

IT 00-10

Tax Type: Income Tax

Issue: Insurance Company Issues

Unitary – Inclusion of Company(ies) In A Unitary Group

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

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

v.

**“GATSBY INDUSTRIES, INC.”,
Taxpayer**

No. 98-IT-0000
FEIN: 00-0000000
Tax yrs.: 1992,1993, 1994

Charles E. McClellan
Administrative Law Judge

**ORDER ON TAXPAYER’S MOTION FOR
PARTIAL SUMMARY JUDGMENT**

This matter comes on for consideration on a motion for partial summary judgment filed by “Gatsby Industries, Inc.” (“taxpayer”) and a cross-motion for partial summary judgment filed by the Department. The motions have been fully briefed by both parties and oral argument was heard on April 17, 2000.

The Motions:

Taxpayer’s motion asks that it be granted summary judgment on the issue of whether “Pennypacker Insurance Company” (“PIC”), taxpayer’s wholly owned captive insurance company, is properly included in taxpayer’s unitary group, the taxpayer’s argument being that it should be excluded as a single factor insurance company.

The Department’s cross-motion asks that the taxpayer’s motion be denied and that it be granted summary judgment holding that “PIC” is not a valid insurance company and

is, therefore, properly included in taxpayer's unitary group. The Department also asks for a ruling that inclusion of "PIC" in taxpayer's unitary group does not violate the uniformity clause of the Illinois Constitution.

I am denying the taxpayer's motion and granting summary judgment to the Department.

Undisputed Facts:

1. This matter involves the tax years ending December 31, 1992, December 31, 1993, and December 31, 1994. Taxpayer's Motion ¶ 1.
2. Taxpayer is a Pennsylvania corporation whose business includes manufacturing and marketing branded products for use in finishing the interiors of residential and commercial buildings. *Id.* ¶ 2.
3. Taxpayer is the indirect corporate parent of "PIC". *Id.* ¶ 3.
4. "PIC" is a Vermont corporation engaged in writing insurance and reinsurance as a captive insurance company pursuant to Title 8, Vermont Statutes Annotated, Chapter 141, Captive Insurance Companies. *Id.* ¶ 4.
5. Vermont's Department of Banking, Insurance and Securities has issued "PIC" a Certificate of Authority, authorizing the company to transact the business of a captive insurance company. *Id.* ¶ 5.
6. During the years at issue, "PIC" filed Vermont Captive Insurance Premium Tax Returns reporting gross premiums of \$2,166,666.66, \$2,300,000.00, and \$1,100,000.00 and paid taxes on direct insurance premiums and reinsurance premiums in the amounts of \$22,246.66, \$24,045.00 and \$11,120.50, respectively. *Id.* ¶ 6, Ex. 4.

7. In each of the years at issue, “PIC” maintained reserves for losses for casualty events. *Id.* ¶ 7.
8. The Department audited taxpayer’s books and records for the years at issue. *Id.* ¶ 8.
9. As a result of its audit, the Department proposed to adjust the composition of taxpayer’s unitary business group to include “PIC” for each of the years at issue. *Id.* ¶ 9.
10. “PIC” is authorized to loan funds to its parent corporation. *Id.* ¶ 10.
11. On March 23, 1994, taxpayer contributed an additional \$380,000,000 to the capital of “PIC”. Dept. Motion ¶ 5.
12. During the audit years, “PIC” loaned taxpayer \$474,026,410.59. *Id.* ¶ 7.
13. As a result of intercompany loans, “PIC” derived over 68% of its income from interest during the audit years. *Id.* ¶ 9.
14. On “PIC’s” books, notes receivable from the taxpayer accounted for 97%, 98.7%, and 98.6% of “PIC’s” assets during the years ended December 31, 1992, 1993 and 1994, respectively. *Id.* ¶ 10
15. “PIC” issued insurance policies to taxpayer, but not to third parties. *Id.* ¶¶ 12, 13.
16. The Internal Revenue Service does not recognize “PIC” as a valid insurance company for federal income tax purposes, and “PIC” does not file US-1120- PC Property and Casualty Insurance Company Income Tax Returns.¹ Dept. Motion pg. 4; Tr. p. 30.
17. For federal income tax purposes, premiums paid to “PIC” by its parent are treated

¹ The Internal Revenue Service’s determination is based on its finding that there is no economic substance in the transfer of premium funds between the parent corporation and the captive insurance company because there is no transfer of risk outside of the parent subsidiary group. *See, Gulf Oil Corporation v. Comm.*, 914

as non-deductible capital contributions, and payments made by “PIC” to pay claims are treated as dividends paid by “PIC” to its parent. Tr. pp. 6, 30.

