IT 98-2
Tax Type: INCOME TAX
Issue: Insurance Company Issues
Reasonable Cause Asserted On Application of Penalties

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

THE DEPARTMENT OF REVENUE OF THE STATE OF ILLINOIS	
	No. 94-IT-
v.	FEIN:
	TYE: 12/31/89 to 12/31/91
ABC COMPANY,	
	C. O'Donoghue
Taxpayer	Admin. Law Judge

RECOMMENDATION FOR DISPOSITION

Appearances: Mr. Lawrence M. Friedman, of Lord, Bissell & Brook, for ABC COMPANY; Mr. Thomas P. Jacobsen, Special Assistant Attorney General, for the Illinois Department of Revenue.

Synopsis:

This matter comes on for hearing pursuant to ABC COMPANY's (hereinafter "taxpayer" or "ABC") timely protest of the Notice of Deficiency for the tax years ending 12/31/90 and 12/31/91. The Department has proposed adjustments based on its contention that the taxpayer improperly calculated its Illinois base income by failing to "add back" all interest income "excluded from gross income," as required by 35 **ILCS** 5/203(b)(2)(A). The taxpayer also protested the Department's exclusion of certain insurance premiums derived from Texas ("Texas Premiums") as reinsurance premiums of the taxpayer and has requested that it be allowed to use an alternative apportionment formula pursuant to Sec. 304(f), which would permit it to include the Texas Premiums in the insurance factor.

Lastly, the taxpayer seeks abatement of penalties due to reasonable cause.

Upon consideration of the record, it is recommended that the IITA Section 203(b)(2)(A) addition modification issue be resolved in favor of the Department, the taxpayer's request for alternative apportionment be denied and that the penalties proposed under Section 1005 be cancelled.

Findings of Fact:

1. The Department's *prima facie* case, inclusive of all jurisdictional elements, was established by the Notice of Deficiency dated November 17, 1993 for the taxable years ending December 31, 1990 and December 31, 1991. Stip. Ex. No. 4.
2. The Department conducted an audit of the tax years and determined that the taxpayer and certain other insurance companies comprised a unitary business group. The Department also advised the taxpayer on November 17, 1993 of an overpayment for the tax year ending 12/31/89 in the amount of ($16,817.00). Stip. Ex. No. 6. The taxpayer filed a form IL-1120X dated March 9, 1994, claiming a refund in the amount of $16,806.00. Stip. Ex. No. 7.
3. The proposed deficiencies at issue in the administrative hearing are as follows, as reflected in Stip. Ex. Nos. 4 & 6:

TYE	PROPOSED DEFICIENCY TAX	PENALTY
12/31/89	$(16,817.00)	
12/31/90	77,227.00	$ 11,463.00
12/31/91	77,431.00	6,835.00

Stip. ¶ 5.

4. The adjustments to the addition modification for tax exempt interest that are the subject of the administrative hearing, as reflected in Stip Ex. Nos. 4, 5, 6 are as follows:

TYE	ADDITION MODIFICATION AS REPORTED	ADDITION MODIFICATION AS ALLOWED	ADJUSTMENT CONTESTED
12/31/89	6,044,119	7,717,509	1,673,390
12/31/90	8,173,686	10,164,666	1,990,980
12/31/91	8,489,780	12,680,959	4,191,179

Stip. ¶ 8.

5. The addition modifications reported by the taxpayer on the Forms IL-1120 (line 2a) and the adjustments by the Department to the addition modification were based on the tax exempt interest shown on the taxpayer's timely filed 1989 to 1991 consolidated US Forms 1120-PC of ABC COMPANY for the tax years. Specifically, the reported addition modifications and the adjustments relate to the 15% reduction of losses incurred as described in Internal Revenue Code Section 832(b)(5) and computed on Schedule F of the consolidated US Forms 1120-PC. Stip. ¶ 9; Stip. Ex. Nos. 11, 12, 13.

