IT 97-4
Tax Type INCOME TAX
Issue: Reasonable Cause Asserted on Application of Penalties
Reversionary Sales
Throwback Sales (General)

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

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

RECOMMENDATION FOR DISPOSITION

APPEARANCES: Marilyn A. Wethekam and Fred O. Marcus of Horwood, Marcus & Braun, for TAXPAYER; Sean Cullinan, Special Assistant Attorney General, for the Illinois Department of Revenue.

SYNOPSIS:

This case involves TAXPAYER ("TAXPAYER" or "taxpayer") which filed combined returns in Illinois for the tax years ending January 31, 1986 through January 31, 1991. On December 8, 1989, the Department of Revenue issued a Notice of Deficiency against the taxpayer for the tax years ended January 31, 1986 and January 31, 1987 in the amounts of $72,856 and $236,408, respectively, including a Section 1005 penalty for the year ended January 31, 1986. On October 30, 1991, the Department issued a Notice of Deficiency against the taxpayer for the tax years ended January 31, 1988 and January 31, 1989 in the amounts of $300,949 and $229,769,

respectively, inclusive of Section 1005 penalties. On June 25, 1993, the Department issued a Notice of Deficiency against the taxpayer for the tax years ended January 31, 1990 in the amount of $162,878, inclusive of Section 1005 penalties.

TAXPAYER timely protested these Notices of Deficiency on January 19, 1990, December 6, 1991 and August 23, 1993. In addition, taxpayer has filed amended returns for the tax years ending January 31, 1986 through January 31, 1990.[1]

At issue is whether, pursuant to Section 304(a)(3)(B)(ii) of the Illinois Income Tax Act[2], sales originating in Illinois are thrown back for purposes of inclusion in the numerator of the sales factor where the taxpayer is not taxable in the destination state. TAXPAYER argues that Section 502(e) permits a unitary group to elect to be treated as one taxpayer, and therefore, for purposes of determining throwback sales, if any member of the unitary group is taxable in the state of destination, no sales are to be thrown back.

In addition, taxpayer has protested the Department's imposition of Section 1005 penalties.

On consideration of these matters, it is recommended that these issues be resolved in favor of the Department in part, and in favor of the taxpayer in part.

FINDINGS OF FACT:

[1] The amended returns for the tax years ended January 31, 1986 through January 31, 1990 were not audited by the Department and on completion of this case, taxpayer has agreed that the Department may audit these returns. Taxpayer has two claims for refund for the tax years ended January 31, 1989 and January 31, 1990, one of which is the subject of another case before this tribunal, Docket No..

[2] 35 **ILCS** 5/304(a)(3)(B)(ii).

1. TAXPAYER ("TAXPAYER") is a Delaware corporation with its commercial domicile in Chicago, Illinois. (Stip. ¶1)[3]

2. TAXPAYER, TAXPAYER A ("TAXPAYER B"), TAXPAYER A, Inc. ("TAXPAYER B") and the other members of the TAXPAYER affiliated group which are listed on Exhibit 5 of the Statement of Stipulated Facts were members of a unitary business group ("TAXPAYER Business Group"), engaged in the business of manufacturing, distributing, and selling women's and men's apparel. (Stip. ¶3, Ex. No. 3)

3. The members of the TAXPAYER affiliated group which are subject to tax in Illinois ("Illinois Filers") are: TAXPAYER, TAXPAYER B, TAXPAYER A (Stip. ¶4, Ex. No. 4)

4. For the years at issue, the members of the TAXPAYER Business Group filed their Illinois return on a combined basis pursuant to Section 502(e) of the Illinois Income Tax Act. (Stip. ¶¶5 and 21, Ex. No. 5)

5. For the years at issue, the Department determined that sales made by TAXPAYER B and TAXPAYER Afrom Illinois into states where they did not file returns or pay tax should be thrown back to Illinois for purposes of computing the numerator of the TAXPAYER Business Group's Illinois combined sales factor. (Stip. ¶32, Ex. No. 8)

6. The Department determined that for the year ended January 31, 1986, TAXPAYER B and TAXPAYER Amade sales of $103,071,691 and $12,962,513, respectively, to purchasers in states where they did not file tax returns or pay tax. (Stip. ¶23)

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[3] References to "Stip. ¶___" are to the Statement of Stipulated Facts executed by the Department and taxpayer on June 5, 1996 and entered into the record at hearing. References to "Ex. No. ___" are to the exhibits annexed to the Statement of Stipulated Facts.

