IT 95-40
Tax Type: INCOME TAX
Issue: Abatement of Penalties/Interest Only

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

THE DEPARTMENT OF REVENUE OF THE STATE OF ILLINOIS	)	
	)	Docket No.:
v.	)	FEIN or SSN:
XXXXX Taxpayer	)	Harve D. Tucker, Administrative Law Judge

RECOMMENDATION FOR DISPOSITION

APPEARANCES: XXXXX, for XXXXX; Thomas P. Jacobsen, Special Assistant Attorney General, for the Illinois Department of Revenue.

SYNOPSIS: This is a case involving XXXXX for tax year 1988. An original return was filed on or about September 11, 1989 and an amended return was filed on January 7, 1991. A partial denial of claims was issued on December 31, 1991. A protest was filed February 10, 1992, objecting to (1) the Department's calculation of interest and (2) the imposition of the 35 ILCS 5/1005 penalty.

FINDINGS OF FACT:

1. The XXXXX business group filed original returns for the tax year 1987 on a separate company basis.

2. The XXXXX business group filed original returns for tax year 1988, on or about September 11, 1989. The returns were filed on a separate company basis. The separate returns for XXXXX XXXXX (Advisory) and XXXXX XXXXX (Marketing) reported tax liabilities. The return for XXXXX showed no tax liability. (Dept. Ex. No. 7)

3. The XXXXX unitary business group filed amended returns for the tax years 1987 and 1988 on January 7, 1991. The amended returns changed

the method of computation of the tax from separate to combined apportionment. In addition, a net operating loss was reported for the tax year 1987, and was applied to generate refund claims for 1988 for Advisory and Marketing. The amended return for 1988 for XXXXX showed no tax liability. (Dept. Ex. No. 6)

4. The Department reviewed and corrected the amended returns, reducing the 1987 net operating loss, resulting in additional assessments against XXXXX and Marketing.

5. The Department's review also resulted in an additional net assessment against XXXXX of $15,064. However, interest and penalty were computed on the additional tax liability that would have been reported prior to the application of the net operating loss deduction, said tax liability being $243,167. Interest and penalty were computed from the due date for 1988 tax payments (March 15, 1989) to the date the amended returns were filed (January 7, 1991). (Dept. Ex. No. 3)

6. Notices for payment were issued to XXXXX. (Dept. Ex. No. 9) Payment was satisfied by offsetting against refunds due Investment. Since the claimed total refunds were in excess of the actual amount being refunded, the notification from the Department was characterized as a partial denial of the claims. (Dept. Ex. No. 3)

7. The Taxpayer agrees with the computation of the net operating loss deduction and the offset to pay the additional assessment. The protest only objects to the calculation of the interest on the liability prior to, rather than after consideration of, the net operating loss deduction; and also objects to the imposition of the 35 ILCS 5/1005 penalty.

CONCLUSIONS OF LAW: The Department's notice of December 31, 1991, states:

> The NLD carryover or carryback for losses occurring after 12/31/86 serve as a reduction in liability on the

> carry year as of the date the claim is received [Reg. 100.9110(c)(3)(C)]. For XXX, Inc. and XXX XXXX balance due interest and 1005 penalty remain due on the liability (prior to the NLD) from the due date to the claim received date . . . .

The issue herein, commonly known as "restricted interest," is based entirely on the parenthetical phrase in the Notice of Deficiency, "prior to the NLD," in that both interest and penalties have been calculated on the deficiency prior to consideration of the net loss deduction. The Department's arguments are flawed.

The Department maintains that the application of the net loss deduction in the computation of the tax liability of XXXXX should be governed by 86 Admin. Code ch. I, Sec. 100.9400(c)(3)(C), (hereinafter sometimes referred to as the "regulation"), with the reduction in tax effective on the date the amended return was filed. The Department's justification is based on an irrelevant and inapplicable provision and is, therefore, erroneous on its face in light of two significant particulars: the issue herein relates to (1) an underpayment, (2) generated by a loss carryforward. As the Department itself admits (Dept. Brief p.12), the Illinois Income Tax Act does not have a specific rule for computing interest on underpayments affected by net loss deductions. Specifically, the regulation cited by the Department applies to interest on overpayments whereas the issue herein relates to an underpayment. The regulation is, therefore, not applicable. Neither does the Internal Revenue Code ("IRC") assist in the resolution of the issue since IRC Sec. 6601 clearly and specifically refers only to loss carrybacks, not carryforwards.