6. Taxpayer is an Illinois domiciled property-casualty insurance company, which files statutory financial statements with the State of Illinois. Stip. ¶ 10; Stip. Ex. Nos. 14, 15. The taxpayer is subject to the jurisdiction of the Illinois Department of

Insurance, which periodically conducts an examination of the taxpayer. Stip. ¶ 11; Stip. Ex. No. 16.

7. The taxpayer on July 1, 1986 entered into an agreement titled "100% Quota Share Reinsurance Treaty" (the "Agreement") with XYZ CORPORATION ("XYZ"). Stip. ¶ 12; Stip. Ex. No. 17. Policies were issued pursuant to this Agreement. Stip. ¶ 14; Stip. Ex. No. 19 & 20.

8. XYZ is a Texas domiciled mutual insurance company, which filed Annual Statements for the Audited Tax Years. Stip. ¶ 13; Stip. Ex. No. 18.

9. On July 15, 1986, XYZ through its designated intermediary, entered into an agency agreement with the taxpayer and its wholly owned subsidiary, ABC Insurance Agency ("ABCIA"). Stip. ¶ 15; Stip. Ex. No. 21. ABCIA also entered into other agency agreements. Stip. ¶ 15; Stip. Ex. No. 23.

10. ABC Managing General Agency, Inc., ("ABC MGA") another wholly owned subsidiary of the taxpayer, entered into producer agreements. Stip. ¶ 16; Stip. Ex. No. 22. ABC MGA prepared and mailed premium notices and renewal notices to policyholders, handled the administration and settlement of claims on stationary bearing its name and on stationary bearing the name of the taxpayer. Stip. ¶ 17. ABC also conducted all activities related to the processing of premiums and claims which were the subject of the Agreement. Stip. ¶¶ 18, 19.

11. The adjustments to the insurance factor ("everywhere") that are the subject of the administrative hearing, as reflected in Stip. Ex. Nos. 4, 5, 6, are as follows:

INSURANCE FACTOR	INSURANCE FACTOR	ADJUSTMENT

TYE	AS REPORTED	AS ALLOWED	CONTESTED
12/31/90	$154,268,474	$132,613,450	$21,654,024
12/31/91	155,581,030	121,955,368	33,625,662

Stip. ¶ 20.

12. The adjustment contested amounts represent the Texas premiums received pursuant to the agreement. Stip. ¶ 21; Stip. Ex. No. 17.

13. The parties stipulate that the issues for the administrative hearing are as stated in the pre-trial order entered on October 10, 1996, as follows:

> Was the Department correct in adjusting the Sec. 203(b)(2)(A) addition modification for tax exempt interest of the taxpayer's unitary business group for the tax years ending 12/31/89, 12/31/90 and 12/31/91, described in the notice of deficiency dated November 17, 1993, from 85% to 100% [the 15 percentage point difference between the addition modification reported by the taxpayer and the addition modification as adjusted by the Department represents the reduction of "losses incurred" pursuant to IRC Section 832(b)(5)(A)] of the interest received by the taxpayers, which are property and casualty insurance companies and subject to IRC Sections 831 to 835?
>
> Was the Department correct in adjusting the Section 304(b) insurance factor of the taxpayer's unitary business group for the tax years ending 12/31/90 and 12/31/91, described in the notice of deficiency dated November 17, 1993, to exclude the premiums related to Texas insurance business pursuant to the 100% Quota Share Reinsurance Treaty dated July 1, 1986 between ABC COMPANY and State and County Mutual Insurance Company?
>
> Is the taxpayer entitled to use an alternative apportionment formula pursuant to Section 304(f)?
>
> Was the Department correct in imposing Section 1005 penalties?

Stip. ¶ 7.