7. The Department determined that for the year ended January 31, 1987, TAXPAYER B and TAXPAYER Amade sales of $94,588,692 and $13,637,209, respectively, to purchasers in states where they did not file tax returns or pay tax. (Stip. ¶24)

8. The Department determined that for the year ended January 31, 1988, TAXPAYER B and TAXPAYER Amade sales of $113,162,349 and $16,798,514, respectively, to purchasers in states where they did not file tax returns or pay tax. (Stip. ¶25)

9. The Department determined that for the year ended January 31, 1989, TAXPAYER B and TAXPAYER Amade sales of $136,709,862 and $14,554,256, respectively, to purchasers in states where they did not file tax returns or pay tax. (Stip. ¶26)

10. The Department determined that for the year ended January 31, 1990, TAXPAYER B and TAXPAYER Amade sales of $136,159,316 and $14,145,545, respectively, to purchasers in states where they did not file tax returns or pay tax. (Stip. ¶27)

11. The Department determined that for the year ended January 31, 1991, TAXPAYER B and TAXPAYER Amade sales of $141,994,531 and $12,297,995, respectively, to purchasers in states where they did not file tax returns or pay tax. (Stip. ¶28)

12. One or more members of the TAXPAYER Business Group have filed a return in and paid one of the taxes enumerated in Section 303(f)(1) to the states to which the Department has determined that throwback sales should be calculated for TAXPAYER B and TAXPAYER Afor each of the years at issue. (Amended Stip. ¶23-29[4], Ex. No. 6)

[4] Reference to "Amended Stip. ___" indicates the paragraph number of the Statement of Stipulated Facts as amended by the Amendment to

13. TAXPAYER Afiled a return and paid taxes in California for the tax year ended January 31, 1986. (Amended Stip. ¶18, Ex. No. 11)

14. The Ohio Department of Revenue made the determination that TAXPAYER B was subject to tax in Ohio, and as a result, TAXPAYER B and Ohio entered into a settlement agreement by which TAXPAYER B paid tax to Ohio for the tax years ending January 31, 1986 through January 31, 1991. (Amended Stip. ¶19, Ex. No. 12)

15. The Pennsylvania Department of Revenue made a determination that TAXPAYER B was subject to tax in Pennsylvania for the tax years ending January 31, 1986 through January 31, 1991. As a result, TAXPAYER B filed tax returns and paid tax for each of the years. (Amended Stip. ¶20, Ex. No. 13)

16. Although taxpayer objects to the Department's inclusion of the throwback sales related to TAXPAYER B and TAXPAYER Ain the numerator of the sales factor, it does not object to the method the Department used in computing the amount of those sales. (Stip. ¶30)

17. The Department assessed additional tax for the years in question, as follows: for the year ended 1/31/86, $59,761; for the year ended 1/31/87, $236,408; for the year ended 1/31/88, $249,209; for the year ended 1/31/89, $212,395; for the year ended 1/31/90, $142,267. (Stip. ¶14)

18. TAXPAYER filed various amended returns on behalf of the group for the tax years ending January 31, 1986 through January 31, 1990. These returns have not been audited by the Department. For the year ended 1/31/86, the refund requested was $8,218. For the year ended

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Statement of Stipulated Facts executed by the parties on July 7, 1996.

1/31/87, a refund of $588 was requested. For the year ended 1/31/88, two amended returns were filed, one requesting a refund of $459,539, and the other requesting a refund of $4,671. For the year ended 1/31/89, two amended returns were filed, one showing a liability of $42,381, which was paid, and the other showing a refund of $491,265. Two amended returns were filed for the year ended 1/31/90, one requesting a refund of $102,696, and the other requesting a refund of $133,065. (Stip. ¶7-12, Ex. Nos. 1A-1H).

