IT 97-1
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	)	
	)	**No.**
v.	)	
	)	**FEIN:**
TAXPAYER	)	
	)	
	)	**Christine O'Donoghue**
Taxpayer	)	**Admin. Law Judge**
	)	

RECOMMENDATION FOR DISPOSITION

Appearances: Mr. Richard E. Peterson of Kirkland and Ellis for TAXPAYER; Mr. Sean Cullinan, Special Assistant Attorney General, for the Illinois Department of Revenue.

Synopsis:

This matter comes on for hearing pursuant to taxpayer's timely protest of the Notice of Deficiency issued by the Department on October 14, 1994 for tax deficiencies and for penalties pursuant to 35 **ILCS** 5/1005 for fiscal year ended June 30, 1989.

Taxpayer, TAXPAYER, was a corporation with headquarters in Westport, Connecticut. One of its subsidiaries operated an office in Illinois. For TYE June 30, 1989, taxpayer filed its Illinois Income and Replacement Tax Return on a unitary basis. The Department subsequently conducted an audit of TYE June 30, 1989 and June 30, 1990 (hereinafter referred to as the "audit period"), making various audit adjustments which comprised the basis for the Notice of Deficiency issued by the Department for TYE June 30, 1989.

Two of the audit adjustments arose out of a re-classification of income (loss) arising out of the sale of a subsidiary, AGENCY, as business income (loss). This transaction created a capital loss and also created ordinary income (arising from the sale of a covenant not to compete) in the year of the sale. The capital loss and the income had been excluded from the taxpayer's base income in its return as filed, as it was their position that the income and the capital loss were both nonbusiness income (loss). Taxpayer's position on its return was consistent with a position taken by it in an earlier audit period (TYE June 30, 1987) wherein it had characterized capital gain income arising from the sale of a subsidiary as nonbusiness income on its return as filed. In August, 1992, while the instant audit was pending, taxpayer settled the issue for the earlier audit period with the Department's Administrative Hearings Division, with taxpayer agreeing to reclassify the 1987 capital gain income as business income. For the instant audit period, taxpayer then agreed that the income from the sale as well as the capital loss arising from the sale should be similarly treated as apportionable business income (loss).

Although no formal claim was filed, taxpayer sought to carry back its 1989 capital loss to TYE 6/30/87. In its protest, taxpayer raised four issues: (1) the disallowance of a carryback to TYE 6/30/87 of a net capital loss incurred during TYE 6/30/89; (2) the disallowance of a carryback of a net operating loss incurred during TYE 6/30/90; (3) the imposition of a penalty under 35 **ILCS** 5/1005; and (4) the Department's calculation of interest.

Findings of Fact:

1. Taxpayer was a Connecticut corporation with headquarters in Westport Connecticut. Dept. Ex. No. 2, 4.

2. Taxpayer and its subsidiaries were engaged in various diverse businesses. Dept. Ex. No. 4.

3. Taxpayer's Illinois Income and Replacement Tax Return was filed on a combined unitary basis. Dept. Ex. No. 4.

4. Taxpayer and those subsidiaries who were members of the unitary business group for Illinois purposes were engaged in the business of marketing and promotional services. Dept. Ex. No. 4.

5. During TYE 6/30/89, taxpayer sold its controlling interest in AGENCY, an advertising agency located in Westport, Connecticut and New York City and one of the members of taxpayer's unitary business group. Dept. Ex. No. 3.

6. The sale transaction consisted of a sale of stock, which resulted in a capital loss of $10,752,733, as well as the execution by taxpayer of a covenant not to compete in the advertising business, which generated ordinary income in the amount of $5,400,000. Dept. Ex. No. 3.

7. Neither taxpayer nor AGENCY had nexus with the state of Illinois. Dept. Ex. No. 3.

8. In its return as filed, taxpayer classified the capital loss and the ordinary income arising from the sale of AGENCY as nonbusiness income, not apportionable to the state of Illinois. Dept. Ex. No. 3. Tr. p. 26.