Conclusions of Law:

Addition Modification Adjustment

ABC is a corporation subject to pay tax in Illinois on its "net income for the taxable year" pursuant to 35 **ILCS** 5/201. Net income is defined in 35 **ILCS** 5/202 which provides in pertinent part that "a taxpayer's net income shall be that portion of his base income for such year ... which is allocable to this State." Under the Illinois Income Tax Act ("IITA"), a corporation's base income is an amount equal to the taxpayer's taxable income for the taxable year as modified by paragraph (2). Section 203(b)(2)(A) of the IITA provides that base income shall be adjusted by "[A]n amount equal to all amounts paid or accrued to the taxpayer as interest and all distributions received from regulated investment companies during the taxable year to the extent excluded from gross income in the computation of taxable income." 35 **ILCS** 5/203(b)(2)(A)

Section 203(e) indicates that taxable income or gross income means the amount of gross income or taxable income reportable for federal income tax purposes under the Internal Revenue Code ("IRC"). Therefore, on the IL-1120 the taxpayer must begin with federal taxable income on line 1 in its calculation of base income. Taxpayer is then required pursuant to Section 203(b)(2)(A) to add back all interest which has been excluded from federal gross income. IITA Section 203(e)(2)(B) substitutes insurance company taxable income as the starting point for the computation of Illinois base income. The tax-exempt interest addition modification for property and casualty insurance companies, therefore, is limited to the amount of tax exempt interest that was excluded in the computation of insurance company taxable income.

As a property and casualty insurance company, ABC is taxed under §831 through §835 of the IRC. IRC §832(b)(1) provides that gross income of a property and casualty insurance company consists of the gross amount earned during the taxable year, from investment income and underwriting income. IRC §832(b)(2) provides that investment income is comprised of income from interest, dividends, and rents, while IRC §832(b)(3) provides that underwriting income is equal to gross premiums less losses incurred and expenses incurred.

The issue at hearing centers around the deductions described in IRC §832(c)(4) and (7), the losses incurred deduction and the tax-exempt interest deduction. The Department contends that Section 203(b)(2)(A) requires property and casualty insurance companies to add back 100% of its tax-exempt interest in computing its base income. The taxpayer, on the other hand, argues that 15% of its tax-exempt interest has been included in its federal taxable income, therefore, Section 203(b)(2)(A) only requires an addition modification of 85% of its' tax exempt interest.

This issue arises for tax years ending after December 31, 1986 due to the proration concepts added to the insurance provisions of the IRC by the Tax Reform Act of 1986. IRC Section 832(b)(5)(B) provides a 15% reduction to the losses incurred deduction equal to the sum of tax-exempt interest plus other amounts not relevant to this hearing. The losses incurred deduction reflects losses paid during the year and the increase in reserves for losses incurred but not paid. Congress determined that it was inappropriate to fund loss reserves on a fully deductible basis with tax-exempt income and reduced the losses incurred deduction by a prorated portion of the tax-exempt interest which had been used to fund the taxpayer's loss reserves.

The taxpayer argues that to determine what interest has been excluded from federal gross income, we must look to the IRC to define "gross income," as required by 35 **ILCS** 5/203(e) and, furthermore, maintains that the IRC defines gross income to include 15% of tax-exempt interest as a reduction of "losses incurred". Taxpayer's contention, however, is undermined by an examination of the IRC. Insurance company taxable income is comprised of both investment income and underwriting income. In computing insurance company taxable income, the IRC distinguishes between the tax-exempt interest deduction and the losses incurred deduction. Losses incurred is provided for in §832(b)(5) and requires that the amount "shall be reduced by an amount equal to 15% of the sum of" tax-exempt interest and the deductible portion of dividends received. IRC §832(b)(3) clearly identifies the losses incurred deduction as an adjustment to underwriting income, thus, the 15% losses incurred deduction reduction is expressly limited to the computation of underwriting income. The tax-exempt interest and the dividend deduction, therefore, are used only as a means to measure the allowable losses incurred deduction.

