IT 09-3
Tax Type: Income Tax
Issue: Federal Change (Individual)

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

THE DEPARTMENT OF REVENUE	)	Docket No. 08-IT-0000
OF THE STATE OF ILLINOIS	)	Tax ID No. 000-00-0000
	)	Tax Year 2003
v.	)	Refund Claim
	)	
John and Jane Doe,	)	Julie-April Montgomery
Taxpayers.	)	Administrative Law Judge

RECOMMENDATION FOR DISPOSITION

Appearances: James L. DiBenedetto of JLD & Associates, Ltd. for John and Jane Doe; Ronald Forman, Special Assistant Attorney General, for the Illinois Department of Revenue.

Synopsis:

This matter arose from a protest filed by John and Jane Doe ("Taxpayers") to the January 4, 2008 "Amended or Duplicate Filer Letter" ("Letter") issued to Taxpayers by the Illinois Department of Revenue ("Department") that denied Taxpayers' claim for an income tax refund for the tax year ending December 31, 2003. The Letter was issued pursuant to the Illinois Income Tax Act ("IITA"), 5 ILCS 5/101 *et seq.* Taxpayers protested the denial and requested a hearing.

The parties agreed that the sole issue to be determined was whether Taxpayers were entitled to a credit for taxes paid in another state. September 22, 2008 Pre-Trial Order. A hearing was held on November 24, 2008 at which the Taxpayers and Department stipulated what the relevant documentary evidence would be, followed by

counsels for the parties' presentation of their respective legal arguments and positions. Following the submission of the stipulated evidence and a review of the record, it is recommended that the Department's denial of Taxpayers' refund claim be affirmed. In support thereof, are the following findings of fact and conclusions of law.

Findings of Fact:

1. Taxpayers were nonresidents of New Jersey in 2003. Parties' Gr. Ex. No. 1 (New Jersey Return and 1040 Return).
2. Taxpayers were residents of Illinois in 2003. *Id.*
3. In 2003 Taxpayers sold their New Jersey condominium and realized a gain of $168,788. Taxpayers also realized a capital loss of $900 from a stock sale. A net gain of $167,918 was realized by Taxpayers on their sales activities. Parties' Gr. Ex. No. 1 ("State of New Jersey Income Tax – Nonresident Return" for 2003 -- "New Jersey Return"); Tr. pp. 6, 11.
4. Taxpayers paid New Jersey tax on the gain realized from the sale of the condominium. Parties' Gr. Ex. No. 1 (New Jersey Return).
5. Taxpayers' 2003 federal income tax return reported the $167,918 net gain on line 13a. Parties' Gr. Ex. No. 1 ("1040 U.S. Individual Income Tax Return 2003" -- "1040 Return").
6. Taxpayers had a total loss of $168,788 from real estate activities in 2003. Parties' Gr. Ex. No. 1 ("Schedule E, Supplemental Income and Loss" for 2003).
7. Taxpayers' 2003 Federal Income Tax Return reported the $168,788 real estate loss on line 17. Parties' Gr. Ex. No. 1 ("1040 Return").

8. Taxpayers' adjusted gross income for the tax year 2003, as reported on their 1040 Return, was $246,136. *Id.*

9. Taxpayers reported $246,136 as income on their Illinois income tax return for the tax year 2003. Parties' Gr. Ex. No. 1 ("Form IL-1040-X: Amended Individual Income Tax Return" for 2003 – "Illinois Return"); Tr. p. 6.

10. Taxpayers filed a refund claim for $4,940 with the Department in October, 2007 that stated they wished to "claim credit for double taxed income…[that] was taxed by New Jersey." Parties' Gr. Ex. No. 1 (Illinois Return and "Schedule CR: Credit for Tax Paid Other States" for 2003); Tr. pp. 6-7.

11. The Department denied Taxpayers' refund claim on January 4, 2008. Parties' Gr. Ex. No. 1 ("LTR-405 Amended or Duplicate Filer Letter"); Tr. pp. 5, 7.

Conclusions of Law:

Section 904(a) of the IITA provides that the admission into evidence of the Amended or Duplicate Filer Tax Letter establishes the Department's *prima facie* case and is *prima facie* evidence of the correctness of the amount of the refund due. 35 ILCS 5/904(a). Once the Department's *prima facie* case is established, the burden of proof is shifted to the taxpayer to overcome the Department's *prima facie* case. Clark Oil & Refining Corp. v. Johnson, 154 Ill. App. 3d 773 (1st Dist. 1987).

In order to overcome the presumption of validity attached to the Department's *prima facie* case, taxpayer must produce competent evidence, identified with their books and records that show the Department's determination is incorrect. A.R. Barnes & Co. v. Department of Revenue, 173 Ill. App. 3d 826 (1st Dist. 1988). Testimony alone is insufficient to overcome the Department's *prima facie* case. Mel-Park Drugs, Inc. v.