Conclusion:

The standards for granting summary judgment have been described by the Illinois Supreme Court in the following terms:

“Section 2-1005(c) of the Civil Practice Law [now 735 ILCS 5/2-1005] provides that summary judgment shall be granted if the pleadings, depositions, and admissions on file together with the affidavits, if any, show that there is no genuine issue as to any material fact and that the moving party is entitled to a judgment as a matter of law. Although summary judgment is to be encouraged as an aid in the expeditious disposition of a lawsuit [citation omitted], it is a drastic measure and, therefore, should be allowed only when the right of the moving party is free from doubt [citations omitted]. The court must construe the pleadings, depositions, admissions, exhibits, and affidavits on file strictly against the movant in determining whether a genuine issue of material fact exists. [Citation omitted]. Reed v. Bascon, 124 Ill. 2d 386 (1988); Mutual Life Insurance Company of New York v. Washburn, 183 Ill. App. 3d 978 (4th Dist. 1989).

The statute provides that, “a plaintiff may move . . . for a summary judgment in his or her favor for all or any part of the relief sought” [735 ILCS 5/2-1005(a)]; and, “if a party moves for a summary determination of one or more but less than all, of the major issues in the case, and the court finds that there is no genuine issue of material fact as to that issue or issues, the court shall thereupon draw an order specifying the major issue or issues that appear without substantial controversy, and directing such further proceedings upon the remaining undetermined issues as are just.” [735 ILCS 5/2-1005(d)].

Both parties state that there is no genuine issue of material fact, so summary judgment is appropriate.

F.2d 396 (3rd Cir. 1990), Mobil Oil Corp. v. U.S., 8 Cl. Ct. 555 (1985) Because there is no transfer of risk, the courts view the premium payments as the equivalent of funding a self-insurance reserve. *Id.*

Taxpayer has attached copies of documents to its motion that establish that “PIC” is a *de jure* captive insurance company under Vermont law. Taxpayer asserts that, because “PIC” is a valid captive insurance company under the Vermont statutes, it is required to apportion its income using the single factor apportionment formula prescribed for insurance companies by IITA § 304(b) of the Illinois Income Tax Act.² Taxpayer concludes that because “PIC” is required to apportion its income using a single factor, it is precluded from being included in taxpayer’s unitary group by the provisions of IITA § 1501(a)(27) which bars single factor apportionment companies from being included in the same unitary group with three factor apportionment companies.

Taxpayer’s argument fails, however, because it incorrectly interprets the IITA by not taking into account the effect of the Internal Revenue Service’s determination that “PIC” is not a valid insurance company for federal income tax purposes. The taxation scheme set forth in the IITA for taxing corporations is described as follows:

The Act imposes a tax on the net income of every corporation. 35 ILCS 5/201(a) (West 1996). Net income is a taxpayer's base income less the standard exemption and a deduction that is not relevant here. 35 ILCS 5/202 (West 1996). A corporation's base income is equal to its "taxable income" as modified by the Act. 35 ILCS 5/203(b)(1) (West 1996). A taxpayer's taxable income is defined as that individual's "taxable income properly reportable for federal income tax purposes for the taxable year under the provisions of the Internal Revenue Code." 35 ILCS 5/203(e)(1) (West 1996). Thus, federal taxable income is the starting point when determining a corporation's state income tax liability. See, generally, Searle Pharmaceuticals, Inc. v. Department of Revenue, 117 Ill.2d 454, 111 Ill.Dec. 603, 512 N.E.2d 1240 (1987); Bodine Electric Co. v. Allphin, 81 Ill.2d 502, 43 Ill.Dec. 695, 410 N.E.2d 828 (1980); Chicago Title & Trust Co. v. Department of Revenue, 146 Ill.App.3d 923, 100 Ill.Dec. 502, 497 N.E.2d 480 (1986). Peoria and Pekin Union Railway Company v. Dept. of Revenue, 301 Ill.App.3d 736, 235 Ill.Dec. 311, 704 N.E.2d 884 (3rd Dist. 1999)

² Unless otherwise noted, all statutory references are to 35 ILCS 5/101, *et seq.*, the Illinois Income Tax Act (“IITA”).

