

**IT 09-10**

**Tax Type: Income Tax**

**Issue: IITA sec. 304 (d) (2) and Pipeline Transportation Miles**

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

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**THE DEPARTMENT OF REVENUE  
OF THE STATE OF ILLINOIS**

v.

**ABC PIPELINE  
CO., et al. AND XYZ  
TRANSMISSION CORP, et al.,  
Taxpayers**

**No. 06-IT-0001  
FEIN 00-0000000  
(ABC  
Pipeline Co., et al.)  
00-0000000  
(XYZ  
Transmission Corp.,  
et al.)  
Tax Years 1997 - 2000**

**Ted Sherrod  
Administrative Law Judge**

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**RECOMMENDATION FOR DISPOSITION**

**Appearances:** Special Assistant Attorneys General Rick Walton, Esq. and Brian Fliflet, Esq., on behalf of the Illinois Department of Revenue (“Department”); David Hughes, Esq. of Horwood Marcus and Berk Chartered, and Craig B. Fields, Esq. and Mitchell A. Newmark, Esq. of Morrison & Foerster LLP on behalf of ABC Pipeline Co. et al., and XYZ Transmission Corp. et al. (“taxpayers”).

**Synopsis:**

The instant case is before this administrative tribunal as a result of protests filed by ABC Pipeline Co., et al., and by XYZ Transmission Corp. et al., (“taxpayers”) to the

Department's Notices of Denial issued to them on November 4, 2005. The disputed issue raised in the taxpayers' protests is whether the Department properly included certain revenue miles attributable to the transportation of gas between origin and destination points outside of Illinois in apportioning income of the designated taxpayers and their affiliated group members to Illinois for the years 1997 through 2000. Specifically, the principal dispute involves the construction and interpretation of section 304(d)(2) of the Illinois Income Tax Act ("IITA"). The Department has concluded that the aforementioned revenue miles should be included in the numerator of the apportionment formula set forth in section 304(d)(2) of the IITA which measures the amount of revenue miles attributable to the transportation of gas in Illinois. The taxpayers dispute this conclusion. The taxpayers also argue that the Department should exclude these revenue miles from this numerator under its authority to use an alternative to the statutorily prescribed apportionment formula when it does not fairly represent the taxpayers' business activities in the state.

In lieu of a hearing, the parties have submitted a joint stipulation of facts ("Stip."), along with related exhibits. I am including in this recommendation findings of fact and conclusions of law based upon a review of the complete record and of briefs submitted by the parties in this matter. I recommend that the denial of the taxpayers' refund claims be finalized as issued.

**Findings of Fact:**

1. XXX Corporation ("XXX") was engaged in, among other activities, the receipt, transportation, storage and delivery of natural gas in various states, including Illinois, during the tax years ending December 31, 1997, December 31, 1998, December

31, 1999, December 31, 2000 and December 31, 2001 (the “Tax Years at Issue”). [Stip. ¶1].<sup>1</sup>

2. XXX was the parent company of XXX Capital Corporation during the Tax Years at Issue. [Stip. ¶2; Stip. Exhibits 4, 6].

3. During the Tax Years at Issue, three natural gas pipeline systems owned and operated by subsidiaries of XXX traversed the State of Illinois: the XYZ Transmission System, the MMM Gas Transmission System and the ABC System. [Stip. ¶3].

4. The three pipeline systems transported natural gas owned by others. [Stip. ¶4].

5. During tax years ending December 31, 1997 and December 31, 1998, ABC Pipeline Company (“ABC”) was engaged in the business of transporting natural gas by pipeline. Stip. Exhibits 8 through 11. ABC was a wholly-owned subsidiary of ZZZ Corporation, which was owned 100% by XXX Capital Corporation. [Stip. ¶5; Stip. Exhibits 5, 6].

6. The ABC natural gas pipeline system began in Kansas and terminated in Michigan. [Stip. ¶6].

7. During the Tax Years at Issue, XYZ Transmission Corporation (“XYZ”) was engaged in the business of transporting natural gas by pipeline. XYZ was a wholly-owned subsidiary of ZZZ Corporation. [Stip. ¶7; Stip. Exhibits 8 through 11].

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<sup>1</sup> Except as indicated by brackets, all Findings of Fact are *verbatim* recitations of stipulations agreed to by the parties.

8. The XYZ natural gas pipeline system began in Texas and terminated in New Jersey. [Stip. ¶8].

9. During the tax years ending December 31, 1997 and December 31, 1998, MMM Gas Company (“MMM”), a wholly-owned subsidiary of ABC, was engaged in the business of transporting natural gas by pipeline. [Stip. ¶9; Stip. Exhibits 6, 7].

10. The MMM natural gas pipeline system began in Texas and Louisiana and terminated in Michigan. [Stip. ¶10].

11. During the Tax Years at Issue, XXX’s transportation unitary business group (the “Transportation Group”) operated pipelines that transported natural gas. During tax years ending December 31, 1997 and December 31, 1998, ABC was the designated agent of a group of companies that comprised XXX’s Transportation Group. [Stip. ¶11; Stip. Exhibits 56, 57].

12. On March 29, 1999, XXX sold ABC and MMM to CCC Energy. As a result, XYZ replaced ABC as the designated agent of XXX’s Transportation Group. Thereafter, during tax years ending December 31, 1999 and December 31, 2000, XYZ was the designated agent of XXX’s Transportation Group. [Stip. ¶12; Stip. Exhibits 58, 59].

13. During tax years ending December 31, 1999, December 31, 2000, and December 31, 2001 XYZ was the designated agent of a group of companies that comprised XXX’s transportation unitary business group that operated pipelines that transported natural gas. [Stip. ¶13; Stip. Exhibits 58, 59].

14. On or about October 8, 1998, ABC, as designated agent for the Transportation Group, timely filed an IL-1120 for the taxable year ending December 31, 1997. [Stip. ¶16; Stip. Exhibit 57].

15. On or about October 12, 1999, ABC, as designated agent for the Transportation Group, timely filed an IL-1120 for the taxable year ending December 31, 1998. [Stip. ¶17; Stip. Exhibit 58].

16. ABC, as designated agent for the Transportation Group timely filed amended Illinois income tax returns on October 15, 2001 and October 15, 2002 for the 1997 and 1998 tax years, respectively, to exclude miles traveled by natural gas in pipelines through Illinois from the numerator of its apportionment factor where the gas neither originated nor terminated in Illinois and to claim refunds of tax paid previously for each tax year. The claims for refund claimed corrected amounts of tax due of \$258,827 and \$377,673 for 1997 and 1998, respectively, and requested refunds of the amounts paid in excess of the corrected amounts. [Stip. ¶18; Stip. Exhibits 60, 61].

17. On November 4, 2005, the [Department] issued a Notice of Denial to the Transportation Group for the claim for refund filed on October 15, 2001 for the taxable year ending December 31, 1997. The Department denied the claim in its entirety. [Stip. ¶19; Stip. Exhibit 1].

18. On November 4, 2005, the [Department] issued a Notice of Denial to the Transportation Group for the claim for refund filed on October 15, 2002 for the taxable year December 31, 1998. The Department denied the claim in its entirety. [Stip. ¶20; Stip. Exhibit 2].

19. On December 22, 2005, the Transportation Group timely protested the denial of the claims for the 1997 and 1998 taxable years. [Stip. ¶21].

20. XYZ was the designated agent for a group of corporations owned directly or indirectly by XXX Corporation that were engaged in a unitary pipeline transportation energy business (the “Transportation Group”) for the tax years ended December 31, 1999 and December 31, 2000. [Stip. ¶24].

21. On or about October 3, 2000, XYZ, as designated agent for the Transportation Group, timely filed an IL-1120 for the taxable year ending December 31, 1999. [Stip. ¶25; Stip. Exhibit 58].

22. On October 15, 2001, XYZ, as designated agent for the Transportation Group, timely filed an IL-1120 for the taxable year ending December 31, 2000. [Stip. ¶26; Stip. Exhibit 59].

23. On October 11, 2002, XYZ, as designated agent for the Transportation Group timely filed an IL-1120 for the taxable year ending December 31, 2001. [Stip. ¶27; Stip. Exhibit 63].

24. XYZ, as designated agent for the Transportation Group, timely filed amended Illinois income tax returns on March 18, 2003 for the 1999 and 2000 tax years to exclude miles traveled by natural gas in pipelines through Illinois from the numerator of its apportionment factor where the gas neither originated nor terminated in Illinois and to claim refunds of tax paid previously for each tax year. The claims for refund claimed corrected amounts of tax due of \$767,793 and \$6,356 for 1999 and 2000 respectively, and requested refunds of the amounts paid in excess of the corrected amounts. [Stip. ¶ 28; Stip. Exhibit 64, 65].

25. The Department audited XYZ for the taxable years ending December 31, 1999, December 31, 2000 and December 31, 2001. [Stip. ¶29].

26. As a result of the Department's audit of the tax year ending December 31, 2001, the Department determined that XYZ was entitled to an Illinois net loss in the amount of \$1,636,329. [Stip. ¶30; Stip. Exhibit 3].

27. On November 4, 2005, the [Department] issued a Notice of Denial to XYZ for the claims filed on March 18, 2003 for the taxable years ending December 31, 1999 and December 31, 2000 respectively. The Department denied the claims in their entirety. [Stip. ¶31; Stip. Exhibit 3].

28. The Notice of Denial dated November 4, 2005, also contained an invitation to XYZ to file a claim to increase the Illinois net loss for 2001 identified by the Department in its audit of the 1999, 2000 and 2001 tax years. [Stip. ¶32; Stip. Exhibit 3].

29. To protect its rights in the event the Department prevailed in the claim denials for 1999 and 2000, XYZ accepted the Department's claim invitation and timely filed an IL-1120-X for the tax year ending December 31, 2001 to claim the increased loss. In order to be certain that the increased Illinois net loss would not be forfeited, XYZ actually filed two identical amended returns for the tax year to claim the increased Illinois net loss. The first amended return was filed at the conclusion of the audit. The second identical amended return was filed upon receipt of the Notice of Denial and Claim Invitation dated November 4, 2005. [Stip. ¶33; Stip. Exhibit 66].

30. On October 10, 2005, concurrent with the filing of the first amended return for the December 31, 2001 tax year, XYZ timely filed an amended return for the tax year ending December 31, 1999 to carry back the Illinois net loss for the December

31, 2001 tax year. XYZ claimed a refund of income tax in the amount of \$119,439 for the taxable year ending December 31, 1999. [Stip. ¶34; Stip. Exhibit 67].

31. On December 22, 2005, XYZ timely protested the denial of the refund claims for the 1999 and 2000 taxable years. [Stip. ¶35].

32. On March 9, 2007, XYZ received a Notice of Denial from the Department for the October 10, 2005 claim for refund filed by the Transportation Group in the amount of \$119,439 for the taxable year ending December 31, 1999. [Stip. ¶36; Stip. Exhibit 68].

33. On May 7, 2007, XYZ timely protested the denial of the October 10, 2005 claim for refund for the taxable year ending December 31, 1999. [Stip. ¶37].

34. For the 1999, 2000 and 2001 tax years, the Transportation Group apportioned business income among Illinois and other states. [Stip. ¶38].