The IITA requires that taxpayers add back all interest excluded from gross income in the computation of taxable income and 100% of tax exempt interest is, in fact, excluded from gross income in the insurance company taxable income computation and the 15% arithmetic effect to federal taxable income occurs only due to a reduction to the losses incurred deduction. An examination of the US 1120-PC, Schedule A, supports this interpretation as it expressly excludes tax-exempt interest in the computation of gross income (Line 14). Tax exempt interest (Line 3b) is subtracted from gross interest (Line 3a) to obtain taxable interest (Line 3c) which is the amount that is added to gross income. The use of "excluded" in the addition modification provision refers only to the exclusion of tax exempt interest from gross income that is allowed under IRC Section 103 for all taxpayers. The language of IRC §832(c)(7) clearly describes the tax-exempt interest deduction as the amount of interest that is excluded from gross income pursuant to IRC §103. Moreover, the legislative history describes the tax-exempt interest deduction as making the IRC §103 exclusion available for eligible investment or interest income of the property and casualty insurance companies. (*See*, General Explanation of the Tax Reform Act of 1986, Joint Committee on Taxation, p. 598, Dept. Attachment 2). The addition modification provision does not encompass the 15% losses incurred deduction reduction because this reduction is used for a different purpose than that which the term "excluded" means in Section 203(b)(2)(A).

The taxpayer cites two Wisconsin cases in support of its position, Wisconsin Department of Revenue v. Heritage Mutual Insurance Company, 208 Wis. 2d 582 (1997) and American Family Mutual Insurance Company v. Wisconsin Department of Revenue, Wisconsin Tax Appeals Commission, 94-I-1009 (April 11, 1996), CCH Wisconsin Tax Reports - New Matters, §400-212. Both decisions were based upon the Courts' interpretation of Section 71.45(2) of the Wisconsin Franchise and Income Tax Act. Paragraph (3) in effect prior to 1989, provided that the federal taxable income, that was the basis for the Wisconsin income tax, was adjusted, "by adding to federal taxable income an amount equal to interest income received or accrued during the taxable year to the extent such interest was used as a deduction in determining the company's federal taxable income." The subsequent rewording of the statute which was the basis of the American Family decision provided for an adjustment "by adding to federal taxable income an amount equal to interest income which is not included in federal taxable income." In

Heritage Mutual, *supra*, the Wisconsin Court of Appeals determined that Wisconsin law required that 85% of tax exempt interest be added back to federal taxable income because 15% of tax exempt interest was applied to reduce a loss deduction in arriving at the taxpayer's federal taxable income. The court found that the Wisconsin statute allowed the insurer to add back the amount of interest income received to the extent such interest was used as a deduction in determining the taxpayer's federal taxable income, and, accordingly, the taxpayer had properly calculated its addition modification. *Id*.

The language of the Wisconsin and Illinois statutes is significantly different and as a result the persuasiveness of the courts' analysis is limited. The Wisconsin statute refers to a deduction or non-inclusion while the reference in IITA Section 203(b)(2)(A) is to the amount excluded, which limits the analysis to the effect of IRC §832(c)(7) - the deduction that in effect provides for the exclusion of tax exempt interest pursuant to IRC § 103.

Taxpayer also contends that the Department's interpretation of the statute violates the Equal Protection Clause of the fourteenth amendment to the U.S. Constitution. Taxpayer looks towards Continental Illinois National Bank and Trust Company of Chicago v. Lenckos, 102 Ill. 2d 210 (1984), where the Illinois Supreme Court held that interpreting IITA Section 203(b)(2)(A) to accord different treatment to federally taxable bonds than to federally tax-exempt bonds was unconstitutional and contends that it applies with equal force in the case at hand.

The Illinois Supreme Court in Continental considered whether the taxpayer added back the proper amount of federal tax-exempt interest income in calculating its Illinois base income. Continental, like ABC, had interest income from state and local bonds which was exempt from federal tax and had to be added back to calculate its Illinois base income.