CONCLUSIONS OF LAW:

1. Throwback Sales

The primary issue in this case is determining what sales are to be included in the numerator of the sales factor for apportionment purposes. According to 35 **ILCS** 5/304(a), business income, with limited exceptions, will be apportioned to Illinois on the basis of the three-factor formula. The business activity of a corporate taxpayer in Illinois is measured by the property, payroll and sales in the State as compared to these factors everywhere. Generally speaking, sales are located in the destination state for apportionment purposes. Section 304(a)(3)(B)(ii) of the Illinois Income Tax Act provides an exception to the general rule by what is commonly referred to as the throwback rule:

> (B) Sales of tangible personal property are in this State if:
> ...
> (ii) The property is shipped from an office, store, warehouse, factory or other place of storage in this State and either the purchaser is the United States government or the person is not taxable in the state of the purchaser....

That is, where the taxpayer is not subject to tax in the destination state, sales are "thrown back" to the state of origination.

The purpose of the throwback rule is to assign sales to some state, if not the destination state because the taxpayer is not taxable there, then to the state of origin. In so doing, 100% of sales will be assigned assuring that there is neither a gap nor overlap in taxing income. *See* GTE Automatic Electric v. Allphin, 68 Ill. 2d 326 (1977).

The instant case involves combined returns filed by a unitary group and the application of the throwback rule to a unitary group. Certain members of the group (TAXPAYER B and Fashionaire) ship products from Illinois to states in which they are not taxable, although other members of the group are. The Department of Revenue has thrown back these sales to Illinois. This application of the throwback rule is often referred to as the "Joyce rule" in reference to a California administrative decision, Appeal of Joyce, Inc., 1966 Cal. Tax LEXIS 18 (Cal. SBE, 11/23/66). Joyce involved a unitary business consisting of an Ohio parent and a California subsidiary. The Ohio corporation had no nexus with the State of California. In determining the tax liability for the unitary group, the California Franchise Tax Board included the California property, payroll and sales of both corporations in the numerators of the three factors. Taxpayer protested the inclusion of sales made by a corporation over which the Franchise Tax Board had no taxing jurisdiction in the numerator of the sales factor. The State Board of Equalization ("SBE") agreed with the taxpayer and ruled that a corporation which

is immune from tax pursuant to Public Law 86-272 cannot be taxed even though it is a member of a combined unitary group.

In 1990, the SBE issued a decision that has come to be known as "Finnigan II."[5] In that decision, the SBE effectively overruled Joyce, and held that out-of-state sales made by a member of a unitary group should not be thrown back where another member of the group was taxable in the destination state.

Illinois has consistently followed the Joyce rule. According to Department Regulation Section 100.5270(b)(1)(A)[6], sales made by corporations which are not taxable in Illinois due to P.L. 86-272 are not to be included in the numerator of the sales factor of the unitary group. The same regulation also treats the issue of throwback sales for members of a unitary group.[7] According to Example 2 of Regulation Section 100.5270, where Corporations A, B, and C are a unitary group, subject to tax in Illinois, and Corporation A is not subject to tax in the destination state, but Corporations B and C are, the combined Illinois sales factor includes those sales made by Corporation A which are thrown back to Illinois.

This issue was directly addressed in Dover Corp. v. Department of Revenue, 271 Ill. App. 3d 700 (1st Dist. 1995). In Dover, the taxpayers were members of a unitary group filing in Illinois. They argued that the entire unitary group is the "taxpayer" and therefore, a tax payment by any member of the group meant that the taxpayer was taxable in the destination state. The Court looked to GTE Automatic

[5] Appeal of Finnigan Corp., 1990 Cal. Tax LEXIS 4 (Cal. SBE 1/24/90), *aff'g* 1988 Cal. Tax LEXIS 28 (Cal. SBE 8/25/88).
[6] 86 Admin. Code ch. I, Sec. 100.5270(b)(1)(A).
[7] 86 Admin. Code ch. I, Sec. 100.5270(b)(1)(B).