35. During tax years ending December 31, 1997 and December 31, 1998, a portion of ABC's natural gas pipeline was located in Illinois. [Stip. Exhibits 4, 5]. ABC operated and maintained the following miles of natural gas pipelines for the tax years identified below:

<u>Tax Year</u>	<u>Miles of Pipe in Illinois</u>	<u>Total Miles of Pipe</u>
12-31-1997	1,228.5	6,334.0

12-31-1998	1,228.5	6,335.7
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[Stip. ¶42; Stip. Exhibits 4, 5].

36. During tax years ending December 31, 1997 and December 31, 1998, a portion of MMM's natural gas pipeline was located in Illinois. [Stip. Exhibits 6, 7]. MMM operated and maintained the following miles of natural gas pipelines for the tax years identified below:

<u>Tax Year</u>	<u>Miles of Pipe in Illinois</u>	<u>Total Miles of Pipe</u>
12-31-1997	725.1	4,142.7
12-31-1998	725.1	4,070.9

[Stip. ¶43; Stip. Exhibits 6, 7].

37. During the Tax Years at Issue, a portion of XYZ's natural gas pipeline was located in and traveled through Illinois. [Stip. Exhibits 8 through 11]. XYZ operated and maintained the following miles of natural gas pipelines for the tax years identified below:

<u>Tax Year</u>	<u>Miles of Pipe in Illinois</u>	<u>Total Miles of Pipe</u>
12-31-1997	110.1	9,411.3
12-31-1998	110.1	9,220.5
12-31-1999	110.1	9,087.8
12-31-2000	110.1	8,981.7

[Stip. ¶44; Stip. Exhibits 8 through 11].

38. During the Tax Years at Issue, ABC, MMM and XYZ owned compressor stations in Illinois. Multiple engines were located at each compressor station. [Stip. ¶45; Stip. Exhibits 4 through 11].

39. During tax years ending December 31, 1997 and December 31, 1998, ABC owned and operated four compressor stations in Illinois. ABC's Illinois compressor stations (one at each location) were located in Anywhere, Anywhere2, Anywhere3, and Anywhere4, Illinois. [Stip. ¶46; Stip. Exhibits 4, 5].

40. ABC's four compressor stations located in Illinois operated the following number of natural gas fired engines during tax years ending December 31, 1997 and December 31, 1998:

- a. Anywhere, Illinois, 7 engines;
- b. Anywhere2, Illinois, 17 engines;
- c. Anywhere3, Illinois, 19 engines; and
- d. Anywhere4, Illinois, 6 engines.

[Stip. ¶47; Stip. Exhibits 4, 5].

41. During tax years ending December 31, 1997 and December 31, 1998, MMM owned three compressor stations in Illinois. MMM's Illinois compressor stations (one at each location) were located in Anywhere5, Anywhere6 and Anywhere3, Illinois. [Stip. ¶48; Stip. Exhibits 6, 7].

42. MMM's three compressor stations located in Illinois operated the following number of natural gas fired engines during tax years ending December 31, 1997 and December 31, 1998:

- a. Anywhere5, Illinois, 8 engines;
- b. Anywhere6, Illinois, 9 engines; and
- c. Anywhere3, Illinois, 5 engines.

[Stip. ¶49; Stip. Exhibits 6, 7].

43. During the Tax Years at Issue, XYZ owned two compressor stations in Illinois. XYZ's Illinois compressor stations (one at each location) were located in Anywhere7 and Anywhere8, Illinois. [Stip. ¶50; Stip. Exhibits 8 through 11].

44. XYZ's two compressor stations located in Illinois operated the following number of natural gas fired engines during the Tax Years at Issue:

- a. Anywhere7, Illinois, 7 engines; and
- b. Anywhere8, Illinois, 2 engines.

[Stip. ¶51; Stip. Exhibits 8 through 11].

45. The compressor station at Anywhere8, Illinois was idle during the Tax Years at Issue, but remained available if XYZ needed it. [Stip. ¶52; Stip. Exhibits 8 through 11].

46. The engines at the Transportation Group's compressor stations located in Illinois consumed natural gas drawn from the Group's pipelines in Illinois. [Stip. ¶53].

47. The compressor stations owned by ABC, MMM and XYZ located in Illinois were staffed twenty-four hours per day, 365 days per year. However, the compressor stations did not operate twenty-four hours per day. [Stip. ¶54].

48. The engines located at the compressor stations owned by the Transportation Group recompressed the natural gas in the pipelines to move the gas through the pipelines. [Stip. ¶55].

49. The natural gas could not move through the pipelines without the pressure generated by the compressor stations located in Illinois and in other states. [Stip. ¶56].

50. Under the Clean Air Act Permit Program (“CAAPP”), the Illinois EPA had the authority to issue CAAPP permits to the Transportation Group, under 415 ILCS 5/39.5(3). [Stip. ¶57].

51. The engines at the Illinois compressor stations owned by the Transportation Group emitted nitrogen oxides, a regulated pollutant under the Illinois Environmental Protection Act, 415 ILCS 5/1 *et seq.* [Stip. ¶58; Stip. Exhibits 12, 14 through 17].

52. During the Tax Years at Issue, ABC, XYZ and MMM could not legally operate the engines at the compressor stations located in Illinois without obtaining a CAAPP Permit from the Illinois Environmental Protection Agency (“Illinois EPA”). During the Tax Years at Issue, ABC, MMM and XYZ could not obtain a CAAPP Permit without submitting a CAAPP permit application to the Illinois EPA. [Stip. ¶59].

53. The Transportation Group held CAAPP Permits, issued by the Illinois EPA, for each of the compressor stations that it owned and operated in Illinois during the Tax Years at Issue. [Stip. ¶60].

54. Unless otherwise stated in the permit, a CAAPP Permit issued by the Illinois EPA for a source covered by the CAAPP expires five years after the date of issue, [See 415 ILCS 5/39.5(3)]. Stip. Exhibit 12. The Illinois EPA notified ABC, MMM and XYZ, in writing, that the CAAPP Permit for each Illinois compressor station was going to expire on the date set forth in the notice. [Stip. ¶61].

55. During the Tax Years at Issue, the Transportation Group was required, by 415 ILCS 5/39.5(5), to submit a construction application to the Illinois EPA to obtain a permit to construct engines or other equipment at the compressor stations located in Illinois or to modify the engines or equipment at the compressor stations located in Illinois if such modification was considered “construction” under the applicable statute. [Stip. ¶62. Stip. Exhibit 20 (Example of application that ABC submitted to the Illinois EPA to obtain a construction permit for one of the compressor stations (ID No. 167801AAA))].

56. On December 24, 1997, in response to ABC’s application for a construction permit (App. No. 97050141) to install a “clean burn” emission system at its compressor station in Anywhere, Illinois (ID No. 167801AAA), the Illinois EPA issued ABC a Permit Denial. [Stip. Exhibit 13]. Subsequently, ABC filed a petition with the Illinois Pollution Control Board asking that body to order the Illinois EPA to issue the requested construction permit. [Stip. ¶63].

57. Pursuant to the CAAPP Permit, the members of the Transportation Group, ABC, MMM and XYZ, were each required to designate, in writing, a corporate official as the responsible official for each compressor station located in Illinois. [(See 415 ILCS 5/39.3(1))]. The responsible official was required to sign each document (including reports) that the permittee was required to submit to the Illinois EPA. Stip. Exhibit 12. ABC, MMM and XYZ were required to notify the Illinois EPA, in writing, any time the responsible official changed. [Stip. ¶64].

58. The responsible official was required, among other things, to sign, under penalties of perjury, certain documents (e.g., semi-annual monitoring reports, compliance

certificate, etc.) that were filed with the Illinois EPA. [Stip. Exhibit 34 (examples of a semi-annual monitoring report), Stip. Exhibit 39 (Annual Compliance Certificate) and Stip. Exhibit 43 (Annual Emissions Report) that were signed by a responsible official and subsequently filed with the Illinois EPA. Stip. ¶65].

59. ABC, MMM and XYZ were required to file with the Illinois EPA a Prevention of Significant Deterioration Permit application to the Illinois EPA to obtain authorization to increase emissions of nitrogen oxides at their Illinois compressor stations. [Stip. ¶66].

60. On September 29, 1997, XYZ submitted a Supplemental CAAPP Permit application for its compressor station (ID No. 193807AAE) located at Anywhere7, Illinois. [Stip. ¶67; Stip. Exhibit 18].

61. In the event ABC, MMM or XYZ submitted an incomplete application in an attempt to obtain either a construction permit or a CAAPP Permit, the Illinois EPA issued the applicant a Request for Additional Information if the application was incomplete. Stip. Exhibit 22. [Correspondence], dated April 9, 1997 [see Stip. Exhibit 23] is an example of a Request for Additional Information that the Illinois EPA issued in response to ABC's Application No. 95120063 that ABC submitted to obtain a CAAPP Permit for its compressor station (ID No. 137867AAA) located at Anywhere4, Illinois. On June 27, 1997, ABC responded to the Illinois EPA's Request for Additional Information. Stip. Exhibit 25. On June 18, 1997, the Illinois EPA issued a Notice of Incompleteness to ABC in response to a construction permit application (App. No. 167801AAA) that ABC submitted to the Illinois EPA for its compressor station (ID No.

97050141) located in Anywhere, Illinois. [Stip. Exhibit 22]. On September 10, 1997, ABC submitted a response to the Illinois EPA. [Stip. ¶68; Stip. Exhibit 55].

62. On June 18, 1998, in response to application No. 95120040, the Illinois EPA issued CAAPP Permit (ID No. 193807AAE) to XYZ for its compressor station located at Anywhere7, Illinois. The CAAPP Permit applied to the period beginning June 18, 1998 and ending June 18, 2003. [Stip. ¶69; Stip. Exhibit 12].

63. On May 19, 1997, ABC submitted a Supplement CAAPP Permit application to the Illinois EPA to obtain a CAAPP Permit for its compressor station located in Anywhere4, Illinois (ID No. 137867AAA). [Stip. ¶70; Stip. Exhibit 17].

64. On April 4, and September 3, 1997, ABC sent the Illinois EPA a letter commenting on the draft of the CAAPP Permit (App. No. 95120052) for ABC's compressor station located at Anywhere2, Illinois (ID No. 149820AAB). [Stip. ¶71; Stip. Exhibits 26, 27].

65. On April 4, 1997, ABC submitted comments to the Illinois EPA regarding a preliminary draft of a CAAPP Permit for the compressor station (ID No. 149820AAB) located at Anywhere2, Illinois. [Stip. ¶72; Stip. Exhibit 27].

66. On June 18, 1998, in response to permit application No. 95120063, the Illinois EPA issued ABC a CAAPP Permit (ID. No. 137867AAA) for its compressor station located at Anywhere4, Illinois for the period beginning June 18, 1998 and ending June 18, 2003. [Stip. ¶73; Stip. Exhibit 12].

67. On August 28, 1997, ABC submitted a letter to provide additional information and comments concerning the preliminary draft CAAPP Permit for the

compressor station (ID No. 137867AAA) located at Anywhere4, Illinois. [Stip. ¶74; Stip. Exhibit 29].

