CTL, Inc.*, 251 Ill. App. 3d 193, 621 N.E. 2d 921 (5th Dist. 1993), *app. den*., 154 Ill.2d 558, 631 N.E. 2d 706 (1993). Where a moving party's right is clear and free from doubt, a trial court has no discretion in ruling on a motion for summary judgment and must grant the relief requested. *McCray v. Merit Ins. Co.*, 233 Ill. App. 3d 36, 598 N.E. 2d 366 (1992); *Loyola Academy v. S & S Roof Maintenance, Inc.*, 146 Ill. 2d 263 (1992). In this case, the parties agree that there is no genuine issue of material fact. The only issue to be resolved is a matter of statutory construction.

The granting of an income tax deduction is a privilege created by statute as a matter of legislative grace, and a taxpayer is not entitled to a deduction unless clearly allowed by statute. *National Realty Investment Co. v. Dept. of Revenue*, 144 Ill.App.3d 541, 552, (2nd Dist. 1986) citing *Bodine Electric Co. v Allphin*, 81 Ill.2d 502, 410 N.E.2d 828 (1980).

[2] Unless otherwise noted, all statutory references are to 35 ILCS 5/101, *et seq*., the Illinois Income Tax Act ("IITA" or the "Act").

This case involves statutory construction, so these rules must be taken into account when analyzing the IITA statutory scheme for taxing life insurance companies.

The taxpayer in this case is seeking a loss carryback deduction, so the taxpayer must show that a three-year carryback period is allowed by the IITA. I find that it has failed to do so.

The statutory scheme for taxing the income of a corporation provides for the assessment of a specified percentage of the corporation's net income. 35 ILCS 5/201. The Act specifies that a corporation's net income is its base income for the year. 35 ILCS 5/202. Base income of a corporation is defined in § 203(b)(1) as being the taxpayer's taxable income for the year as modified by the specific modifications set forth in § 203(b)(2). Section 203(e)(1) defines the term "taxable income" as being the amount of taxable income properly reportable for federal income tax purposes. A special rule is provided for life insurance companies subject to federal income tax imposed by IRC § 801. That provision states that for purposes of the Illinois Act, a life insurance company's taxable income is its taxable income determined under IRC § 801 plus the amount of distribution from pre-1984 policyholder surplus accounts as calculated under IRC § 815(a). 35 ILCS 5/203(e)(2)(A). This income is "life insurance taxable income" ("LICTI"), a term of art defined in IRC § 801(b) and referred to in the IITA.

IITA § 207(a) is the provision in the IITA that allows loss carrybacks and carryovers. It provides as follows:

> (**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;**

[3] 26 USCA § 172.

> **(1) for any taxable year ending prior to December 31, 1999, such loss 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).**

For losses incurred in 1998, IRC § 172 provided that losses could be carried back for two years. 26 U.S.C.A. § 172. The Department's regulation, in effect for 1998, reiterated the rule that losses incurred in years beginning after August 5, 1997, could be carried back two years as provided by IRC § 172. 86 Ill. Admin. Code § 100.2330.

There is a significant difference between IITA § 207(a) and IRC § 172, the IRC section that provides for the carryback and carryover of net operating losses. When terms set forth in the IRC are referred to in the IITA their meaning is determined by the IRC. IITA § 102 states that, "Except as otherwise expressly provided or clearly appearing from the context, any term used in this Act shall have the same meaning as when used in a comparable context in the United States Internal Revenue Code . . . or any successor law or laws relating to federal income taxes . . .." 35 ILCS 5/102.

The term "net operating loss" is a term of art defined in IRC § 172(c). The IITA does not adopt the Federal Income Tax net operating loss concept. Section 207(a) does not use or adopt the term "net operating loss". " [Section 102 of the IITA] does not incorporate substantive provisions of the code such as section 172, so as to allow a state taxpayer to compute a net operating loss on a state tax return." *Bodine Electric Co. v Allphin*, 81 Ill.2d at 509, 410 N.E.2d at 831. IITA § 207 does not provide for the carryback of federal net operating losses. Rather, it provides that if the calculation of base income results in a loss it may be carried back **in the manner allowed** under IRC § 172. For the 1998 year, the manner allowed for a carryback under IRC § 172 specified the two-year period prior to the

year in which the loss was incurred. Although the IITA recognizes the differences unique to the life insurance industry in calculating taxable income as provided in IITA § 203(e)(2)(A), the IITA does not provide a separate loss carryback provision for life insurance companies.

It would violate fundamental rules of statutory construction to adopt taxpayer's position that the three-year carryback period as provided in IRC § 810 applies in this case. Where statutory language is clear and unambiguous, the plain and ordinary meaning of the words will be given effect without resorting to extrinsic aids for construction. *Board of Education of Rockford School District No. 205 v. Illinois Educational Labor Relations Board*, 165 Ill. 2d 80, 87 (1995). A fundamental rule of statutory construction is that statutes are to be construed so that no term is rendered superfluous or meaningless. *Texaco-Cities Service Pipeline Company v. McGaw*, 182 Ill.2d 95, 525 N.E.2d 73 (1988). Taxing statutes are to be strictly construed and their language is not to be extended or enlarged by implication beyond its clear import. *Canteen Corp. v. Department of Revenue*, 123 Ill.2d 95, 525 N.E.2d 73 (1988).

Taxpayer's argument that the three-year carryback provision of IRC § 810 prevails over the two-year carryback provision of IITA § 207 would require that I read into the statute, by implication, language allowing a three-year carryback period for a net loss incurred by a life insurance company. It would also render IITA § 207 meaningless because nothing in that section would apply to life insurance companies. Therefore, taxpayer's 1998 loss is limited to the two-year period allowed by IRC § 172 for 1998 as specified in IITA § 207 for that year.