Department of Revenue, 218 Ill. App. 3d 203 (1st Dist. 1991). Rather, documentary proof is required to prevail against a Department determination of the amount of the refund due. Sprague v. Johnson, 195 Ill. App. 3d 789 (4th Dist. 1990).

The parties agree that the issue to be decided is whether Taxpayers paid tax to both New Jersey and Illinois with respect to the gain realized from the sale of the New Jersey condominium ("Condo Sale"). Tr. p. 8, 12. The Department says no. Tr. p. 8. Taxpayers say yes. Tr. p. 11.

Section 601(b)(3) of the IITA is determinative of the issue. This section provides for a foreign tax credit ("FTC") against one's regular income tax liability where income tax has been paid to another state on the same income subjected to tax by Illinois. Department Regulation, Section 100.2197 ("Regulation") regarding the FTC provides:

> Tax qualifying for the credit. A tax qualifies for the credit only if it is imposed upon or measured by income and is paid by an Illinois resident to another state on income which is also subject to Illinois income tax.
>
> A) A tax "imposed upon or measured by income" shall mean an income tax or tax on profits imposed by a state and deductible under IRC section 164(a)(3). Such term shall not include penalties or interest imposed with respect to the tax.
>
> B) A tax is "paid by an Illinois resident" to another state "on income which is also subject to Illinois income tax" only to the extent the income included in the tax base of the other state is also included in base income computed under IITA Section 203 during a period in which the taxpayer is an Illinois resident….
>
> 4) Base income subject to tax both by another state and by this State or "double-taxed income" means items of income minus items deducted or excluded in computing the tax for which credit is claimed, to the extent such items of income, deduction or exclusion are taken into account in the computation

> of base income under IITA Section 203 for the person claiming the credit….
>
> > B) An item of income is not included in double-taxed income to the extent it is excluded or deducted in computing the tax for which the credit is claimed….
> >
> > C) An item of income that is excluded, subtracted or deducted in the computation of base income under IITA Section 203 cannot be included in double-taxed income.
> 86 Ill. Admin Code, Ch. 1, Sec. 100.2197(b).

The Department's Letter was entered into evidence under both the certificate of the Director of Revenue and by stipulation of the parties, and as such, the Department's *prima facie* case was established, and the burden of proof shifted to Taxpayers to overcome the Department's *prima facie* case.

The Department argues that "the gain from New Jersey was never taxed in Illinois because Section 469 of the Internal Revenue Code allows for the taxpayer to deduct passive losses against passive gains, and that's the only time that they can take those losses. Basically pursuant to our regulations, 100.2197, they would not be taxed in Illinois on those gains." Tr. p. 8. In support of their argument the Department cites Schwalbach v. Commissioner of Internal Revenue, 111 T.C. 215, 223 (1998). The Department further argues that the "only reason [Taxpayers] were allowed to deduct those losses [from 2003 and prior years[1]] was because of the gain from the New Jersey condominium, and therefore, that gain never went into the adjusted gross income for

[1] Parties' Gr. Ex. No. 1, "Passive Activity Loss Limitations" reflects "Prior year's unallowed losses" of $175,990.

2003 of the taxpayer. Thus, it was not taxed by Illinois, and therefore it disqualifies them for the foreign tax credit under 601(b)(3)." Tr. p.10.

Taxpayers respond that while IRC Section 469 applies to this matter this section "has no relevance to the …issue…[of whether the gain from the Condo Sale was] double taxed and whether you can use deductions to offset the income taxed in Illinois." Tr. p.16.

New Jersey imposes a gross income tax on nonresidents who receive income from New Jersey sources and have total income from all sources in excess of $20,000. The tax of such a nonresident "shall be equal to the tax computed …as if such nonresident were a resident, multiplied by a fraction, the numerator of which is the taxpayer's income from sources within this State …and the denominator of which is that taxpayer's gross income from the taxable year as if such taxpayer were a resident." N.J.S.A. 54A:2-1.1. Pursuant to New Jersey's Gross Income Tax, N.J.S.A. 54A *et seq.,* Taxpayers reported total income from everywhere of $415,141 and identified the gain from the Condo Sale as income from a New Jersey source. Only Taxpayers' exemption of $3,500 was deducted from their total income so as to result in $411,541 being subject to tax by New Jersey. Parties' Gr. Ex. No. 1, New Jersey Return. Inasmuch as New Jersey taxes an individual's total income from all sources, it is clear New Jersey subjected the gain from the Condo Sale to tax.