68. In a letter dated August 29, 1997, XYZ submitted comments to the Illinois EPA regarding the draft CAAPP Permit (No. 95120040) for the Anywhere7 compressor station (ID No. 193807AAE). [Stip. ¶75; Stip. Exhibit 30].

69. On March 20, 1997, the Illinois EPA issued ABC a Violation Notice (A-1997-000999) because ABC's compressor station located at Anywhere, Illinois exceeded the emissions limits necessary to avoid application of the federal rule pertaining to the Prevention of Significant Deterioration of air quality. [Stip. ¶76; Stip. Exhibit 28].

70. On May 15, 1997, ABC filed a Proposed Compliance Commitment Agreement Notice with the Illinois EPA in response to Violation Notice A-1997-000999 regarding the compressor station located at Anywhere, Illinois. [Stip. ¶77; Stip. Exhibit 28].

71. The members of the Transportation Group owned the land, in fee simple, on which its compressor stations in Illinois were located during the Tax Years at Issue. [Stip. ¶78].

72. During the Tax Years at Issue, the Transportation Group's pipelines in Illinois were located on land for which the Group had obtained permanent easements. The members of the Group purchased the permanent easements directly from landowners. The pipelines were located underground along the right-of-way for which the Group had purchased the permanent easements. [Stip. ¶79].

73. During the Tax Years at Issue, the members of the Transportation Group each employed an individual at each compressor station referred to as an area supervisor.

The area supervisor was responsible for, among other things, the operation and maintenance of his/her assigned geographic portion of the pipeline system, which included a compressor station and a segment of the pipeline on both sides of a particular compressor station. An area supervisor was also responsible for personnel matters and managing a budget. [Stip. ¶80].

74. During tax years ending December 31, 1997 and December 31, 1998, ABC reported to the Illinois Department of Employment Security (“IDES”) that it employed between 79 and 88 individuals per quarter in Illinois. [Stip. ¶81; Stip. Exhibits 50, 51].

75. ABC reported wages in the amount of \$1,064,379.92 to \$1,260,167.10 to IDES as the combined wages it paid to its Illinois employees during tax years ending December 31, 1997 and December 31, 1998. [Stip ¶82; Stip. Exhibits 50, 51].

76. During the first three quarters of 1997, the first quarter of 1998 and the fourth quarter of 1998, XYZ reported to IDES that it employed between 17 and 19 individuals per quarter in Illinois. [Stip. ¶83; Stip. Exhibit 52].

77. XYZ reported wages in the range of \$256,113.79 to \$295,972.91 per quarter to IDES as the combined wages it paid to its Illinois employees for the first three quarters of 1997, the first quarter of 1998 and the fourth quarter of 1998. [Stip. ¶84; Stip. Exhibit 52].

78. During the tax years ending December 31, 1997 and December 31, 1998, MMM employed approximately 58 individuals per year in Illinois. Stip. Exhibits 48, 49. During the tax years ending December 31, 1997 and December 31, 1998, the average

quarterly wages that MMM paid each of its Illinois employees was comparable to the average quarterly wages that ABC and XYZ paid to their Illinois employees. [Stip. ¶85].

79. During the Tax Years at Issue the Illinois EPA conducted Tier II and Tier III inspections of the Transportation Group's compressor stations located in Illinois. The Illinois EPA issued reports of the inspections. [Stip. Exhibits 16, 46, 47]. The purpose of the inspections was to determine compliance with emission and operating permit conditions. [Stip. ¶86].

80. The members of the Transportation Group were required to prepare and file a Semi-Annual Monitoring Report with the Illinois EPA for each compressor station located in Illinois. [Stip. ¶87; Stip. Exhibits 33 through 38].

81. Pursuant to the terms of the CAAPP Permit, the members of the Transportation Group were required to file an Annual Compliance Certification with the Illinois EPA for each compressor station located in Illinois. In the Compliance Certification, ABC, MMM and XYZ were required to state whether they were in compliance with all terms and conditions contained in the CAAPP Permit, the compliance status, whether that compliance status was continuous or intermittent, and the method used to determine compliance status. [Stip. ¶88; Stip Exhibits 39 through 41].

82. As provided for in the Illinois Environmental Protection Act (415 ILCS 5/31(a)(1)), the Illinois EPA had the authority to issue a permit holder a Non-Compliance Advisory letter, which notified a permit holder (either a construction permit holder or a CAAPP Permit holder) of a violation of the Illinois Environmental Protection Act and the accompanying regulations. [Stip. ¶89].

83. The members of the Transportation Group submitted annual emissions reports to the Illinois EPA for each of its Illinois compressor stations for the Tax Years at Issue. [Stip. ¶90; Stip. Exhibit 9].

84. During the Tax Years at Issue, the members of the Transportation Group conducted general inspections of its pipelines, including the portion of the pipeline located within the geographic borders of Illinois. [Stip. ¶91].

85. During the Tax Years at Issue, the members of the Transportation Group conducted cathodic protection tests of their pipelines, including the portions of the pipelines located within Illinois, to ensure that the pipelines were adequately protected from corrosion to avoid rusting, leaking or general degradation of the pipelines. [Stip. ¶92].

86. During the Tax Years at Issue, the members of the Transportation Group conducted aerial patrol inspections of their pipelines and the pipeline right-of-way, including the portions of the pipelines and pipeline rights-of-way located in Illinois, to identify and detect evidence of any third-party activity along the pipelines and to protect the pipelines and the pipeline right-of-way from third-party damage such as excavation or similar activities that could threaten the safe operation of the pipelines. During the relevant tax years, a XXX pilot conducted the aerial patrol inspections. [Stip. ¶93].

87. During the Tax Years at Issue, the area supervisors for ABC, MMM and XYZ were responsible for investigating all reports of unauthorized activities (as identified in the aerial patrol inspections) along the portions of the pipelines under their jurisdiction by sending employees, located in Illinois who reported to the area

supervisors, to the site of the unauthorized activity to conduct on-site visual inspections. [Stip. ¶94].

**Stipulations Concerning Issues Presented in this Case**

88. The issue presented in this case is whether miles traveled by natural gas transported in pipelines through Illinois constitute revenue miles in the state that are includible in the numerator of the Transportation Group's Illinois apportionment factor where the gas neither originates nor terminates in Illinois. [Stip. ¶14].

89. If it is determined that natural gas traveling in pipelines through Illinois that neither originates nor terminates in Illinois is includible in the numerator of the Transportation Group's Illinois apportionment formula, then the issue is whether such revenue miles are excludible from the numerator of XYZ's apportionment formula under an alternative method of apportionment. [Stip. ¶15].

90. The parties agree that if this Tribunal adopts the [taxpayers'] position that the miles traveled by natural gas transported in pipelines through Illinois do not constitute revenue miles in the state that are includible in the numerator of ABC's Illinois apportionment factor where the gas neither originates nor terminates in Illinois, the Notice of Denial will be reversed and the claims filed on October 15, 2001 and October 15, 2002, will be processed by the Department taking into consideration any other necessary adjustments such as for federal RARs and offsets as provided under the law that are timely asserted by the Department. [Stip. ¶22; Stip. Exhibits 60, 61].

91. The parties further agree that if this Tribunal or court upon review adopts the Department's position that miles traveled by natural gas transported in pipelines through Illinois that neither originates nor terminates in Illinois constitute revenue miles

in the state that are includible in the numerator of ABC's apportionment factor, and this Tribunal is not reversed on appeal, ABC is not entitled to refunds of tax for 1997 and 1998, unless this Tribunal concludes that such revenue miles are excludible from the numerator of the taxpayers' apportionment formula under an alternative method of apportionment. [Stip. ¶23].

92. The parties agree that if this Tribunal adopts the [taxpayers'] position that the miles traveled by natural gas transported in pipelines through Illinois do not constitute revenue miles in the state that are includable in the numerator of XYZ's Illinois apportionment factor where the gas neither originates nor terminates in Illinois, the Notice of Denial will be reversed and the claims for refund for tax years ending December 31, 1999 and December 31, 2000 filed by XYZ on March 18, 2003, will be processed by the Department taking into account any other necessary adjustments such as for federal RARs and any offsets as provided under the law that are timely asserted by the Department. [Stip. ¶39; Stip. Exhibit 64].

93. The parties agree that if this Tribunal or court upon review adopts the Department's position that the miles traveled by natural gas transported in pipelines through Illinois that neither originates nor terminates in Illinois constitute revenue miles in the state that are includible in the numerator of the Transportation Group's Illinois apportionment factor and the Tribunal is not reversed on appeal, XYZ is not entitled to the reductions in the Group's sales factor and refunds of tax for 1999 and 2000 as claimed on the Group's amended returns filed on March 18, 2003, unless this Tribunal concludes that such revenue miles are excludible from the numerator of the taxpayer's

apportionment formula under an alternative method of apportionment. [Stip. ¶40; Stip. Exhibit 64].

94. The parties further agree that if this Tribunal adopts the Department's position as to the miles to be includible in the numerator of the Transportation Group's apportionment formula, and if this Tribunal also does not conclude that such revenue miles are excludible from the numerator of the taxpayers' apportionment formula under an alternative method of apportionment, the Transportation Group is entitled to the increased Illinois net loss identified for the tax year ending December 31, 2001 and the Transportation Group is entitled to the refund of tax for the tax year ending December 31, 1999 resulting from the carryback of the 2001 Illinois net loss subject to adjustments for federal RAR and offsets as provided under the law that are timely asserted by the Department. [Stip. ¶41; Stip. Exhibit 66]

## **Conclusions of Law:**

### **I. Overview of Statutory Framework**

When a corporation conducts business in more than one state, it must be determined how much income is derived from each of the states where business is transacted. Under the apportionment methods contained in Article 3 of the Illinois Income Tax Act ("IITA"), formulas are used to compute the percentage of a corporation's business conducted in the State of Illinois. 35 ILCS 5/304(a)-5/304(h). Consistent with the Uniform Division of Income for Tax Purposes Act, the uniform act upon which the IITA is based (see Citizens Utilities Company v. Department of Revenue, 111 Ill. 2d 32, 41-42 (1986)), a fraction consisting of an Illinois numerator and an

everywhere denominator is calculated and multiplied by the corporation's total taxable business income in order to determine the portion of taxable income earned within the state.

Apportionment does not increase or decrease the tax base (total taxable income). It is a method of calculation for determining what portion of that income was earned in each of the states in which the taxpayer transacts business. The Illinois Supreme Court has previously determined the General Assembly's intent behind these apportionment formulas as follows:

[t]he purpose of the uniform act and article 3 of the Illinois act is to assure that 100%, and no more or no less, of the business income of a corporation doing a multistate business is taxed by the states having jurisdiction to tax it.

GTE Automatic Electric, Inc. v. Allphin, 68 Ill. 2d 326, 335 (1977).

Generally, section 304(a) of the IITA, as in effect during the tax years in controversy, directs that multistate corporations doing business in Illinois must apply a three factor apportionment formula, based on property, payroll, and sales when apportioning business income to the State of Illinois. The General Assembly has provided for special apportionment formulas for corporations in the insurance, financial, and transportation businesses to use in apportioning income. 35 ILCS 5/304(b)-5/304(d).