Electric v. Allphin, *supra*, where the Illinois Supreme Court stated that the purpose of apportionment is to have 100% of the taxpayer's income taxable by the states having the jurisdiction to do so. The Dover Court held that treating a unitary group as one taxpayer for purposes of the throwback rule would defeat apportionment's purpose of assuring that 100% of a taxpayer's business income is subject to taxation. If the tax payment by any member of the group means the entire group is treated as being taxable in the destination state, certain sales would neither be included in the sales numerator of the destination state, since the individual corporation did not file or pay tax there, nor would they be thrown back to Illinois, thus resulting in "nowhere sales." That is, when applying the three factor apportionment formula, the sum of the sales numerator in every state for all the members of the group will be less than the unitary group's total or "everywhere" sales.

The only difference between the instant case and Dover is that the taxpayer here has argued that the enactment of Section 502(e)[8] of the Illinois Income Tax Act now allows a unitary taxpayer to elect to be treated as a single taxpayer, and therefore the unitary group should be the relevant taxpayer for purposes of the throwback rule as well. Section 502(e) states:

> For taxable years ending on or after December 31, 1985, and before December 31, 1993, taxpayers that are corporations...having the same taxable year and that are members of the same unitary business group may elect to be treated as one taxpayer for purposes of any original return, amended return which includes the same taxpayers of the unitary group which joined in the election to file the original

[8] Originally enacted as Section 502(f).

> return, extension, claim for refund, assessment, collection and payment and determination of the group's tax liability under this Act. This subsection (e) does not permit the election to be made for some, but not all, of the purposes enumerated above....

Taxpayer argues that 502(e) mandates the treatment of the unitary group as a single taxpayer for throwback purposes as well as the specific instances enumerated in the statute: sales should only be thrown back when no member of the group is subject to tax in the destination state. I disagree. Former Director of Revenue J. Thomas Johnson testified at hearing that 502(e) was enacted to correct procedural problems which existed when unitary taxpayers filed separate returns on a unitary basis. Illinois law prohibited consolidated returns, so that prior to Section 502(e), if six members of a unitary group had nexus in Illinois, each would file a separate return. Each return would show the total income of the unitary group and the denominators of the apportionment factors would be the total denominators of the group, but the numerator of the apportionment factors would only reflect the numerator of that member. This method created problems where adjustments were made on audit. Since the Department took the position that each taxpayer stands on its own, some members of the group may have owed interest and penalties on underpayments while other members of the group were due refunds. The enactment of Section 502(e) corrected these administrative problems. (Tr. pp. 48-53)

Mr. Johnson's testimony highlights the problems of unitary reporting prior to the recognition of combined returns, yet his testimony sheds no light on whether the issue of throwback sales was

considered in the context of Section 502(e). I believe the result in Dover, *supra*, is unchanged by Section 502(e). The rationale behind the decision is still viable: 100% of business income should be apportioned to the states, so that "nowhere sales" are prevented.

Looking at the language of Section 304(a)(3)(B)(ii), the statute states that sales are in Illinois if the "person" is not taxable in the destination state. Although taxpayer has argued that "person" must be read as the unitary group where the taxpayer has elected under Section 502(e) to be treated as one taxpayer, this interpretation is not consistent with the combined method of apportionment. Even though taxpayers combine their taxable incomes and "everywhere" factors, the numerator of the apportionment factors must be looked at on a company-by-company basis. Only corporations which have nexus in Illinois can have Illinois sales included in the numerator.

Public Law 86-272 provides protection to companies by restricting the ability of states to impose income taxes on companies whose only contact with the state is the solicitation of orders. If we were to follow taxpayer's reasoning that the unitary group is to be considered as one person for apportionment purposes, the sales of companies in the unitary group having only minimal connections with Illinois could be included in the apportionment factor. Thus, nexus of one company in the unitary group would be sufficient to subject the sales of all members of the unitary group to taxation. The Department of Revenue has taken the position that for purposes of determining nexus and the apportionment factors of a unitary group the appropriate unit to examine is the individual entity. In my

opinion, this position is consistent with the statute, regulations and Dover Corp. v. Department of Revenue, *supra*, and I find that throwback sales of TAXPAYER Aand TAXPAYER B should be included in the numerator of the TAXPAYER Unitary Business Group sales factor.

