IT 97-7
Tax Type: INCOME TAX
Issue: Throwback Sales (General)
Reasonable Cause Asserted On Application of Penalties

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

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

RECOMMENDATION FOR DISPOSITION

APPEARANCES: Marilyn A. Wethekam and Fred O. Marcus of Horwood, Marcus & Braun, for TAXPAYER; Robert C. Asbille, 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 June 30, 1990 and June 30, 1991. On June 30, 1994, the Department of Revenue issued a Notice of Deficiency for the year ended June 30, 1990 against the taxpayer for additional tax of $49,823 plus interest and Section 1005 penalty, and for the year ended June 31, 1991, additional tax of $140,077 plus interest and Section 1005 penalty.

TAXPAYER failed to protest this Notice of Deficiency and accordingly received a Notice and Demand for payment on December 16, 1994. On January 6, 1995, taxpayer made payment of all outstanding taxes, penalties and interest in the amount of $285,631 (which included interest and penalties calculated through 12/16/94) and filed amended returns requesting refund of the deficiencies it believed were improperly assessed. These claims for refund were denied by the Department on January 13, 1995, and TAXPAYER filed a timely protest on behalf of the TAXPAYER unitary group on February 3, 1995.

At issue is whether the Department has properly applied Section 304(a)(3)(B)(ii) of the Illinois Income Tax Act[1] which provides that sales originating in Illinois are thrown back for purposes of inclusion in the numerator of the sales factor where the taxpayer is not subject to taxation 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 calculation of interest and the imposition of Section 1005 penalties.

On consideration of these matters, it is recommended that the throwback issue be resolved in favor of the Department, the interest calculation issue be resolved in favor of the taxpayer, and that the penalty issue be resolved in favor of the Department for the tax year ended 6/30/90, and no penalty should have been imposed on the taxpayer for the tax year ended 6/30/91.

FINDINGS OF FACT:

[1] 35 **ILCS** 5/304(a)(3)(B)(ii).

1. TAXPAYER's ("TAXPAYER") principal business activity was the sale and distribution of laundry and cleaning products, personal care products, food products, and other miscellaneous products on a nationwide basis. (Stip. ¶2)[2]

2. 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. ¶22) During the years in issue the following companies comprised the TAXPAYER Business Group: The TAXPAYER Company, The TAXPAYER Manufacturing Company, The TAXPAYER Distributing Company, TAXPAYER Productions, Inc., The Company, Foods, Inc., The Company, The TAXPAYER Company, The TAXPAYER Company, The TAXPAYER Company, The TAXPAYER Company, The Manufacturing Company, International Inc., International Inc., Beverages. (Stip. ¶18, Ex. No. 7)

3. During the years at issue, the following related corporations were required to file returns and pay tax in Illinois: TAXPAYER, TAXPAYER Manufacturing Company, (collectively "TAXPAYER Business Group"). (Stip. ¶19)

4. TAXPAYER was the designated agent for the combined group for the years at issue. (Stip. ¶22)

5. TAXPAYER and other members of the TAXPAYER Business Group operated sales offices and distribution facilities in Illinois. All products in the distribution facilities were manufactured outside of Illinois. (Stip. ¶23)

[2] References to "Stip. ¶___" are to the Statement of Stipulated Facts executed by the Department and taxpayer on February 15, 1996 and entered into the record at hearing. References to "Ex. No. ___" are to the exhibits annexed to the Statement of Stipulated Facts.

6. For the years at issue, the Department determined that sales made by TAXPAYER, from their Illinois distribution facilities into states where TAXPAYER, respectively, 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. ¶30)

7. For the 1990 tax year, the Department threw back to Illinois the following sales: TAXPAYER, $2,014,546;, $450,157; 23,652,102; and, $262,999. (Stip. ¶31)

8. For the 1991 tax year, the Department threw back to Illinois the following sales: TAXPAYER, $1,372,005; $4,424,723; $38,427,892; and $239,308. (Stip. ¶32)

9. Taxpayer's original return for the year ended 6/30/91 was filed on 4/15/92, the extended due date, and showed a liability of $2,771,510. Taxpayer had made estimated and tentative tax payments of $3,115,600 prior to the due date of the return, 9/15/91. On its tax return, taxpayer requested that the overpayment be applied to the next fiscal year. (Tr. pp. 65-67; Ex. No. 1, Sched. P)

10. The Department has calculated interest on the proposed underpayment from the date of the first estimated tax payment for the next tax year, 10/15/91. (Tr. p. 67; Ex. No. 3)

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 states, 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. Certain members of the group 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 in the numerator of the sales factor made by a corporation over which the Franchise Tax Board had no taxing jurisdiction. 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."[3] 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)[4], 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.[5] According to Example

[3] 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).
[4] 86 Admin. Code ch. I, Sec. 100.5270(b)(1)(A).
[5] 86 Admin. Code ch. I, Sec. 100.5270(b)(1)(B).

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.

The same issue was 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 Electric v. Allphin, 68 Ill. 2d 326 (1977), 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)[6] 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 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

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

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 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), 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 an individual 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 which are not subject to Illinois taxation would be included in the apportionment factor so long as one member of the group has nexus with the State. 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 appropriate 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, and I recommend that the Notice of Deficiency be finalized, as issued, on the throwback issue.