When purchased, Continental paid a premium and, thereafter, reduced its municipal interest addition modification for amortization of the bond premium. The Court determined the meaning of the term "interest" under Section 203(b)(2)(A) and allowed the amortized premium adjustment. Under federal law, the premium was a return of capital; thus, disallowing a reduction for the amortized premium would improperly result in the taxation of capital, rather than net income. *Id*., at 218.

In addition, the Supreme Court in Continental concluded that interpreting the statute to allow taxation of the premium for tax-exempt bonds would result in the disparate treatment of federally tax-exempt bonds and federally taxable bonds. *Id*. The Court determined that this interpretation of the Act would be unconstitutional. The Continental decision was premised upon the fact that under federal law amortization of bond premium is a return of capital. Federally taxable bonds were allowed a deduction under federal law for amortized bond premium; thus, this amount was not included in the bond holder's federal taxable income, which flowed to line 1 on the Illinois income tax return. A deduction was not allowed for tax-exempt bonds, therefore, this premium was included in the tax-exempt bondholder's federal taxable income. To not allow the bank to reduce the interest received by the amortized bond premium would have resulted in taxing federally tax-exempt bonds at a higher rate than federally taxable bonds for state tax purposes.

Here, the Department's interpretation of the statute does not violate the equal protection clause in that it accords the same treatment to insurance companies that it does to all other taxpayers; it requires the taxpayer add back 100% of its tax-exempt interest. To allow the taxpayer to add back only 85% of its tax-exempt interest would result in favorable treatment. Taxpayer cannot point to a section which clearly indicates that 15%

of tax-exempt interest is included in insurance company taxable income, thus, it is not truly being taxed on 115% of its tax-exempt interest as claimed, only 100% as are all other taxpayers with tax-exempt interest income.

Apportionment Issue

Pursuant to Section 304(b), taxpayer used the single factor apportionment formula properly applicable to insurance companies. Under the statute, the apportionment fraction differs depending on whether the insurance company's premiums are principally derived from reinsurance or direct insurance. The direct insurance factor is based only on direct premiums written, while the reinsurance factor is comprised of both direct premiums written and premiums written for reinsurance. The IL-1120 instructions which have the force and effect of Department regulations pursuant to Section 1401 and Section 1501(a)(19), provide that an insurance company is a "direct writing company" and, thus, required to use an apportionment formula comprised of only direct insurance premiums, if 50% or more of its insurance premiums are derived from direct insurance. A reinsurer may include both direct insurance premiums and reinsurance premiums in its apportionment formula if reinsurance premiums comprise 50% or more of its insurance premiums. *See,* Department Attachment 3.

During the audit it was determined that the taxpayer's unitary group was comprised of direct writing companies and, therefore, the insurance factor was adjusted by the amount of reinsurance premiums included by ABC for the tax years ending 12/31/90 and 12/31/91 – decreasing the denominator of the insurance factor by $21,654,024.00 and $33,625,662.00, respectively. Stip. ¶ 20; Stip. Ex. Nos. 4 & 5. The denominator adjustments were the premium amounts ABC had reported as reinsurance from other insurance companies on its Annual Statements filed with the Illinois Department of Insurance for 1990 and 1991. *See*, Dept. Ex. No. 1; Stip. Ex. Nos. 14 & 15.

During the years at issue, taxpayer had entered into a "fronting agreement" with XYZ, a Texas organization, because Texas law provides for more relaxed regulations over organizations such as XYZ. This agreement allowed the taxpayer to provide non-standard automobile insurance in Texas on a more cost-effective basis. Initially, the taxpayer argues that the premiums received with respect to its Texas business should be treated as direct insurance because the taxpayer acts both economically and functionally as the direct insurer. Taxpayer maintains that it assumed all the risk and bore all of the administrative costs just as if it was a direct insurer and thus should be allowed to include such premiums in the denominator of its' insurance factor.

