IT 96-47
Tax Type: INCOME TAX
Issue: Investment Tax Credit
Miscellaneous Accounting Issues
Net Operating Loss (Section 207)

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

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

RECOMMENDATION FOR DISPOSITION

APPEARANCES: Jordan M. Goodman of Horwood, Marcus & Braun Chartered, for TAXPAYER; Shepard K. Smith, Special Assistant Attorney General, for the Illinois Department of Revenue.

SYNOPSIS:

TAXPAYER ("TAXPAYER") is a limited partnership with two partners: PARTNER A ("PARTNER A") and PARTNER B ("PARTNER B"). The instant case involves PARTNER A for the tax years 12/28/88, 12/31/88 and 12/31/89 and TAXPAYER for the tax year 12/28/88. Notices of Deficiency were issued August 17, 1993. The tax at issue for PARTNER A has been reduced from the original Notices of Deficiency pursuant to findings at informal review. The adjusted tax liability for PARTNER A for 12/31/88 and 12/31/89 is $179,156 and $60,538, respectively, plus interest and penalties. Additionally, TAXPAYER has filed a protective claim for the year ended 12/28/88. Taxpayer has timely filed a protest on September 13, 1993.

TAXPAYER filed and paid the Personal Property Replacement Tax ("replacement tax") for the year ended 12/28/88. On audit, the Department determined that the

non-operating partnership, PARTNER A, was subject to the replacement tax and that TAXPAYER should have received a subtraction modification in the amount of the income distributable to PARTNER A thereby reducing TAXPAYER's taxable income to zero. TAXPAYER claimed investment credit for property placed in service in Illinois for the period ending 12/28/88 which was disallowed by the auditor since TAXPAYER now had no tax liability to offset. In addition, PARTNER A was denied the use of the investment credit since it was not the owner of the property placed in service.

The primary issue here is whether the investment tax credit generated by TAXPAYER flows through to the partners. Taxpayer, in its protest, has also claimed a net operating loss carryback from 1992, and protested the imposition of the Section 1001 and 1005 penalties.

Following an administrative hearing, it is recommended to the Director that the investment credit issue be resolved in favor of the Department and that the Section 1001 and 1005 penalties be resolved in favor of the taxpayer.

FINDINGS OF FACT:

1. TAXPAYER is a limited partnership with assets located in Illinois and Louisiana. (Stip. 1) TAXPAYER is an operating partnership that manufactured PVC resins and petrochemicals. (Tr. p. 10; Dept. Ex. No. 6)

2. PARTNER A is a Delaware limited partnership which was formed to hold the investment in TAXPAYER. PARTNER A is a limited partner of TAXPAYER with a 98.99% ownership interest, and PARTNER B is the corporate general partner with a 1.01% ownership interest. (Stip. 3, 4, 5)

3. PARTNER A has no assets, payroll or sales other than its interest in TAXPAYER. (Dept. Ex. No. 7)

4. TAXPAYER filed a IL-1065 for the tax year ending 12/31/88 showing a replacement tax liability of $221,021 after an investment credit of $11,913. (Stip. 9, 27) The Department determined on audit that the $221,021 was overpaid for 1988. (Dept. Ex. No. 1, 6)

5. PARTNER A filed replacement tax returns for the short tax years ending 12/28/88 and 12/31/88. (Tr. p. 23; Taxpayer Ex. No. 5; Stip. 21))

6. PARTNER A filed a replacement tax return for the tax year ending 12/31/89 and claimed an investment credit of $53,369. (Stip. 24) The investment credit was based on assets owned by TAXPAYER. (Stip. 9; Dept. Ex. No. 8)

7. Taxpayer protested an adjustment made to the sales factor which was corrected in informal review. The informal reviewer found that with the sales factor adjustments, the tax liability for PARTNER A for 1988 should be $179,156 and for 1989 the tax liability should be $60,538. (Dept. Ex. No. 9)

8. PARTNER A included a Schedule NLD with its protest showing an Illinois net operating loss of $2,788,314 incurred in 1992 which it purportedly was carrying back to 1989. (Dept. Ex. No. 2)

CONCLUSIONS OF LAW:

Replacement Tax Investment Credit

The Personal Property Replacement Tax ("replacement tax") was enacted to replace the ad valorem personal property tax in 1979.[1] The tax base for the replacement tax is net taxable income, the same as the income tax base. In the case of a partnership, income tax liability is imposed at the partner level, that is, taxable income "flows through" to the partners. The replacement tax, on the other hand, is imposed on the partnership itself. 35 **ILCS** 5/201(c).

The parties have stipulated that the assets owned by TAXPAYER in Illinois generate the investment credit. (Stip. 8) The issue, then, is limited to whether the investment credit will flow through to the partner in the case where the credit is not used by the partnership. Since the replacement tax investment credit, however, "shall not be allowed to the extent that it would reduce a taxpayer's liability in any tax year below zero..." 35 **ILCS** 5/201(e)(1). In the instant case, the income of the operating partnership, TAXPAYER, has been reduced to zero by the subtraction modification for income distributable to

[1] Article 9, §5, Illinois Constitution.

entities subject to the replacement tax. 35 **ILCS** 5/203(d)(2)(I). TAXPAYER, therefore, is unable to utilize its investment credit, and PARTNER A seeks to use it as a pass-through.