2. Interest Calculation

The taxpayer also contests the Department's methodology in calculating interest. Taxpayer's original return for the year ended 6/30/91 was filed on 4/15/92, the extended due date, and showed a liability of $2,771,510. Taxpayer made estimated and tentative tax payments of $3,115,600 prior to the due date of the return, 9/15/91. On its tax return, taxpayer requested that the overpayment be applied to the next fiscal year. The overpayment was credited by the Department to the first quarter estimated tax payment of taxpayer for the next fiscal year. On audit, the Department assessed additional taxes of $140,077. The Department calculated interest on the proposed underpayment from the date of the first estimated tax payment, 10/15/91, the date to which the overpayment was applied. Taxpayer argues that interest should begin to run from 4/15/92, the date the tax return was filed and the overpayment was claimed.

Section 1003 of the Illinois Income Tax Act deals with interest on deficiencies. According to Section 1003(a), "[i]f any amount of tax imposed by this Act...is not paid on or before the date prescribed for payment of such tax (determined without regard to any extensions), interest...shall be paid for the period from such date to the date of payment of such amount...." On the original due date of the return, without regard to extensions, the taxpayer had paid in sufficient funds to cover the proposed deficiency assessed by the Department. Since the government had the use of the full $3,115,600 from the original due date of the return, which was in excess of the assessed liability of $2,771,510, there was no underpayment until the taxpayer filed its return showing the lower amount and requesting that the overpayment be applied to its estimated taxes for the next fiscal year.

Although this issue has not been addressed in Illinois, a number of courts have examined the IRS's imposition of interest in a like manner to the Department's interest application in this matter. All of the reported cases were held in favor of the taxpayer, that is, interest should only be calculated from the date the tax is both due and unpaid. ***See*** Kimberly-Clark Tissue Co. v. U.S., 97-1 USTC (CCH) ¶50,308 (E.D. Pa., 3/17/97); May Department Stores Co. v. U.S., 96-2 USTC (CCH) ¶50,596 (Ct. Cl. 1996); Sequa Corp. v. United States, 1996 U.S. Dist. LEXIS 5288 (S.D.N.Y., 4/22/96); Avon Products, Inc. v.

U.S., 588 F.2d 342 (2d Cir. 1978); Eagle-Picher Industries, Inc. v. U.S., 1979-1 USTC (CCH) ¶9255 (S.D. Ohio 1979). In Avon Products, Inc. v. U.S., 588 F.2d 342 (2d Cir. 1978), which involved a virtually identical fact pattern to that herein, the Court stated:

> During the three-month period in dispute, Avon had unquestionably paid enough - indeed, $17,000 more than enough - to satisfy its 1967 tax liability. Moreover, it is a clearly established principle that interest is not a penalty but is intended only to compensate the Government for delay in payment of the tax. [citations] Avon should not be required to pay interest for this period on a later-created deficiency unless the Internal Revenue Code compels such an extraordinary result. We do not believe it does.
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> The IRS would have us charge Avon interest under IRS §6601(a). That section provides: "If any amount of tax...is not paid on or before the last date prescribed for payment[7], interest on such amount...shall be paid for the period from such last date to the date paid." Manifestly, if we were to construe §6601(a) literally, it would not even be apposite to this case. Avon's full tax was in fact paid "on or before the last date prescribed for payment," June 15, and so the premise of the provision is undercut. Reading §6601(a) more broadly, it provides that interest shall begin running when a tax becomes both due and unpaid. Avon's 1967 taxes became due on June 15, 1968 and they were paid in full from that date until a deficiency was created on September 15. It is the latter date from which interest should run.

588 F.2d at 343.

Taxpayer cannot be required to pay interest on a deficiency at a time that no deficiency existed. No evidence was introduced which would indicate that taxpayer needed the overpayment to be applied to satisfy its first quarter estimated tax obligation for the 6/30/92 fiscal year, nor that taxpayer was attempting to receive a double

[7] This is the same language as is found in Section 1003 cited above.

benefit for its overpayment. Interest for the tax year ended 6/30/91, therefore, should have been computed from April 15, 1992, the date the return was filed.

3. Penalties

There are two issues regarding the imposition of the Section 1005 penalty. First, whether the taxpayer has established reasonable cause to abate the penalty, and second, whether the penalty was properly calculated for the year ended 6/30/91.

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, and this regulation was in effect at all pertinent times. Section 100.5270(b)(1)(B) requires that the throwback rule be applied on a single company basis. Indeed, taxpayer's Manager of Taxes testified that he was aware of the regulation (Tr. pp. 71-72), and yet chose not to follow it. The taxpayer has failed in its burden of proof to show reasonable cause sufficient to abate the Section 1005 penalty.

Regarding the proper imposition of the Section 1005 penalty to the tax year ending June 31, 1991, Section 1005(a) provides:

> If any amount of tax required to be shown on the 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 in the manner and at the rate prescribed by the Uniform Penalty and Interest Act.

Taxpayer has argued that since it had made sufficient estimated and tentative tax payments by the due date of the original return, 9/15/91, to pay in full the assessed deficiency, it has complied with the requirements of Section 1005(a) and no penalty should be imposed.

The Section 1005 penalty is imposed for failure to pay the tax which is required to be shown on the return. In this case, the taxpayer paid in full, by the original due date of the return, the tax shown on the return plus the deficiency assessed by the Department. Since taxpayer's payments were more than sufficient to cover the liability as assessed, there was no underpayment at the due date of the return, without regard to extensions, and therefore, no Section 1005 penalty may be imposed for the tax year ended 6/30/91 pursuant to the plain language of the statute.

WHEREFORE, for the reasons stated above, it is my recommendation that as to the throwback issue, taxpayer's claim is denied. Taxpayer's claim, however, is allowed for the decrease in interest for the tax year ended 6/30/91, in that it should be calculated from 4/15/92, and no Section 1005 penalty should be imposed for the tax year ended 6/30/91.

Date: ______________________________

Linda K. Cliffel
Administrative Law Judge