The taxpayers, an affiliated group of corporations having as its designated agent ABC Pipeline Co. ("ABC") and an affiliated group of corporations having as its designated agent XYZ Transmission Corporation ("XYZ"), during the years at issue in this case, were furnishing gas pipeline transportation services and were, therefore,

required to apportion their business income using the special apportionment formula in section 304(d) of the IITA.<sup>2</sup> The apportionment formula for transportation service companies in section 304(d) uses a fraction based upon revenue miles.

Section 304(d)(2) of the IITA, 35 ILCS 5/304(d)(2) (“section 304(d)(2)”) provides in part as follows:

...business income derived from transportation by pipeline shall be apportioned to this State by multiplying such income by a fraction, the numerator of which is the revenue miles of the person in this State and the denominator of which is the revenue miles of the person everywhere. (emphasis added)  
35 ILCS 5/304(d)(2)

Section 304(d)(2) defines a “revenue mile” as follows:

...the transportation by pipeline of ... 1,000 cubic feet of gas ... the distance of 1 mile for consideration.  
*Id.*

The principal dispute in this case concerns whether the language “revenue miles ... in this State” (emphasis added) includes Illinois revenue miles attributable to gas transported by pipeline through Illinois that neither originates nor terminates in Illinois (“interstate flow-through miles”).

Both parties agree that the taxpayers are required to apportion their business income to Illinois under section 304(d)(2). However the taxpayers and the Department reach opposite results as to how the statutory language should be construed. The taxpayers argue that interstate flow-through miles are not revenue miles “in this State”

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<sup>2</sup> Members of a combined group treated as a single taxpayer for Illinois tax purposes must designate the group’s controlling corporation (i.e., the corporation that owns a controlling interest in all of the other members of the group) as the group’s agent for Illinois tax reporting and compliance purposes. If the controlling corporation is not a member of the Illinois combined group, the group must designate an Illinois taxpayer member as the group’s agent. 86 Ill. Admin. Code, ch. I, section 100.5220.

under section 304(d)(2) and, therefore, are not included in the calculation of revenue miles attributable to Illinois and includable in the apportionment factor numerator of the state's apportionment formula pursuant to this section. Taxpayer's Post-Trial Brief ("Taxpayers' Brief") pp. 8-14.<sup>3</sup>

## **II. Meaning of Section 304(d)(2)**

The taxpayers' construction of section 304(d)(2) is that the phrase "in this State" contained in this section distinguishes between revenue miles directly related to income derived from Illinois sources that are includable in the numerator of the transportation company apportionment formula and interstate flow-through miles which are not. Taxpayers' Brief pp. 8-14. They contend that income is directly related to Illinois sources only when it is derived from transporting gas to and from points within this state. *Id.* Where they are paid for transporting gas from points outside of Illinois to other points outside of Illinois they contend that the revenues derived from this activity must not be included in the numerator of the Illinois apportionment formula. *Id.*

The taxpayers deduce their construction of section 304(d)(2) from the Illinois Supreme Court's admonition that the taxation of business income be confined "to that portion ... [of income]... which is attributable to activities in Illinois." Caterpillar Tractor Co. v. Lenckos, 84 Ill. 2d 102, 123 (1981). In Northwest Airlines, Inc. v. Department of Revenue, 295 Ill. App. 3d 889 (1<sup>st</sup> Dist. 1998), the Illinois appellate court

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<sup>3</sup>The taxpayers have designated the group of affiliated corporations engaged in gas transportation in Illinois during the Tax Years at Issue as the "Transportation Group" or "Taxpayer." Taxpayers' Brief p. 1. Because the "Transportation Group" consisted of two different unitary business groups during the Tax Years at Issue, I have designated the members of this group "taxpayers" in my Findings of Fact and Conclusions of Law contained herein.

held that Illinois lacked sufficient nexus with the transactions it sought to include in the numerator of the apportionment formula in determining the transportation miles of a passenger airline, namely flights over Illinois that neither originated nor terminated in the state. The taxpayers contend that the facts and applicable law in the instant case and in Northwest Airlines are identical. Taxpayers' Reply Brief, p. 10 ("The Appellate Court's decision in *Northwest Airlines, Inc. v. Department of Revenue*, 295 Ill. App. 3d 889, 892-94 ... (1<sup>st</sup> Dist.), *appeal denied*, 179 Ill. 2d 589 ... (1998), interprets the relevant statutory language and the constitutional issues surrounding revenue miles that neither originate nor terminate in Illinois and holds that such revenue miles are *not* included in the numerator of the apportionment formula."). Accordingly, they conclude that the decision reached in Northwest "mandates the same result in this case that section 304(d) cannot be read to include interstate flow-through miles in the numerator of the apportionment formula." Taxpayers' Brief p. 14.

The court's holding in Northwest does not address the question whether Illinois had sufficient nexus with Northwest to impose tax since nexus for purposes of taxation was conceded by the taxpayer in this case. Rather, the issue presented in this case was whether there was a sufficient connection between flyovers involving flights that neither originate nor terminate in Illinois and the state to include these flyover miles in measuring the amount of tax due the state. Northwest, *supra* at 894. ("Although the Department maintains that the nexus requirement is satisfied where the corporation avails itself of the privilege of carrying on business in this state, GTE plainly requires something more, i.e., there must be nexus with the Illinois transaction by which the tax is measured."). The court enumerates the factual basis for its holding that there was

insufficient physical or economic connections between these flyovers and Illinois to include them in determining the amount of tax due, stating as follows:

Unlike the GTE case, the record before this court amply demonstrates that the nexus requirement cannot be satisfied. Flight plans for overflights are not filed with any Illinois state or municipal authorities. There are no voice communications with overflights, and such flights make no use of Illinois facilities, services, or employees. There exists no physical contact between overflights and this state, or any economic connection. We do not find the mere possibility that an overflight might avail itself of services and facilities in this state in the event of an unscheduled landing sufficient to establish nexus.” *Id.*

The court notes that the taxpayer had facilities in Illinois and serviced aircraft and passengers in this state. *Id.* However, the court reached its determination to exclude flyover miles because it found no connection between these in-state operations and flights over the state that neither originated nor terminated in Illinois. *Id.*

Unlike the situation in Northwest, the facts in the instant case do not support a finding that there was no physical or economic connection between the flow-through miles at issue in this case and Illinois. This is plainly evident from the salient facts stipulated by the parties. Specifically:

1. During the Tax Years at Issue, one sixth of the taxpayers’ total natural gas pipeline mileage through which gas generating flow-through miles passed was located in Illinois. Stip. ¶¶ 42-44. During the Tax Years at Issue, the taxpayers’ pipelines in Illinois were located on land for which the taxpayers had obtained permanent easements directly from landowners. The pipelines were located underground along the right-of-way for which the taxpayers had purchased the permanent easements. Stip. ¶79.

2. The taxpayers owned a total of 80 compressor engines that were housed in compressor stations located in Anywhere, Anywhere<sup>2</sup>, Anywhere<sup>3</sup>, Anywhere<sup>4</sup>, Anywhere<sup>5</sup>, Anywhere<sup>6</sup>, Anywhere<sup>3</sup>, Anywhere<sup>7</sup> and Anywhere<sup>8</sup>, Illinois.<sup>4</sup> Stip. ¶¶ 45-56. The engines located at the compressor stations owned by the taxpayers recompressed the natural gas in the pipelines to move the gas through the pipelines. Stip. ¶55. Natural gas could not move through the pipelines without pressure generated by the engines at these compressor stations. Stip. ¶56. These engines consumed natural gas drawn from the taxpayers' pipelines in Illinois. Stip. ¶53.
3. The compressor stations owned by the taxpayers were located in Illinois and staffed twenty-four hours a day 365 days a year. Stip. ¶54.
4. The taxpayers owned the land, in fee simple, on which the compressor stations in Illinois were located during the Tax Years at Issue. Stip. ¶78.
5. During a portion of the Tax Years at Issue, 1997 and 1998, ABC reported to the Illinois Department of Employment Security ("IDES") that it employed between 79 and 88 individuals per quarter in Illinois. Stip. Exhibits 50, 51. During the first three quarters of 1997, the first quarter of 1998 and the fourth quarter of 1998, XYZ reported to the IDES that it employed between 17 and 19 individuals per quarter in Illinois. Stip. Exhibit 52. During a portion of the Tax Years at Issue, 1997 and 1998, ABC reported wages paid to Illinois employees of between \$1,064,379.92 and \$1,260,167.10 to the IDES during this period. Stip. ¶82. XYZ

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<sup>4</sup> Only two of these compressor engines, located at Lick Creek, Illinois, were idle during the Tax Years at Issue. Stip. ¶52.

reported wages in the range of \$256,113.79 to \$295,972.91 per quarter to the IDES as the combined wages it paid to its Illinois employees for the first three quarters of 1997, the first quarter of 1998 and the fourth quarter of 1998. Stip. ¶84. The average quarterly wages that MMM paid each of its Illinois employees during this period was comparable to the average quarterly wages that ABC and XYZ paid to their Illinois employees. Stip. ¶85.

As the foregoing clearly indicates, unlike Northwest, where there was no evidence of physical or economic contact between overflights that neither originated nor terminated in Illinois, the record in this case is replete with evidence of physical and economic contacts between Illinois and the flow-through miles the state seeks to include in the numerator of the taxpayers' apportionment formula.

In sum, the taxpayers' analysis overlooks the obvious factual differences between an air carrier transporting over a state and having no physical contact with the state, and transportation through pipelines that are physically in the state using power generated by engines that are physically in the state and operated by employees in this state with the presence of both the equipment and employees necessary for the transportation of the product through Illinois. The court's holding in Northwest, that Illinois lacked sufficient physical contact with flights above the state to include them in the calculation of Northwest's Illinois income tax, is premised upon the obvious fact that such flights never touched the ground in Illinois. Northwest, *supra* at 894 ("There exist no physical contacts between overflights and this state ... [.]"). In stark contrast, transportation by gas pipeline flows through pipelines that are privately owned parts of the state's

infrastructure. Stip. ¶¶3, ¶¶42-63.<sup>5</sup> This infrastructure is clearly “in” this state under any commonly understood meaning of the term “in.” If the infrastructure used to transport gas through Illinois is “in” this state, it is difficult to conceive of how gas flowing through this infrastructure could not be.

Moreover, unlike aircraft passing overhead, the propulsion of gas through these pipelines requires the direct application of power sources such as pumps and other devices operated by the taxpayers that are physically affixed to and situated on land owned by the taxpayers throughout the state. Stip. ¶¶45-56. Accordingly, the court’s finding that Illinois lacked any physical and economic contact with Northwest’s overflights is premised upon the absence of any of the types of tangible physical and economic connections between these flights and the taxing state that are, in contrast, clearly present where gas flows through pipelines that are located in the state using power generated by engines located in compressor stations that are in this state. Indeed, the court in Northwest acknowledges the limited applicability of its precedent to facts and circumstances other than the unique situation the court in that case addresses, stating as follows:

To the extent there is some uncertainty as to what constitutes sufficient nexus, we need not reach that issue, as here there is a total absence of any nexus between the overflights and this state.  
Northwest, *supra* at 894.