In contrast, Illinois piggybacks the federal tax system, as expressly allowed by Article IX, Section 3(b) of the Illinois Constitution. This means that the amount of a taxpayer's federal adjusted gross income, as defined by IRC Section 62(a) after appropriate modifications is deemed Illinois base income. 35 ILCS 5/203(a). Section

203(e)(1) of the IITA provides that a taxpayer's federal adjusted gross income is the amount of adjusted gross income "reportable for federal income tax purposes for the taxable year under the provisions of the Internal Revenue Code." 35 ILCS 5/203(e)(1). *See* Mitchell v. Mahin, 51 Ill. 2d 452, 466 (1972). It is this federal adjusted gross income amount that is the starting point for computation of Illinois base income on which Illinois tax is calculated. 35 ILCS 5/201-203. In addition, Section 203(h) of the IITA provides that there can be no modification to federal adjusted gross income unless expressly provided in Section 203. In this case, there were no modifications, and as such, Taxpayers' federal adjusted gross income and Illinois base income are the same.

Taxpayers' 2003 federal adjusted gross income of $246,136 was computed as follows:

$224,169	wages
20,986	taxable interest
1,851	ordinary dividends
167,918	Condo Sale gain
(168,788)	Schedule E loss
$246, 136	

Based upon the above computation of federal adjusted gross income, the Condo Sale gain was given consideration in the computation of Taxpayers' federal adjusted gross income. However, there remains the question of whether the Condo Sale gain was excluded from federal adjusted gross income so as to be subject to tax by Illinois.

When IRC Section 469 is applied to Taxpayers, a passive loss of $171,979 (Parties' Gr. Ex. No. 1: "Passive Activity Loss Limitations") is allowed for 2003. This passive loss is reported on Taxpayers' Schedule E which is entitled "Supplemental Income and Loss" and is combined with income of $3,191 so that a net loss amount of

$168,788 results. It is this net loss that Taxpayers reported on line 17 of their 1040 Return.

IRC Section 469 provides that passive income be offset against passive losses so that one can calculate the amount of any allowable passive loss or passive gain to be reported on the federal return and thereby enable a determination of federal adjusted gross income to be made. While there was no deduction of the Condo Sale gain from federal adjusted gross income, there was an offset of Taxpayers' passive loss from line 17 against Taxpayer's passive gain from the Condo Sale on line 13 so that the loss completely absorbed the gain. Hence, the purpose of IRC Section 469 to ensure that "passive losses be used only to offset passive income" (Schwalbach, *supra* at 223) was achieved.

Taxpayers are correct that IRC Section 469 is irrelevant to the issue of whether the gain from the Condo Sale was double-taxed. The section merely addresses how much of Taxpayers' passive loss may be offset against passive income in computing federal adjusted gross income. Taxpayers followed the directives of IRC Section 469 and had an allowable passive loss to report on their 1040 Return. The result was federal adjusted gross income or Illinois base income of $246,136. There was no modification to this $246,136 amount on either Taxpayers' 1040 Return or Illinois Return.

Taxpayers' adjusted gross income of $246,136 for 2003 included wages, interest, dividends, the passive Condo Sale gain and passive losses. Pursuant to Schwalbach, *supra* and IRC Section 469, the passive losses of $168,788 were offset against the passive Condo Sale gain of $167,918. The effect of such an offset was to totally "wipe-out" or "exclude" the passive Condo Sale gain from Taxpayers' federal adjusted gross income.

Thus, Taxpayers' Illinois income tax base does not include Taxpayers' profit from the Condo Sale.

The Department also has a "Publication 111, Illinois Schedule CR Comparison Formulas for Individuals" ("Publication") which provides assistance on how a taxpayer would "compute double-taxed income and tax [paid to another state] when figuring Illinois Schedule CR, Credit for Tax Paid to Other States" ("Schedule CR"). Department Publication 111, February 2007, p. 1. This Publication states that:

> An item of income is double-taxed only to the extent that both Illinois and the other state or taxing jurisdiction include it as income….
> IL-1040 Schedule CR.

When the Regulation and Publication are applied to Taxpayers, the amount of $246,136 represents Taxpayers' Illinois base income for 2003 because this amount is Taxpayers' federal adjusted gross income, without modification. Inasmuch as this $246,136 amount does not include the Condo Sale gain, Taxpayers' double-taxed income is zero. While New Jersey subjected the Condo Sale gain to tax, Illinois did not because the Condo Sale gain was not part of Taxpayers' Illinois base income.