Departmental regulations at Section 100.2100(c), 86 Admin Code ch. I, Sec. 100.2100(c), however, state that the property must be used by the taxpayer in Illinois. In this case the property is being used by TAXPAYER, not PARTNER A.

Looking only at the statutory language regarding the replacement tax investment credit, the statute is silent as to whether a pass-through of the credit from a partnership to its partners is appropriate. The statutory provisions for the Enterprise Zone credit and the training expense credit, however, shed light on the subject. 35 **ILCS** 5/201(f)(1) provides that in the case of the Enterprise Zone credit, "[f]or partners and shareholders of Subchapter S corporations, there shall be allowed a credit under this subsection (f) to be determined in accordance with the determination of income and distributive share of income under Sections 702 and 704 and Subchapter S of the Internal Revenue Code." The same language is contained in 35 ILCS 5/201(j), which provides for the training expense credit.

The legislature, therefore, was apparently aware of the question as to whether, in the case of a partnership, tax credits should flow through to the partners. Since the statutory language regarding Enterprise Zone and training expense credits provides for the pass-through of those credits to a partner, and the fact that similar language is missing in the case of the replacement tax investment credit, according to the canon of statutory construction, *expressio unius est exclusio alterius,* or the expression of one thing is the exclusion of another, the legislature's intent was not to allow a pass-through to the partner of the replacement tax investment credit.

In its brief, taxpayer argues that PARTNER A is not subject to the taxing jurisdiction of the State of Illinois since it is a limited partner and the Illinois property and business activities of TAXPAYER should not be attributed

to it. Taxpayer, however, has stipulated to the fact that PARTNER A is subject to the replacement tax (Stip. 7), so taxpayer has conceded that argument.[2]

Even though PARTNER A is subject to the replacement tax, it is not entitled to claim the investment credit on assets owned by TAXPAYER. Consequently, the Department properly disallowed the investment credit.

Net Operating Loss Carryback

Taxpayer included a Schedule NLD with its protest showing a net operating loss ("NOL") carryback from 1992 which purportedly offset the proposed deficiency. To claim a net operating loss carryback, taxpayer is required to file an amended return. 86 Admin. Code ch. I, Sec. 100.9400(f)(6). Merely attaching the Schedule NLD to the protest is not sufficient. A Form IL-843 which is signed subject to penalties of perjury is necessary in order to make a sufficient return. In the absence of such a return, I cannot consider the NOL carryback.

Section 1001 Penalty

In the Notice of Deficiency, the Department imposed a Section 1001 penalty on PARTNER A for failure to file its 1988 tax return. Taxpayer testified that it filed two short period returns in 1988, for the periods ending 12/28/88 and 12/31/88. Taxpayer introduced these tax returns into evidence and the Department accepted them for the purpose of showing they were filed. Therefore, since there is no remaining controversy on this issue, the Section 1001 penalty is dismissed.

Section 1005 Penalty

TAXPAYER filed a partnership tax return showing a tax liability, after the application of the investment credit, of $221,021 in 1988. On audit, the Department determined that TAXPAYER had a zero tax liability and PARTNER A owed $223,832 (tax liability without the investment credit). Since Illinois law provides for a subtraction modification for income distributed to a

[2] Further evidence of PARTNER A acknowledging being subject to the replacement tax is the fact that it filed Illinois partnership returns. (Taxpayer Ex. No. 1, 2; Stip. 7; Tr. pp. 22-23)

partner that is itself subject to the replacement tax, TAXPAYER's income was reduced on audit to zero (35 **ILCS** 5/203(d)(2)(I)), and PARTNER A's income was increased by a like amount.

Section 1005 of the Illinois Income Tax Act provides that:

> ...If any amount of tax required to be shown on a return prescribed by this Act is not paid on or before the date required for filing such return (determined without regard to any extension of time to file), a penalty shall be imposed at the rate of 6% per annum upon the tax understatement unless it is shown that such failure is due to reasonable cause. This penalty shall be in addition to any other penalty determined under this Act...

Under federal case law, "reasonable cause" includes taking a good faith position on a tax return. See I.R.C. Section 6664(c). In general, if there is an honest difference in opinion between the taxpayer and the IRS regarding the correct amount of tax, no penalty is imposed. As a result, no penalty would be imposed due to a deficiency arising from a good faith tax return position with regard to law or facts. *See*, Ireland v. Commissioner, 39 T.C. 978 (1987); Webble v. Commissioner, 54 T.C.M. 281 (1987); Balsamo v. Commissioner, 54 T.C.M. 608 (1987).

TAXPAYER had paid what it in good faith believed to be its tax liability of $221,021, but which was, in fact, the liability of PARTNER A. In my opinion, taxpayer used due care in preparing its tax returns, and the misstatement between the related companies was inadvertent and due to reasonable cause.

In addition, since the pass-through of the investment credit has not been clarified by regulation or case law, I find that taxpayer's position was not unreasonable.

Taxpayer has demonstrated reasonable cause for the understatement of tax and, therefore, the Section 1005 penalty is abated.

WHEREFORE, for the reasons stated above, it is my recommendation that the Notice of Deficiency should be finalized as to the additional tax liability, but all penalties are abated.

Date: ______________________________

Linda K. Cliffel
Administrative Law Judge