9. Taxpayer's nonbusiness classification of the net capital loss and the gain income was consistent with a position taken on its prior Illinois income tax return for a prior audit period (TYE 6/30/87) in which it had classified the capital gain income from a sale of one of its unitary subsidiaries in the coupon business as non-apportionable nonbusiness income. Dept. Ex. No. 3; Tr. p. 26.

10. Taxpayer's rationale for its nonbusiness treatment of the capital loss and ordinary income arising out of its sale of AGENCY was that the income and loss arose from a transaction which did not occur in the regular course of business. Tr. p. 31, 32.

11. Prior to filing its TYE 6/30/89, SECRETARY, taxpayer's Corporate Secretary and Director of Tax, who was responsible for taxpayer's federal and state tax compliance and tax planning, researched the Illinois statutes and regulations for guidance on the issue but found nothing on point. Tr. p. 25, 31.

12. After the filing of taxpayer's return, Mr. SECRETARY found a private letter ruling agreeing with taxpayer's position that income from the sale of a business constitutes nonbusiness income. Tr. p. 32.

13. Mr. SECRETARY has a law degree and an undergraduate degree in accounting and has sixteen years experience dealing with state income tax issues. Tr. pp. 25, 32.

14. During an audit of TYE 6/30/87, the Department re-classified the capital gain income as business income, and while the instant audit was pending, in August, 1992, taxpayer agreed with the Department's reclassification for the TYE 6/30/87 audit. Tr. p. 36.

15. The Department conducted an audit for the instant audit period (TYE 6/30/89 and TYE 6/30/90) which began in March, 1992 and which ended in 1994 and which resulted in the issuance of the Notice of Deficiency on October 14, 1994. Dept. Ex. No. 4.

16. During the instant audit, the Department made various adjustments, including the reclassification of the net capital loss and the ordinary income arising from the sale of AGENCY to business income (loss). This was consistent with the audit adjustment for the prior period (TYE 6/30/87) which reclassified gain from the sale of the coupon business as business income apportionable to Illinois. Dept. Ex. No. 4; Tr. p. 27.

17. At the audit level, taxpayer did not object to the reclassification but sought to carry the net capital loss back to a prior year (TYE 6/30/87) to offset net the capital gain in that year. Dept. Ex. No. 4; Tr. p. 10.

18. Taxpayer did not file an amended return or formal written claim (Form IL-1120X) to carryback the net capital loss to TYE 6/30/87, but instead asked the Department's auditor to make an adjustment to the prior audit period (TYE 6/30/87). Tr. pp. 29, 44.

19. In 1990, taxpayer filed an amended federal income tax return (U.S. 1120X) which carried back, for federal purposes, the TYE 6/30/89 loss to TYE 6/30/87. Tr. p. 42.

20. During the instant audit, taxpayer and the Department executed four consecutive "Consents to Extend the Time to Assess or Refund Income Tax", Form IL-872, for TYE 6/30/89, which extended the time for assessments of tax deficiencies until March 31, 1995 and extended the time for the filing of a claim for refund until six months after such date, September 31, 1995. Dept. Ex. No. 5.

21. The Department did not include in the Notice of Deficiency a net operating loss carryback from TYE 6/30/90 to TYE 6/30/87 and TYE 6/30/89. Dept. Ex. No. 3, 4.

Conclusions of Law:

The first issue raised by the taxpayer concerns its ability to carryback a TYE 6/30/89 net capital loss to a prior year, TYE 6/30/87, a year not covered by the audit period. If the taxpayer were to prevail, there would be no tax effect on the audit year in question, TYE 6/30/89, and the proposed tax liabilities contained in the Notice of Deficiency would not be reduced. Tr. p. 43; Taxpayer Brief, p. 6. Taxpayer is seeking to have the carryback issue resolved here because taxpayer could then offset its liability in the instant audit period with its refund for the earlier year.