In Northwest the court held that Illinois lacked a sufficient nexus with flights over Illinois that did not originate or terminate in Illinois to include them in the numerator of

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<sup>5</sup> The on-line encyclopedia Wikipedia defines “infrastructure” as “the basic physical and organization structures need for the operation of ... [an] enterprise” and lists natural gas pipelines as an example of an “Energy infrastructure.” See Infrastructure – Wikipedia, the free encyclopedia, available at <http://en.wikipedia.org/wiki/Infrastructure> (last visited July 23, 2009).

Northwest's apportionment formula. The taxpayers herein cite a number of contacts between Northwest and Illinois which they contend might have supported a different conclusion. These include Northwest's extensive operations in Illinois and the fact that the company was subject to the state's taxes and fees. Taxpayers' Brief pp. 12-14. In spite of these connections the court in Northwest held that its flyover miles were not includable in that taxpayer's apportionment formula numerator. These same connections, they note, exist between the taxpayers in this case and Illinois and, for this reason, they contend that the Northwest precedent is indistinguishable from the present case. Taxpayers' Brief pp. 13, 14. However, the court in Northwest makes it clear that the aforementioned connections had nothing to do with the conclusion it reached. The court was well aware of Northwest's in-state operations in Illinois (Northwest, *supra* at 890) but considered them to be irrelevant and unrelated to Northwest's flyover miles which it determined had nothing to do with the state. *Id.* at 894.

As noted above, unlike the non-existent connection between flyover miles and Illinois that forms the basis of the court's holding in Northwest, there are numerous connections between the interstate flow-through miles at issue in this case and Illinois. These connections arise from the fact that, as pointed out above, gas flowing through this state utilizes the taxpayer's in-state infrastructure. Taxpayers must actively execute affirmative acts with respect to their transport of gas in Illinois so that the gas will continue to move from state of origin to state of final delivery. Moreover, the movement of gas through this state requires the attention of numerous members of the taxpayers' in-state workforce. See Stip. ¶¶80-85. This workforce operated compressor engines and other equipment that were absolutely necessary to move gas through pipelines.

Taxpayer's Illinois workforce also monitored the environment for harmful emissions of gas related chemicals to insure compliance with state environmental protection laws, investigated reports of unauthorized activities along pipelines in Illinois, and conducted general inspections and testing of pipelines in Illinois for corrosion, rusting, leaking and general degradation. Stip. ¶¶ 57-77, 86-94.<sup>6</sup> In this respect, the facts at issue in this case and those presented in Northwest are completely distinguishable. For the foregoing reasons, I do not find persuasive the taxpayers' claim that the Northwest case is precedent for its conclusion that the numerator of the transportation formula enumerated at section 304(d)(2) does not include interstate flow-through miles.

The taxpayers further argue that their interstate flow-through miles cannot be included in the numerator of their apportionment formula because these revenue miles "generate no income to the Taxpayer from furnishing transportation services in this State and, thus, cannot be included in the numerator of the apportionment formula." Taxpayers' Brief p. 10. The record in this case does not support the taxpayers' claim that they derived no income that can be attributed to Illinois from transporting gas from points of origin outside the state to points of termination outside the state. The record clearly indicates that the taxpayers were compensated for all of the gas transportation services they performed including those involving the transit of gas through the state that

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<sup>6</sup> Because the taxpayers' activities involved the emission of regulated pollutants, every detail of the taxpayers' operations including planning, construction and maintenance of equipment and facilities, and the taxpayers' day-to-day operations were closely regulated and routinely inspected by the Illinois Environmental Protection Agency ("EPA"). Stip. ¶¶ 57-78, 86-94. The taxpayers were required to obtain permits and certificates and prepare and submit (under penalty of perjury) compliance reports with the EPA in Illinois in order to conduct business operations in this state. *Id.*

is neither shipped from nor delivered in Illinois. Stip. ¶¶1-11, 16-28.<sup>7</sup> To reach the conclusion the taxpayers aver, I would have to find that the taxpayers' compensation for moving gas through the state must be sourced to the location where the gas is either shipped from or delivered to. The taxpayers have cited no case having precedent status or any other authority in support of this claim. While there are sales tax and telecommunications tax cases that have endorsed this view (see Goldberg v. Sweet, 488 U.S. 252 (1989); Oklahoma Tax Commission v. Jefferson Lines, Inc., 514 U.S. 175 (1995)), I am aware of no income tax decision that can be cited for this position.

In the absence of any precedential authority supporting the taxpayers' claim, I find that I cannot accept it as a basis for concluding that section 304(d)(2) must be read in the manner the taxpayers contend.<sup>8</sup>

The taxpayers also note the following:

\*\*\*New subsections 304(d)(3) and (d)(4) were added by P.A. 95-233 and then amended by P.A. 95-707. Both sets of amendments were passed by the General Assembly and signed into law in 2007. They expressly apply only to tax years ending on or after December 31,

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<sup>7</sup> For purposes of computing the apportionment formula prescribed by section 304(d)(2), a "revenue mile" is defined as "...the transportation by pipeline of ... 1,000 feet of gas ... the distance of 1 mile for consideration." Given this definition, I find that the taxpayers' inclusion of interstate flow-through miles in the numerator and denominator of the taxpayers' apportionment formula on their original returns for the Tax Years at Issue (see Stip. ¶¶16-18, 21, 22, 24) and in the denominator of their amended returns filed for these years to be an admission that they were compensated for this type of transportation through the state.

<sup>8</sup> Illinois Supreme Court Rule 23(e) provides as follows: "An unpublished order of the court is not precedential and may not be cited by any party except to support contentions of double jeopardy, *res judicata*, collateral estoppel or law of the case." IL ST. S. CT. Rule 23(e). While the taxpayers have also discussed the court's ruling in Erievue Cartage, Inc. v. Department of Revenue, 278 Ill. App. 3d 1123 (1<sup>st</sup> Dist. 1996), a Rule 23 decision, in support of their position, this case cannot be cited by this tribunal as binding judicial precedent in the instant case. Accordingly, this case is provided, and accepted by this tribunal, only as an elaboration upon the reasoning enumerated in taxpayers' brief in support of their contention that section 304(d)(2) does not authorize the inclusion of interstate flow-through miles in the numerator of the taxpayers' gas pipeline transportation apportionment formula. For the reasons enumerated above, I do not agree with the taxpayers' reasoning and, therefore, do not agree that section 304(d)(2) can be read in the manner the taxpayers advocate.

2008. Old Section 304(d)(2), which applies to the Tax Years at Issue, was kept completely intact.

New subsection 304(d)(3) substantively changes the apportionment formula for pipeline transportation companies. This change consists of the inclusion of the Illinois flow-through miles portion of interstate shipments in the numerator of the apportionment formula. New subsection (d)(3) provides that the numerator of the apportionment formula consists of the sum of: (1) all receipts from intrastate shipments ... ; and (2) a pro rata portion of the receipts from interstate shipments measured by miles traveled in Illinois (304(d)(3)(a)(ii)).

A review of the plain language of the amendments to Section 304(d) makes it clear that ... the legislature intended a substantive change in the way transportation companies apportion business income. Generally, a significant change in the language of a statute creates the presumption that the legislature intended to change the law. State v. Mikusch, 562 N.E. 2d 168, 172 (Ill. 1990). The Illinois Supreme Court has stated that “the passage of an amendment raised a presumption that the legislature intended to change the substantive law ...” Commonwealth *Edison Co. v. Dep’t of Local Gov’t Affairs*, 426 N.E.2d 817 (Ill. 1981).

\*\*\*With two different subsections on the books now, subsections 304(d)(2) and (d)(3), the rules of statutory construction dictate that the two subsections cannot mean the same thing. *See Donnan v. Bang*, 3 Ill. App. 400, 407 (1879). ...

\*\*\*Rules of statutory construction also dictate that “[w]here there are [no] repugnant provisions ... no part of [an] act should be ignored ... effect should be given to it all.” *Donnan*, 3 Ill. App. at 407. Unless conflicting provisions exist, statutory language cannot be discarded as superfluous. *Id.* Any attempt to apply retroactively the new expanded scope of the apportionment formula numerator contained in Section 304(d)(3) would directly conflict with this fundamental rule. To ignore the presence of the effective date of subparagraph (d)(3) renders that portion of the statute meaningless. As this section of the statute does not conflict with any other provisions, such a result would be improper.

By amending Section 304(d) as it did, the General Assembly expressly applied the amendments only to the tax years ending on or after December 31, 2008. Consequently, interstate pass-through shipments were not included in the numerator of the apportionment formula for the Tax Years at Issue.

Taxpayers’ Brief pp. 21-24

As is evident from the above, the taxpayers seek to invoke rules of statutory construction in favor of a perceived legislative intent arising from the legislature’s change

adding section 304(d)(3). As the taxpayers correctly point out, pursuant to these rules, it is presumed that the legislature intends to effect a change in the law when it enacts a statutory amendment. Taxpayers' Brief p. 22. Moreover, such substantive changes are presumed to be applied prospectively only. Taxpayers' Brief p. 23. However, exceptions to the presumption favoring prospective application exist; specifically, an amendatory act will be construed as retroactive where the amendment changes procedure alone or where it merely clarifies existing law. Royal Imperial Group, Inc.v. Joseph Blumberg & Associates, Inc., 240 Ill. App. 3d 360, 364-65 (1992); Borden Chemicals and Plastics, L.P. v. Zehnder, 312 Ill. App. 3d 35, 46-47 (1<sup>st</sup> Dist. 2000). For the reasons set forth below, I am not constrained to address taxpayers' conclusions regarding these rules of statutory construction.

As noted in Caveney v. Bower, 207 Ill. 2d 82, 87-88 (2003), the primary goal in construing a statute is to determine and give effect to the legislature's intent. The best indication of the legislature's intent is the statutory language given its plain and ordinary meaning. *Id.* Accordingly, "clear and unambiguous statutory language provides a better indicator of legislative intent than does a subsequent amendment, which, as this court has noted, is equivocal in nature and may indicate either a change in policy by the legislature or its intent to correct an erroneous interpretation of the statute." People v. Hare, 119 Ill. 2d 441, 451 (1988) (citation omitted). When the language of a statute is plain and unambiguous, it must be applied as written without resort to aids of statutory construction. Krautsack v. Anderson, 223 Ill. 2d 541, 553 (2006); Northwest, *supra* at 892 ("If the language is clear and unambiguous, the statute will be construed according to

its terms without resort to aids of construction.”) (citing Branson v. Department of Revenue, 168 Ill. 2d 247, 254 (1995)).

In the instant case, the parties agree that section 304(d)(2) designates all miles gas is transported by pipeline as the denominator of the apportionment ratio prescribed by this section. Stip. ¶¶18-31. The taxpayers contend, however, that the statute includes in the numerator of the apportionment formula prescribed by section 304(d)(2) only gas transportation miles resulting from the transportation of gas through Illinois pipelines that either originates or terminates in this state. Taxpayers’ Brief pp. 8-21. The Department contends that the statute calls for the inclusion of all miles resulting from the transportation of gas through Illinois pipelines in the numerator of the apportionment formula. Department’s Brief pp. 20-26. I agree with the Department.