Taxpayers' argue that Illinois cannot "allow deductions against income that was taxed twice" (tr. p. 12) because the issue is whether "you can use deductions to offset the income taxed in Illinois." Tr. p. 16. The evidence clearly reflects that Taxpayers, on their Illinois Return for 2003, did not make any modifications to their federal adjusted gross income. Rather, Taxpayers' application of IRC Section 469 provided Taxpayers an offset that effectively eliminated the Condo Sale gain from their federal adjusted gross income and thus from Illinois base income. Moreover, Taxpayers have presented no

facts[2] that show that there was income that was taxed twice. Hence, this argument is not only without merit but unsupported by books and records.

Taxpayers also argue that the example cited in section 100.2197(b)(1)(4)(B) of the Regulation can be distinguished from the instant case. Taxpayers assert that the example addresses a case that involves an exclusion of a portion, or sixty percent (60%), of a capital gain so that only the remaining portion, or forty percent (40%), of such gain is the subject of double taxation (by Illinois and another state), and as such, represents a distinguishable example from the present matter which involves no exclusion but a deduction. Tr. pp. 12, 16-18. This is incorrect. Taxpayers' case involves a matter where all of the gain from the Condo Sale was excluded from their federal adjusted gross income, pursuant to IRC Section 469, so as to not be subject to taxation by Illinois because Taxpayers' federal adjusted gross income was the same amount reported on the Illinois Return as base income. The exclusion of the Condo Sale gain was the direct result of this gain being fully absorbed by, offset against, or deducted from Taxpayers' loss. Whether such elimination was by exclusion or deduction is irrelevant, the bottom line is, the Condo Sale gain was eliminated from Taxpayers' federal adjusted gross income.

Taxpayers further argue that "it has to be defined in the Code to say double taxed income minus any related deductions or anything else to have the State prevail." Tr. p.18. This is exactly what the Regulation states:

> An item of income is not included in double-taxed income to the extent it is excluded or deducted in computing the tax for which the credit is claimed.

[2] While Taxpayers allege the income that was taxed twice was on "Schedule D, brought to the front page of the tax return" (tr. pp. 13-14), Schedule D was neither proffered at the hearing nor placed into evidence so that the veracity of Taxpayers' assertion could be substantiated.

86 Ill. Admin. Code, sec. 100.2197(b)(1)(4)(B).

The gain from the Condo Sale was not a part of Taxpayers' federal adjusted gross income, and as such, it could not be a part of Taxpayers' Illinois' base income without an addition modification which added the Condo Sale gain back to federal adjusted gross income. Pursuant to the Regulation, to the extent that an item is not included in Taxpayers' Illinois base income because it was eliminated from federal adjusted gross income by exclusion, deduction or offset, there is no double-taxed income eligible for credit.

In light of the above, it is evident that Taxpayers did not present evidence that was legally sufficient to overcome the Department's *prima facie* case or show that the gain from the Condo Sale was double-taxed income subject to the foreign tax credit of Section 601(b)(3) of the IITA.

Recommendation:

It is recommended that the Department's January 4, 2008 Letter denying Taxpayers' claim for a refund for the year 2003 be affirmed.

April 3, 2009
Date

Julie-April Montgomery
Administrative Law Judge

Illinois Department of Revenue
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THE DEPARTMENT OF REVENUE	)	Docket No. 08-IT-0027
OF THE STATE OF ILLINOIS	)	Tax ID No. 056-56-7773
	)	Tax Year 2003
v.	)	Refund Claim
	)	
John and Jane Doe,	)	Julie-April Montgomery
Taxpayers.	)	Administrative Law Judge

NOTICE OF DECISION

TO: James L. DeBenedetto
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Lisle, Illinois 60532

Ronald Forman, SAAG
Illinois Department of Revenue
100 W. Randolph Street, 7th Floor
Chicago, Illinois 60601

YOU ARE HEREBY NOTIFIED that the attached Order or Recommendation for Disposition issued by the Office of Administrative Hearings in the above entitled cause has been adopted by the Director of Revenue as dispositive of the issues herein. Unless you otherwise request a rehearing pursuant to the provisions of Section **908(c) of the Illinois Income Tax Act, 35 ILCS 5/908(c)**, this determination shall become a final administrative decision 30 days from the date of mailing. Following expiration of the 30 days, or after issuance of a denial for rehearing, should one be requested, you may pursue your rights to administrative review by filing a complaint in the circuit court under the requirements of Illinois Compiled Statutes **735 ILCS 5/3-101 *et seq***., and within the time requirements set forth therein. **PLEASE NOTE:** Should you choose not to pursue your right to seek remedy in court as provided by law, any tax remaining due (excluding interest) as a result of the administrative decision herein, must be paid within 95 days following the date of mailing of this notice in order to avoid imposition of further penalties under the provisions of **35 ILCS 735/3-3(b)(2).**

April 6, 2009

Brian A. Hamer, Director
Illinois Department of Revenue