The agreement between the taxpayer and XYZ, however, designates ABC as the "reinsurer" and expressly provides for the assumption of reinsurance by ABC COMPANY. Stip. ¶ 12; Stip. Ex. No. 17. Moreover, Section 304(b) expressly defines direct premiums written for income tax purposes as the amount of premiums reported by insurance companies to the Illinois Department of Insurance on its Annual Statements. ABC reported its direct premiums written, as defined in the statute, on its Underwriting and Investment Exhibits in the Annual Statements (Stip. Ex. Nos. 14 & 15 parts 2 and 2B) and in the Annual Statement's General Interrogatories (Question 17), ABC stated that its insurance business included the assumption of risks or reinsurance. (Stip. ¶ 11 and Stip. Ex. No. 16, pp. 5 and 6) Furthermore, the record reflects that the taxpayer has admitted that it assumed reinsurance in amounts equal to the Department's adjustments to the apportionment factor for the years in question. Dept. Ex. No. 1. Where the statute is clear and unambiguous, a court is not at liberty to depart from the plain language and meaning of the legislation. Kraft, Inc., v. Edgar, 561 Ill. 2d 656 (1990). In the present case, the Department's adjustment - removing all premiums that the taxpayer did not report on its' Annual Statements as direct premiums – follows the plain language of the statute. The legislature chose to precisely define the term "direct premiums written" in the statute and taxpayer's argument that this definition should be ignored is unpersuasive.

In the alternative, taxpayer seeks to use an alternative apportionment formula pursuant to IITA Section 304(f) which provides in pertinent part:

> Alternative Allocation. If the allocation and apportionment provisions of subsection 9 a) through 9 e) do not fairly represent the extent of a person's business activity in this State, the person may petition for, or the Director may require, in respect of all or any part of the person's business activity, if reasonable: (1) Separate accounting; (2) The exclusion of any one or more factors; (3) The inclusion of one or more additional factors which will fairly represent the person's business activities in this State; or (4) The employment of any other method to effectuate an equitable allocation and apportionment of the person's business income.

35 **ILCS** 5/304(f).

The Department's regulations provide that the taxpayer must establish that the exclusion of the reinsurance premiums from the apportionment formula under Section 304(b) grossly distorts the income attributed to Illinois and is out of proportion to the taxpayer's insurance activity in Illinois. Secondly, the taxpayer must prove that the inclusion of the premiums attributed to the Texas business more fairly and accurately apportions the taxpayer's income to Illinois. *See*, 86 Ill. Admin. Code Ch. I, Section 100.3390 (*formerly* Ill. Admin. Code Ch. , Section 100.3380)

Taxpayer contends that the million dollar increase in Illinois-apportioned income resulting from application of the Department's formula equals gross distortion. The Department's method resulted in apportionment factors of .419879 and .424248 for 1991 and 1992, respectively, while the taxpayer's formula resulted in factors of .360942 and .332555 for 1991 and 1992. This results in differences of .058937 and .091693 for the two years. A determination of whether the taxpayer is entitled to use an alternative apportionment formula requires more than an examination of these numerical differences however; one must consider the theory and constitutional principles surrounding fair apportionment as well.

The factors used in the apportionment formula must reflect a reasonable sense of how the taxpayer's income is generated and a rational relationship between the income attributed to Illinois and the intrastate values of the taxpayer's business. An apportionment formula is not invalid because it may result in taxation of some of the taxpayer's income that did not have its source in Illinois. The apportionment formula should only be replaced if it attributes income to Illinois that is out of all proportion to the business the taxpayer's transacts in Illinois. Container Corp. v. Franchise Tax Board, 463 U.S. 159 (1983); Moorman Manufacturing Co. v. Bair, 437 U.S. 267 (1978); Hans Rees' Sons, Inc. v. North Carolina ex rel. Maxwell, 283 U.S. 1315 (1931); Underwood Typewriter Co. v. Chamberlain, 254 U.S. 113 (1920); Citizens Utilities Co. v. Department of Revenue, 111 Ill. 2d 32 (1986); General Telephone Co. v. Johnson, 103 Ill. 2d 363 (1984); Caterpillar Tractor Co. v. Lenckos, 84 Ill. 2d 102 (1981); Miami Corp. v. Department of Revenue, 212 Ill. App. 3d 702 (1st Dist., 1991).