The statute defines the numerator as follows: “(2) Such business income derived from transportation by pipeline shall be apportioned to this State by multiplying such income by a fraction, the numerator of which is revenue miles of the person in this State ... [.]” (emphasis added). In the context of gas transporters the Department interprets this phrase to mean gas flowing through pipelines in Illinois. By contrast, the taxpayers read this phrase to mean gas flowing through Illinois pipelines where gas is either sent from or delivered to this state. The courts have required that adjudicatory forums not depart from the plain language of a statute by reading into it exceptions, limitations, or conditions not expressed by the legislature. People ex. Rel. Department of Professional Regulation v. Manos, 202 Ill. 2d 563, 568 (2002). Yet this is exactly what the taxpayers propose be done in construing section 304(d)(2). Had the legislature intended the more limited construction the taxpayers advocate, it could and would have used the limiting language

the taxpayers propose. For example, instead of using the language “revenue miles in this State” the legislature would have provided that the numerator is “revenue miles in this State where gas is delivered to or shipped from this State.” See e.g. 35 **ILCS** 105/3-60, 35 **ILCS** 105/3-61. It did not do so. Consequently, the statute does not contain the restriction on the scope of the numerator the taxpayers urge.

Moreover, “[I]t is improper for a court to depart from the plain terms of a statute or to read in a condition that would conflict with or defeat ... the intent of the provision at issue.” (emphasis added). Branson v. Department of Revenue, 168 Ill. 2d 247, 258 (1995). As previously noted, the Illinois Supreme Court has declared that Article 3 of the IITA, the state’s income tax apportionment provisions, should be construed so as to effectuate the legislative intent of these provisions “to assure that 100%, and no more or no less, of the business income of a corporation doing a multistate business is taxed by the states having jurisdiction to tax it.” GTE Automatic, *supra* at 335.<sup>9</sup> If, as the taxpayers contend, interstate flow-through miles are includable in the denominator but not the numerator of the taxpayers’ apportionment formula pursuant to section 304(d)(2), this legislative objective of Article 3 of the IITA, which includes section 304(d)(2), would not be achieved. Since the denominator, but not the numerator of the formula would take into account interstate flow-through miles, assuming all states used the same method of apportionment, a part of the income of gas transportation companies like the taxpayers in this case would not be assigned to or taxed by any state. This mismatch of the formula numerator and denominator would result in the assignment of less than 100%

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<sup>9</sup> The Illinois Appellate Court has indicated that achieving the objective of full apportionment does not take precedence over constitutional constraints prohibiting the use of apportionment factors derived from contacts with states that are too tenuous to provide a taxable nexus, e.g. flyover miles. Northwest, *supra*.

of the taxpayers' income to the states in which the taxpayers are subject to tax. Conversely, under the Department's formula all of the taxpayers' income would be apportioned to and taxed by a jurisdiction in which the taxpayers conduct business assuming all states are using the same apportionment method. Consequently, the Department's interpretation of section 304(d)(2) rather than the taxpayers' interpretation best effectuates the legislative intent of this section in accordance with the dictates of the Illinois Supreme Court.

For the aforementioned reasons, I find that the language of section 304(d)(2) is clear on its face and that it conforms to the Department's interpretation. Indeed, the taxpayers initially believed that this is what the statute clearly stated when they filed their original returns which fully conformed to the Department's interpretation of section 304(d)(2). Stip. ¶¶16-31. Therefore, resort to any of the rules of statutory construction premised upon legislative changes noted above is unnecessary in this case.

### **Summary**

For the foregoing reasons, I conclude that interstate flow-through miles are includable in the numerator of the transportation company apportionment formula applicable to natural gas transportation companies pursuant to section 304(d)(2) of the IITA. Consequently, I do not agree with the taxpayers that this measure must be construed to exclude their interstate flow-through miles from the numerator of this formula in determining their income apportionable to and taxable by Illinois for the Tax Years at Issue in this case.

### **III. Constitutional Issues**

The taxpayers contend that section 304(d)(2) as construed by the Department violates the commerce clause of the United States Constitution (U.S. Const., art. I, sec. 8). In addressing the taxpayers' constitutional challenges to the notices of denial at issue in this case, some preliminary points must be clearly understood. First, pursuant to Article VI of the Illinois Constitution, only a circuit court or higher court has the authority to declare a legislative act unconstitutional. See Ill. Const., art. VI, § 1. In contrast, the Department, including an administrative law judge acting as an agent of the Director, lacks any such authority even if so inclined. See 20 ILCS 2505/2505-10 *et seq.* (Powers of the Department). I address the constitutional issues the taxpayers have raised here, however, because I find that the statute at issue, as applied to the taxpayers by the Department, does not violate the commerce clause as the taxpayers contend.

Second, “a person to whom a statute may constitutionally be applied may not challenge that statute on the ground that it may conceivably be applied unconstitutionally to others in situations not before the Court.” New York v. Ferber, 458 U.S. 747, 767 (1982). As will be discussed below, the taxpayers have failed to provide sufficient evidence to show that they have suffered any discrimination or injury due to any of the constitutional violations they allege arise from the Department's interpretation of the transportation company apportionment formula the taxpayers are contesting.

### **Taxpayers' Commerce Clause Objections**

The commerce clause imposes limitations upon a state's taxing authority. In Complete Auto Transit v. Brady, 430 U.S. 274 (1977), the United States Supreme Court

has prescribed a four-step test to determine whether an out-of-state corporation's activities in interstate commerce may be subject to state taxation without violating the Commerce Clause: (1) the activity sought to be taxed has sufficient nexus with the State; (2) the tax does not discriminate against interstate commerce; (3) the tax is fairly apportioned; and (4) the tax is fairly related to services provided by the State. The taxpayers contend that, if the Department's interpretation of section 304(d)(2) is embraced, this measure would violate the commerce clause because it would not meet any of the Complete Auto Transit tests the Supreme Court has prescribed. Taxpayers' Brief pp. 14-21. The Department does not agree with this contention.

### **1. The Nexus Prong of the Complete Auto Transit Test**

With respect to the nexus prong of the Complete Auto Transit test, the taxpayers argue as follows:

In order to satisfy the first requirement of the *Complete Auto Transit* test, the activity under scrutiny must have a substantial connection to the taxing state. In the instant case, a sufficient nexus does not exist between Illinois and the interstate flow-through miles.

The United States Supreme Court discussed whether an activity that merely passes through a state has a sufficient connection to the state for Commerce Clause purposes in *United Airlines, Inc. v. Mahin*, 410 U.S. 623 (1973), a case involving an Illinois use tax on fuel purchased by airlines. In that case the Court stated that "[T]he fuel cannot be taxed by States through which it is merely transported." *Id.* at 630.

Sixteen years later, the Court restated its conclusion that a state through which an activity merely passes does not have sufficient nexus to tax the transaction. *Goldberg v. Sweet*, 488 U.S. 252, 263 (1989). In the context of Illinois' telecommunications tax, the Court found only two states have a nexus substantial enough to tax the purchase of an interstate telephone call (*i.e.*, the purchase of interstate telecommunications service). Those states were: (1) the state in which the service originates or terminates and where the service is charged to a service address in the state; and (2) the state in which the service originates or terminates and where the service is billed or paid within

that state. *Id.* The Court provided that states through which an interstate telephone call's signals merely pass would not have sufficient nexus to tax the interstate call as a sufficient connection between the call and the state would not exist. *Id.*

Similarly, the interstate flow-through miles in the present case also fail to establish the requisite nexus with Illinois to allow Illinois to tax them. These interstate flow-through miles represent the transportation of gas molecules from an origination point outside of Illinois to a delivery point outside of Illinois. The only connection with Illinois is that the interstate gas passes through the State. Just like the interstate calls that neither originate nor terminate in the state discussed in *Goldberg*, such pass-through transportation miles do not establish the necessary connection with the State.

The fact that the Taxpayer in the instant case has pipelines and other property in Illinois does not change this result. This simply means that there is a sufficient nexus between Illinois and Taxpayer for the Taxpayer to be subject to tax. It does not, however, create a nexus between Illinois and the interstate gas passing through Illinois to permit Illinois to subject such activity to tax.

In *Goldberg* there was certainly telephone equipment consisting of wires, cables, fiber optics, towers, etc. which were used to transmit the telecommunications service through the states through which the interstate call passed, but did not originate or terminate. Nonetheless, the Supreme Court stated that there was not a sufficient nexus between such states and the activity of the telecommunications service to subject that service to tax.

Thus, consistent with the Supreme Court's interpretation of the substantial nexus requirement in both *United* and *Goldberg*, reading Section 304(d) to include interstate flow-through miles in the numerator would cause that section to conflict with the first prong of the *Complete Auto Transit* test. Consequently, Taxpayer's interstate flow-through miles cannot be included in the computation of the numerator of its apportionment formula.

Taxpayers' Brief pp. 15-17.

In essence, the taxpayers contend that in order for nexus to exist between a taxpayer and a taxing state that state must have nexus with more than the transportation activity in which the taxpayer is engaged. This contention is not supported by well-settled constitutional jurisprudence addressing when the nexus requirement of the commerce clause is satisfied.

With respect to apportioned income taxes, satisfaction of the nexus requirement under the commerce clause has long required only a “minimal connection” between interstate activities a taxpayer is engaged in and the taxing state. Container Corporation of America v. Franchise Tax Board, 463 U.S. 159, 165-66 (1983). Such a “minimal connection” will be found to exist when at least some portion of a taxpayer’s unitary business enterprise is conducted in the state. *Id.* at 166. In Exxon Corp. v. Wisconsin Department of Revenue, 447 U.S. 207 (1990), the Supreme Court determined that the commerce clause nexus requirement was satisfied when due process nexus was established. *Id.* at 227-230. The Supreme Court stated in this case that nexus is established where a corporation “avails itself of the substantial privilege of carrying on business within the State.” *Id.* at 220. Consequently, although in Exxon the taxpayer’s activities in Wisconsin were limited to marketing, nexus existed for including income from out-of-state exploration and production in the taxpayers’ apportionment formula. *Id.* at 227-230.

The taxpayers’ argument that, as a constitutional proposition, nexus does not exist where a taxpayer merely passes a commodity through a state, relies upon two Supreme Court cases, namely, United Airlines, Inc. v. Mahin, 410 U.S. 623 (1973), and Goldberg, *supra*. Neither of these cases involved an apportioned income tax similar to that at issue in the instant case. The United Airlines case cited by the taxpayers concerned a use tax on a consumer’s purchase of aviation fuel where the taxable event was deemed to be storage rather than consumption. The Goldberg case concerned a tax on a consumer’s purchase of interstate telephone calls which the court analogized to a sales tax. Goldberg, *supra* at 262. The Supreme Court has expressly distinguished these types of taxes from

an apportioned income tax based on the fact that where a sales tax is imposed upon the sale of goods or services the taxable event is deemed to occur in the state where the sale is consummated. In Oklahoma Tax Commission, *supra*, the Court, in distinguishing between taxes that are ordinarily apportioned and other taxes, makes the following observations:

The very term “apportionment” tends to conjure up allocation by percentages, and where taxation of income from interstate business is in issue, apportionment disputes have often centered around specific formulas for slicing a taxable pie among several States in which the taxpayer’s activities contributed to taxable value. In Moorman Mfg. Co. v. Bair, 437 U.S. 267, 98 S. Ct. 2340, 57 L. Ed. 2d 197 (1978), for example, we considered whether Iowa could measure an interstate corporation’s taxable income by attributing income to businesses within the State “in that proportion which the gross sales made within the state bear to the total gross sales.” *Id.*, at 270, 98 S. Ct., at 2342-2343. We held that it could. In Container Corp., we decided whether California could constitutionally compute taxable income assignable to a multi-jurisdictional enterprise’s in-state activity by apportioning its combined business income according to a formula “based, in equal parts, on the proportion of [such] business’ total payroll, property, and sales which are located in the taxing State.” 463 U.S., at 170, 102 S. Ct., at 2943. Again, we held that it could. Finally, in Central Greyhound, we held that New York’s taxation of an interstate bus line’s gross receipts was constitutionally limited to that portion reflecting miles traveled within the taxing jurisdiction. 334 U.S., at 663, 68 S. Ct. at 1266.