Although taxpayer asserts that it filed a claim which the Department refused to grant, there is no evidence in the record to support this allegation. Tr. p. 44. 35 **ILCS** 5/909(d) requires that every claim for refund shall be filed with the Department in writing, in such form as the Department may by regulations prescribe, and shall state the specific grounds upon which it is founded. The Department regulation 100.9400(f)(6)[1] states that informal claims

[1]. Formerly Section 100.9110(f)(6)

are not permitted and are insufficient for the purpose of establishing or extending any of the limitations periods. The record contains no evidence that a written claim was ever filed by the taxpayer. It is important to note that under IITA Section 911(a), the taxpayer can file a claim one year after the tax is paid. If TAXPAYER pays the tax owed for TYE 1987, it can file a TYE 1987 claim within one year of payment.

The second issue raised by the taxpayer addresses the disallowance of a carryback of a net operating loss incurred during TYE 6/30/90 to TYE 6/30/87 and TYE 6/30/89. Again, taxpayer must file a formal claim for refund pursuant to 35 **ILCS** 5/909(d) for the carryback years and state the specific grounds upon which it is founded. Regulation 100.9400(f)(6) does not permit informal claims and taxpayer's failure to file an amended return precludes me from addressing its arguments further.

In Chrysler Corporation v. Raymond T. Wagner, 94 L 50003, the court addressed the issue of "whether the Director erred in not recognizing Chrysler's protest of certain notices of deficiencies as a protective claim for refund." The court rejected the taxpayer's informal approach and found that taxpayer's failure to file an IL-1120X was dispositive of this issue. It found the "filing of a claim for refund a simple and unburdensome act", and was unwilling to "construe the simple, straightforward statutory requirements in ways that would leave tax authorities in doubt as to whether refund claims have been filed ... ." Chrysler, *quoting*, Shiseido Cosmetics v. Franchise Tax Board, 235 Cal. App. 3d at 495.

Like Chrysler, the instant case deals with a taxpayer who asks that it not be held to the administrative filing requirements. I am unwilling to allow such an interpretation of the applicable statute when the language of such puts forth the filing requirements in clear and straightforward language.

Penalties were proposed pursuant to Section 1005 of the Illinois Income Tax Act (hereinafter referred to as "IITA"). For periods prior to January 1, 1994[1], Section 1005 of the IITA provides in part:

> If any amount of tax required to be shown on a return prescribed by this Act is not paid on or before the date required for filing such return (determined without regard to any extension of time to file), a penalty shall be imposed at the rate of 6% per annum upon the tax underpayment unless it is shown that such failure is due to reasonable cause... .

35 **ILCS** 5/1005.

To avoid the imposition of the Section 1005 penalty under the IITA, a taxpayer must affirmatively put forth evidence which establishes that the taxpayer acted in good faith and exercised ordinary business care and prudence. *See*, IRC Sec. 6664(c). Ordinary business care and prudence is determined by examining all of the facts and circumstances in a particular case.

The law regarding the classification of income as business versus nonbusiness was not clearly defined and the taxpayer was not able to find any Illinois authority directly on point. Taxpayer determined that the capital gain realized from the sale of its subsidiaries constituted allocable nonbusiness income.

In Letter Ruling (IT-91-302), the Department of Revenue reached the same conclusion with regards to similar circumstances. The Department of Revenue is bound by this ruling only with regards to the taxpayer to whom it was directed. Nevertheless, it provides evidence that taxpayer's Director of Taxes exercised ordinary business care and prudence and thus, the Section 1005 should be abated.

The last issue addresses interest calculation. This forum does not have authority to address this issue. The taxpayer acknowledged this (Tr. p. 46), and indicated that it was challenging the interest computation only on equitable grounds.

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[1]. As of January 1, 1994, Section 1005 penalties are provided for under the Uniform Penalty and Interest Act. *See*, 35 **ILCS** 735/3-1 *et seq*.

WHEREFORE, for the reasons stated above, it is my recommendation that the Notice of Deficiency be finalized as modified by the abatement of penalties.

Christine O'Donoghue
Administrative Law Judge