As the taxpayer explains in its response to the Department's motion, a life insurance company is unique in having two distinct business activities, those being its underwriting activities and its investment activities. Because of this unique situation, it is difficult to determine a life insurance company's true income on an annual basis. This was recognized in the IRC beginning in 1984 when a separate set of rules was enacted to determine a life insurance company's taxable income on an annual basis.

The provisions of the IRC that pertain to life insurance companies are contained in Part I of subchapter L of the IRC consisting of sections 801 through 818. Basically, the taxable income of a life insurance company is calculated by determining its gross income as defined in IRC § 803 and deducting from that number the allowable deductions enumerated in IRC § 805. IRC § 805(a)(5) allows the deduction of an "operating loss deduction" as determined under IRC § 810. A "net operating loss", a term of art defined in IRC § 172(c), is not the same as an "operations loss deduction" or a "loss from operations", which are terms of art defined in IRC § 810. In fact, IRC § 805(b)(4) bars a life insurance company from claiming "net operating losses" provided in IRC § 172, except in limited circumstances, not relevant here. Basically, an operations loss deduction is an excess of life insurance deductions over life insurance income for the year plus any operations loss carryback or carryover modifications. The carryback and carryover modifications must be reduced by "offsets" which are adjustments defined in IRC § 810(d).

Under the IITA, the statutory scheme for computing a life insurance company's taxable income or net loss for Illinois income tax purposes starts with LICTI, a term of art defined in IRC § 801(b), plus the amount of pre-1984 policyholder surplus accounts as

calculated under IRC § 815. 35 ILCS 5/203(e). The next step is to add and subtract the modifications set forth in IITA § 203(b)(2). The only modification at issue in this case is the addition modification in IITA § 203(b)(2)(D) requiring a net operating loss deduction to be added back. In fact, IRC § 805(b)(4) prohibits a life insurance company from having a net operating loss deduction except in limited circumstances not applicable here. Therefore, taxpayer in this case, a life insurance company, cannot have a net operating loss addition modification for Illinois income tax purposes.

Under the IITA, the number arrived at after taking into account the modifications set forth in IITA § 203(b)(2) is the life insurance company's base income or taxable income, if there is no apportionment required, or net loss. If that number is a net loss, IITA § 207 states that it is carried back or forward "in the manner allowed under Section 172 of the Internal Revenue Code." For the years at issue, that means it is carried back to the second year preceding the year of the loss, 1996 in this case. In this calculation, any operations loss deduction incurred by the taxpayer is taken into account in arriving at LICTI as provided by IRC §§ 805(a)(5) and 810.

Taxpayer argues that because the concept of "life insurance company taxable income" is recognized by the IITA § 203(e)(2)(A), "the federal statutory scheme, which the Illinois statute essentially incorporates by reference, makes it clear that, in almost all instances the loss carryover rules for life insurance companies are to be governed by the special rules contained in part I of subchapter L of the IRC."

This argument fails because, as noted above, the IITA does not incorporate the federal scheme by reference or by implication. Therefore, just because the IITA makes LICTI the starting point for computing base income for a life insurance company does not

mean that the entire federal statutory scheme for taxing life insurance companies is incorporated into the IITA by reference.

Taxpayer argues further that the Department's failure to follow the federal rules for the taxation of life insurance companies, including the rules relating to the treatment of losses from operations would result in some illogical tax consequences for life insurance companies, many of which would be detrimental to Illinois. To illustrate its point, the taxpayer presents the following example:

> First, consider the case of a life insurance company, which incurs a loss from operations of $1,000x in year 1 that must be carried forward. Assume also that in year 2 the company earns tentative LICTI (before the operations loss deduction) of $2,000x. On its federal income tax return the life company would deduct its $1,000x loss from operations in year 2, pursuant to IRC § 810, and reduce its LICTI to $1,000x. Tp. memo p. 6.

The taxpayer argues that under the approach set forth by the Department a double deduction would arise. The taxpayer states, correctly, that that taxpayer's base income is determined by reference to LICTI which would be $1,000x for year 2 because IRC § 810 provides that an operations loss carryover is deductible in arriving at LICTI. The taxpayer then argues that under the Department's theory, as argued in its memorandum in support of its motion for summary judgment, the $1,000x loss carryover would result in $-0- taxable income because it would be deducted once in the determination of LICTI, the starting point for calculating Illinois base income, and again as a carryover. The Department in its response disputes that result arguing that the deduction in arriving at LICTI would be added back to LICTI as required of net operating loss deductions under IITA § 203(b)(2)(D).

The Department's analysis of the taxpayer's example is incorrect, because it assumes that the legislature intended to use the term "net operating loss" in a generic sense so that the "operations loss deduction" allowed by IRC § is the same as a "net operating loss" under the federal income tax rules. As noted above, the term "net operating loss" is a term of art defined in IRC § 172(c). The term "operations loss deduction" is also a term of art defined in IRC § 810(a). As noted above, IITA § 102 provides that any term used in the IITA shall have the same meaning as when used in a comparable context in the IRC. Contrary to the Department's assertion, the term "net operating loss" is not synonymous with the term "operations loss deduction" so they cannot be treated as being synonymous.

Although the carryback periods in IRC § 810 and IRC § 172 as adopted by IITA § 207 for 1998 are different, it would require action by the legislature to allow the three-year carryback taxpayer seeks.

Conclusion:

For the reasons set forth above, I am granting the Department's motion and denying the taxpayer's cross-motion for summary judgment. I recommend that the Department's denial of the taxpayer's claim for refund be made final.

Date: 2/3/2003

Charles E. McClellan
Administrative Law Judge