The Stipulation of Facts states that ABC Managing General Agency, Inc and ABC Insurance Agency, who were not members of the taxpayer's unitary business group, conducted the management, administration and processing activities directly related to the reinsurance agreement. Stip. ¶¶ 17-19. The taxpayer has not protested the composition of the unitary group, moreover, these entities are statutorily prohibited from being included in the taxpayer's unitary group pursuant to Section 1501(a)(27). Considering the activities of these entities in the determination of the apportionment formula to apportion taxpayer's income is inappropriate, in that it would result in a formula which would not represent the activities of the taxpayer's unitary business group in Illinois.

The insurance factor compares direct premiums written on Illinois property and risk to total direct premiums written to measure the extent of the insurance company's Illinois business activity. The taxpayer may only include direct insurance premiums in its factor, while a reinsurer may combine both direct insurance premiums and reinsurance premiums. This distinction is reasonable because it reflects substantial differences in the nature of direct insurance versus reinsurance. ABC, as a direct insurer writes automobile coverage in certain states, while ABC, as a reinsurer assumes risks related to policies issued by a third party insurer. *See*, Stip. Ex. Nos. 14, 15 and 16, p. 5. These two activities are distinct in that reinsurance is not a contract to insure those who face the risk of loss, instead, it is a promise by one insurance company to reimburse the original insurer should it be required to pay under the policy of direct insurance. The distinction can be further illustrated by the different regulatory treatment accorded the two activities. Illinois heavily regulates direct insurers, while reinsurers who reinsure non-Illinois risks are subject to less extensive regulatory requirements. *Compare*, 215 **ILCS** 5/6 to 35.1 to 215 **ILCS** 5/173 to

179b. Distinguishing between the respective premiums is reasonable given these differences, therefore, the taxpayer has not established that the formula unfairly represents the taxpayer's Illinois activities.

The remaining issue is whether the Department's proposed assessment of penalties under Section 1005 of the IITA should stand. 35 **ILCS** 5/1005 (formerly Ill. Rev. Stat. 1991, ch. 120, §10-1005). Section 1005 provides that the penalty shall not apply if the taxpayer's failure to pay is due to reasonable cause. The Department's regulations state that reasonable cause is to be determined on a case by case basis taking into account all of the facts and circumstances. 86 Admin. Code ch. I, Sec. 700.400(b). Section 700.400 indicates that it must be determined to what extent the taxpayer made a good faith effort to determine the correct tax liability and subsection (c) provides that a taxpayer is considered to have made a good faith effort if he uses ordinary business care and prudence. Factors which are considered in determining whether the taxpayer exercised ordinary business care and prudence are the clarity of the law and its interpretation, and the taxpayer's education, experience and knowledge. *Id*.

The Tax Reform Act of 1986 changed the calculation of taxpayer's federal taxable income and as a consequence its Illinois taxable income. The change in the federal law arguably affected the interpretation of Section 203(b)(2)(A) and the Department did not have a regulation on point. The taxpayer interpreted the statute by eliminating the arithmetic effect of the amendment to IRC §832(b) from the calculation of its Illinois taxable income. There was then no published authority in support of either the Department's position or that of the taxpayer. Accordingly, the taxpayer's interpretation of

Section 203(b) of the Act was made in good faith and it is my recommendation that the Section 1005 penalties should be abated.

Wherefore, for the reasons stated herein, the Notices of Deficiency should be finalized as revised by this recommendation.

Enter:

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Christine O'Donoghue
Admin. Law Judge