In reviewing sales taxes for fair share, however, we have had to set a different course. A sale of goods is most readily viewed as a discrete event facilitated by the laws and amenities of the place of sale, and the transaction itself does not readily reveal the extent to which completed or anticipated interstate activity affects the value on which a buyer is taxed. We have therefore consistently approved taxation of sales without any division of the tax base among different States, and have instead held such taxes properly measurable by the gross charge for the purchase, regardless of any activity outside the taxing jurisdiction that might have preceded the sale or might occur in the future. See, e.g., McGoldrick v. Berwind-White Coal Co., *supra*.

Such has been the rule even when the parties to a sale contract specifically contemplated interstate movement of goods either immediately before, or after, the transfer of ownership. See, e.g.,

Wardair Canada Inc. v. Florida Dept. of Revenue, 477 U.S. 1, 106 S. Ct. 2369, 91 L. Ed. 2d 1 (1986) (upholding sales tax on airplane fuel); State Tax Commission of Utah v. Pacific States Cast Iron Pipe Co., 372 U.S. 605, 83 S. Ct. 925, 10 L. Ed. 2d 8 (1963) (per curiam) (upholding tax on sale that contemplated purchaser's interstate shipment of goods immediately after sale). The sale, we held, was "an activity which ... is subject to the state taxing power" so long as taxation did not "discriminate[e]" against or "obstruct[t]" interstate commerce, Berwind-White, 309 U.S., at 58, 60 S. Ct., at 398, and we found a sufficient safeguard against the risk of impermissible multiple taxation of a sale in the fact that it was consummated in only one State. As we put it in Berwind-White, a necessary condition for imposing the tax was the occurrence of "a local activity, delivery of goods within the State upon their purchase for consumption." *Ibid.* So conceived, a sales tax on coal, for example, could not be repeated by other States, for the same coal was not imagined ever to be delivered in two States at once. Conversely, we held that a sales tax could not validly be imposed if the purchaser already had obtained title to the goods as they were shipped from outside the taxing State into the taxing State by common carrier. McLeod v. J.E. Dilworth Co., 322 U.S. 327, 64 S. Ct. 1023, 88 L. Ed. 1304 (1944). The out-of-state seller in that case "was through selling" outside the taxing State. *Id.*, at 330, 64 S. Ct., at 1025. In other words, the very conception of the common sales tax on goods, operating on the transfer of ownership and possession at a particular time and place, insulated the buyer from any threat of further taxation of the transaction. \*\*\*

Oklahoma Tax Comm., *supra* at 186-87.<sup>10</sup>

As is evident from the foregoing, rules governing the sufficiency of nexus the taxpayers rely upon only pertain to cases involving unapportioned sales taxes where 100% of the receipt is allocated to a single location. In such cases, a finding that nexus exists with other states through which transportation related to sales transactions occur would result in multiple taxation of the same receipt since 100% of the receipt would already be taxed. However, since an apportioned income tax is applied and taxed in multiple states by virtue of apportionment, the nexus sufficiency standard adhered to in

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<sup>10</sup> See also Mobil Oil Corp. v. Commissioner of Taxes of Vermont, 445 U.S. 425 (1980) wherein the court distinguishes between property taxes allocated to a single situs and apportioned income taxes.

sales tax cases is unnecessary to avoid multiple taxation of the same income and, therefore, is inapplicable. In sum, because the cases the taxpayers have cited only address nexus in cases involving situs-oriented sales and sales-type taxes that are allocated to a single situs rather than in cases involving an apportioned income tax, such as the tax at issue in the instant case, these cases do not support the taxpayers' nexus analysis or their claim that the nexus prong of the commerce clause test is not met in this case.

## **2. The Fair Apportionment Prong of the Complete Auto Transit Test**

An apportionment formula is fair if it is internally consistent and externally consistent. Container Corp., *supra* at 169. The internal consistency test is designed to determine whether a tax, if applied by every state, would subject the taxpayer to multiple taxation of the same income. The external consistency test is designed to determine whether a state has taxed more than the portion of revenues from interstate activity that reasonably reflects the in-state component of the activity being taxed. *Id.* at 169-170. The taxpayers have not argued that the apportionment of their gas revenues in the manner the Department proposes fails the internal consistency test, and therefore concede that the Department's proposed formula is internally consistent.

However, the taxpayers vigorously argue that the Department's proposed formula fails the external consistency test because the inclusion of interstate flow-through miles in the numerator causes this formula to improperly reflect "a reasonable sense of how income is generated" (*id.* at 169) by the taxpayer in Illinois. Taxpayers' Brief pp. 18, 19. The gravamen of the taxpayers' claim is that they derived no income from gas transportation services in Illinois where gas was neither picked up nor delivered in this

state, and, therefore, the external consistency test is violated by including revenues attributable to this activity in the “in-state” numerator of the taxpayers’ apportionment formula. *Id.*

In the instant case, the Department’s *prima facie* case was established by the introduction into evidence of copies of its determinations denying the taxpayers’ claims for refund. 35 ILCS 5/904; Branson, *supra* at 257-58. The Department’s *prima facie* case *ipso facto* includes all elements of its determination including its implicit finding that the apportionment formula it has utilized in making its determination is constitutional. *Id.*; Soho Club v. Department of Revenue, 269 Ill. App. 3d 220, 232 (1<sup>st</sup> Dist. 1975). The Illinois courts have consistently held that the burden of rebutting the Department’s *prima facie* case falls squarely upon the taxpayer. Balla v. Department of Revenue, 96 Ill. App. 3d 293, 295 (1<sup>st</sup> Dist. 1981). Moreover, mere testimony is not sufficient to meet this burden. Mel-Park Drugs, Inc. v. Department of Revenue, 218 Ill. App. 3d 203, 217 (1991); PPG Industries, Inc. v. Department of Revenue, 328 Ill. App. 3d 16, 34 (1<sup>st</sup> Dist. 2002). The taxpayers must rebut the Department’s *prima facie* case by producing books, records and other documentary evidence corroborating their claims. *Id.*

The record herein contains no evidence to support the taxpayers’ claim that the taxpayers derived no income from natural gas transportation services resulting in interstate revenue miles, where gas was neither picked up nor delivered in Illinois.<sup>11</sup>

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<sup>11</sup> For reasons discussed previously, taxpayers concede that the taxpayers were compensated for gas transportation resulting in interstate flow-through miles since these miles were included in the numerator and denominator of the taxpayers’ apportionment formula on their original Illinois income tax returns and in the denominator of their amended returns for the Tax Years at Issue in this case. See footnote 7.

Consequently, the taxpayers have failed to present sufficient documentary proof to rebut the Department's determination by corroborating the factual claims underlying their contention.

Moreover, in order to establish unfair apportionment, taxpayers must demonstrate that there is "no rational relationship between the income attributed to the State and the intrastate values of the enterprise," by proving that the income apportioned to Illinois is "out of all appropriate proportion to the business transacted by the [taxpayer] in [this] State." Container, *supra* at 180-81 (citation omitted). The taxpayers have also failed to make this required showing. In sum, the record contains insufficient documentary evidence to support the taxpayers' claim that the external consistency test prescribed by the Supreme Court to determine fair apportionment has not been met in this case.

### **3. The Discrimination Prong of the Complete Auto Transit Test**

For purposes of applying the four prong test in Complete Auto Transit, "discrimination" means "differential treatment of in-state and out-of-state economic interests that benefits the former and burdens the latter." Oregon Waste, Inc. v. Department of Environmental Quality of Oregon, 511 U.S. 93, 99 (1994). In Amerada Hess Corp. v. N.J. Taxation Division, 490 U.S. 66 (1989), the Supreme Court enumerates the factors to be evaluated in determining whether the no-discrimination requirement of Complete Auto Transit is met. Pursuant to this case, a state tax discriminates against

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interstate commerce if it: (1) is explicitly, or “facially” discriminatory, (2) has a discriminatory intent, or (3) as applied, has the effect of unduly burdening interstate commerce. *Id.* at 75. If any one of these factors is present, discrimination against interstate commerce is established under Complete Auto Transit.

The taxpayers concede that the Illinois transportation company apportionment factor, even where interstate flow-through miles are included in the apportionment factor numerator, does not facially discriminate against interstate commerce. Taxpayers’ Brief p. 18. Nor have they argued that this formula has a discriminatory intent. The taxpayers’ sole basis for claiming a violation of the “discrimination” prohibition in Complete Auto Transit is the claim that, as applied to them, the formula, as interpreted by the Department, unduly burdens interstate commerce.

The premise of the taxpayers’ reasoning (which is essentially the same as the reasoning that forms the basis of the appellate court’s non-precedential order in Erievue), is that the formula as interpreted by the Department discriminates in favor of exclusively intra-state gas transporters and against interstate gas transporters because, unlike interstate gas transporters, exclusively intra-state gas transporters are not required to include interstate flow-through miles in the numerator of their apportionment formula. Taxpayers’ Brief, pp. 18, 19.

In making an “as applied” constitutional challenge, a taxpayer bears the burden of demonstrating how the statute is unconstitutional as “applied to the particular facts of their case.” Steffan v. Perry, 41 F. 3d 677, 693 (D.C. Cir. 1994) (quoting United States v. Salerno, 481 U.S. 739 (1987)). The record in this case contains no facts to support the taxpayers’ claim that they have been victims of unconstitutional discrimination due to the

disparate impact of section 304(d)(2) as interpreted by the Department on interstate and exclusively intrastate gas transportation companies. Indeed, there is no evidence in the record that interstate and exclusively intrastate gas transportation companies even compete for the same customers in the same market. See General Motors Corp. v. Tracy, 519 U.S. 278 (1997) (holding that a taxing scheme that exempted sales of natural gas by local public utilities while taxing sales of natural gas by interstate gas marketers did not violate the commerce clause where local and interstate sellers did not compete with one another). Consequently, the taxpayers have failed to present any evidence to support their claim that the apportionment formula, as applied to them, burdens interstate commerce. Accordingly, I find no factual basis for the taxpayers' claim that the challenged apportionment formula at issue in this case violates the "discrimination" prong of the Complete Auto Transit test.