“The key feature of the IITA is that it is based on the federal concepts of taxable income and on amounts reported on the taxpayer’s federal income tax return.” Chicago Title & Trust Co., 146 Ill.App. 3d at 925. “[T]he Illinois Act clearly borrows the federal concepts of taxable income.” *Id.* It does not change the federal definition of taxable income. *Id.* Thus, if the Internal Revenue Service determines that the insurance premiums taxpayer pays to its captive insurance company are not deductible because the relationship between the taxpayer and the captive insurance company has no economic substance, that determination carries through to the determination of the taxpayer’s Illinois net income because federal taxable income is the starting point for calculating the taxpayer’s Illinois net income. Since “PIC” is not regarded as a valid insurance company in the determination of taxpayer’s federal taxable income it cannot be valid under the IITA.

Taxpayer’s argument begins with the language in the Illinois Insurance Code that provides, “Domestic captive insurance companies shall be insurance companies subject to the rules now provided for such companies under the Illinois Income Tax Act.” 215 ILCS 5/123C-16(B). Next, taxpayer refers to IITA § 304(b) which provides that insurance companies must apportion their income using single factor apportionment formula. Taxpayer then cites IITA § 1501(a)(27) which bars the inclusion of a single factor apportionment company from being included in the same unitary group with three-factor apportionment companies. Although 215 ILCS 5/123C-16(B) refers to domestic captive insurance companies, taxpayer concludes that even though taxpayer is a Vermont captive insurance company, the Department must treat it the same as a domestic insurance company or it will violate the uniformity clause of the Illinois Constitution of 1970. Ill. Const. art. IX, § 2.

Taxpayer's interpretation of the IITA ignores the fact that it is based on federal concepts of taxable income. Taxpayer's argument that "PIC" must be treated the same as a domestic captive insurance company to avoid running afoul of the uniformity clause of the Illinois Constitution is misplaced. The IITA does not treat domestic and foreign captive insurance companies differently. If the Internal Revenue Service determines that a captive insurance company, either domestic or foreign, is a valid entity for federal income tax purposes, it will be recognized as such for Illinois income tax purposes. If the Internal Revenue Service determines that it is not a valid entity for federal income tax purposes, it will not be recognized for Illinois income tax purposes.

The taxpayer cites two cases in support of its motion. Both are inapposite. The first case, Milwaukee Safeguard Insurance Company v. Director of Insurance, 179 Ill.2d 94, 688 N.E.2d 68. (1997), involves a privilege tax imposed on foreign insurance companies but not on domestic insurance companies. The court held the tax to be unconstitutional for violating the uniformity clause of the Illinois Constitution of 1970. (Ill.Const.1970, art IX, § 2) because the classification did not bear a reasonable relation to the object of the legislation or to public policy. The case under consideration here does not involve a tax imposed on one class but not another, so this case does not support taxpayer's motion.

The next case, Allegro Services, Ltd. v. Metropolitan Pier and Exposition Authority, 172 Ill.2d 243, 665 N.E.2d 1246 (1996), involves an occupation tax imposed on operators of taxicabs, limousines, and buses that transport passengers from O'Hare Airport for hire to destinations in Chicago and elsewhere. The amount of tax varies with the capacity of the vehicles. The tax was upheld because there was no showing that the classifications are unreasonable. Again, the situation in Allegro Services, is factually

distinguishable from the case at issue because the classification was found not to be in violation of the uniformity clause of the Illinois Constitution. In addition, as discussed above, the IITA does not violate the uniformity clause.

As a further demonstration of the fallacy of taxpayer's argument, it is worth following taxpayer's theory through to its logical end. If "PIC" were to be treated as a separate single factor corporation not included in taxpayer's unitary business group for Illinois income tax purposes, consistency would require recognizing the premiums taxpayer paid to "PIC" as a valid deduction. Either taxpayer's federal taxable income would have to be recalculated to allow the deduction, or the premiums would have to be treated as a subtraction modification under IITA § 203.

If the Department were to recalculate taxpayer's federal taxable income for its own purposes, the result of the recalculation would no longer be taxpayer's federal taxable income. The IITA is based on the amounts reported for federal income tax purposes borrowing federal concepts of taxable income without change or modification. Chicago Title & Trust Co. v. Dept. of Revenue, *supra*. The IITA specifies federal taxable income as the starting point, so recalculation is not an option.

The allowable addition and subtraction modifications are set forth in IITA § 203. There is no subtraction modification specified for nondeductible premiums paid to a captive insurance company. Thus, this analysis illustrates that taxpayer's approach would render the language specifying the calculation of net income in the IITA meaningless, and statutes in Illinois are to be construed so that no term is rendered superfluous or meaningless. Texaco-Cities Service Pipeline Company v. McGaw, 182 Ill.2d 262, 270 (1998).

For the above reasons, taxpayer's motion is denied and the Department's motion is granted.

ENTER: May 16, 2000

Administrative Law Judge