The Department then argues that pursuant to 35 ILCS 5/1003, interest is imposed on any additional tax that should have been paid by the date prescribed for payment. For the tax year 1988, March 15, 1989 was the date for payment of all tax required to be shown on the return. The Department must assess and collect interest and penalty on any amount of tax that was

due for the 1988 tax year and not paid by March 15, 1989. Thus interest and penalty must be computed on the underpayment for the period between the due date and the date on which any additional tax was paid. (Dept. Brief pp.7-8) The Department's reasoning is accurate, but the conclusion does not logically follow. The statute begins: "If any amount of tax imposed by this Act . . . ." The amount of tax imposed by this Act is $15,064. This is the amount that should have been shown on the return and is the total underpayment based on the net income determined after the net loss deduction.1 To stop part-way through a calculation and ignore a deduction which was available to the taxpayer as of the first day of the taxable year is not justified.

The Department further argues that January 7, 1991, was the first time the Department was notified, through the amended return, that the Taxpayer would apply a net loss deduction to reduce tax underpayment. The Department contends that it is limited in its capacity to apply payments or other credits to a tax liability by the authorizing actions of the taxpayer. (Dept. Brief p.9) This blanket statement is obviously incorrect. If a taxpayer has made an estimated payment or carried forward an overpayment from the previous year, the Department will certainly give the taxpayer credit without the Taxpayer's "authorization." Therefore, to conclude that the Department must be notified of all deductions or credits to be taken is incorrect.

It is further argued by the Department that the regulations require notification in writing of the use of the net loss - that it is not available to reduce the 1988 additional liability until the requisite notification to the Department is made by the Taxpayer of the application of the loss. (Dept. Brief pp.10-11) While true in a technical sense in that the regulations require "a concise statement . . . setting forth the amount of the net loss deduction claimed," this cannot be used against the

Taxpayer to enforce a rule which requires, in practice, no more from the Taxpayer than is required for any other deduction - use of the deduction. And it does not require that it must be used on the original return or it will be lost or not allowed in full.

The fallaciousness of the Department's arguments can be demonstrated with a simple example to illustrate the issue. Suppose a Taxpayer files an original return but fails to report $10,000 of income from a land deal in Arkansas on which he never received any verification. He voluntarily files an amended return, disclosing the income; or assume that this failure to report the income is revealed in the course of an audit. In either case, in the process of reviewing his original return, he also realizes that he forgot to claim an additional exemption to which he was entitled. Will the Department calculate the tax on the deficiency, with interest and penalties based on the additional $10,000 of income, then separately calculate a "claim" based on the exemption that was not taken on the original return and consider it filed on the date the amended return was filed? Of course not. The Department will not bifurcate this amended return or the final audit adjustments; the Department will calculate a net deficiency, with interest and penalties calculated accordingly on the net deficiency.

Why should the situation with XXXXX be different? If the issue were anything but a net loss would the elements of the net deficiency be bifurcated? Other than the fact that a net loss carryforward amount requires a special calculation, it exists as of the last day of the loss year, and exists and is available on the first day of the ensuing tax year. This is true whether or not the Taxpayer made a mistake on the loss year's return or knew it existed and inadvertently did not take advantage of it. (In fact, unlike many other deductions, a net loss carryforward is available on the first day of the tax year whereas as most other deductions are generated during the year.)

The taxpayer's position with regard to interest on the deficiency is sustained and should be calculated on the additional net tax deficiency of $15,064, determined after the net loss deduction. Accordingly, $39,754 should be refunded to the Taxpayer. (See Dept. Ex. No. 3)

With regard to the 35 ILCS 5/1005 penalty issue, the Taxpayer states in its brief:

> If the Department's own legal counsel (both in Springfield and in Chicago) are unable to determine how to calculate interest on a tax deficiency, surely the Taxpayer's confusion on a far more complex issue -- should be excused as reasonable. Had Taxpayer filed a combined return, the overpayments realized by other members of Taxpayer's "unitary group" would have offset Taxpayer's tax deficiency resulting in the elimination of the current issue. The Law and Regulations in existence at the time Taxpayer filed its 1988 tax return offered little guidance. (Taxpayer's Brief p.6)

The Taxpayer's confusion as to combined apportionment is not mitigated by its perception of the Department's "confusion" on an unrelated issue - the calculation of interest - or the absence of regulations on point. The Department did not misguide the Taxpayer, but rather provided no guidance. Therefore, the Taxpayer's confusion was its own. Further, the Taxpayer's statement as to reasonable reliance on professional tax consultants is based on facts not in the record. As such, reasonable cause for abatement of the penalty is not found. The penalty of $26,051 is sustained.

It is therefore recommended that a final decision be issued consistent with the determinations memorialized above.

Harve D. Tucker
Administrative Law Judge

Date

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1 35 ILCS 5/201(a) imposes a ". . . tax measured by net income. . . ." 35 ILCS 5/202 defines net income as ". . . that portion of his base income for such year . . . which is allocable to this State under the provisions of Article 3, less . . . the deduction allowed by Section 207." 35 ILCS 5/207 provides that the net loss deduction be taken into consideration in determining the tax imposed under IITA Section 201.