#### **4. Fairly Related to Presence and Activities Prong of The Complete Auto Transit Test**

The fourth prong of the Complete Auto Transit test requires that the tax be "fairly related to the presence and activities of the taxpayer within the State." Goldberg, supra at 266. The taxpayers contend that the application of the transportation formula in the manner the Department proposes fails this test. Taxpayers' Brief pp. 19, 20. By including interstate flow-through miles, they contend, the formula creates a measure of the tax imposed that is not commensurate with the activities the taxpayers actually conduct in Illinois. *Id.* They argue that a proper measure of the taxpayers' Illinois activities is the amount of deliveries and pick-ups in the state which the taxpayers agree are properly includable in the numerator of the apportionment formula. *Id.*

The taxpayers seek to apply the fourth prong of the Complete Auto Transit test in a manner far narrower than the Supreme Court requires. In effect, they seek to impose a requirement that benefits received from the state be compared to the taxes levied. Accordingly, they contend that because the state provides few benefits that contribute to the taxpayers' Illinois revenues from the taxpayers' interstate flow-through miles these miles cannot be used to measure the amount of income taxable in this state. *Id.* However, the Supreme Court has expressly stated that the fourth prong of the Complete Auto Transit test does not require any such comparison of "the amount of tax or the value of the benefits allegedly bestowed as measured by the costs the State incurs on account of the taxpayer's activities." Commonwealth Edison v. Montana, 453 U.S. 609, 625 (1981). With respect to the fourth prong of the Complete Auto Transit test, the U.S. Supreme Court has stated that satisfaction of this test does not require a detailed accounting of the costs incurred by the state to provide the services a taxpayer receives from the state. Instead, interstate commerce may be required to contribute to the cost of government services that include those from which it receives no direct benefit. Goldberg, *supra*; Commonwealth Edison, *supra*.

Rather than the test the taxpayers espouse, the correct test is whether the tax itself is fairly related to the taxpayers' presence and activities in Illinois. As the taxpayers readily admit, they have extensive activities in Illinois, including scores of employees, and numerous properties. Moreover, the taxpayers receive police and fire protection of their extensive in-state pipeline infrastructure and other advantages of civilized society. See D.H. Holmes Co., Ltd. v. McNamara, 486 U.S. 24 (1988). Indeed, the taxpayers are engaged in highly regulated activities in the state and have, on numerous occasions,

availed themselves of the state's regulatory and administrative law procedural remedies. Stip. ¶¶50-70; 79-83.

The taxpayers seek to rely upon the Illinois Appellate Court's ruling in American River Transportation Co. v. Bower, 351 Ill. App. 3d 208 (2d Dist. 2004), wherein the appellate court ruled that Illinois could not constitutionally apply its use tax to fuel and supplies that the taxpayer purchased for use on tugboats that traversed the Mississippi, Illinois and Ohio rivers. The Illinois Appellate Court found that while the taxpayers' tugboats plied the waters of this state, "Illinois provided no services to those tugboats" because "[t]he waters are all navigable waterways of the United States and are maintained by the United States, not Illinois." American River, *supra* at 212. However, as pointed out by the Department:

The Taxpayer's reliance on [American River Transportation] to support its argument that the State did not provide any benefits to justify imposing the tax is inapposite. In [American River Transportation], the court determined that the United States government maintained the waterways in which the tugboats operated, not Illinois. 351 Ill. App. 3d at 212. Therefore, the state did not provide any benefits for which it could seek compensation. *Id.* In the current matter, the Taxpayer's pipeline facilities were located in Illinois. (¶¶59-60). Therefore, Illinois, not the United States government, provided the benefits and services that the Taxpayer relied upon (e.g., police and fire protection, public roads, free educational system, etc.). The Illinois EPA issued the permits that the members of the Transportation Group needed to operate the compressor stations. The State of Illinois also provided a forum in which the Taxpayer could seek redress when it believed it had been wrongly denied a permit or similar matters. (Dept's Exhibit Nos. 2 and 3). Illinois has a right to seek compensation from the Taxpayer in exchange for the foregoing services and benefits.

I agree with the Department. There is no question taxpayers' physical presence in Illinois is extensive and includes real and personal property that it must continuously

monitor and that is highly regulated. The taxpayers' many Illinois employees man the taxpayers' property in Illinois twenty four hours a day seven days a week. The taxpayers' equipment in Illinois is actively operated by these employees at all times that taxpayers product is flowing through it.

For the foregoing reasons, I conclude that the section 304(d)(2) as applied to the Department in this case does not violate the fourth prong of the Complete Auto Transit test.

### **Summary**

In summary, under the correct application of the four prong Complete Auto Transit test to the facts presented in this case, section 304(d)(2), as interpreted by the Department, does not violate the commerce clause of the United States Constitution.

### **IV. Section 304(f) Alternative Apportionment**

The taxpayers also contend that, in the event section 304(d)(2) is found to include interstate flow-through miles in the numerator of the taxpayers' transportation company formula, the Director should nevertheless exclude these revenue miles from the numerator by exercising his powers pursuant to section 304(f) of the IITA. Section 304(f) provides that, if the allocation and apportionment provisions of subsections (a) through (e) or (h) "do not fairly represent the extent of a person's business activity in this State, the person may petition for, or the Department may require, in respect of all or any part of the person's business activity in this State," the use of an alternative method "to effectuate an allocation and apportionment of the person's business income." 35 ILCS 5/304(f).

The circumstances under which section 304(f) may be invoked are governed by the Department's regulation at 86 Ill. Admin. Code, Ch. I, section 100.3390(c) ("section 100.3390(c)") which provides in part that:

A departure from the required apportionment method is allowed where such methods do not accurately and fairly reflect business activity in Illinois. An alternative apportionment method may not be invoked, either by the Director or by a taxpayer, merely because it reaches a different apportionment percentage than the required statutory formula. However, if the application of the statutory formula will lead to a grossly distorted result in a particular case, a fair and accurate alternative method is appropriate. The party (the Director or the taxpayer) seeking to utilize an alternative apportionment method has the burden of going forward with the evidence and proving by clear and cogent evidence that the statutory formula results in the taxation of extraterritorial values and operates unreasonably and arbitrarily in attributing to Illinois a percentage of income which is out of all proportion to the business transacted in this State. In addition, the party seeking to use an alternative apportionment formula must go forward with the evidence and prove that the proposed alternative apportionment method fairly and accurately apportions income to Illinois based upon business activity in this State.

As indicated by the foregoing, the regulation interpreting section 304(f) provides that an alternative apportionment method is appropriate "if the application of the statutory formula will lead to a grossly distorted result in a particular case." *Id.* The person seeking to utilize an alternative apportionment method has the burden of proving "by clear and cogent evidence that the statutory formula results in the taxation of extraterritorial values and operates unreasonably and arbitrarily in attributing to Illinois a percentage of income which is out of all proportion to the business transacted in the State." *Id.*

The Illinois and federal courts have placed a heavy burden of proof on taxpayers seeking to challenge the validity of state apportionment schemes. Citizens Utilities Co., *supra* at 52; Butler Brothers v. McColgan, 315 U.S. 501, 507 (1942) (“[O]ne who attacks a formula of apportionment carries a distinct burden of showing by ‘clear and cogent evidence’ that it results in extraterritorial values being taxed ...”). To prevail, a taxpayer must show that “in any aspect of the evidence its income attributable” to the taxing State was “out of all appropriate proportion to the business transacted ... in that State.” *Id.* One way of meeting this burden is by showing that the apportionment scheme results in the imposition of tax on income arising from business conducted beyond the borders of the state. Hans Rees’ Sons, Inc. v. North Carolina, 283 U.S. 123 (1931). In that case, the United States Supreme Court found that the state’s apportionment scheme produced an apportionment of income to North Carolina “out of all appropriate proportion” to the taxpayer’s activities in the taxing state. *Id.* at 135. Consistent with the foregoing line of authority, the Illinois appellate court, in Rockwood Holding Co. v. Department of Revenue, 312 Ill. App. 3d 1120 (1<sup>st</sup> Dist. 2000), upheld a trial court’s determination that section 304(f) “only pertains to situations where the general statutory formulae for ‘allocation and apportionment’ fail to fairly represent the true extent of a taxpayer’s activities within Illinois.” *Id.* at 1126.

As noted above, in determining whether the taxpayers have satisfied their burden of proof, section 100.3390(c) and case law require a showing “by clear and cogent evidence” that section 304(d)(2), as interpreted by the Department in this case, reaches a grossly distorted result. Section 100.3390(c) states that this burden will be met only if the statutory formula including interstate flow-through miles in the numerator of the

taxpayers' apportionment formula is demonstrated to operate "unreasonably and arbitrarily" in attributing to Illinois a percentage of income that is out of all proportion to the business transacted in this state.

The taxpayers argue that the facts here are consistent with those in Lakehead Pipeline Co. v. Department of Revenue, 192 Ill. App. 3d 756, 764 (1989). In Lakehead, a variance of as much as 1.4452% between the formula proposed by the Department and the formula proposed by the taxpayer was not found to constitute gross distortion. *Id.* As pointed out by the taxpayers, the record in the instant case shows that the variance in the taxpayers' Illinois apportionment percentages resulting from differences between the taxpayers' method and the Department's greatly exceeds the variances at issue in Lakehead. Taxpayers' Brief pp. 25, 26.<sup>12</sup> However, the Illinois courts have held that this type of a showing is legally insufficient to carry the taxpayers' burden. The Illinois Supreme Court has held that a taxpayer must prove distortion by clear and cogent evidence, and that this burden cannot be met by reliance upon "bare percentages" or a showing that a taxpayer's methodology results in a lower tax alone. Citizens Utilities, *supra* at 52-53.<sup>13</sup> In accord with Citizens Utilities I find that the variance between the

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<sup>12</sup> The taxpayers' argument is premised upon a comparison of the apportionment percentage reflected in the taxpayers' original returns and the apportionment percentage used by the taxpayers in their amended returns. Compare Stipulation Exhibits 56-59 (including flow-through miles in the numerator of the taxpayers' apportionment formula), and Stipulation Exhibits 60, 61, 64 and 65 (excluding flow-through miles from the numerator of the taxpayers' apportionment formula).

<sup>13</sup> In determining whether there is "clear and cogent" evidence of distortion, the Illinois courts have essentially applied the criteria used to determine whether, as a constitutional matter, an apportionment formula meets the external consistency test. See Miami Corporation v. Illinois Department of Revenue, 212 Ill. App. 3d 702 (1<sup>st</sup> Dist. 1991). In this case the court found that a taxpayer was entitled to section 304(f) alternative apportionment where the standard apportionment formula failed to reflect the manner in which the income being apportioned was earned.

amount of the taxpayers' income apportioned to Illinois under the conflicting methods proposed by the parties in the instant case fails as "clear and cogent" evidence to establish that the application of section 304(d)(2) as interpreted by the Department leads to a grossly distorted result.

For the foregoing reasons, I find that the record does not support the taxpayers' claim to section 304(f) relief in the instant case. Consequently, I find that the Director is not required to apply an alternative apportionment method pursuant to section 304(f) so as to exclude the taxpayers' interstate flow through miles from the numerator of their apportionment formula in the manner the taxpayers propose.

**WHEREFORE**, for the reasons stated above, it is my recommendation that the Department's denial of the taxpayers' claims for refund for the tax years 1997-2000 be upheld.

Ted Sherrod  
Administrative Law Judge

Date: August 24, 2009