While, based on the foregoing, I agree with the Department's theory regarding the throwback rule, I must also examine how it has been calculated. The Statement of Stipulated Facts indicates that TAXPAYER B and TAXPAYER Ahave paid taxes to states from which the Department has thrown back sales.

TAXPAYER Afiled a return and paid taxes in California for the tax year ended January 31, 1986. TAXPAYER Ais clearly taxable in California for that year, and therefore no sales made by TAXPAYER Ato California for that period should have been thrown back to Illinois.

As a result of the Departments of Revenue of Ohio and Pennsylvania making a determination that TAXPAYER B was subject to tax in those states, TAXPAYER B paid tax to both states. TAXPAYER B filed returns and paid tax to Pennsylvania, and entered into a settlement agreement with Ohio and paid the tax. Although TAXPAYER B's returns to Pennsylvania were filed late, TAXPAYER B and Pennsylvania are in agreement that TAXPAYER B is subject to tax in Pennsylvania, and therefore, TAXPAYER B's Pennsylvania sales should not be thrown back for the tax years ended January 31, 1986 through January 31, 1991. Likewise, even though no tax returns were filed in Ohio, TAXPAYER B and Ohio have reached a settlement whereby back taxes were paid. I find that TAXPAYER B was taxable for the tax years ended January 31, 1986 through January 31, 1991, and Ohio sales made by TAXPAYER B should not be thrown back for that period.

In conclusion, regarding the throwback issue, I find in favor of the Department with the exception that throwback sales should be recalculated to exclude TAXPAYER Asales made to California for the tax year ended January 31, 1986 and TAXPAYER B sales made to Ohio and Pennsylvania for the tax years ended January 31, 1986 through January 31, 1991.

2. Penalties

Section 1005 of the Illinois Income Tax Act provides that:

> ...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. This penalty shall be in addition to any other penalty determined under this Act...

Under federal case law, "reasonable cause" includes taking a good faith position on a tax return. See I.R.C. Section 6664(c). In general, if there is an honest difference in opinion between the taxpayer and the IRS regarding the correct amount of tax, no penalty is imposed. As a result, no penalty would be imposed due to a deficiency arising from a good faith tax return position with regard to law or facts. see, Ireland v. Commissioner, 39 T.C. 978 (1987); Webble v. Commissioner, 54 T.C.M. 281 (1987); Balsamo v. Commissioner, 54 T.C.M. 608 (1987).

Taxpayer's position is that Section 502(e) applies to the throwback rule. There is, in fact, a Departmental regulation which is contrary to their position. Regulation Section 100.5270(b)(1)(B)[9]

[9] 86 Admin. Code ch. I, Sec. 100.5270(b)(1)(B).

requires a unitary group to apply the throwback rule on a single company basis. For the tax years ending January 31, 1988 through January 31, 1990[10], however, taxpayer's sole support for its theory is Finnigan II, which is a California administrative decision without precedential value. Since taxpayer failed to follow Departmental regulations, it has failed to meet its burden of proof to establish reasonable cause, and the Section 1005 penalty will stand for the years ended January 31, 1988 through January 31, 1990.

This regulation, however, was issued on February 21, 1986 with an effective date of November 3, 1986. For the tax year ending January 31, 1986, prior to the effective date of the regulation, I find that taxpayer's filing position was reasonable in light of the available authority and therefore the Section 1005 penalty is abated.

WHEREFORE, for the reasons stated above, it is my recommendation that the Notice of Deficiency should be affirmed with the following exceptions:

1. The Notice of Deficiency should be recalculated to exclude TAXPAYER Asales made to California for the tax year ended January 31, 1986 and TAXPAYER B sales made to Ohio and Pennsylvania for the tax years ended January 31, 1986 through January 31, 1991.

2. The Section 1005 penalty relating to the tax year ending January 31, 1986 is abated for reasonable cause.

Date:

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Linda K. Cliffel
Administrative Law Judge

[10] No penalty was imposed for the tax years ending January 31, 1987 and January 31, 1991.